

Essay on strategic management

[Business](#), [Marketing](#)



Thesis

This paper will discuss how capital markets influenced the creation of new economy bubble and the subsequent banking crisis. The first section of this paper will cover the topic of shadow banking and its emergence in United States. The Second section will highlight the phases of Bubble which United States economy went through in between the period of 2000-2008. The final section of the paper will list few reasons which were most relevant in bring the economic crisis and crippling the United States economy for coming years.

Introduction

In year 2007, with the burst of Housing bubble led to defaults on subprime mortgages in an astonishingly high rate. By March 2008, bad mortgages exposure doomed the market to Bear Sterns which led to banking crisis. The inevitability of Recession was clear with government veto of Lehman Bros. bailout in September 2008. This turned out be the biggest bankruptcy this world has ever seen and led to powerful economic contraction (Weisberg, 2010). United States Subprime mortgage comprised of events and conditions which led to the banking crisis, it comprised of delinquencies in subprime mortgage, foreclosures and resultant securities decline which were backed by these mortgages. Between the periods of 2004-06, these low-quality subprime mortgages have risen from 8% to a historical high of 20% or greater, greater number of these subprime mortgages was adjustable rate mortgages (“stat.unc.edu”). The unprecedented rise of shadow banking which comprised of investment banks and financial institutions that operated

freely in capital markets beyond regulatory apparatus's reach which was placed during the Great Depression. This banking system threatened traditional banks who responded by taking their grievances to regulators and Congress for removal of restrictions which helped banks to break from their traditional banking shackles and join shadow bankers in vehemently growing industry. This resulted in emergence of two parallel and enormous financial systems; this competition helped the American people and Wall Street as the costs of mortgages were lowered and returns on 401 (k)s were boosted. This codependent competition turned out to highly profitable with the element of risk (gpo. gov, 2011).

Shadow Banking and Capital Markets

The Financial Crisis exposed the relevance of interdependence among Capital markets, banking system and settlement system to bring economic crisis. Vulnerability increases by focusing on only one of them, like highly rated debt securities performing poorly led to disruption in security market, which further increased the problems of financial institutions. Banks were forced to take assets back, trigger backstop credit lines, blocking securitization of bank loans which increased pressure on their balance sheets. Then, credit availability was reduced that led to increase in economic activity downward pressure, causing values of assets to further decline and increase of stress in the financial system (Dudley, 2009). The financial crisis was not one event but a series of events which affected the financial health of the system and the overall economy. When one area of the market was in distress, it affected other areas too as vulnerabilities and interconnections which government officials, bankers and regulators dismissed or missed.

When risky mortgages like subprime were issued in the housing bubble many experts failed in identification of future crisis and consequences was unexpected increase in default rate, which caused the financial market to fail abruptly. With spreading of contagion, investors started to panic and whole system was under the manifest in small duration of time. Many brand name institutions were felt dependent on taxpayer's dime with many left bankrupt

Chairman of Federal Reserve said “ Prospective subprime losses were clearly not large enough on

their own to account for the magnitude of the crisis, Rather, the system's vulnerabilities, together with gaps in the government's crisis-response toolkit, were the principal explanations of why the crisis was so severe and had such devastating effects on the broader economy”(gpo. gov, 2011) .

Phases of Economic Bubble

Stock market collapse of 2000 led to minor recession in the United States economy with cushioned business losses, greater economic disruptions which were curtailed by the Real estate boom/bubble. This was termed as “ The Great Bubble Transfer” by Stephanie Pomboy, a financial analyst at MacroMavens, as home mortgage bubble compensated for the stock market burst. Hyperspeculation was again in motion when reserve requirements of banks were changed and interest was lowered to make more funds free for mortgages in housing market. With this mortgage lending started to skyrocket and prices of houses soared.

Novel Offering

Here novel offering was the mortgage loans which were “ securitized” with use of CDO (Collateralized Debt Obligation) a new financial instrument. Since 1970s, banks pooled individual mortgage loans for generating mortgage-backed residential securities. Later, these loans were securitized and repackaged as CMOs which comprised of “ tranches”, income groupings streams from mortgages which were divided for paying off principal in every tranche’s debt. This was done by paying highest tranche first and the remaining lower tranches in sequence. By 1990s, banks started to construct CDOs by mixing high, medium and low risk mortgages along with other debts they held. These tranches represented the default risk now, with default absorbed by lowest tranche before next higher tranche and so on. Higher tranches of CDOs were given rating of investment grade by three credit rating agencies. Everything was planned on the assumption that sector and geographical dispersion of portfolio and risk “ slicing and dicing” will convert all tranches apart from the lowest into safe bet investment. This expanded mortgage lending market enormously and quickly encompassed subprime borrowers who were earlier incapable to get mortgages (Foster, 2008).

Credit Expansion

Credit expansion is needed for feeding price bubble of any asset which can only be done when individuals or corporations take on more debt. Housing bubble had lowest possible interest rates and reserve requirements of banks were changed to have more credit available for borrowers even those who were subprime. In January 2001, Federal Reserve decreased the interest rates in 12 successive rate deductions which reduced the rate from 6% to

1% by June 2003. Despite the increasing house rates, cheap financing increased the number of borrowers and longer mortgages and lower rates made monthly payments affordable. Those who could not afford even the low monthly payments means were devised for them for further lowering the initial payments. This was done by adjustable mortgage rates with featured “teaser” rates which were reset after introductory period which used be 3-5 years (Foster, 2008).

Speculative Mania

The rapid increase in debt quantity with reminiscently rapid debt quality is feature of speculative mania. Financial assets were bought on the basis of increasing prices of assets and not on the basis of income streams of the buyer. This was called “ Ponzi Finance” or Hyperspeculation. CDOs were exposed to these subprimes lending as borrowers and mortgage lenders joined the frenzy. Many people started to buy houses on the presumption of cashing in “ big time” in future. Homeowners viewed this increase in real estate rate as permanent and natural and started to take mortgages with low interest rates. Despite stagnating income this was considered as the safe means to earn money. At its height, Real Estate mortgage increased by \$1. 11 trillion between the period of October and December 2005 itself, bringing mortgage debt to \$8. 66 trillion which was 69. 4% of the United States GDP (Foster, 2008).

Distress

Distress was marked with abrupt change in the financial market as result on Housing bubble burst. In 2006, the increase in interest rates started to

influence the housing rates as regions with subprime population like Arizona, California and Florida saw plunging rates. Mortgage borrowers who were counting on low interest rates and steep increase in property rates were now confronted with increasing interest rates and rapidly declining property rates. Many investors started to get concerned about the housing market's cooling down will have its ripple effect on mortgage market eventually affecting the economy. In 2007, this distress was indicated with credit debt swaps which were created for protecting investors and speculation of credit quality increased 49% globally for covering notional \$42.5 trillion in debt (Foster, 2008).

Crash and Panic

Final stage of this bubble is Crash and Panic which was marked by rapid sales of assets, making Cash the 'king' all over again. In 2007, initial crash shook the market with 2 Bear Sterns Hedge funds holding mortgage-backed securities worth nearly \$10 billion imploded. While one melted down completely, the other one lost 90% of its value. With time it became clear these hedge funds were unable to clarify their real value which led to Banks in Asia, Europe and United States acknowledging their exposure to toxic effects subprime mortgages. Credit crunch started to ensue among financial institution as none were aware of the toxic financial waste they were in possession of at that time. Seeping of credit crunch in the CP (Commercial Paper) market blocked the main funding source for bank sponsored SIVs. The risk of big banks being exposed to credit default swaps was revealed started to come to the fore. In 2007, one of the key events was the failure and eventual bailout out of British nationalized mortgage lender Northern Rock

became the first bank to experience bank run where customers stood in line to withdraw their accounts. Even the United States bond insurers started to implode with their credit default swap underwritings on mortgage backed securities (Foster, 2008).

Reasons for Crisis

Housing Bubble

Housing Bubble began in 2001 and reached its peak by 2005. With rapid increase in value of housing projects and low interest rates, many people started to invest with their plans to cash in big in future. But this was not how things worked out as with time the mortgage rates were increased after subprime lending and the monthly payment increased on these housing projects. Investors who planned to sell on profit saw the value of properties plummet within small space of time. Mortgage crisis is believed to be on the instigators of the Economic crisis. With settlement payments not matching the mortgage lending the default risk became reality of the market (Bianco, 2008).

Historically Low Interest Rates

During the Housing bubble United States banks offered historically low interest rates of just 1%, which was done after the Dot Com bubble burst of 2000. When the bubble bursted between 2004 and 2006, Federal Reserve raised the interest rates 17 times and increased it from 1% to 5.25%, which only stopped after they feared the downturn of housing industry will influence the overall economy. This increase in rates led to freefall of the

housing sector which derailed the economy and led to eventual recession (Bianco, 2008).

Subprime Lending

This is considered as the most relevant reason behind the economic crisis which has been well documented in documentaries like ‘ The Giant Pool of Money’ (“ Matos, 2008”). During the Housing Bubble United States home ownership rate increased from 64% in 1994 to 69. 2% in 2004. Home owners even started to take advantage of these increased values by refinancing their homes to lower interest rates and took out second mortgage against the increased value for their spending. In 2007, the United States household debt-income percentage rose to 130%, a total 30% greater from 2006. By 2006, subprime mortgages were \$600 billion which accounted to 1/5 of the United States home loan market. With \$1. 3 trillion outstanding subprime loans (Bianco, 2008).

Bad Mortgages turned into Toxic Assets

Mortgage securitization process converted mortgages into mortgage-backed securities with GSEs (Government Sponsored Enterprises) Freddie Mac, Fannie Mae and other ‘ Private label competitors’. Process of securitization helps in flow of capital from investors to home buyers. Without securitization, mortgage lending would end up being limited to portfolio lenders or banks which are supported with sources like deposits. Securitization makes enormous amounts available to homeowners for additional funding which makes home ownership affordable. CDOs were engineered from bundled payment streams of mortgage backed securities. Unfortunately, this system

failed in long run as flaws in the process of collateralization and securitization made things worse (Eakin & Thomas).

In 2011, the United States Financial Crisis Inquiry Commission reported from their findings " the crisis was avoidable and was caused by: Widespread failures in financial regulation, including the Federal Reserve's failure to stem the tide of toxic mortgages; Dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk; An explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis; Key policy makers ill prepared for the crisis, lacking a full understanding of the financial system they oversaw; and systemic breaches in accountability and ethics at all levels" (unc. edu).

Conclusion

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