Revisiting 2008 Financial Crisis

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Abstract

Despite having several challenges in implementing certain provisions to combat global financial malfunctioning, the fate of Dodd-Frank Act seems positive with the reélection of Obama in the United States. This article tries to explore some of the recent regulatory affairs in the backdrop of the 2008 global financial crisis, probably one of the most virulent one in the history of the crises reflected in the imprudent lending following the ‘originate-to-distribute’ model by banks in US and the reckless borrowing at easy credit condition by borrowers (especially by sub-prime borrowers) without understanding the complexity of most of the financial products and transactions, unless become visible in a massive negative home equity.

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Introduction

History tells us that the Great Depression of the 1930s is considered to be a defining moment in terms of economic recessions. However, in the post-1930s, the nature of recession has become more complicated due to the development of sophisticated technological and related factors, particularly in the global financial architecture. Regulatory affairs for the financial sector have become extremely important in light of the proliferation of financial institutions and financial techniques that are getting further complicated with time. The development cycle of the whole “financial business” starts from a “bubble” and culminates in a “burst”, when the pain becomes unbearable (for the society). This type of financial sector development (or rather financial sector activities) has made the world market incredibly volatile.

But, in spite of recognising the present disastrous role of the financial sector in the global economic/financial crisis, it is undeniable that a sound financial system is essential for the development of real economy. There is, of course, a need for banking and financial systems to coordinate between lending and borrowing requirements or to mobilise savings for investment needs. There is always a substantial need of capital for small and medium enterprises, which can
be met by a well-developed banking and financial system. So long as the financial institutions are doing such activities, it is on the up and up; the problem, however, crops up when such institutions engage in excessive speculative activities to make more profits. The presupposed beneficial impact from the international financial sector (or architecture) at present is largely missing. According to Reddy:

The belief that growth of the financial sector leads to economic development, and hence greater financialisation would necessarily add to efficiency and stability, stands discredited….The tendency of the financial sector to redistribute wealth in its own favour rather than create wealth, and its potential to distort commodity prices from genuine supply-demand factors indicate the need for an assessment of the optimal financial activity in the system (Reddy 2011:135).

**Destabilising Mechanisms and Related Issues**

Although ample literature is available on the motivating factors behind the 2008 financial crisis, for the purpose of the paper it is worth reviewing some of the most fundamental reasons and subsequently on the regulatory affairs pertaining to them. There are at least two basic reasons behind the recent financial crisis (a)Lack of understanding by borrowers regarding loans offered via complex financial products( triggered an ever-increasing risks associated with debt-related financing)ii (b) Reckless loans provided by banks to borrowers without knowing their repaying ability( motivated by the originate-to-distribute model, bypassing risks to others, though actually risks lie with banks). The very fact of the concentration of substantial proportion of such loans into subprime mortgage ultimately revealed the whole gamut of such irrational financial practice.

The development of the so-called *shadow banking system* (investment banks, money market mutual funds or MMMF, mortgage brokers, hedge funds etc.) apart from the traditional banks (particularly in the US) comprising sophisticated characteristics in capital markets was the major motivating factor behind the crisis. Though the core activities of such hybrid institutions are subject to regulation and monitoring by central banks and other government institutions, many of their transactions do not exist in their conventional balance sheet accounting (Gorton and Metrick 2010). Consequently, such transactions are not visible to regulators or uninformed investors. The gradual growth of the shadow banking and the practice of securitisationiii have proliferated since the 1980s due to deregulation, liberalisation and globalisation of financial
markets as well as financial innovation in capital markets which substantially undermined the competitive advantage of traditional banks and bank deposits.

Another reason for the crisis is the lack of understanding about complex financial products such as Collateralised Debt Obligations (CDO), Asset Backed Mortgages (ABM), Credit Default Swaps (CDS) by banks, borrowers and other financial institutions. This raises the issue of whether such type of financial innovation benefits society in any way and to what extent it is growth enhancing.\textsuperscript{iv} Whereas an innovation in medical sciences might contribute to the health sector (possibly with a cure for cancer), the benefits of financial innovation are quite often outweighed by its negative side effects. For instance, in securitisation, the originating firm may create some bad loans or highly illiquid assets, which may not be realised prima facie, as such loans would be pooled into a portfolio before selling to a Special Purpose Vehicle (SPV). For banks, this process enhances their lendable capacity( this can also be beneficial in terms of liquidity) by lowering the regulatory capital requirement. Hence, this process gained increased popularity among banks and financial institutions. However, the higher probabilities of passing bad loans down the chain through financial intermediaries carries its own risk, and remains in the financial system as ‘hot potato’(Shin 2009).

The increasing risk of Collateral Debt Obligations(CDOs) is also inherent in its nature of transactions. A typical CDO generally issues four classes of securities, namely senior debt, mezzanine debt, subordinate debt and equity, where each subsequent class is supposed to protect the former class from losses from the entire portfolio. Typically, the highest rating classes(AAA/Aaa ratings) are considered to be the safest, yielding lowest yields and investors demand higher yields from high-risk assets. The relatively lower level CDO tranches( equity and mezzanine tranches) bear maximum credit risk(Gibson 2004).The equity tranches were mostly held by hedge funds, willing to take more risks for a much higher return for their investors.

This process of securitisation and pooled investment via sophisticated financial products/arrangements like CDOs, is a shift towards a ‘originate to distribute’ model of mortgage origination, where the originator could pass a mortgage loan to others ( i.e. financial intermediaries) without bearing the fear of loss in case of default( Rakhsit 2008:112).\textsuperscript{v} Such a practice cannot avoid the possibility of ‘moral hazard’ where the tendency of pooling bad loans in the portfolio increases, and the risk could not be identified till a large proportion of the
underlying collateral start to default, often reflected into a sudden abnormal increase in teaser rates. The ‘hot potatoes’or bad loans on which there are default, come back to the originator (mostly banks) which is a bitter lesson post-sub-prime crisis.

The level of complexity of financial products can be understood from a report published by a top group of bankers from large financial institutions like Lehman Brothers, Citibank of America and others that formulated the Counter-party Risk Management Policy Group (CRMPG) in August 2008:

….throughout the credit market crisis, the behavioral characteristics of several classes of structured credit instruments have accounted for a significant fraction of the write-downs and losses incurred by large integrated financial intermediaries, hedge funds, specialized financial institutions and other market participants. Moreover, there is almost universal agreement that, even with optimal disclosure in the underlying documentation, the characteristics of these instruments and the risk of loss associated with them were not fully understood by many market participants. This lack of comprehension was even more pronounced when applied to CDOs, CDOs squared,4 and related instruments, reflecting a complex array of factors, including a lack of understanding of the inherent limitations of valuation models and the risks of short-run historical data sets. As a consequence, these instruments displayed price depreciation and volatility far in excess of levels previously associated with comparably rated securities, causing both a collapse of confidence in a very broad range of structured product ratings and a collapse in liquidity for such products. (CRMPG III Report 2008:53, emphasis added)

**Essence of Regulation and Appropriate Regulatory Mechanisms for Global Finance**

Bank of England Governor Mervyn King’s comment: “While banks are global in life, they are national in death,” relates to the fact that globalisation of finance has happened ahead of globalisation of regulation.

It is increasingly felt that the *level of required sophistication in regulatory skills* falls short of the complexity of the global financial system. Consequently, the question: What should be the *ideal* structure of the financial sector to achieve the desired beneficial impact? The challenge, therefore, lies in formulating appropriate policies to reactivate financial sector activities towards development for the real sector. Considering financial malfunctioning as a global evil, the development of appropriate policy regimes and scrutiny of the financial sector has become imperative. It is a fact that the costs of financial crises are more pronounced in poor and developing countries because of fragile regulatory and supervisory institutions. The social costs of financial crises are also much higher in these countries since they lack adequate social security
nets and necessary fiscal space. Therefore, a concern appears regarding the appropriate policy regime to prevent financial/economic crisis. To quote:

At the same time, it is important to recognise that the financial sector should also be an instrument of public policy for facilitating development. Simply put, if public intervention is necessary and justified in the interest of correcting market imperfections to assure stability, there is no reason why public policy should not use regulation for development purposes. Further, if regulation is justified for containing possible asset bubbles in a free market system, there is no reason why that regulation should not be used for the creation of assets, especially more productive assets. (Volcker 2011)

A better approach might be to draw lessons from some countries that are much less affected compared to other countries/regions. Developed countries such as Australia and Canada and emerging countries like India and China have been able to avoid much of the recessionary impact compared to other countries. A control on capital account openness coupled with a prudential regulation on banking and financial sector by India and China has also enabled them protection against the macroeconomic crisis faced by a number of East Asian countries like Thailand, Malaysia and Indonesia. Moreover, developing countries have been mostly affected via their financial sector linkages with the developed countries (the repercussion effects of the Western crisis) rather than their own domestic financial/banking sector related policies.

In the early 1930s, the problem of bank run affected the US economy so severely that the Federal Deposit Insurance Corporation (FDIC) was established to provide insurance against bank deposits. The Banking Act of 1933, known as the Glass-Steagall Act introduced by former Treasury Secretary Carter Glass and Chairman of the House Banking and Currency Committee Henry B. Steagall, tried to make banks safer repositories for public money. As per the Act, commercial banks were separated from investment banks in order to protect people’s bank accounts from risky investments. The Act also created FDIC, which insures bank deposits. The nature of the crisis has become much more complex since then; it goes way beyond the issue of backing or maintaining confidence in bank deposits. The recent financial crisis (2008 onwards) has seen amplification of risky assets as a consequence of excessive leverage. This has led to default on a large scale, affecting the whole financial system, and ultimately, the global economy as a whole. The aspect of transparency and complete information in financial lending and borrowing has become more crucial in today’s context. Touching on this problem, Federal Reserve Bank of New York President William Dudley writes:
On the international side, there are many important things that need to be done. Even after this crisis, there is unbelievably inadequate information sharing across borders in terms of supervisors. Sitting in New York, we do not know very much at all about Deutsche Bank as a global bank. We can look at the U.S. piece. The Financial Services Authority can look at the London piece. Only BaFin (the Bundesbank and German Federal Financial Supervisory Authority) really looks at the whole thing, and even then we really do not have a very good idea about how these institutions look on an overall basis. (Dudley 2011:40)

The most discussed regulatory proposals in today’s financial crisis are *Dodd-Frank Wall Street Reform (or Dodd-Frank Act) and Consumer Protection Act* and the *Volcker Rule*. vi The Dodd-Frank Act has been introduced by US Senators Barney Frank and Chris Dodd and passed in its revised form through legislation in 2010. It has introduced a number of provisions while agencies such as FDIC, US Securities and Exchange Commission (SEC), Federal Reserve and the Securities Investor Protection Corporation (SIPC) have been engaged in the process of converting such provisions into implementable rules. The legislation intends to stimulate the financial stability of the United States by improving accountability and transparency in the financial system, to provide a safeguard for the American taxpayers by ending bailouts, to protect consumers from abusive financial services practices (Consumer Protection Act) etc. However, the Act has been criticised regarding its inadequate emphasis upon some important factors behind the recent financial crisis, like money market mutual funds (MMMFs).

The Volcker Rule was originally proposed by Paul Volcker to check US banks from making certain kinds of speculative investments that do not benefit their customers. The rule is often referred to as a ban on *proprietary trading* vii by commercial banks. However, a criticism levelled against it is that proprietary trading has a less significant role in the crisis compared to other factors (excessive leverage, imprudent lending, imperfect risk assessment, poor liquidity management etc.). Moreover, the revenue generated from proprietary trading helped some firms to offset losses in other areas. Critics opine that a poorly-implemented Volcker Rule could reduce liquidity in financial markets and aggravate the situation further. (Swagel 2011)

The policies (or laws like Doff-Frank Act or Volcker) may have their own drawbacks, but such attempts are inevitable. Since the global economy has been considerably crippled due to financial gambling, there must be some policy to curb the practice; drawbacks of the policies cannot be an excuse for preventing them from being implemented. Each policy has its downside, but this can
be rectified through the opinion of the public and of experts. It is crucial to identify the fundamental reasons for such crises, and action taken accordingly. A two-fold approach for reforming the international financial architecture could be adopted – (a) A specific or operational approach to address the factors responsible for the recent financial crisis (for instance, regulating derivative trading or excessive leverage), and, (b) A fundamental approach addressing basic structural problems that tend to create instability in the economy. The fundamental approach would have broader implications in reforming the international financial architecture. It requires a global accountability norm for all premier institutions including IMF, World Bank, credit rating agencies and the International Accounting Standard Boards as well as in restructuring the sovereign debt of different countries.

A relatively bold strategy might be to prohibit certain newly-invented financial products, regarding which there is lack of clarity or uncertainty regarding the impact of the products on the financial market. In the case of India, former RBI Governor Y.V. Reddy was severely criticised by a number of economists and the financial sector for regulating newer financial products.

Prior to the recent financial crisis, Mr. Y.V. Reddy was vilified by the financial sector, many economists and the financial press for strong regulations on new financial products that the critics said stifled innovation and were preventing India from entering the 21st century in financial innovation. But after the financial crisis, when India escaped some of the worst fall-out that gripped the United States, the UK and other financial centres, Mr. Reddy was widely lauded as a financial genius and hero. (Epstein and Crotty 2009:7)

In reformulating the global financial architecture, the Emerging Market Economies (EMEs) have a crucial and bigger role to play. The EMEs have shown a potential for strong economic growth and stability. (Reddy 2007:7) On the other hand, the US and some European countries have exhibited certain economic problems in recent years. For instance, the US has persistent current account and fiscal deficits. The 2008 financial crisis has its roots in the United States, from where it spilled over into a global recession. The Eurozone is facing trouble due to lack of fiscal coordination while some European countries are struggling with the currency Euro vis-à-vis their own currencies.
Exploring Some Regulatory Affairs

With the win of the Democrats in the US through Obama’s reelection, the Dodd-Frank Act is, at least supposed to prevail. The Act has been criticised on several grounds, and despite missing a number of deadlines, it is a serious effort for a complete overhaul of the present US financial structure. Implementation of certain provisions remains a challenge also due to industry lobby, whereas often it is difficult to confirm whether certain concerns (on provisions of the Act) of different industry groups are driven by legitimate concerns for clarification on rules or simply some delaying tactics (Mcgrane and Eaglesham 2012). The Dodd-Frank Swap reporting requirements (part of the title VII) confronts challenges as well, as compliance issue is becoming problematic in a given time frame complained mainly by Swap institutions. For instance, Chicago Mercantile Exchange Inc. or CME group expressed complaints through a lawsuit against the requirement of providing non-public reports of cleared swap transactions by all registered Derivatives Clearing Organisations (DCOs) to a newly established swap data repository (SDR) provision in the Act, which according to the company is already been provided directly to the Commodity Future Trading Commission (CFTC). Nevertheless, the issue of appropriate disclosure norms coupled with appropriate regulation is becoming extremely important given the repeated corporate and accounting scandals, particularly in mitigating off-balance sheet transactions. Another challenge is maintaining parity between capital requirements and implementation schedules with the Basel III, specified in the Collins Amendment (Section 171) in the Dodd-Frank Act.

In case of extreme difficulties and/or uncertainties in rating risk appetite for any particular financial product(s) or process(s) by standard credit rating agencies, the relevant financial product(s)/process(s) should be carefully reviewed before allowing in the global financial market (e.g. junk bonds or financial instruments carrying high embedded leverage). The Exchange Traded Funds (ETFs), particularly synthetic ETFs are highly risk-prone due to their opaque characteristics. Elizabeth Warren, heading the Financial Product Safety Commission (FPSC), announced that the Commission would regulate mortgages and other financial instruments in a similar manner other commissions regulate the safety of toys, drugs or airplanes. Often full disclosure by banks on their financial products and related transactions are
insufficient for borrower’s full understanding; as crucial details are delivered in complex terminology that are difficult to comprehend.

One or two Supreme credit rating agencies (preferably a public regulatory authority) may be operative in order to ensure the overall transparency in rating processes and to correct any influence of big financial institutions/clients over credit rating agencies. A potential problem for CRAs is that for big clients there is a conflict of interests between the consulting fees from clients and adverse rating. A public regulatory authority or a third party is required to ensure the existence of a mutual cooperation between clients and CRAs and to remove such conflict of interests. Such attempts are ongoing as The House 2009 bill (United States) on financial reform aims at reducing conflicts of interest as well as enforce a liability standard on the agencies. There is also an agreement by the European Council on the regulation of CRAs in the European Union (EU). There is also a need of careful scrutiny for relevant valuation models and disclosure by CRAs regarding the risk assessment models and time period of the data used to evaluate default probabilities. Instead of viewing as a panic indicator, downgrading can be treated as a signal for rectifying reasons for downgrading.

There are also hot debates regarding Financial Transactions Tax (particularly Tobin tax) as a mechanism to curb volatility in financial markets. A number of research papers made cases for and against such taxes. Whether such taxes would help in reducing the possibility of financial crises is a debatable issue. The initial idea of Tobin was to put a marginal tax rate (initially between 0.1%-0.5% which he proposed as much as 1% in a later speech) on all spot conversions of one currency into another, proportional to the size of the transactions (Tobin 1978:155). The idea was to deter speculative short-term currency trading for quick profits. To quote:

“The proposal is an internationally uniform tax on all spot conversions of one currency into another, proportional to the size of the transaction. The tax would particularly deter short-term financial round-trip excursions into another currency.” (Tobin 1978:155)

Elaborating on the functioning of such taxes, Tobin proposed the tax would be an internationally agreed uniform tax which would be administered by each government over its own jurisdiction. He also did not eliminate the possibility of some stabilising long-term transactions getting discouraged, but he emphasized upon that the main purpose of such a tax is to curb extremely
short period trading which are highly destabilising for the financial system. Such a tax on foreign exchange transactions is supposed to apply on all retail spot, swap and forward exchange of currencies. He stressed upon a globally uniform tax to avoid tax saving relocation efforts, whereas enforcement would depend on the major banks of the world and on the jurisdictions regulating such tax system( Tobin 1996). Though acknowledging the aspect of tax saving efforts via ‘off-shore tax free’ locations by currency traders, Tobin stated this fear is somewhat exaggerated given considerable costs involved in such relocations ( ibid 67). The possibility depends upon the perception of traders regarding the underlying net cost-benefit analysis of moving towards such jurisdictions. A minimal tax might not enhance the transactions costs much, hence could be a disincentive for searching for tax-free locations.

Irrespective of the role of a FTT/CTT in curbing the possibility of global financial crises, an important aspect with respect to Financial Transactions Taxes or FTT( broadly FTT comprises of securities transactions tax or STT, Currency Transactions Tax or CTT, i.e. Tobin tax, capital levy/registration tax, bank transactions tax or BTT, insurance premium tax, real estate transactions tax) is its revenue generating capacity( Matheson 2011). If some sort of FTT could generate substantial revenue then a case might be made in using such revenues (by maintaining a buffer stock through a specified percentage of total revenues realized from such sources) in bailing out banks during crisis. However, country experiences in this regard are mixed. In certain cases, revenue implications are far from satisfactory, e.g. Sweden’s turnover tax applied on fixed-income securities(including government debt and related derivatives, like interest rate futures and options).On the other hand, the stamp duty in United Kingdom remains a source of substantial revenue for the government(Campbell and Froot 1994; pp.280-292). In terms of revenue collection through STT, experiences of Hong Kong and Taiwan remain most impressive in terms of revenue during 1990-2009( almost 1-2 percent of GDP). During the same period, U.K., South Korea, Switzerland and South Africa have experienced revenue collection in the range of 0.2-0.7 percent of GDP. On the other hand, experiences of Japan, Germany, Italy and France remains relatively less impressive, they experienced 0.2 percent of GDP (Matheson 2011, p.10).However, it can be remembered that the basic objective of Tobin tax is somewhat contradictory to the revenue generating capacity via such taxes, since if speculation is curbed, some amount of trading must disappear from the financial market reducing the tax base. On the
other hand, if transaction taxes do not increase much consequent upon such taxes, the adverse impact on government revenue might be reduced. Though the importance of Tobin tax cannot be denied, the impact of such a tax in mitigating financial crises seems relatively less strong at the current juncture of the crisis that requires stricter regulation norms on lending practices of private sector banks.

**Conclusion**

To the extent economic recession happens due to normal ups and downs inherent in business cycles, it may be accepted, but global recession due to irrational financial practices (that never contribute to the real economy and only redistribute wealth within their domain) is inexcusable. Worse still, is the process of bailing out such institutions from the taxpayer’s money. Some mechanisms may be explored to create a buffer stock of reserves via collecting taxes from big multinational banks and financial institutions in boom times since bailing out such institutions during crises period through taxpayers’ money is unfair and socially inequitable. Moreover, boom times should be seen with skepticism instead of being complacent, as too much of a good thing might turn to be as bad as the recent global crisis, which Minsky termed as ‘stability breeds instability’. The regulatory affair should broaden its operational domain by going beyond the boundary of addressing certain failures, and incorporating its effort in influencing mindsets and ideas. Often, regulations face stiff opposition due to the strong political influence of vested interest groups, which prohibits enforcement and leads to a repetition of the crisis. Dealing with such deeper political aspects and implementation of regulatory mechanisms always remain a challenge. In an increasingly inter-connected global economy, some economies flourish while others find it hard to make ends meet. Instead of playing a blame game and politicising the issue, the better course would be to look for policies that address the fundamental problems of global imbalances in a cooperative manner and enforce these in letter and spirit.
References:


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i Sankhanath Bandyopadhyay is with Centre for Budget and Governance Accountability (CBGA), New Delhi.

ii Something akin to eating without knowing the digestive capacity.
Securitisation is a financial practice of pooling various types of contractual debt such as commercial mortgages, residential mortgages and credit card debt obligations and selling consolidated debt as bonds or Collateralised Mortgage Obligations (CMOs) to various investors.

Financial innovations, like ATMs are in contrast to such type of innovations, that reduces transactions costs, for instance.

This is particularly true for capital-constrained banks who also avoided resource expenditure to screen their borrowers.

Apart from these regulatory Acts, a number of recommendations have been made by several Commissions, for instance the Stiglitz or UN Commission, the Geneva report headed by Charles Goodhart, the Lord Turner report of UK etc.

Proprietary trading occurs when a firm trades stocks, bonds, currencies, commodities, their derivatives, or other financial instruments, with the firm's own money as opposed to its customers' money, so as to make a profit for itself. Regulator’s often claim that large financial institutions or banks do not maintain clarity in their non-proprietary trading and proprietary trading as proprietary trading is riskier and results in more volatile profits.