The financial crisis and its issues

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ABSTRACT

The financial crisis has had a severe impact on the U. S. economy. This paper examines the timeline and causes of the financial crisis. The impact of the crisis has been severe, but in terms of the banking industry 305 banks were failed in 2009 while 1,600 banks failed during the 1980s and early 1990s. Government intervention helped mitigate the crisis by providing funds to a number of financial institutions. The Glass-Steagall Act repeal appeared to open the door to allowing financial institutions to develop risky financial products. Toxic assets, mortgages, and subprime lending seem to be the risky elements in this financial crisis. The credit crunch limited available credit which compounded the problem.

Keywords: Financial crisis, banks, mortgages, subprime loans, toxic assets

INTRODUCTION

The banking industry is experiencing times that recall the crisis of the late 1980s and early 1990s. The list of troubled banks on regulatory agencies' watch list is at an unusually high level and so is the number of banks that are insolvent and forced to close. During 2009, the Federal Deposit Insurance Corporation failed 305 banks. Although this is a relatively small percentage of the total banks, the trend that this represents is the real cause for concern. This number is more than 12 times the number, 25, that failed in 2008. To put the crisis in perspective, with the financial crises of the 1980s and early 1990s, the Federal Deposit Insurance Corporation (2010) noted that between 1980 and 1994, they closed 1,600 banks. Among the banks that were forced to close their doors during 2008 was Washington Mutual; the largest bank to date that has been forced to close their doors. However, they were able to escape total liquidation by being absorbed by JP Morgan Chase. This benefitted JP Morgan Chase since it gave them a footprint on the west coast that they had been seeking for some time.

Times for the banking industry became so bad that the U.S. government once again had to intervene to prevent a more widespread deterioration of the financial services industry. With the decline in the real estate and mortgage markets accelerating, banks were experiencing more loan defaults. Government intervention provided the opportunity to withstand the unexpected financial difficulties while developing a plan to correct the practices that were pushing the financial services industry rapidly toward an even greater crisis.

The financial crisis that our country is currently trying to solve cannot be blamed on a single action. It took many events and the actions (or lack of action) by a lot of people to cause such turmoil on a global level. In addition to greedy people trying to take advantage of the system, the collapse of the real estate bubble and the subsequent credit policy changes added impetus to the decline of the financial system. Banks reacted to the early stages of the financial problems by tightening up credit standards to reduce real estate losses. Lack of credit then forced some companies to reduce the number of employees and other companies to shut down completely.

FINANCIAL CRISIS TIMELINE

The Federal Reserve Bank of St. Louis (2010) chronicled the events of the financial crisis on its web site. Unless you examine the timeline in retrospect, it is difficult to see how it developed. Many have questioned why scholars, government, or others did not see the event happening and stop it. In reality, there were so many events that were not simultaneous, hence not obvious.

The FRB St. Louis (2010) timeline is set out in summary form to show the major events, but excludes the policy decisions.

- February 27, 2007—The Federal Home Loan Mortgage Corporation notes that it will cease the purchase of the most risky subprime mortgages and mortgage-related securities.
- April 2, 2007—New Century Financial Corporation a top subprime lender files for Chapter 11.
- June 1, 2007—Standard and Poor’s and Moody’s Investment Services downgrade over 100 bonds backed by second-lien subprime mortgages.
- June 7, 2007—Bear Stearns informs investors that it will no longer provide redemptions form its High-Grade Structured Credit Strategies Enhanced Leverage Fund.

- July 11, 2007—Standard and Poor's calls for a credit watch classification on 612 subprime backed residential mortgages.
- July 24, 2007—Countrywide Financial Corporation, one of the nation's largest mortgage lenders files notice with the SEC of "difficult financial conditions.
- July 31, 2007—Bear Stearns has to liquidate two hedge funds tied to mortgage back securities.
- August 6, 2007—American Home Mortgage Investment Corporation files for Chapter 11 Bankruptcy.
- August 9, 2007—France's largest bank (BNP Paribas) stops redemptions on three funds.
- August 16, 2007—Countrywide Financial Corporation is downgraded to BBB+ and has to borrow $11.5 billion for liquidity.
- November 1, 2007—The intensity of financial market pressures virtually eliminates liquidity in interbank funding markets.
- January 11, 2008—Bank of America announces purchase of Countrywide Financial for $4 billion in stock.
- February 13, 2008—The Economic Stimulus Act of 2008 becomes law in attempt to bolster markets.
- February 17, 2008—Northern Rock is taken over by the Treasury of United Kingdom.
- March 5, 2008—Carlyle Capital Corporation is noticed for default for failing to meet margin calls on its mortgage bond fund.
- March 24, 2008—Federal Reserve Bank of New York provides term financing for JP Morgan Chase to acquire The Bear Stearns Companies, Inc.
- July 11, 2008—The Office of Thrift Supervisions closes IndyMac Bank, F.S.B.
- July 13, 2008—To save Fannie Mae and Freddie Mac from collapse, The Federal Reserve Board authorized lending to provide liquidity, if necessary.
- September 7, 2008—The Federal Housing Finance Agency places Fannie Mae and Freddie Mac in government Conservatorship.
- September 15, 2008—Bank of America announces that it will purchase Merrill Lynch & Co. for $50 billion.
- September 15, 2008—Lehman Brothers Holdings Incorporated files for Chapter 11 bankruptcy.
- September 15, 2008—The Federal Reserve Board authorizes Federal Reserve Bank of New York to lend up to $85 billion to American International Group (AIG).
- September 17, 2008—The SEC placed a temporary ban on short selling of financial companies stock.
- September 25, 2008—The Office of Thrift Supervision closes Washington Mutual Bank with JP Morgan Chase acquiring the banking assets.
- September 29, 2008—Citigroup authorized by the FDIC to purchase the banking assets of Wachovia Corporation, however, Wells Fargo presented a competing proposal to acquire Wachovia on October 3rd.
- October 3, 2008—The $700 billion Troubled Asset Relief Program (TARP) becomes law.
- October 7, 2008—FDIC increases deposit insurance coverage to $250,000 to stabilize balances in bank deposits.

- October 28, 2008—The U. S. Treasury purchases $125 billion in preferred stock in nine of the nation's largest banks to give financial support.
- November 14, 2008—Additionally, The U. S. Treasury purchases a total of $33.5 billion in preferred stock in 21 of the nation's largest banks.
- November 18, 2008—General Motors, Ford, and Chrysler request TARP money.
- November 21, 2008-- The U. S. Treasury purchases $3 billion in preferred stock in 23 banks to give financial support.
- December 5, 2008-- The U. S. Treasury purchases $4 billion in preferred stock in 35 banks to give financial support.
- December 12, 2008-- The U. S. Treasury purchases $6.25 billion in preferred stock in 28 banks to give financial support.
- December 19, 2008—The U. S. Treasury authorized loans of up to $13.4 billion for General Motors and $4 billion fro Chrysler from TARP

Given the above data, it should be obvious that this was a "domino effect" as opposed to all of the problems happening at one time. Several significant events assisted in creating the "domino effect." For example, on July 11, 2007, Standard and Poor's called for a credit watch classification on 612 subprime-backed mortgages. Twelve days later, Countrywide Financial Corporation, one of the nation's largest mortgage lenders put the Securities and Exchange Commission on notice of its "difficult financial condition" and was subsequently absorbed by Bank of America. Then, the midpoint of the crisis came on November 1, 2007, when financial pressures virtually eliminated liquidity in the interbank funding market causing the Economic Stimulus Act (2009) to be passed to bolster liquidity in the markets. The final dominos came when Bear Stearns Companies, Inc. collapsed and the Federal Reserve provided term financing for J. P. Morgan Chase to acquire them, and then, Lehmann Brothers bankruptcy and the A. I. G. meltdown shook the entire world into the crisis mode.

GLASS-STEAGALL ACT REPEAL OPENS FINANCIAL DOORS

The Glass-Steagall Act of 1933 was put into place to create a "firewall" between commercial banking and investment banking. The reasoning stated for the Act was to eliminate the risks involved in allowing the intermingling of corporate or investment assets with commercial banking to create financial crises. The Act remained in place until 1999 when Congress repealed it by passing the Gramm-Leach-Bliley Act, which allowed commercial banks, insurance companies, and investment banks to merge and interact.

Many in the banking and business communities opposed the repeal of the Glass-Steagall Act with concerns that the intermingling of various financial entities with commercial banks could cause a financial crisis. Their concerns became reality with the interrelated transactions between merged financial institutions. Had the Glass-Steagall Act been in place, law would have prevented most of the elements causing the financial crisis. This is not to say that some financial firms would not have violated the law established by the act, but in all likelihood the financial crisis could not have been incubated.

TOXIC SECURITIES

Although the reasons for the crisis are interwoven in a complex scenario, the concept of toxic securities is one place to attempt to begin the unraveling process. This term has been applied to securities that include subprime mortgages, collateralized debt obligations, and other risky loans. Just as bankers would not make a bad loan, they would not be likely to risk bank capital in securities that had already been proven to be toxic. Instead, they reacted to competition in their normal areas of expertise by moving into activities that looked promising based on the dynamic economy that had been enjoyed for several years. It was only when the economy stalled that the true risks of these securities became obvious. "For the past 18 months, the banks' problems with toxic securities, especially collateralized debt obligations (CDOs) and other exotic products that packaged subprime mortgages, attracted most of the attention – and alarm" (Tully, 2009).

Bankers were enjoying a good lending environment as long as the economy was growing. Therefore, some bankers began to push their loan to deposit ratios higher in order to have all their money working for them that was possible. In addition, some bankers sought to take advantage of the opportunities they thought they saw in rapidly growing areas such as Arizona, California, Florida, and Nevada. This effort made it more difficult for the banks to properly evaluate and price risk due to lack of complete knowledge of economic situations outside their normal operating locations. As is so often the case, a booming economy can conceal bad management decisions and even look unusually profitable. However, the pain became quickly apparent once the bubble burst and underlying collateral such as real estate started to decrease in value.

MORTGAGES

Some of the earliest indicators of the impending financial crisis appeared in the mortgage market. While the economy was enjoying an extended period of growth, real estate values were also climbing. This led some bankers to offer purchase money mortgages with little or no equity required. Borrowers were happy with this opportunity because they could get into home ownership without waiting to save up for a significant down payment and also allowed them to get into houses that were actually beyond their means. This lending practice worked well as long as borrowers were able to meet their obligations until time to sell at a price higher than their original purchase price.

Low equity loans often had another characteristic that could lead to disaster if the economy did not continue to grow at the expected pace. Often these loans were made with adjustable interest rates. A relatively low initial rate was often provided to assist with borrower qualification. " of the mortgages originated in 2006 that were later securitized, 92 percent of subprime, 68 percent of near-subprime, 43 percent of jumbo and 23 percent of prime mortgages had adjustable rates" (DiMartino, 2007). This did not create a problem as long as interest rates decreased, or at least did not rise, or if the borrower's future income increased to offset payment increases when interest rates adjusted upward.

Changes in the economy or other factors began to create the need for the borrower/home owner to sell or refinance the property. With the downturn in the economy, many borrowers found themselves in the situation where the property was not worth the outstanding balance amount and they could not afford the difference for either sale or refinance. Foreclosure was often the result.

SUBPRIME LENDING

Another mortgage-related contributor to the financial crisis was the policy of lending to people that did not have the best credit, popularly known as subprime lending. Bankers were happy to find a demand for the high interest rate loans associated with subprime lending and the borrowers were glad to be able to find credit at any price. Again, this situation paid off well for the bankers during the early part of the 21st Century due to the state of the rest of the economy and this part of the market enjoyed enormous growth from 2001 through the first part of 2006. "The value of subprime mortgages originated in America shot up from $190 billion in 2001 to $600 billion in 2006" (Economist, 2008). As could be expected, when the economy began to show signs of decline, these subprime mortgages failed at a much higher rate than conventional mortgages.

CREDIT CRUNCH

Another reason for the financial crisis that we are experiencing is because of the credit crunch that started in 2007. As lending institutions began to anticipate the impending problems led by the decline in the subprime market in late 2006, they reacted by tightening their lending policies. Businesses that began to see the results of the economic decline, found that loans to expand or even ride out the weak economy were no longer forthcoming. Lenders were not only taking a closer look at loan applications, they were also reducing loan-to-value rates to make it even more difficult for borrowers to get the loans needed for survival (DiMartino, et al 2007).

UNINTENDED CONSEQUENCES

As result of the abuses that have become evident, President of the United States Barack Obama in a January 21, 2010 press release proposed trading restrictions on commercial banks. He said that banks should be prohibited from owning, investing in or sponsoring hedge funds, private equity funds, or proprietary trading operations for their own profit. Examining the President's statement it would seem that he favors most of the restraints imposed by the 1933 Glass-Steagall Act whose repeal seems to be one of the major culprits in allowing banks to enter into risky and exotic financial instruments and trading (DiMartino, et al 2007).

CONCLUSION

While it is obvious that this has been one of the most disastrous financial events since the Great Depression, and that toxic securities, mortgages, subprime lending, and the credit crunch played a major role in causing the financial crisis; what is not obvious is how to fix the problem. Government officials, academics, and the general public have shown great concern relating to the continuation and depth of the devastating economic crisis. As the "blame game" starts to subside, the Administration and the Congress must arrive at a well thought-out, permanent solution. Many people have weighed-in on taking authority away from one agency and giving it to another, but Paul Volcker, former Federal Reserve Chairman, is probably one of the most highly respected problem solvers in Washington because of the economic stability he brought to the economy during the Jimmy Carter presidency.

Paul Volcker recently spoke to The Economic Club of New York. He noted that the crisis is moral hazard and that the elephant in the room, referring to Congress as the room, is not going away and must be dealt with. Mr. Volcker feels that it behooves the Administration, the Congress, and other national authorities to find a solution and do it correctly. It is his firm belief that the hedge funds, private equity funds, and proprietary trading need to be eliminated.

Further, Mr. Volcker felt that those who wanted the Federal Reserve shorn of its regulatory and supervisory responsibilities presented a disturbing perspective. He firmly believes that the Federal Reserve should have a strong voice. Volcker (2010) said, "…Ways and means can be found to bring a variety of points of view to bear. But I would insist that neither monetary policy nor the financial system will be well served if a central bank loses interest in, or influence over, the structure and performance of the finance system."

It appears that the economic indicators are pointing toward recovery. Therefore, action must be taken to strengthen the financial system and restore public confidence.

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