Financial Crisis

Class 1: Beginning of Financial Crisis

Pop Economics

EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání

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Start of Financial Crisis in 2008

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DJIA 10917.51 ▼504.48 -4.4% NASDAQ 2179.91 ▼3.6% NIKKEI Closed (12214.76) DJ STOXX 50 2744.81 ▼4.0% 10-YR TREAS ▲2 3/32, yield 3.482% OIL $95.71 ▼$5.47 GOLD $783.10 ▲$22.80 EURO $1.4310 YEN 104.88

AIG, Lehman Shock Hits World Markets

Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclays in Talks to Buy Core Lehman Unit

By Susanne Craig, Jeffrey McCracken, Jon Hilsenrath and Deborah Solomon

The convulsions in the U.S. financial system sent markets across the globe tumbling, as two of Wall Street's biggest firms looked set to exit the scene and insurance titan American International Group Inc. turned to the Federal Reserve and the state of New York for assistance.

The U.S. stock market suffered its worst daily point plunge since the first day of trading after the Sept. 11, 2001, terrorist attacks. Financial markets were rattled by the rushed sale Sunday of Merrill Lynch & Co. and the bankruptcy-court filing of Lehman Brothers Holdings Inc., which scrambled Monday to sell its most-prized businesses before too many employees and customers walk out the door. (Please see related article on Page C1.)

All day Monday, top Lehman officials were huddled in Manhattan at their Seventh Avenue

ing. For much of the day, the major U.S. market indexes were down 2%, which, while a good-sized decline, was smaller than many had thought would be the case. But in the final hour of trading, a wave of selling hit, driven by concerns about the fate of AIG. The Dow Jones Industrial Average ended down 504.48 points on Monday, off 4.4%, at its daily low of 10917.51, down 18% on the year. Of the Dow industrials' 30 components, all but one—Coca-Cola Co.—fell, led by a 60.8% plunge in AIG.

In Europe, London's FTSE 100 index dropped 3.9%. Several Asian markets, including Japan and China, were closed Monday due to holiday. By Tuesday, Tokyo shares were down 5.1% in early trading, and Hong Kong's Hang Seng index was down 6.1%.

Monday's action was the latest fallout in a widening financial crisis that began a year ago with the fall of American housing prices and is now reordering the U.S. financial system. Steps unveiled by the Federal Reserve to expand its emergency lend-

AIG Faces Cash Crisis As Stock Dives 61%

By Matthew Karnitschnig, Liam Pleven and Serena Ng

American International Group Inc. was facing a severe cash crunch last night as ratings agencies cut the firm's credit ratings, forcing the giant insurer to raise $14.5 billion to cover its obligations.

With AIG now tottering, a crisis that began with falling home prices and went on to engulf Wall Street has reached one of the world's largest insurance companies, threatening to intensify the financial storm and greatly complicate the government's efforts

- Collapse of the housing bubble: fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages
- Trillions of dollars in risky mortgages

Sources of Financial Crisis I

- Community Reinvestment Act (1977)
  - Aim 1: prohibition of **redlining** and **statistical discrimination** approach of banks by a new obligation: provision of credits to all parts of a community, regardless of the relative wealth or poverty of a neighborhood
  - Aim 2: support of **ownership housing**

Effect: Banks left their traditional risk management model and must provide higher-risk loans and mortgages.

Sources of Financial Crisis II

- Mortgage Agencies
  - Freddie Mac (Federal Home Loan Mortgage Corporation)
  - Fannie Mae (Federal National Mortgage Association)
- Government would back them in case of troubles in order to support the ownership housing.
- Aim of the agencies: to buy mortgages from banks and issue mortgage-backed **securities** (CDO - Collateralized Debt **Obligation**)
- Effect: Banks accepted high-risk loans and could get rid of risks by selling the mortgages to agencies.

Sources of Financial Crisis III

- Credit Rating Agencies (CRA)
- rate a debtor's ability (countries, securities) to pay back debt and the likelihood of default.
  - Standard & Poor‘s
  - Moody‘s
  - Fitch
- Did not see risk in CDOs and rated them as AAA

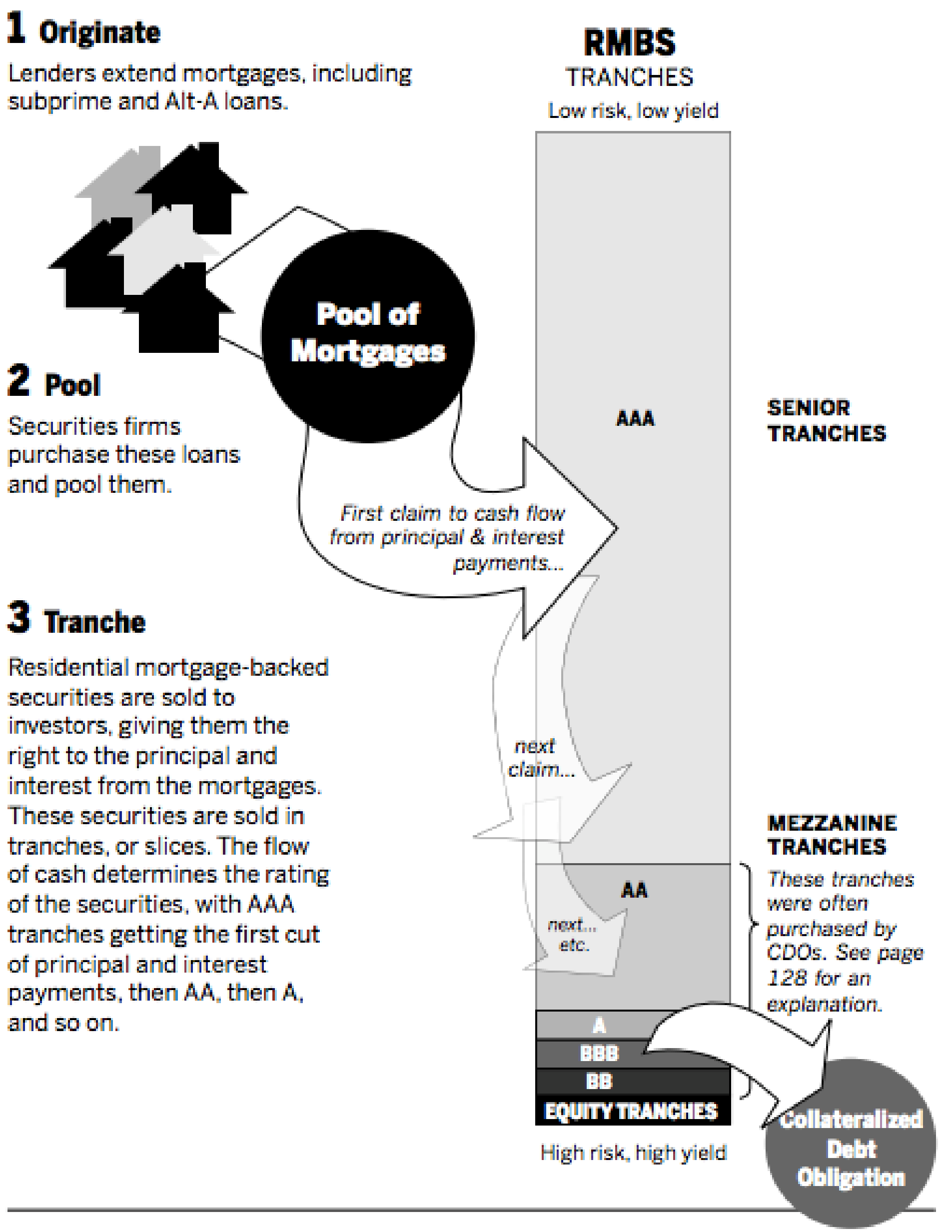
Consequences

- Predatory lending, also NINJA loans
  - NINJA: no income, no job, no assets
  - half 1990s to 2007
  - subprime mortgages

- Moral hazard of banks
  - Moral hazard: a person/institution takes more risks because someone else bears the cost of those risks
  - Lender did not have to pay instalments for the first two years
  - Bank employees received bonuses for mortgage amout.
  - *Recommendation: The Big Short (movie or book)*

CDO (Collateralized Debt Obligation)

- A security that pools together cash flow-generating assets (i.e. mortgages, bonds and loans)
- It often composed of the riskier portions of mortgage-backed securities: toxic asset
- CDOs evolved into the mortgage and mortgage-backed security (MBS) markets
- Tranches divided according to risk: prime (less risky), average, subprime (most risky)

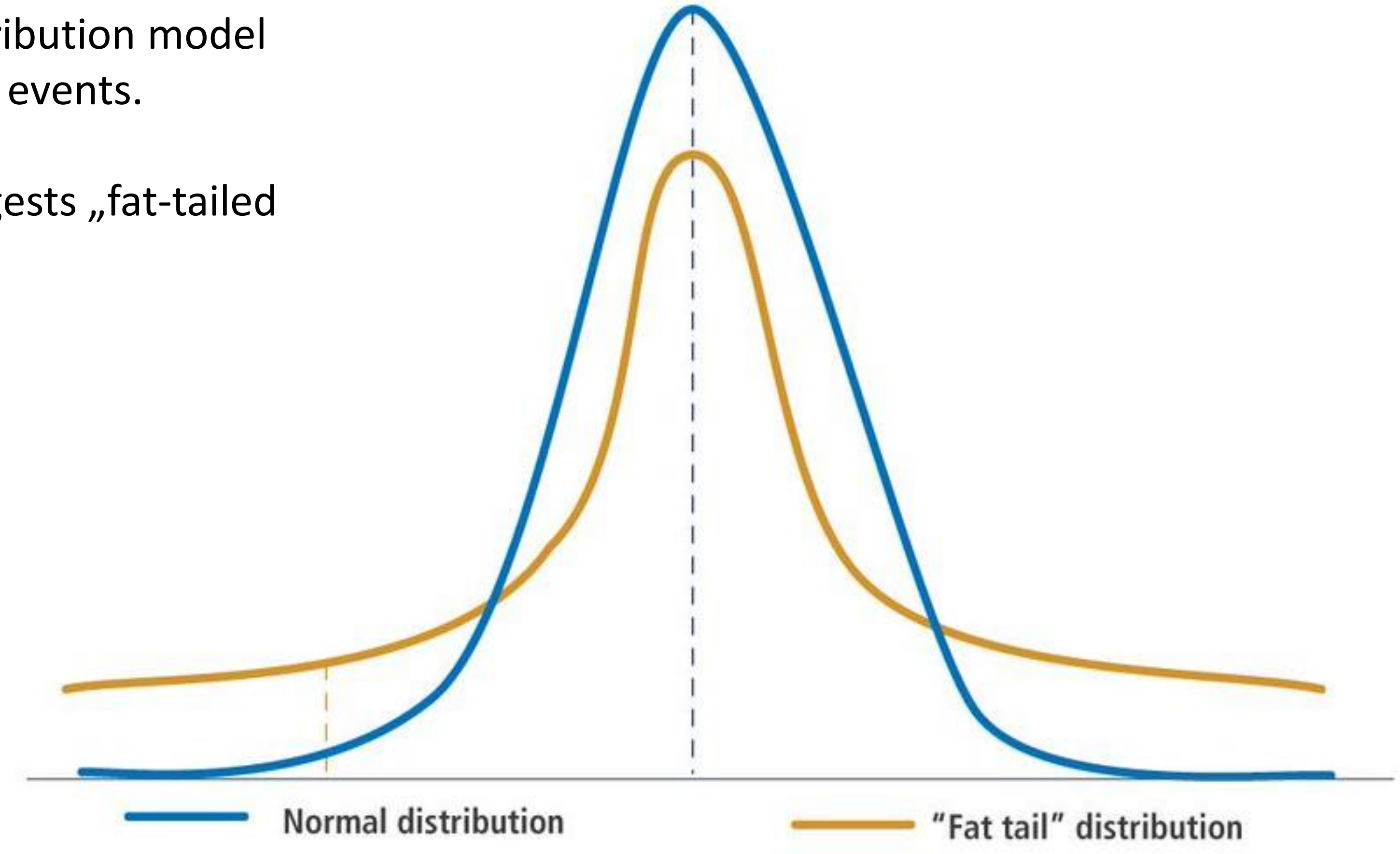


Source: The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, 2011

Normal Distribution Model of Risks Failed

Nassim Nicholas Taleb in Black Swan explains the normal distribution model underestimates extreme events.

In finance he rather suggests „fat-tailed distributions".



Diversification reduces a risk – really?

- Harry Markowitz: When one diversifies assets in portfolio well, they are better immune to the crisis.
- Did not work
- All the assets were loosing the value.

Source: www.thefamouspeople.com

What to remember

- Security
- Statistical discrimination
- CDO
- MBS
- NINJA
- Freddie Mac, Fannie Mae
- Normal and fat-tailed distribution
- Rating Agencies

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