Chapter 11

Case Study—US Banks and the Financial Crisis

1. a. What is leverage?

In the context of the case, leverage refers to the ratio of loans made by banks to the capital held by the bank. Capital refers to the money that banks get from their shareholders along with any profits they have retained.

b. Why did banks lobby for rules on leverage to be relaxed?

Banks have a history of lobbying for the relaxation of existing regulation and resisting new regulation. Their attitude to rules on leverage illustrates this. Banks wanted leverage rules to be relaxed to give them more freedom to increase their lending which would facilitate their ability to achieve the objectives of increased profits, growth, and bigger bonuses.

2. Explain why trading in bonds was more attractive for banks than lending to business.

It appears that banks were attracted by the short-term profits generated by trading in bonds. The securitization of mortgages and other assets was seen by the banks as easier, quicker, and less risky way (based on the judgment of ratings agencies) of raising money than giving loans to business which they saw as being riskier and taking longer to pay off.

3. What factors brought about the tipping point in the subprime bond market?

In 2007, house prices in the USA were falling, interest rates for mortgage holders were rising and, as a result, the default rate on mortgages increased rapidly. This led to a significant drop in the value of mortgage-based bonds which created panic in the sector. Financial institutions became increasingly unwilling to lend to other institutions for fear that they were in possession of large amounts of devaluing sub-prime assets. Lenders feared that loans would not be repaid and the result was a credit crunch/a shortage of liquidity in the financial system.

4. a. Explain the term contagion.

In the context of finance: contagion occurs when a financial shock in one country or region spreads to others. The possibility of such contagion increases with the degree of cross-border integration in the financial sector

b. How did the crisis spread internationally from the USA?

Cross-border integration in the financial sector had gone on apace in the run up to the financial crisis to a large extent through cross-border M&As. Non US banks, particularly from W. Europe and Japan had been involved in the USA providing sub-prime mortgages and were also active in the trading of sub-prime mortgage bonds.

c. How did the crisis spread internationally from the US?

The most endangered economies included the US and those countries whose financial institutions were most highly integrated internationally such as Japan and in W. Europe, the UK, Germany, and the Netherlands. The Icelandic and Irish economies also suffered enormously from the crisis. With their financial institutions being less integrated internationally, other countries such as the emerging economies of South East Asia suffered less.

5. Discuss the results of the subprime crisis for:

a. Banks

Some banks went bust, others were taken over, and some received massive government subsidies or were nationalized. Some banks had to undertake massive write-downs of the value of their assets.

b. Governments and central banks

Governments, both individually and collectively (see G20 video in the ORC) had to come up with emergency plans to avoid the collapse of the world financial system and the global economy e.g. agreeing to pursue policies that would promote growth and employment. Central banks pumped massive amounts of financial support into the financial system through policies of quantitative easing.

6. Andy Haldane (2015), chief economist at the Bank of England asserts that, 'The historical evolution of the financial system has been a game of cat and mouse between the state and the banking system'.
Discuss in the light of the global financial crisis.

Students could be directed to the following as aids to carrying out the task:

https://www.iif.com/publication/regulatory-report/multiple-layers-financial-regulatory-reforms-hold-back-economic-growth
https://www.euromoney.com/article/b12kj6qrkkc587/regulation-iif-fears-impact-of-regulation-on-latin-american-banks
http://newcityagenda.co.uk/wp-content/uploads/2014/11/Online-version.pdf

and the following for cultural explanations for bankers' behaviour:
https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-culture-in-banking.pdf
https://www.scientificamerican.com/article/banking-culture-encourages-dishonesty/

Students could refer here to the historical tension between banks who wish to be left free to pursue the strategies and policies which will allow them to achieve their objectives of profits and growth and governments wishing to ensure the stability and effective operation of the financial system. They could draw on attempts by financial institutions to move into other geographical areas where regulation is slack or non-existent. The discussion could also cover attempts by banks to avoid regulation by devising new financial products and financial institutions e.g. shadow banks which do not appear on their balance sheets. Attempts by banks to capture their regulators could also be included in the discussion e.g. in the run up to the financial crisis of 2007/8 when regulators failed to devise and enforce effective financial regulations.

Students may advance explanations of bankers' behaviour in the face of regulation e.g. by reference to the culture of financial institutions.

Students could also discuss how efforts by the authorities to regulate financial institutions often appear as attempts to catch up with developments, for example the increasing cross-border integration of the sector e.g. the Basel I, II, III, IV measures.

Students, in some disagreement with Haldane, might point out that in the past regulatory bodies have sometimes not seemed to be very effective cats, being too trusting of the banks e.g. before the crisis the SEC allowing US investment banks to make their own risk assessments to determine how much capital they need to hold, or the UK's light touch regulation. This may be because employees in the regulatory authorities are often drawn from the sector which they are supposed to be regulating—because they are the people with the knowledge and understanding of how financial institutions operate.