Credit risks in financial markets prior to credit crisis

Economics, Financial Markets

Introduction

In the last 25 years, the world suffered boom-bust economical recycling . What impressed us was the serious financial crisis happened in 1930, however, the credit crunch in 2008 was even worse. It crisis is the culmination of a super boom that has lasted for more than twenty-five years and seems a sign of the end of an era of credit expansion based on the dollar as the international reserve currency. It might be formed because of the bursting of the Internet bubble in late 2000. The Fed responded by cutting the federal funds rate from 6. 5% to 3. 5% within space of just a few months. Occasionally, came with the terrorist attack of September 11, 2001. To counteract the disruption of the economy, the Fed continued to lower rates in half a century, where it stayed for a full year. For thirty-one consecutive months the base inflation-adjusted short-term interest rate was negative. These consequent activities remain the interest rate in a low level for years that the rational lender will keep on lending until there is no one else to lend to, whenmoneyis free, an explosion of leveraged buyouts, and other excesses became conventional. Meanwhile, an endangered supper housing bubble is growing silently.

According to the national statistic in the U. S., from 2000 until mid-2005, the market value of existing homes grew by more than 50%, and there was a frenzy of new construction. A shocking discovery by Merrill was that about half of all American GDP growth in the first half of 2005 was housing related, either directly, through home building and housing-related purchases like new furniture, or indirectly, by spending the cash generated from the refinancing of mortgages.

This means, starting around 2005, securitization became a mania. It was easy and fast to create “ synthetic” securities that mimicked the risks of real securities but did not carry the expense of buying and assembling actual loans. Therefore, Risky paper could be multiplied well beyond the actual supply in the market. Conversely, this activity led to an enormous increase in the use of leverage. To hold ordinary bonds requires a margin of 10%; synthetic bonds created by credit default swaps can be traded on a margin of 1. 5%. It turned to be an opportunity for those hedge funds to show good profits by exploiting risk differentials on a leveraged basis, driving down risk premiums.

Credit risks in financial markets

The story began in early 2007, signs of trouble started to multiply. On February 22, HSBC fired the head of its U. S mortgage lending business, recognizing losses reaching $10. 8 billion. Later on, DR Horton, the biggest homebuilder, warned of losses from subprime mortgages on March 9. Three days after, New Century Financial, one of the biggest subprime lenders, had its shares suspended from trading amid fears that the company was headed for bankruptcy. Then it was reported that late payments on mortgages and home foreclosures rose to new highs. What`s more , Accredited Home Lenders Holding put up $2. 7 billion of its subprime loan book for sale , on March 16, at a heavy discount to generate cash for business operations. Even worse on April 2, New Century Financial filed for Chapter 11 bankruptcy protection after it was forced to repurchase billions of dollars which were worth of bad loans.

The effects of sub-prime problems were gradually spread across banks around the world when many of the mortgages had been bundled up and sold on to banks and investors. In July, investment bank Bear Stearns tells investors they will get little, if any, of the money invested in two of its hedge funds after rival banks refuse to help it bail them out. On 9 August 2007, investment bank BNP Paribas tells investors they will not be able to take money out of two of its funds because it cannot value the assets in them, for an excuse of a " complete evaporation of liquidity" in the market. Obviously, banks are refusing to do business with each other.

On June 15, 2007, two large mortgage hedge funds of Bears stern were having trouble meeting margin calls. To cope with this, Bear grudgingly created a $3. 2 billion credit line to bail out one fund and let the other collapse which indicated that investors` equity of $1. 5 billion was mostly wiped out.

As late as July 2007, Bernanke still estimated subprime losses at only about $100 billion. When Merrill Lynch and Citigroup took big write-down on in-house collateralized debt obligations, the markets actually staged a relief rally–The S&P 500 hit a new high in mid-July. People release and think it naively finished. Somehow, it was only at the beginning of August that financial markets really took fright. Shockingly, Bear Stearns filed for bankruptcy protection for two hedge funds exposed to subprime loans and stopped clients from withdrawing cash from a third fund. Though it was useless, Bear Stearns had tried to save these entities by injecting $3. 2 billion of additional funding.

Liquidity risks in financial markets

Everything that could go wrong, once the crisis erupted, financial markets unraveled with remarkable dramatically. Investment banks with large positions of CDOs to keep off balance sheet in so-called structured investment vehicles (SIVs). By issuing asset backed commercial paper, the investment banks financed their positions by SIVs. As the value of CDOs came into trouble, the asset-backed commercial paper market dried up, in order to keep the market liquid, the investment banks were forced to bail out their SIVs. Most investment banks took the SIVs into their balance sheet and surrendered to commit that large losses were in the process. Consequently, Investment banks were sitting on large loan commitments tofinanceleveraged buyouts. Normally, they would package these loans as collateralized loan obligations (CLOs) and sell them off, but the CLO market came to a standstill together with the CDO market, and the banks were left holding a bag worth about $250 billion. Some banks allowed their SIVs to go bust, and some reneged on their leveraged buyout obligations.

This, together with the size of the losses incurred by the banks, served to unnerve the stock market, and price movements became chaotic. So-called market-neutral hedge funds, which exploit small discrepancies in market prices by using very high leverage, ceased to be market neutral and incurred unusual losses. A few highly leveraged ones were wiped out, damaging the reputation of their sponsors and unleashing lawsuits.

The banking system suffered all this pressures. They had to put additional items on their balance sheets at a time when their capital base was impaired by unexpected losses. Banks had difficulty assessing their exposure and even greater difficulties estimating the exposure of their counterparts.

Similarly, they were reluctant to lend to each other and eager to save their liquidity. At the very beginning, central banks found it difficult to inject enough liquidity due to commercial banks avoiding used any of the facilities which had a responsible to attach them, and they were also ignored to deal with each other, meanwhile, these obstacles were overcome . After all, if there is one thing central banks know how to do, that is to provide liquidity. Only the Bank of England suffered a major debacle when it attempted to rescue Northern Rock, an overextended mortgage lender. Its rescue effort resulted in a run on the bank. Eventually Northern Rock was nationalized and its obligations added to the national debt, pushing the United Kingdom beyond the limits imposed by the Maastricht Treaty.

Extreme uncertainty and volatility in financial markets

The banking sector tended to filled with liquidity, however, the crisis refused to abate. Credit spreads continued to widen. Correlated that almost all the major banks—Citigroup, Merrill Lynch, Lehman Brothers, Bank of America, Wachovia, UBS, Credit Suisse—announced major write-downs in the final quarter of the year, and most have signaled continued write-downs , separately, most others have signaled continued write-downs in 2008. Both AIG and Credit Suisse made preliminary fourth-quarter write-down announcements that they repeatedly revised, conveying the doubtless accurate impression that they had lost control of their balance sheets. A failed with $7. 2 billion trading at Societe Generale announced in January 2008, coincided with a selling climax in the stock market and an extraordinary 75 basis point cut in the federal funds rate eight days before the regularly scheduled meeting, when the rate was cut a further 50 basis points. This was unprecedented.

Distress spread from residential real estate to credit card debt, auto debt, and commercial real estate. Trouble at the monocline insurance companies, which traditionally specialized in municipal bonds but ventured into insuring structured and synthetic products, caused the municipal bond market to be disrupted. With the intension of credit market, numourous of entities went bankruptcy. This called for large amount of compensation by the insurance companies. No doubt that an even larger unresolved problem is looming in the credit default swaps market (CDSs).

Changing in structure of financial landscape

The effect of the crisis and the way ahead

Over the past several decades the United States has weathered several major financial crises, like the international lending crisis of the 1980s and the savings and loan crisis of the early 1990s. But the current crisis is of an entirely different character. It has spread from one segment of the market to others, particularly those which employ newly created structured and synthetic instruments. Both the exposure and the capital base of the major financial institutions have been brought into question, and the uncertainties are likely to remain unresolved for an extended period of time. This is impeding the normal functioning of the financial system and is liable to have far-reaching consequences for the real economy.

Conclusion

Both the financial markets and the financial authorities have been very slow to recognize that the real economy is bound to be affected. It is hard to understand why this should be so. The real economy was stimulated by credit expansion. Why should it not be negatively affected by credit contractionOne cannot escape the conclusion that both the financial authorities and market participants harbor fundamental misconceptions about the way financial markets function. These misconceptions have manifested themselves not only in afailureto understand what is going on; they have given rise to the excesses which are at the root of the current market turmoil.