

THE LAST FINANCIAL CRISIS. CREDIT RISK RELATED PROBLEMS

1. Introduction

In 2008, the worst financial and economic crisis in recent history put the world's economic system in danger. Ten years after the catastrophe, many studies have been conducted in order to understand what happened. The purpose of this project is to evaluate the different causes of the crisis in the U.S., to identify which were the solutions proposed at the time mainly by American institutions, and to determine whether the changes implemented during the crisis can prevent a similar meltdown in the recent future.

2. Methodology

The project relies on an exhaustive revision of different academic articles, important books on the crisis written by financial experts, Governmental Reports and Governmental data sources, and articles in relevant and trustworthy newspapers.

Throughout the study, the focus is put on the role of Mortgages and its subsequent Securitization in financial markets. The choice of these two variables has been made because they represent the straightforward relationship between financial markets and individuals.

In order to reach the conclusions, the legal and economic settings before and after the crisis have been compared.

3. Context

Before the crisis, the U.S. economy was overheated as many indicators show. For example, the Annual House Price Appreciation from 2001 until 2007 was of 10%, and the stock market indexes grew around 101% at a 15% CAGR.

Moreover, the U.S. Government contributed to the crisis by:

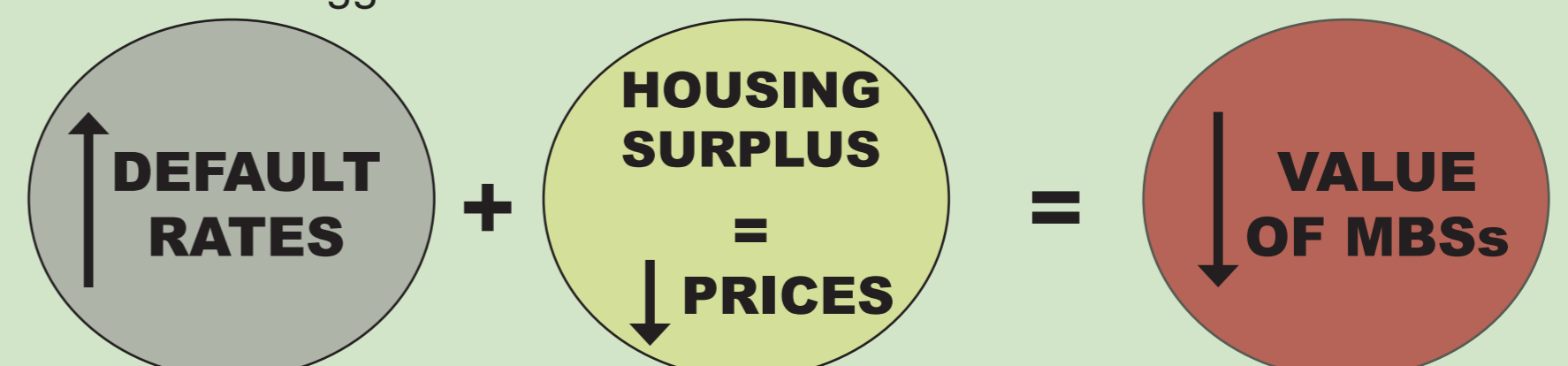
Signing the Commodity Futures Modernization Act (CFMA), which allowed the "unregulated" trade of, for example, Credit Default Swaps (CDS).

Repealing the Glass-Steagall Act, which entailed that investment and commercial banking activities could now blend together, also implied that banks engaged in risky investing activities.

Chartering Fannie Mae and Freddie Mac as government-sponsored enterprises (GSEs). There was more mortgage lending because the GSEs provided liquidity to mortgage lenders by buying them the mortgages. They later issued MBSs with those mortgages as underlying assets. Wall Street firms joined this market later.

5. The crisis

The crisis had two triggers:



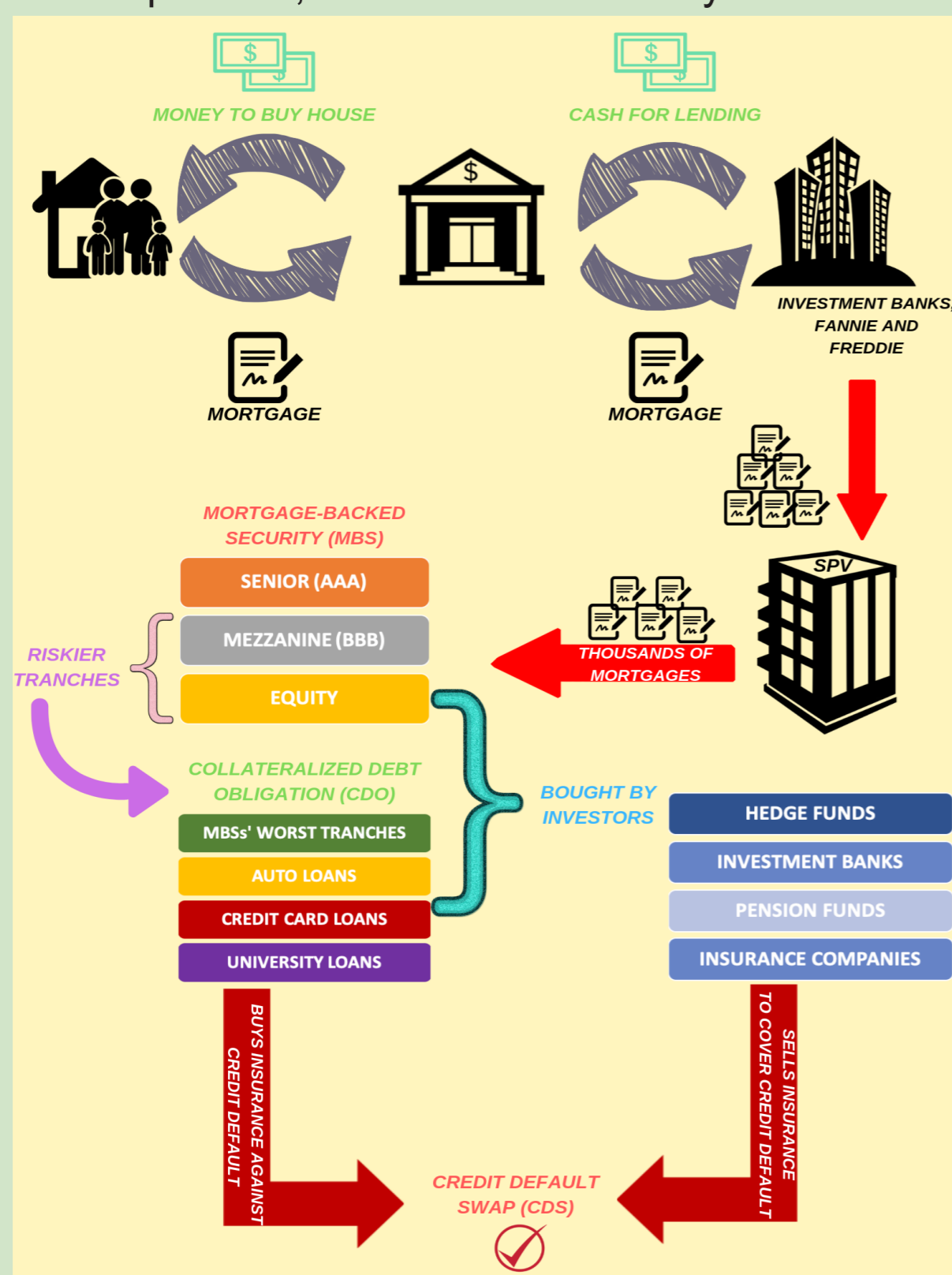
The value of the MBSs plummeted, thereby affecting many big investment banks, Fannie and Freddie, and AIG, who sold CDSs betting against MBSs and couldn't carry through the payment of all the insurances they sold. The sequence of events resulted in a credit crisis.

The government had to intervene by bailing out AIG, by putting the GSEs into conservatorship, and by creating the TARP.

4. Mortgages and Securitization

Two important causes of the financial crisis were the excessive mortgage lending, and the subsequent securitization of these mortgages.

- Excessive mortgage lending**
 - * Was the consequence of a parallel housing bubble.
 - * Mortgage lenders had incentives to write as many mortgages as they could in order to make money with fees.
 - * Lenders granted loans both without a down payment and without the sufficient documentation to people that couldn't pay them back.
- Securitization**
 - * Contributed to the bubble because financial actors bought the mortgages and issued MBSs. Therefore, they required more mortgages to securitize in order to get more profits.
 - * The securitization process, which was financially controversial, worked as follows:



Source: Own creation with Canva.

6. Solutions

The crisis required some changes in the Mortgage Industry and the Financial System:

Mortgage Industry

- Increase down payment requirements.
 - * 20% down payment.
- Tighter FICO score requirements
- Increased documentation requirements:
 - * Tax returns
 - * Pay check stubs
 - * Bank statements

Financial System

Through the Dodd-Frank Act:

- Prohibit speculative investments with customers' deposits.
- SEC and CFTC regulate derivatives.
- Higher reserve requirements for "too big to fail" companies.
- Credit rating agencies must present methodologies used.

Conclusions

The main conclusions can be summarized as follows:

- Excessive mortgage lending (including mortgages granted to less trustworthy borrowers) and the securitization were two major causes of the financial crisis.
- The bubble burst and the transmission to financial markets required the Government's intervention.
- New regulation seems to prevent a crisis from happening again because of the same reasons.
 - * Individuals must behave more rationally because requirements are tighter.
 - * Financial markets are more controlled now despite Trump's efforts to deregulate.
- Experts predict a crisis for 2020 and argue that Governments lack the resources to stop it.
- Governments and regulatory agencies should try to soften the effects of the next crisis as it is impossible to prevent it given the cyclic nature of the economy.

Key References

- Lewis, M. (2010). *The big short: Inside the doomsday machine*. New York, N.Y.: W. Norton & Company.
- Sorkin, A. R. (2009). *Too big to fail: The inside story of how Wall Street and Washington fought to save the financial system from crisis--and themselves*. New York,