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Financial Crisis Report



The U.S. economy shrank by 6.2 percent in fourth quarter 2008

[Source: U.S. Bureau of Economic Analysis](#)

In our last issue, we reviewed what the Congressional Research Service--Congress's own nonpartisan think tank--has told both Democratic and Republican members of Congress about [the shrinking U.S. economy](#). Today, let's speed read another of their recent reports, so you'll have the same knowledge members of Congress do.

This report addresses what the last report said was one of the three major causes of the current

recession: the widespread turmoil in the financial markets. What has caused the financial markets to buckle and break? It's complicated, but the economists who work for all the members of Congress have made it as simple as they can.

What Happened

"In mid-2007, mounting losses in subprime mortgage markets triggered disturbances throughout the international financial system. The scale of the turmoil has been surprising, given the small size of the U.S. subprime market in relation to global financial markets."

"Nevertheless, a wide range of financial institutions have been affected adversely, many of which had little direct exposure to the subprime mortgage market."

"By September 2008, not a single 'bulge bracket' investment bank remained standing: they had either failed (Lehman Brothers), merged (Merrill Lynch and Bear Stearns), or converted themselves into commercial bank holding companies (Goldman Sachs and Morgan Stanley)."

Why Banks Are Special

"To understand how a relatively small market sector--U.S. subprime mortgages--could trigger such widespread chaos in global markets, it helps to consider ways that financial markets have evolved over decades."

"In the 1930s, the last time this level of turmoil occurred, widespread bank failures were followed by a long economic downturn. In response, Congress recognized that banks were special: their assets tended to be long-term loans and their liabilities were primarily short-term deposits."

"This meant that even sound and solvent banks

could be destroyed if depositors sought to withdraw their money at the same time. Their assets were illiquid. Worse, liquidity problems were contagious: if one bank failed, depositors were likely to run on healthy banks."

"To stabilize the country's banking system, Congress instituted deposit insurance and gave bank regulators strong powers to limit the amount of risk that banks could take. Risky activities, like underwriting and the sale of corporate securities, were placed off limits."

When the Game Changed

"Over the years, however, bank services and bank risks migrated outside of the regulatory safety net. Wall Street securities firms, for example, developed the commercial paper market, which replaced much of banks' short-term corporate lending. Investment banks like Merrill Lynch were never subject to the same kind of safety and soundness regulation as commercial banks."

"Newer market participants, like hedge funds, were not subject to any regulation at all. Even regulated banks were gradually allowed to own securities and insurance businesses within a holding company structure, and they were allowed to hold highly risky speculative positions in off-balance sheet 'special purpose entities.'"

"Bank-like investment strategies, such as using leverage (or borrowed money) and financing long-term investments with short-term debt, became common outside the safety net provided by deposit insurance and strong regulation. As a result, nonbank institutions became vulnerable to runs. If markets lost confidence in them, their sources of funds could dry up. And these nonbank runs could also be contagious."

How Complexity Made It Worse

"Another notable development of the past two or three decades is the development of complex and hard-to-value financial instruments. For example, simple debt contracts like home mortgages were sold by the original lenders and packaged into bonds with a wide range of risk and reward characteristics. These bonds were often pooled again and sliced and diced into even more complex packages."

"Synthetic securities were created based on derivative instruments that replicate the price changes of an asset without requiring actual ownership of the asset itself. The relationship between the performance of an underlying financial asset and the complex security or derivative based on it was never simple, and under crisis conditions has proved to be completely unpredictable."

"Complexity reduces transparency. Neither regulators nor market participants can easily assess the true financial condition of firms that hold or trade these newer instruments. Since large parts of derivatives markets are unregulated, there is a global web of financial claims and counterclaims that is essentially invisible to financial supervisors and market participants alike."

Who Wanted More Risk

"The new finance was based on the ability to quantify and disaggregate risks in ways that were not possible before. As derivatives markets grew, a common view was that they made the financial system more efficient and more resilient to shocks: they let risks be transferred to those who were best able to understand them and who were willing to take on risk in search of profits."

"The benefits, in theory, are not confined to market participants. . . . The entire economy gains a valuable shock absorber. If hedge funds and other financial speculators take on credit risk,

interest rate risk, currency risk, and so on, the core institutions of the financial system ought to be able to operate in a more stable and predictable environment."

"The crisis suggests that the system has not worked as hoped. Rather than use derivatives and other innovative financial instruments to shed risk, the core institutions have employed them in speculative investment strategies, increasing their risk. The risks of these strategies appeared tolerable, but now it appears that the underlying risk assumptions or models were deficient."

"There remains great uncertainty about the true value of certain financial instruments, especially those with complex structures or for which active trading markets do not exist."

Where the Safety Net Really Snapped

"The shock of losses from rising mortgage delinquencies and foreclosures, though serious, was probably not in itself sufficient to cause the crisis. It was also necessary that the financial system be structured in such a way as to multiply the initial shock and trigger dynamics that caused widening losses among financial institutions."

"Many of the losses occurring in diverse firms and markets have common features: the use of complex, hard-to-value financial instruments; large speculative positions underwritten by borrowed funds, or leverage; and the use of off-the-books entities to remove risky trading activities from the balance sheets of major financial institutions."

"Congress may view the social costs of failed financial speculation as sufficient to warrant new restrictions to reduce the incidence of losses that have systemwide impacts or to put the markets and the economy in a better position to weather such shocks. The Treasury has already proposed

a sweeping restructuring of financial regulation."

--*Michael Himick*



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