

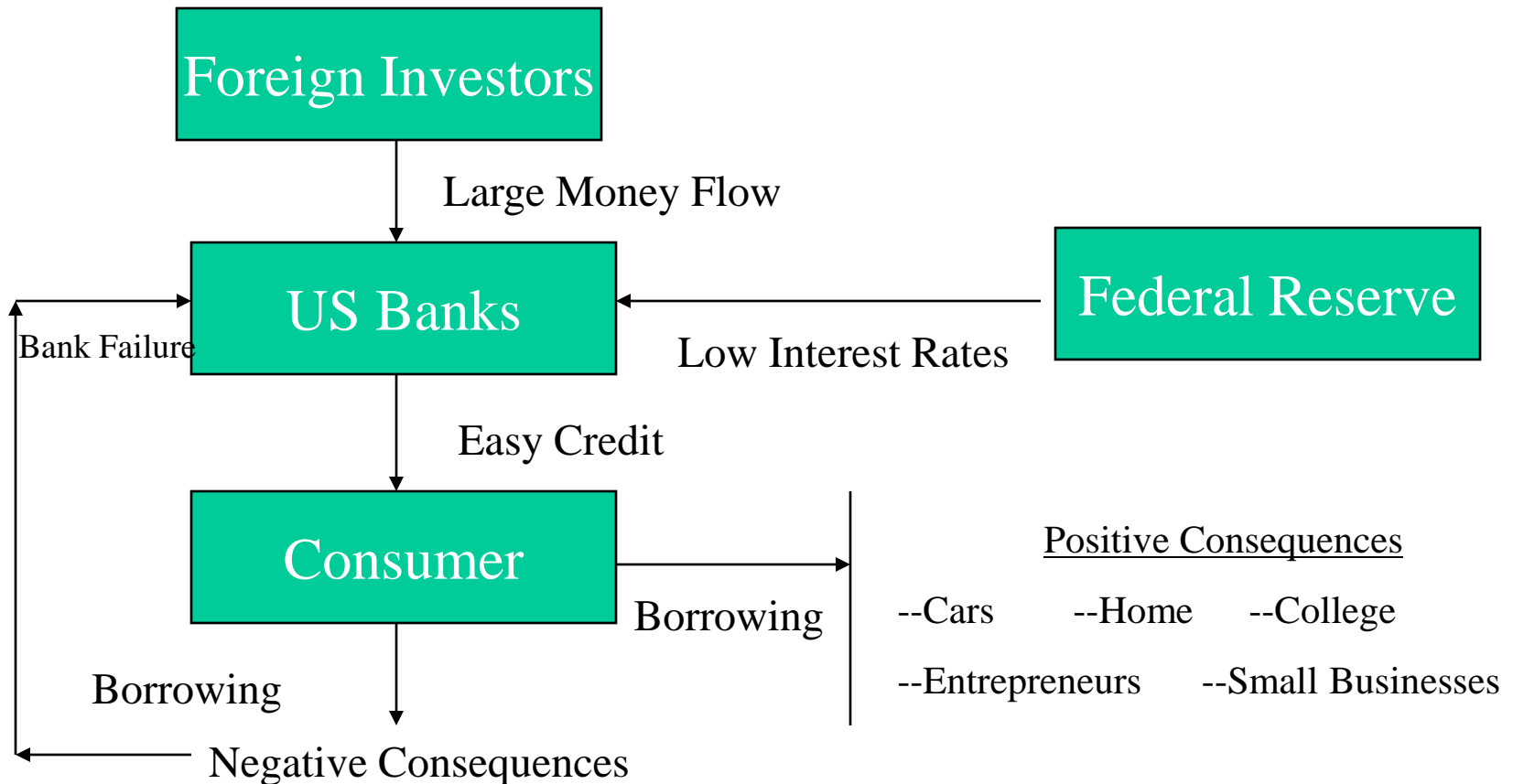
The Global Financial Crisis



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What is the crisis?



What is the crisis?

Negative Consequences

- Over extended borrowers
- Home foreclosures
- Declining home values; home owners caught in a vicious cycle
- Credit crunch for qualified borrowers including businesses
- Bank & other financial institutions failure due to non-repayment of loans
- Loss of confidence
- Declining demand for goods & services in US markets
- Global Economies sliding into recession or reduced growth

Underpinnings of the US Financial Crisis

History of Deregulation

- Financial de-regulation started with S&L's in the Regan era in 1980's
- Many restrictions on the activities of S&L's limiting to the home loan market were removed.
- The result was an orgy of speculation, profiteering and outright plundering of assets, culminating in collapse.
- This resulted in the biggest bailout in US history prior to the current bailout costing the Federal government more than \$500 billion
- Clearly the lessons from these lax regulations had not been learnt.

Underpinnings of the US Financial Crisis

History of Deregulation

- Bank deregulation of 1994
- This allowed bank holding companies to operate in more than one state.
- The result was a rash of merger & acquisitions of regional banks and an appetite for new markets & new sources of revenues.

Underpinnings of the US Financial Crisis

History of Deregulation

- Repeal of the Glass Stegal act in 1999.
- Under the Glass Stegal act, banks, brokerage and insurance companies were effectively barred from entering each other industries -- investment banking and commercial banking were separated.
- Act passed in 1933 in response to:
 - 5000 bank failures,
 - loss of \$7 bil in depositors money,
 - 600,000 foreclosures from 1930-1932 --all due to manipulation of the market by giant banking houses.
- Single most damaging and most consequential act of the Clinton years.

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Underpinnings of the US Financial Crisis

History of Deregulation

- Clinton and the Republicans agreed to the deregulation of the US Financial system in October 1999.
- Most sweeping banking deregulation bill in US history
- Lifted all restraints on the operation of giant monopolies which dominate the financial system.
- No restrictions on the integration of banking, insurance and stock trading imposed by the Glass Steagal act of 1933.
- Huge wave of mergers, ex. Citibank buying Travelers Insurance creating one stop shop for Financial Services
- Law was passed due to pressure from the banks which sought more profitable outlets for their capital especially in the stock market.
- In 1990 JP Morgan was allowed to engage in stock market operations up to 10% of revenues. This was increased to 25% in 1994 and in 1999 it was abolished.

Underpinnings of the US Financial Crisis

History of Deregulation

- SEC voted in June 2004 to publish Regulation B.
- This allows banks to engage in certain Securities activities without first registering as brokers with the SEC.

Underpinnings of the US Financial Crisis

Violation of Net Capital Rule

- SEC allows certain broker-dealer firms to legally violate existing net capital rules that limits debt-to-net capital ratio to 12 to 1 by providing them with exemptions.
- In 2004 the SEC granted an exemption to five firms—Goldman, Merrill, Lehman, Bear Stearns, and Morgan Stanley.—which allowed them to leverage up to 40 to 1.
- Three of these firms have blown up. This reckless leverage has led to the current crisis.
- The so called Net Capital Rule was created in 1975 to oversee broker dealers that traded securities for customers as well as their own accounts.
- The rule requires that firms value all their tradeable assets at market prices, and then it applies a hair-cut to account for market risk. The hair cut is 15% for equities and 6% for Treasury securities because they are less risky. The net capital rule requires that they limit their debt to capital ratio to 12 to 1 and are forced to stop trading if they exceed it.

Underpinnings of the US Financial Crisis

Excessive Leverage by Hedge Funds, etc.

- Failure to stop excess leverage. Excess speculation with borrowed money.
- Typical leverage for a hedge fund and private equity is 30:1.
- For sub-prime mortgage company the leverage is infinite because there is no capital.

Underpinnings of the US Financial Crisis

Credit Default Swaps (CDS)

- CDS are credit derivatives of Mortgage backed securities.
- CDS is a fancy name for insurance. It is not called insurance because regulatory laws require large capital reserves for losses.
- CDS was sold as an insurance for mortgaged backed securities and were used to persuade investors to buy the securities in a declining market.
- When the securities failed, the investors tried cash into the insurance and this made a run on the bank's inadequate reserves resulting in a collapse of these investment firms.
- CDS is the key reason for failure of AIG, Bear Stearns, Merrill Lynch, Lehman Brothers, etc.
- Regulation of CDS was opposed by Clinton Treasury Secretary Robert Rubin & Greenspan in 1999

Underpinnings of the US Financial Crisis

Failure to police Sub-Prime

- The core idea of bank regulation:
 - Is to examine the banks books;
 - Ensure that there are not too many loans behind in interest payments; and
 - Force the banks to raise more capital if needed to cover the losses.
- Regulators basically waived the rule of adequate capital for the new wave of mortgage lenders who created sub-prime.
- Many of the mortgage companies were not banks who made the loans only to sell them off to Wall Street.

Underpinnings of the US Financial Crisis

Packaging & Selling of Bonds backed by Sub-Prime Loans

- Unregulated agencies such as Moody's and S&P to rate these bonds.
- In return for a hefty fee, these agencies helped manipulate the bond so it qualifies for a AAA rating.
- Fannie Mae & Freddie Mac which purchased the loans from the banks financed its operations by selling such bonds.
- By selling the loans to FM & FM, it freed the banks to issue even more sub-prime mortgages.

Global Impact

- Loss of confidence in inter-bank lending.
- Severe credit crunch even for borrowers with good credit history
- High interest rates.
- Increased number of home foreclosures, reduced auto sales, reduced consumer spending
- Declining home values
- Emerging economies such as India & China hit with lower growth rates because of declining demand in the US markets

Rescue Package

Key Issues

- Guaranteeing inter-bank lending
- Guaranteeing mortgage backed loans by Fannie Mae & Freddie Mac
- Delay home foreclosures; allowing refinance at lower fixed rates.
- Increasing money supply
- Increasing consumer & investor confidence

Rescue Package

Initial Package

- \$700 bil initial package from US Govt
- Bail out large institutions such as AIG
- Cleanup balance sheet of financial institutions by buying up bad debt ie mortgage based assets.
- Objective was to free up the companies to make loans again.
- This has not worked!!!!

Rescue Package

Current Package

- Guarantee inter-bank lending
- Guarantee up to \$300 bil in mortgage backed loans from Fannie Mae & Freddie Mac
- Guarantee up to \$350 mil in mortgage loans by Citigroup