THE CRISIS AND THE BAILOUT PLAN IN US AND UK

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Abstract: *Financial markets suffered severe crisis in September 2008 which determined o lot disruption on the other markets. In the present paper I present the underlying causes that instigate it and how US and UK stepped to assist the financial industry to prevent the collapse of the financial industry and its impact of the real economy.*

Key words: *financial crisis, market, bailout plan, subprime mortgage crisis, conservatorship, equity, asset- backed securities, securitization.*

1. INTRODUCTION

Recent history has shown that every time there is a major financial crisis due to lax credit, excessive risk taking, speculation, and poor corporate governance, central banks and governments have stepped in to pick up the mess. This happened in the 1980s during the U.S. savings and loans crisis that ultimately cost tax payers about $200 billion or 4% of its GDP. The same happened in the Asian financial crisis. Since 1994 till 1996, international banks pumped $264 billion of net funds into twenty-five emerging markets, and the total outstanding foreign obligations in South East Asia stood at $736 billion. Many international banks lent to and traded excessively with local banks and corporations under the assumption that these institutions were too large and important to fail and the governments would intervene in a time of crisis. Asian governments pumped in billions to bail out banks and to set up asset management companies to purchase bad loans, all at the expense of tax payers. Studies on the cost of such bail-outs for various countries range from a high of 55% of GDP for Indonesia, to 16% of GDP for Malaysia, 34% for Thailand, 13% for the Philippines, and 24% for Japan. If losses from the present financial crisis reach $500 billion to $1 trillion, it would represent between 4% and 8% of the U.S. GDP.

This financial crisis is particularly significant because it illustrates how stress in one financial market - in this case, housing - may spread to other markets, causing losses to investors and intermediaries not directly involved in the market where the trouble originated. These events raise questions about the ability of policymakers to respond to financial crises since an increasing share of credit market activity now occurs outside the banking system, in unregulated institutions such as nonbank mortgage lenders and hedge funds financial present disruption affect a lot of other market generating a widespread crisis. The importance of financial market and the conseqences of bad choise and insuffcent reglementation is proved of the recent events

In the present paper I presented the main causes of the crisis and the two bailout plan adopted by UK and US in order to solve it.

2. THE CAUSES OF CRISIS

The global financial crisis of 2008 is a major ongoing financial crisis, the worst of its kind since the Great Depression became prominently visible in September, 2008 with the failure, merger or conservatorship of several large United States-based financial firms. The underlying causes leading to the crisis had been reported in business journals for many months before September, with commentary about the financial stability of

leading U.S. and European investment banks, insurance firms and mortgage banks consequent to the subprime moratage crisis

Subprime lending (near-prime, non-prime, or second chance lending) is a financial term that was popularized by the media during the credit crunch of 2007 and involves financial institutions providing credit to borrowers deemed "subprime" (sometimes referred to as "under-banked"). Subprime borrowers have a heightened perceived risk of default, such as those who have a history of loan delinquency or default, those with a recorded bankruptcy, or those with limited debt experience. Although there is no standardized definition, in the US subprime loans are usually classified as those where the borrower has a credit score below a particular level.

Beginning with failures of large financial institutions in the United States, it rapidly evolved into a global crisis resulting in a number of European bank failures and declines in various stock indexes, and significant reductions in the market-value of equities and commodities worldwide. The crisis has led to a liquidity problem and the deleveraging of financial institutions especially in the United States and Europe, which further accelerated the liquidity crisis. The crisis has roots in the subprime mortgage crisis and is an acute phase of the financial crisis of 2007-2008

The factors giving rise to the credit market turmoil that began in summer 2007 can be summarised in three periods.

1) Ultimate sources: Accumulation of imbalances

The years prior to 2007 were characterized by low financial market volatility and risk premia, rapid financial innovation in credit markets, low interest rates across the maturity spectrum, and ample liquidity. In this environment, banks and other investors engaged in a "search for yield" with the help of new credit products and investment vehicles. The pace of this "herding" behavior into ever more complicated forms of securitization far exceeded the market's capacity to solve a number of open valuation, risk management and incentive issues. The result was a highly complex and opaque system of credit risk distribution in which many investors were either ignorant or imprudent with regard to the risks that they had acquired.

2) Trigger events: Emerging tensions in credit markets

The main trigger of the turmoil, which brought the weaknesses mentioned above to the surface, seems to have been the US sub-prime mortgage crisis. Delinquencies on US sub-prime mortgages increased sharply during 2006 and 2007, as a result of lax lending standards and, in some cases, outright fraud coupled with declining house prices and rising interest rates. In June 2007 two Bear Stearns hedge funds investing in sub-prime assets got into severe difficulties and credit default swap premia started to increase sharply. Shortly afterwards rating agencies downgraded a large number of asset-backed securities (ABSs) and collateralized debt obligations (CDOs), and in July 2007 the prices of even AAA-rated CDO index trenches declined below par value. Also signs of weakening in US economic conditions seem to have played some role. The ensuing general reprising of risk and tensions in credit markets spread beyond the United States, even though the sub-prime segment represents only a small share of US financial markets and other countries did not have significant sub-prime mortgage segments.

3) Systemic risk: Transmission to the main money markets

The tensions in the markets for structured finance products did not, however, pose a significant threat to systemic stability until major money markets became seriously affected. In early August money market rates rose sharply across the maturity spectrum and trading dried up. A few medium-sized banks that had large direct or indirect exposures to US sub-prime mortgages or depended particularly heavily on money market funding were saved from default. A number of large and complex financial institutions have also announced heavy losses in their credit business. While the extensive and coordinated provision of central bank liquidity to money markets was successful in reducing very short-term money market rates and volatility, money market rates at one-month, three-month and longer term maturities have remained

stubbornly high. Since the events of 2007 large and complex banks have gone through several rounds of announcing credit losses. So the actual extent of exposures to the problematic instruments and the health of specific financial institutions become only gradually more known and further revelation is expected in the future.

For a detail explanation of what has been happened I can start with the house prices in some regions which grew rapidly after interest rates declined in 2001. Adjusting for inflation, real U.S. house price rose 34% during 2000-2005 (they rose 51% if not adjusted), which is more than double any five –rate in the past 30 years. In rapidly appreciating region, many borrowers refinanced their mortgages quickly, both because they could tap this new equity for other purposes and because the increased equity could improve their credit profile and allow them to borrow on better terms. As a result , mortgage products designed to been refinanced after a short period of time, such as 2/28 (an adjustable rate mortgage where the rate is fixed for the first two years, then adjusts for each of the next 28 years), "interest only" adjustable rate mortgages (ARM's) when no principal is paid off, ARMs with "teaser rates" (with an introductory interest rate that is below market rate) and option ARMs (offer homebuyers several payment options each month: interest, principal or both). Subprime borrowers were attracted to alternative mortgages to take advantage of growing equity's effect on their credit profile. Investors were attracted to alternative mortgages because they allowed larger purchases with less money down, often with little documentation. As long as house prices continued to rise, borrowers in hot markets easily refinanced their loans or sold their homes at a profit, and delinquency rate remain low. When interest rate began rising and house price appreciation slowed, many borrowers in the subprime market found it impossible to refinance on favorable terms and were unable to maintain their mortgage payment when their loan rest. At the same time, house sales fell rapidly, making it more difficult to quickly exit a troubled mortgage by selling. Trouble in housing markets thus caused uncertainty in financial markets and reduced in the liquidity of loans and securities backed by loans.

Changes in the structure of mortgage financing may have contributed to market volatility. Securitization allowed mortgage lenders to bypass traditional banks. Securitization pools mortgages or other debts and sells them to investors in the form of bonds rather than leaving loans on lenders' balance sheets. The MBS market developed in part because long-term fixed rate mortgages held in banks' portfolios place banks at significant risk if interest rates rise (in which case, the banks' interest costs could exceed their mortgage interest earnings). MBS were popular with investors and banks because it allowed both to better diversify their portfolios. But because the MBS market was growing rapidly in size and sophistication, accurate pricing of its risk was difficult and could have been distorted by the housing boom. There are several forms of MBS. The simplest are called pass-through - interest and principal payments from homeowners are collected by the lender (or a service firm) and passed through to the owner of the MBS. More complex securities are created by pooling MBS as well as mortgages, and by giving investors a menu of risk and return options. A mortgage pool may be split into parts (called tranches) to allow cautious investors to purchase safer portions and aggressive investors to purchase the riskier, high-return tranches.

Finally, mortgage cash flows may be combined with derivative instruments that link payment levels to the performance of financial variables, such as interest rates or credit conditions. These securities — combinations of traditional bonds and derivatives — are called structured products. The growth of securitization meant that more loans could be originated by nonbanks, many of which are not subject to examination by federal bank examiners and not subject to the underwriting guidance issued by federal financial regulators. One of the first signs that the slowdown in house price appreciation could have wider financial effects was the early stress on mortgage originators. Securitization facilitated specialty non-bank mortgage lenders that

operate outside the banking reserve system. Beginning in late 2006, some of these non-bank mortgage lenders suffered significant losses and their lines of credit began to dry up. As subprime delinquency and defaults continued to rise in early 2007 and than in 2008, the willingness of investors and securitizers to purchase mortgages from non-bank originators declined and lines of credit began to disappear. Subprime lending contracted severely and at least 90 lenders have gone out of business since the beginning of the year. A significant downturn in the housing market would be expected to cause economic distress among mortgage lenders, homeowners who expected to refinance, sellers, and related sectors such as construction. But it is not inevitable that even a severe disruption in housing should lead to a crisis in the broad financial market.

In the summer of 2008, however, the global credit markets suffered a “liquidity crunch” that went well beyond the mortgage market, and the relatively small subprime segment of the market where stresses were concentrated up to then. In retrospect, it appears that easy credit (caused by the “saving glut”) and underestimation of risk were not confined to the mortgage market. Spreads between risky corporate debt (such as junk bonds issued to finance takeovers) and safe obligations like U.S. Treasury securities were very low by historical standards - investors were willing to take risks without demanding correspondingly high interest rates in return. With both stocks and traditional fixed-income markets producing low yields after 2001, pension funds and other institutional investors were driven by their actuarial needs and competition to seek out higher-yielding investments, creating a market for hedge funds and other investment managers using exotic and complex securities and strategies. Long-term rates did not rise much even after the Federal Reserve began raising the federal funds (overnight) rate in 2004, implying that the market anticipated a plentiful supply of credit to continue into the future. This perception may have encouraged the overuse of leverage, or borrowed money, to boost returns. A financial market adjustment need not cause widespread disruptions. Lenders could tighten their standards, debt holders could re-price their securities to reflect an updated view of risk and take the balance-sheet losses, and reckless speculators could simply go out of business, all without interrupting the mainstream of credit flows that support the global economy. But instead of such an orderly adjustment, financial markets experienced what various observers have called a rout, a panic, a crash, a bursting bubble, or a crunch.

3. THE U.S. BAILOUT PLAN

In the context of this crisis the Treasury asked for $700 billion that it proposes to spend over the next two years to purchase what it calls “troubled assets” from financial institutions. The proposal called for the federal government to buy up to US$700 billion of illiquid mortgage-backed securities with the intent to increase the liquidity of the secondary mortgage markets and reduce potential losses encountered by financial institutions owning the securities. According to the Federal Reserve chairman, the government would pay “hold to maturity”' prices - meaning a price based on some estimate of what the asset would be worth once the crisis of confidence had passed, not on what the asset holder could get by selling it today. By doing so, they said, the government would provide troubled firms with an infusion of capital, reducing doubts about their viability and thereby restoring investor confidence.

This plan can be described as a risky investment, as opposed to an expense. The MBS within the scope of the purchase program have rights to the cash flows from the underlying mortgages. As such, the initial outflow of government funds to purchase the MBS would be offset by ongoing cash inflows represented by the monthly mortgage payments. Further, the government eventually may be able to sell the assets, though whether at a gain or loss will remain to be seen. While incremental borrowing to obtain the funds necessary to purchase the MBS may add to the United States public debt, the net effect will be considerably less as the incremental debt will

be offset to a large extent by the MBS assets.

A key challenge would be valuing the purchase price of the MBS, which is a complex exercise subject to a multitude of variables related to the housing market and the credit quality of the underlying mortgages. The ability of the government to offset the purchase price (through mortgage collections over the long-run) depends on the valuation assigned to the MBS at the time of purchase.

Under the process, the Treasury would advertise an auction, seeking to buy, for example, $1 billion of subprime mortgage loans that were originated around the same time.

In a reverse auction, the financial institution burdened with the bad loans agrees to take the lowest amount bid for the package. A bid of 50 cents on the dollar for a bundle of bad loans would beat out someone only willing to take 60 cents on the dollar. The banks get to unload their bad debt and the government holds the asset either until it reaches maturity or until the market improves enough for it to be sold.

The government would be creating a market that makes pricing easier and more uniform among institutions. That could clear up uncertainty in the market for subprime mortgages. But the clarity could bring bad news to some institutions: The writedowns they have taken could leave them with inflated prices for the bad debt on their books. It could cause some institutions to fall below the capital cushions they are required to hold against loan losses. That could produce bank failures, so many banks might be reluctant to participate

8. CONCLUSIONS

The banking and financial sector is about the only sector that has repeatedly gone through one crisis after another where the state has to come to its rescue. This is because the breakdown of a country's banking and financial system is too disastrous for a modern credit-driven economy, hence the need for constant bail outs.

The subprime mortgage defaults did not cause the financial crisis; they only acted as a trigger. While the trigger for the present financial crisis is the collapse of the housing bubble beginning with defaults in subprime mortgages, it is the financial bubble that resulted from financial innovations over the last three decades that is the fundamental cause of the present crisis.

The financial tsunami has spread out worldwide affecting banks in Europe and Asia, though the latter are still relatively contained and healthy enough to withstand the problems. While the initial negative impact on liquidity in the money market system has been alleviated through massive liquidity injection by central banks, the problem may have escalated to one of insolvency. It remains to be seen how this crisis will be played out.

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