

## US FINANCIAL CRISIS

### Subprime Crisis:

In normal times, problems in the economy cause problems in the financial markets because hard-pressed consumers and businesses have trouble repaying their loans. But this time — for the first time since the Great Depression — problems in the financial markets are slowing the economy rather than the other way around.

“Subprime” refers to the risk associated with a borrower, not to the interest rate being charged on the mortgage. Typically subprime mortgages are offered at interest rates above prime, to customers with below-average credit ratings.

The Real Estate was in boom in 1997-98 and was sector growth was around 124%. It began with Americans wanting to live in their own house. So he seeks a housing loan to give shape to his dream home. But there is a slight problem. If he doesn't have good credit rating, he will be unable to clear all the stringent conditions that a bank imposes on an individual before it sanctions a loan.

The Credit Rating of individuals is done through special Credit Rating companies with the main credit raters — Moody's and Standard & Poor's which give points on 1000 scale. The individuals are rated as:

- AAA : 650 + score
- BBB: < 650
- CCC

Sophisticated investors took Moody's and S&P's word for it, and it turned out that the agencies didn't know what they were doing. Credit raters, who claim to offer only opinions, are party to Wall Street's cycles too. At the beginning, they're far too lenient with borrowers, who are the ones who pay their rating fees.

Since his credit is not good enough, no bank will give him a home loan as there is a fear that the chances of a default by him are high.

Federal banks in America worked on as an autonomous industry without any govt. interference. These banks by late 90's had only tapped 25% of the loan market (that was of the honest and capable individuals- prime) and the 75% market (of doubtful and defaulters- subprime) were still lacking. The banks decided to give these also loan but higher rate of interest at **Adjustable Rate Mortgage (ARM)**.

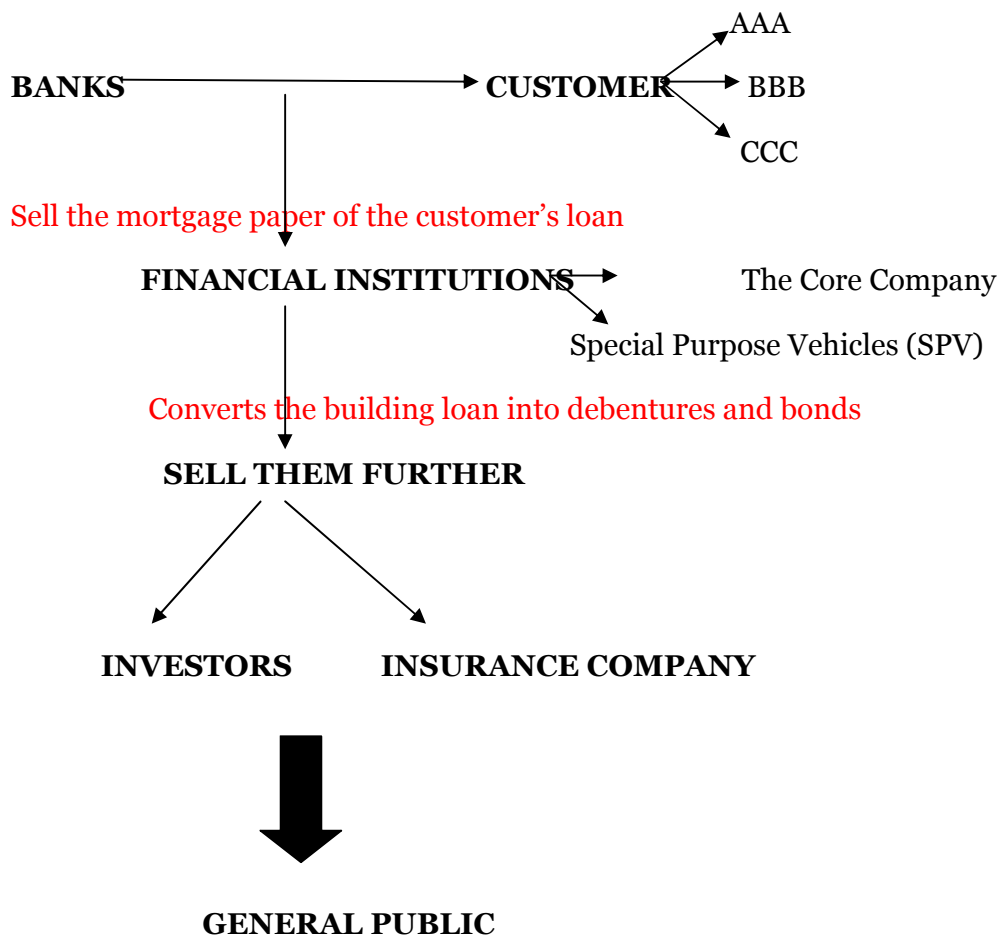
**ARM:** An adjustable rate mortgage (ARM) is a mortgage loan where the interest rate on the note is periodically adjusted based on a variety of indices. In America it was

modulated in a way that the initial years of loan re-payment were at lower rate of interest.

The benefit of the same was that the banks check on the capability of the individuals and in turn the individual could also pay at an easily payable rate. Also due to the high growth in the real estate sector, the banks assumed that in case of default they would take out their money through property.

Now, what actually happened was that there was an assumable slump in the real estate sector smelled by the banks and secondly banks started getting cold feet and realized the mistake they had done.

### LENDING PROCEDURE



The above diagram explains the complete process of lending which in turn led to crisis. The diagram is quite self explanatory except two things:

- i. The Financial Institutes formulated SPV's which were sub-company to the main company and were established to take account of the risky securities under bank. This was majorly done to show a healthy balance sheet to prospective buyers.
- ii. The Federal Banks had a low Cash reserve ratio (CRR) and a high Statutory Liquidity Ratio (SLR) which indirectly was an impetus to the current situation.
- iii. Lastly, Lehman Brothers had 65% stake in AIG Insurance Company which in turn used to sell the ULIP

**How the U.S. real estate bubble fed a global demand for CDO' that couldn't fail; until they did:**

- 1. The Housing Frenzy :** The housing values fell in the over built markets like Miami and Las Vegas, the supply overwhelms demand. The contagion spread and many subprime borrowers found that their homes are worth less than the mortgages. Defaults rose and led to the downward price spiral.
- 2. Run of CDO's :** investors particularly foreign investors, expecting high yield, demand more newfangled collateralized debt obligations (CDO's), which are complicated securities based on pools of other mortgage. They are then rated accordingly.
- 3. Leverage loves Company :** Rather than create and market CDO's, financial firms, leverage it. The money seemed too easy to resist. AIG on the other hand, sells Credit Default Swaps (CDS's), derivatives designed to protect investors from failures.
- 4. The Mortgage Collapse :** consumers who were given big mortgages with small or no documentation, started defaulting on loans that should have never been given. With this FI's like WaMu started feeling the heat.
- 5. Finance takes the next hit :** Rising delinquencies meant, loss in value of CDO's , forcing bank to sell new stock new stock to raise capital. But surprising now no one is buying CDO's. The FI's start falling and AIG cant take the brunt.
- 6. The bailout :** the govt. tries to extend maximum help for sustaining the stability in the economy. Once again, tax payers become the owners of huge institution in trouble

## **Indian Scenario:**

The Indian Scenario is not in danger due to the following reasons:

- The guidelines of housing loans are very strict in India compared to US
- Recently, RBI announced new set of guidelines with stricter rules
- RBI infused \$90,000 cr on 29<sup>th</sup> September to stabilize the effect on the economy
- There was earlier rumour about ICICI going bankrupt as it had Rs.200cr invested from US, but now ICICI chairman, Mr.K V Kamath recently said that bank is not in danger.
- The impact on the India would just be in:
  - Outsourcing
  - Real Estate prices
  - Reduced Foreign Institutional Investment (FII) i.e. reduced capital inflow
  - Reduced Exports, as US was among the major importer of Indian products
  - This in the bargain affects the stock market as well as the ability of Indian corporate to raise resources for investment

## **Financial Institutions involved:**

- Washington Mutual (WaMu): Bought over by JP Morgan Chas
- Lehman Brothers: Bought over by Barclay
- Merrill Lynch: Sold to Bank of America
- Bear Stearns: Bought over by JP Morgan Chas
- The government took effective control of AIG in an \$85 billion bailout.
- The market lost faith in AIG too, but the government was forced to save it.
  - A major reason is that AIG is one of the creators of the aforementioned credit-default swaps. What are those, you ask? They're pixie-dust securities that supposedly offer insurance against a company defaulting on its obligations. If you buy \$10 million of GM bonds, for instance, you might hedge your bet by buying a \$10 million CDS from AIG. In return

for that premium — which changes day to day — AIG agrees to give you \$10 million should GM have an "event of default" on its obligations.

- But as a way to make sure that swap misters can make good on their obligations, they have to post collateral. If their credit is downgraded — as was the case with AIG — they have to post more collateral. What put AIG on the brink was that it had to post \$14 billion overnight, which of course it didn't have lying around. Next week, the looming downgrades might have forced it to come up with \$250 billion. (No, that's not a typographical mistake; it's a real number.) Hence the action.
- Effective nationalisation of mortgage giants Fannie Mae and Freddie Mac (they were govt banks only)
  - Many of the mortgages and mortgage securities owned or guaranteed by Fannie Mae and Freddie Mac were bought by foreign central banks, which wanted to own dollar-based securities that carried slightly higher interest rates than boring old U.S. Treasury securities. A big reason the Fed and Treasury felt compelled to bail out Fannie and Freddie was the fear that if they didn't, foreigners wouldn't continue funding our trade and federal-budget deficits.
- Goldman Sachs and Morgan Stanley were issued Conservative Banking license; that is they would be operating as a bank now
- Lehman Brothers would not be spared; as it was their own mistake to earn quick profits
  - Lehman's fall shows the downside of using borrowed money. Even though Lehman has a 158-year-old name, it's actually a 14-year-old company that was spun off by American Express in 1994. AmEx had gobbled it up 10 years earlier, and it wasn't in prime shape when AmEx spat it out. To compensate for its relatively small size and skinny capital base, Lehman took risks that proved too large. To keep profits growing, Lehman borrowed huge sums relative to its size. Its debts were about 35 times its capital, far higher than its peer group's ratio. And it plunged heavily into real estate ventures that cratered.

## **\$700b Bailout:**

Initially rejected by the House of Representatives but then again passed by the Senate on 1<sup>st</sup> October'08, by a high margin ratio of 74-25 votes. The bailout amount was decided on an assumption basis and has no supportive backing for it.

The US Senate has approved the \$700 billion rescue package proposed by the Bush administration, with some modifications. The Senate passed the bill, which incorporated tax cuts and a higher insurance limit for bank deposits.

### **Why is the bailout being opposed?**

1. There is no guarantee that this \$700 billion will be enough to take care of the crisis on Wall Street.
2. A bailout of this kind will in a way incentivise wrongdoing, as these institutions will think that despite their wrong decisions and greed -- which led to this unprecedented crisis -- the US government will bail them out.
3. People are angry with US bankers, who created fancy financial instruments and extended loans to people with unstable incomes and low creditworthiness and gambled with US money, are now having to be bailed out by ordinary citizens.
4. Every American taxpayer will have to shell out about \$5,500 to help finance the \$700 billion bailout.
5. US citizens are worried that this might lead to an increase in taxes over time.
6. Some economists also believe that the bailout might not work at all.

### **How will the US government pay back the money?**

The assets, or the bonds that are worthless as of now, will eventually be sold. It is believed that once the bailout is done, and the stock and the realty markets stabilize, the bonds will gain back their value and can be sold thus getting back at least half of the \$700 billion.

In the long run, the rest of the money will be paid by the taxpayer.

### **How will the bailout help?**

The bailout money -- \$700 billion -- will be disbursed in instalments. The US Treasury will first get \$250 billion to begin buying the bad mortgage bonds. Then another \$100 billion will be given the Treasury, and finally in the third stage, the remaining \$350 billion will be given. This will, however, be done under strict Congressional monitoring.

An oversight commission that will comprise Democrats and Republicans will be created to monitor the process.

### **Who gains the most?**

The banking industry and the Wall Street will be the biggest winners in what is human history's largest ever financial bailout.

The US economy: To some extent, the infusion of hundreds of billions of dollars into the economy, will help revive it once again. If the bailout works, that is.

Some borrowers can also benefit from this bailout, as banks will have funds to lend for student loans, working capital loans, credit card accounts, even housing loans, etc.

### **Who will lose the most?**

Those who are facing foreclosures and whose houses are on the block will lose big. Then, obviously, the US taxpayers will lose out. A lot of people who have lost their jobs might not get them back anytime too soon. Lastly, the US executives who caused this crisis.

The following is the summary of the '**Emergency Economic Stabilization Act of 2008**,' also called the "**Bailout Plan**":

### **I. Stabilizing the Economy**

The Emergency Economic Stabilization Act of 2008 (EESA) provides up to \$700 billion to the Secretary of the Treasury to buy mortgages and other assets that are clogging the balance sheets of financial institutions and making it difficult for working families, small businesses, and other companies to access credit, which is vital to a strong and stable economy. EESA also establishes a program that would allow companies to insure their troubled assets.

### **II. Homeownership Preservation**

EESA requires the Treasury to modify troubled loans -- many the result of predatory lending practices -- wherever possible to help American families keep their homes. It also directs other federal agencies to modify loans that they own or control. Finally, it improves the HOPE for Homeowners program by expanding eligibility and increasing the tools available to the Department of Housing and Urban Development to help more families keep their homes.

### **III. Taxpayer Protection**

Taxpayers should not be expected to pay for Wall Street's mistakes. The legislation requires companies that sell some of their bad assets to the government to provide

warrants so that taxpayers will benefit from any future growth these companies may experience as a result of participation in this program. The legislation also requires the President to submit legislation that would cover any losses to taxpayers resulting from this program from financial institutions.

#### **IV. No Windfalls for Executives**

Executives who made bad decisions should not be allowed to dump their bad assets on the government, and then walk away with millions of dollars in bonuses. In order to participate in this program, companies will lose certain tax benefits and, in some cases, must limit executive pay. In addition, the bill limits "golden parachutes" and requires that unearned bonuses be returned.

#### **V. Strong Oversight**

Rather than giving the Treasury all the funds at once, the legislation gives the Treasury \$250 billion immediately, then requires the President to certify that additional funds are needed (\$100 billion, then \$350 billion subject to Congressional disapproval). The Treasury must report on the use of the funds and the progress in addressing the crisis.

EESA also establishes an Oversight Board so that the Treasury cannot act in an arbitrary manner. It also establishes a special inspector general to protect against waste, fraud and abuse.

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