



The financial crises: Causes and impacts

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Abstract

Financial crisis can be described as severe contraction of liquidity in global financial markets. The 2006-2008 financial crises originated in the United States and were regarded in the US as the worst economic down turn since the depression of 1933. The financial crisis was caused by a number of factors including the housing market crash. The 2006-2008 financial crises resulted in bankruptcy for many financial institutions. It was a global financial and economic collapse that cost many people their jobs, their life savings, their homes, or all three. Many people lost their homes due to foreclosures because they lost their jobs and could not pay their mortgages.

Banks were failing and needed a bailout. There was a high unemployment. Because the Fed anticipated a mild recession, it reduces federal fund rate 11 times between May 2000 and December 2001 from 6.5% to 1.75%. This reduction enabled banks to extend credit to customers at a lower rate. Consumers including high-risk customers (people with poor or no credit history), started taking advantage of the cheap credit to purchase durable goods including houses. The rush to buy houses created the housing bubble, which led to an increase in house prices above their intrinsic value.

Keywords: financial crises, global financial markets

Introduction

The financial crisis of 2006-2008 was a global financial crisis that was severe and shook the global economy. It was the most serious financial crisis since the Great Depression of 1933. It was a global event, not one restricted to the U.S. Ireland's vibrant economy fell, and Greece defaulted on its international debts. Portugal and Spain suffered from extreme levels of unemployment. Every country's experience was different and complex.

The financial crisis was caused by predatory lending targeting low-income homebuyers, an excessive risk-taking by global financial institutions. The crisis grew big enough that, when it burst, it damaged the world economies and hurt millions of people.

In 2000 and 2001, interest rate was very low; which enabled banks to issue loans to a lot of people including those who were not qualified for the loan (mortgage loan). As more people demanded for mortgage loan (for home purchase), home prices began to rise in 2005.

Banks and lending institutions offered low interest rates on mortgages and encouraged many people to take out loans that they could not afford to pay back.

Lenders created new financial instruments called mortgage-backed securities (MBS), which were essentially bundled together and sold as securities to investors in the US and other foreign countries. When the homeowners could not pay their mortgages, financial institutions took major hits.

The housing market was deeply affected by the crisis. A lot of tenants were evicted and homes were foreclosed. The stock market, in response, began to decline severely (Corporate Finance Institute, 2022) ^[4]. Large U.S. and European banks lost more than \$1 trillion on toxic assets. Major businesses worldwide began to fail, which led to a widespread layoffs and high unemployment.

Other causes of the financial crises

The causes of the financial crisis are a matter of dispute among economists (Duignan, 2019) ^[5]. In 2001, the Federal Reserve (Fed) anticipated a mild recession and therefore, reduced the fund rate from 6.5% to 1.75%. This reduction enabled banks to extend credit at a lower rate (than before) to customers.

In the late 1990s and 2004-2007, sub-prime borrowers who needed to purchase their own homes were considered for mortgages but at a very high interest rate. Therefore, banks became engaged in sub-prime lending at a very high interest rate. In the case of default, banks could repossess the property and re-sell.

Another cause of the financial crises is securitization, whereby banks bundled hundreds or thousands of sub-prime mortgages and other less-risky debt and sold them in the capital markets as securities to other banks and investors (Duignan, 2019) ^[5]. These securities are known as mortgage-backed securities (MBSs), whereby the banks and investors who purchased them received interest and principal payments on the loans. Securitization is a way of diversification, which can help to mitigate risk. By year 2000, MBSs became popular and increased in price. When borrowers could not pay back the mortgages, investors lost big time.

One other cause of the financial crises was the global financial stability and growth, which created over-confidence for a lot of people in the financial industry, the economists, government, etc.. This over-confidence led them to believe that extreme economic volatility was a thing of the past. Banks continued their reckless lending and securitization practices; and the financial industry ignores the clear signs of an impending crisis (Duignan, 2019) ^[5].

In 1999, business was slow; therefore, banks, security firms, and insurance companies decided to merge; resulting in the formation of banks that were believed to be "too big to fail". In 2004, the Securities and Exchange Commission (SEC)

reduced the net-capital requirement, the ratio of capital or assets to debt or liabilities that banks are required to maintain as a safeguard against insolvency. This reduction helped banks to have more funds to purchase more MBSs. The high profit on MBS created more demand for the mortgages (Duignan, 2019) ^[5]. The price increase however depends on the continuity of housing bubble. But unfortunately, housing bubble did not continue; the housing market crashed due to borrowers' default.

Impacts of the financial crises

Despite the warning signs, few investors suspected that the worst crisis was about to swallow the global financial system. In 2001, interest rate was very low; which enables banks to issue loans to a lot of people including those who are not qualified for the loan (mortgage loan). As more people demand for mortgage loan (for home purchase), home prices began to rise in 2005.

Between 2004 June and 2006 June, the Fed increased the funds rate from 1.75% to 5.25%. This rate increase resulted in sub-prime borrowers defaulting on their loans. At the same time, the housing market had reached a saturation point; therefore, house sales, and thus home prices, began to fall. As houses continue to fall in prices, sub-prime borrowers are unable to rescue themselves because they now owe more than their homes are worth.

About 7.5 million jobs were lost between 2007 and 2009, which means the unemployment rate doubled. By 2010, unemployment rate was about 10%. Although by 2018, the unemployment rate had reduced to 3.9%, many of the jobs added were low paying and less secure.

Banks' and investment companies' MBSs based on sub-prime mortgages lost value. United States' MBSs purchased by other countries experienced the same effects. By 2007, the situation has worsened for many banks and other mortgage lenders (Masterworks, 2022) ^[8]; some of them started to liquidate their investments, appealed for government loans, sought mergers with healthier companies, or declared bankrupt. The MBSs were downgraded to toxic assets. Corporate governance and risk management at many banks failed.

In April 2007, banks stopped lending to sub-prime customers. Beginning August 2007, banks became increasingly reluctant to give short-term loans to each other. Federal Reserve increased the availability of 1-month and 3-month discount-window loans to banks. It also created swap lines with foreign central banks to increase the availability of dollar-denominated loans to banks in other countries.

In 2009, the Fed, along with other federal regulatory agencies, conducted a review of the financial condition (stress test) of the 19 largest U.S. banks. Banks that did not have enough capital cushions to protect themselves from loan losses under adverse economic scenarios were required to raise money from private sector or federal government funds i.e. Troubled Asset Relief Program (Federal Reserve Education.org,

n. d.) ^[7]. The Fed started providing short-term loans (like the discount window loans) to banks; which considerably improved the market conditions.

By the end of 2007, BNP, the largest bank in France, announced a huge loss while the US American Home Mortgage Investment Corp. filed bankrupt. A United Kingdom bank, Northern Rock, became illiquid. By 2008 January, the crisis in the US has deepened. It was the

longest and deepest economic downturn in many countries, including the United States, since the great depression (1929–c. 1939).

The Fed reduced the fund rate to 1% by October and 0% by December 2008 (vidio.com) ^[11]. The rate reduction helped stabilize things a little but did not end the crises. Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) were established to provide liquidity to mortgage lenders by buying mortgage loans and selling or holding them. Eventually, both institutions suffered losses. The U.S. Treasury Department nationalized both institutions in September, replaced their directors and agreed to cover their debts.

Lehman Brothers, with \$639 billion in assets, filed the largest bankruptcy in the U.S. history. Its failure led to a lasting turmoil in financial markets worldwide, which severely weakened some banks' portfolios and liquidity. The U.S. Treasury Department refused to bail Lehman Brothers because it would be an encouragement for future reckless behavior by other banks (Federal Reserve Education.org, n. d.) ^[7]. The Federal government however bailed out American International Group (AIG), the US largest insurance company because its failure could cause the failure of many banks. Washington Mutual, the US' largest savings and loan bank, was seized by federal regulators and sold the next day to JPMorgan (Chase bank). The USA's GDP fell by 4.3%, 8.8 million people lost their jobs. Many struggled to find low-paying jobs. Then there was an increase in supervision and regulation on financial institutions to reduce financial risk and to prevent another financial crisis.

To prevent a complete breakdown of the financial system and damage to the U.S. economy, the government decided to give a forceful response to the ongoing financial crises. Therefore, in September 2008, the **Bush** administration proposed legislation, the Emergency Economic Stabilization Act (EESA), to establish a Troubled Asset Relief Program (TARP), for the Secretary of the Treasury, Henry Paulson, to purchase MBSs and other troubled assets up to \$700 billion from the U.S. banks (studysmarter, n. d.).

Impacts on EU

The financial crises have impacts on many European countries. A few of the countries experienced a prolonged recession; while some recovered from the recession. Many countries like Spain, Ireland, Greece, Portugal, etc. took on large debts to help the financial market to recover. The crisis forced Greece into a budget deficit. The International Monetary Fund (IMF) provided Greece with €240 billion to prevent debt default (Amadeo, 2022) ^[1]; but unfortunately, this money was only enough to service the debt but did not cover the principal. Greece's GDP growth declined rapidly to -10.149% in 2011 (Amadeo, 2022) ^[1]. The Republic of Ireland was the first country in the EU to officially enter recession when the 2008 financial crises ^[13] began, but rose again to become the fastest growing economy. Ireland's booming economy came to an end when foreign borrowing by Irish banks grew from €15 billion to €110 billion.

The bailout package

Ten years after the start of the financial crises, the US gross domestic product (GDP) was about 7% lower than it would have been had the crises not occurred. According to the

Federal Reserve of Cleveland, more than 500 banks failed between 2008 and 2015, compared to 25 in the preceding 7 years. Most banks felt the impact of the crises, but not all banks needed to be bailed out (Amadeo, 2022)^[1].

A bailout is the provision of financial help to a corporation or country, which otherwise would be on the brink of bankruptcy (bloomberg.com, 2013)^[2]. There was a federal intervention to rescue banks and restore confidence to the financial sector. In 2008, Congress passed the Emergency Economic Stabilization Act (EESA). The government injected \$700B into banks such as Bank of America, Citigroup, and American International Group (AIG) to enable them continue their operations.

Some people argued that the government should not have bailed out the banks. Allowing the banks to fail could create a worldwide depression though. The total government commitment is \$16.8 trillion of which \$4.6 trillion was already paid out (Collins, 2015)^[3]. However, after the original \$700 billion bailout, the ongoing bailout was kept secret because it was argued that revealing borrowers' (the banks') details would create a stigma and investors could shun firms that used the central bank as lender of last resort. In November 2011, the Congress forced a one-time audit of the Federal Reserve. After the audit, the emergency lending was disclosed to the public. The bailout had no requirements attached to the money and the banks could use it for any purpose including mergers (Collins, 2015)^[3]. Because, the 12 largest banks now control 70% of all bank assets, they have a big lobbying power to buy off Congress.

Most of the failed banks were small regional banks; all of them were acquired by other banks. Some of the "too big to fail" banks such as JPMorgan Chase, Goldman Sachs, Bank of America, and Morgan Stanley were bailed out and they repaid the money to the government. The bail-out helped to stabilize the stock markets.

Regulation

Speculation and lack of effective regulation led to the crash of 2006-2008 and the great recession (Collins, 2015)^[3]. After 2 years of deep recession, financial markets began to revive and the economy began to grow. By 2010, the Congress adopted Dodd Frank Act banking regulations (Wall Street Reform and Consumer Protection Act), to prevent another financial crisis. The Congress also created a Consumer Financial Protection Bureau to regulate sub-prime mortgage loans. Dodd-Frank is to prevent banks from taking on too much risk and allow the Fed to reduce bank size for those that become too big to fail (Amadeo, 2022)^[1]. Dodd-Frank Act also increased government oversight of banks activities and forced them to maintain larger cash reserves with the Fed.

Who Made Money During The Financial Crisis?

Some investors made money from the crisis. Warren Buffett invested billions in companies including Goldman Sachs and General Electric. Hedge fund manager, John Paulson, made a lot of money betting against the U.S. housing market during the bubble and then made a lot of money betting on its recovery after it hit bottom. Investor Carl Icahn made money by buying and selling casino properties before, during, and after the crises using his market-timing talent (Singh, 2022)^[10].

Who is to blame for the financial crisis and or the great recession?

A few sets of people could be blamed for the financial crises. They are:

1. The reckless mortgage lenders who gave loans to people who could not possibly pay back the mortgages they were offered.
2. The investment gurus who bought those bad mortgages and packaged them into bundles for resale to other investors should carry some of the blame.
3. Some rating agencies rated the mortgage bundles as top investment, making them appear to be safe. These 3 sets of people should carry the blame.

Lessons learned from the crises

Some lessons learned are that:

1. Sometimes problems in the financial markets are unforeseeable
2. Market may change but it will self-correct itself. Markets and the economy are independent of politics. Therefore, when there is a crash, throwing money in the economy may worsen the situation.
3. It may be difficult to differentiate a market crash from market volatility. Therefore, when there is crisis, it may have gotten deep before it is realized.
4. Diversification is a good way to mitigate investment risk.

How to prevent another financial crises

To avoid another financial crash, a lot of suggestions were put forward.

1. The US should make derivatives illegal
2. A financial transaction tax should be placed on all sales of stocks, bonds, options, futures, etc. a 15-35% tax should be placed on hedge funds.
3. It was suggested that the rating agencies should be closed down because they are paid for by the banks, which constitutes a conflict of interest.
4. Federal Deposit Insurance Corporation (FDIC) insurance should cover only commercial banking and not investment banking.
5. Bank CEOs and top managers should be criminally liable for a bank's huge losses/failures.

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