

The role of leverage in the current financial crisis assignment

[Business](#)



THE ROLE OF LEVERAGE IN THE CURRENT FINANCIAL CRISIS The United States of America is in the middle of the worst financial crisis in more than 75 years. To date, federal regulators and authorities have taken unprecedented steps to stop the complicated situation of the financial services sector by committing trillions of dollars of taxpayer funds to rescue financial institutions and restore order to credit markets.

Although the current crisis has spread across a broad range of financial instruments, it was initially triggered by defaults on U. S. subprime mortgage loans, many of which had been packaged and sold as securities to buyers in the United States and around the world. With financial institutions from many countries participating in these activities, the resulting turmoil has affected financial markets globally and has spurred coordinated action by world leaders in an attempt to protect savings and restore the health of the markets.

The buildup of leverage during a market expansion and the rush to reduce leverage or “deleverage,” when market conditions deteriorated was common to this and other financial crises. Leverage traditionally has referred to the use of debt, instead of equity, to fund an asset and been measured by the ratio of total assets to equity on the balance sheet. But, as we can see in the current crisis, leverage also can be used to increase an exposure to a financial asset without using debt, such as by using derivatives.

In that regard, leverage can be defined broadly as the ratio between some measure of risk exposure and capital that can be used to absorb unexpected losses from the exposure. However, because leverage can be achieved

through many different strategies, no single measure can capture all aspects of leverage. Federal financial regulators are responsible for establishing regulations that restrict the use of leverage by financial institutions under their authority and supervising their institutions' compliance with such regulations.

According to studies, leverage steadily increased within the financial sector before the crisis began around mid-2007, and banks, securities firms, hedge funds, and other financial institutions have sought to deleverage and reduce their risk since the onset of the crisis. Some studies suggested that the efforts taken by financial institutions to deleverage by selling financial assets and restricting new lending could have contributed to the current crisis. First, some studies suggested that deleveraging through asset sales could trigger downward spirals in financial asset prices.

In times of market crisis, a sharp drop in an asset's price can lead investors to sell the asset, which could push the asset's price even lower. For leveraged institutions holding the asset, the impact of their losses on capital will be magnified. The subsequent price decline could induce additional sales that cause the asset's price to fall further. In the extreme, this downward asset spiral could cause the asset's price to be set below its fundamental value, or at a "fire sale" price.

In addition, a decline in a financial asset's price could trigger sales, when the asset is used as collateral for a loan. However, other theories, such as that the current market prices are the result of asset prices reverting to their fundamental values after a period of overvaluation, provide possible

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explanations for the sharp price declines in mortgage-related securities and other financial instruments. As the crisis is complex, no single theory likely is to explain in full what occurred.

Second, some studies suggested that deleveraging by restricting new lending could contribute to the crisis by slowing economic growth. In short, the concern is that banks, because of their leverage, will need to cut back their lending by a multiple of their credit losses. Moreover, rapidly declining asset prices can inhibit the ability of borrowers to raise money in the securities markets. Financial regulators and market participants had mixed views about the effects of deleveraging by financial institutions in the current crisis.

Some regulatory officials and market participants have said that they generally have not seen asset sales leading to downward price spirals, but others have said that asset sales involving a variety of debt instruments have contributed to such spirals. Regulatory and credit rating agency officials have said that banks have tightened their lending standards for some loans, such as ones with less favorable risk-adjusted returns. They also said that some banks rely on the securities markets to help them fund loans and, thus, need conditions in the securities markets to improve.

Since the crisis began, federal regulators and authorities have undertaken a number of steps to facilitate financial intermediation by banks and the securities markets. Federal financial regulators generally impose capital and other requirements on their regulated institutions as a way to limit the use of leverage and ensure the stability of the financial system and markets.

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Specifically, federal banking and thrift regulators have imposed minimum risk-based capital and leverage ratios on their regulated institutions. The risk-based capital ratios generally are designed to require banks and thrifts to hold more capital for more risky assets.

Although regulators have imposed minimum leverage ratios on regulated institutions, some regulators say that they primarily focus on the risk-based capital ratios to limit the use of leverage. In addition, they supervise the capital adequacy of their regulated institutions through on-site examinations and off-site monitoring. Bank holding companies are subject to capital and leverage ratio requirements similar to those imposed on banks, but thrift holding companies are not subject to such requirements. Instead, capital levels of thrift holding companies are individually evaluated based on each company's risk profile.

Securities and Exchange Commission (SEC) primarily uses its net capital rule to limit the use of leverage by broker-dealers. The rule serves to protect market participants from broker-dealer failures and to enable broker-dealers that fail to meet the rule's minimum requirements to be liquidated in an orderly fashion. For the holding companies of broker-dealers that participated in SEC's discontinued Consolidated Supervised Entity (CSE) program, they calculated their risk-based capital ratios in a manner designed to be consistent with the method used by banks.

In addition to the capital ratio, SEC imposed a liquidity requirement on CSE holding companies. Other financial institutions, such as hedge funds, have become important participants in the financial markets, and many use

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leverage. But, unlike banks and broker-dealers, hedge funds typically are not subject to regulatory capital requirements that limit their use of leverage. Rather, their use of leverage is to be constrained primarily through market discipline, supplemented by regulatory oversight of banks and broker-dealers that transact with hedge funds as creditors and counterparties.

Finally, the Federal Reserve regulates the use of securities as collateral to finance security purchases, but federal financial regulators say that such credit did not play a significant role in the buildup of leverage in the current crisis. The financial crisis has revealed limitations in existing regulatory approaches that serve to restrict leverage. Federal financial regulators have proposed reforms, but have not yet fully evaluated the extent to which these proposals would address these limitations.

First, although large banks and broker-dealers generally held capital above the minimum regulatory capital requirements prior to the crisis, regulatory capital measures did not always fully capture certain risks, particularly those associated with some mortgage-related securities held on and off their balance sheets. As a result, a number of these institutions did not hold capital commensurate with their risks and some lacked adequate capital or liquidity to withstand the market stresses of the crisis.

Federal financial regulators have acknowledged the need to improve the risk coverage of the regulatory capital framework and are considering reforms to better align capital requirements with risk. Furthermore, the crisis highlighted past concerns about the approach to be taken under Basel II, a new risk-based capital framework based on an international accord, such as <https://assignbuster.com/the-role-of-leverage-in-the-current-financial-crisis-assignment/>

the ability of banks' models to adequately measure risks for regulatory capital purposes and the regulators' ability to oversee them.

Federal financial regulators have not formally assessed the extent to which Basel II reforms proposed by U. S. and international regulators may address these concerns. Such an assessment is critical to ensure that Basel II reforms, particularly those that would increase reliance on complex risk models for determining capital needs, do not exacerbate regulatory limitations revealed by the crisis. Second, the crisis illustrated how the existing regulatory framework, along with other factors, might have contributed to cyclical leverage trends that potentially exacerbated the current crisis.

For example, minimum regulatory capital requirements may not provide adequate incentives for banks to build loss-absorbing capital buffers in benign markets when it is relatively less expensive to do so. When market conditions deteriorated, minimum capital requirements became binding for many institutions that lacked adequate buffers to absorb losses and faced sudden pressures to deleverage. As discussed, actions taken by individual institutions to deleverage by selling assets in stressed markets may exacerbate a financial crisis.

Regulators are considering several options to counteract potentially harmful cyclical leverage trends, but implementation of these proposals presents challenges. Finally, the financial crisis has illustrated the potential for financial market disruptions, not just firm failures, to be a source of systemic risk. As some studies suggest, ensuring the solvency of individual institutions

may not be sufficient to protect the stability of the financial system, in part because of the potential for deleveraging by institutions to have negative spillover effects.

A regulatory system should focus on risk to the financial system, not just institutions. With multiple regulators primarily responsible for individual markets or institutions, none of the financial regulators has clear responsibility to assess the potential effects of the buildup of leverage and deleveraging by a few institutions or by the collective activities of the industry for the financial system. As a result, regulators may be limited in their ability to prevent or mitigate future financial crises.

Conclusion The causes of the current financial crisis remain subject to debate and additional research. Nevertheless, some researchers and regulators have suggested that the buildup of leverage before the financial crisis and subsequent disorderly deleveraging have compounded the current financial crisis. In particular, the efforts taken by financial institutions to deleverage by selling financial assets could lead to a downward price spiral in times of market stress and exacerbate a financial crisis.

Also, the drop in asset prices may reflect prices reverting to more reasonable levels after a period of overvaluation or it may reflect uncertainty surrounding the true value of the assets. In addition, deleveraging by restricting new lending could slow economic growth and thereby contribute to a financial crisis. The financial crisis has revealed limitations in the federal regulatory capital framework's ability to restrict leverage and to mitigate crises.

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Federal financial regulators have proposed a number of changes to improve the risk coverage of the regulatory capital framework, but they continue to face challenges in identifying and responding to capital adequacy problems before unexpected losses are incurred. A principal lesson of the crisis is that regulators need to focus on system wide risks to and weaknesses in the financial system, not just on individual institutions.

Although federal regulators have taken steps to focus on system wide issues, no regulator has clear responsibility for monitoring and assessing the potential effects of a buildup in leverage in the financial system or a sudden deleveraging when financial market conditions deteriorate. Given the potential role leverage played in the current crisis, regulators clearly need to identify ways in which to measure and monitor system wide leverage to determine whether their existing framework is adequately limiting the use of leverage and resulting in unacceptably high levels of systemic risk.

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