Anatomy of a crisis

Changes in financial regulation in the past decade, coupled with the loose monetary policy of former Federal Reserve Chairman Alan Greenspan, are partly to be blamed for the financial crisis that has brought the world into the brink of recession, according to INSEAD Affiliate Professor of Accounting and Dean of the MBA programme, Jake Cohen.

“The issue to some extent is a perfect storm of regulatory policy,” says Cohen.

Following the Great Depression of the 1930s, the US Congress passed the Glass-Steagall Act to separate investment and commercial banking industries. As a result some banks split up, with JPMorgan becoming a commercial bank and Morgan Stanley an investment bank.

However, the act was repealed in 1999 as banks lobbied Congress to allow them to be both commercial and investment banks again.

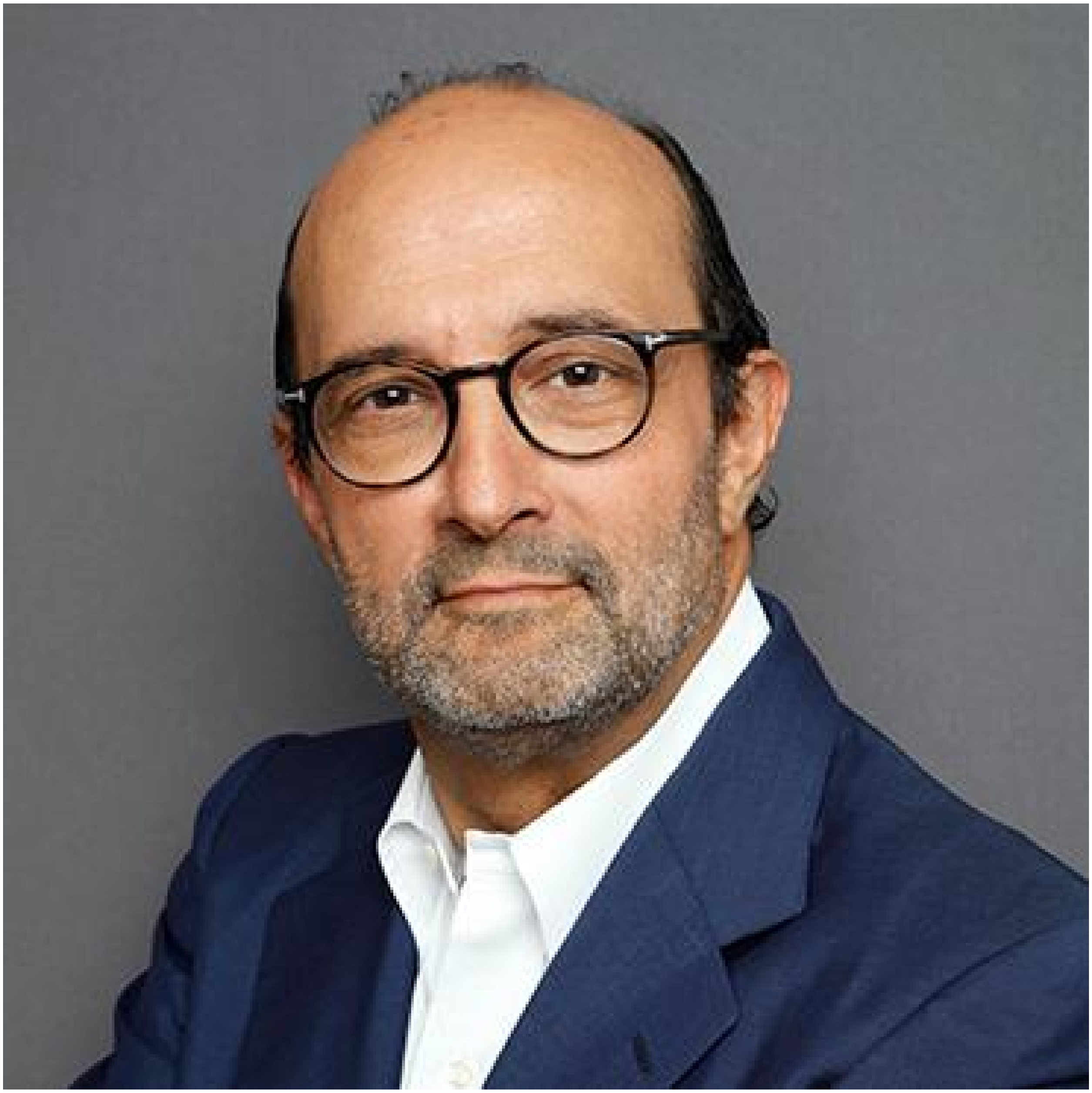
As such, Cohen says banks were able to give mortgages, securitise these mortgages and sell them as collateralised debt obligations (CDOs) to institutional investors. This allowed the banks to lend more because the sale of CDOs gave them access to a new source of funding apart from customer deposits.

Low interest rates in the 1990s along with rising housing prices spawned reckless lending practices that gave birth to subprime lending or lending to people who did not qualify for loans. The subprime borrowers bet that housing prices would continue to rise and allow them to refinance their mortgages at lower interest rates.

They were wrong.

US housing prices peaked in 2005 and have since fallen by nearly 30 per cent from their highs, according to Standard & Poor’s Case-Shiller home price indices.

Subprime borrowers were unable to refinance their loans as the value of their homes fell below the level of their outstanding mortgages, forcing many to default on their mortgage payments and triggering a collapse in the value of CDOs held by banks and institutional investors.



As banks faced mounting mortgage defaults, new accounting rules that took effect in 2007 required banks to mark-to-market their assets, including securities such as the CDOs. Valuations of these assets collapsed as investors stayed away from such risky assets, forcing banks to write-off the value of these assets and subsequently weakening their balance sheets. Banks needed to raise fresh capital to replenish their balance sheets and improve financial ratios but cautious investors were unwilling to lend capital, creating a credit crunch that is now dragging the global economy into recession.

“The crisis may well be subsequently blamed on mark-to-market accounting. It is making things worse because it came into existence at a time when subprime mortgages were already causing problems,” says Cohen.

As the crisis deepens, investors are waiting for the next bank to fail, not only in the US but also in Europe.

In recent months, Lehman Brothers went bust, the Fed had to bail out insurance giant AIG and mortgage giants Fannie Mae and Freddie Mac had to be nationalised. More American banks are in danger of failing, with Merrill Lynch bought over by Bank of America and Wells Fargo taking over Wachovia.

Troubled European banks have also emerged, including Fortis and HBOS. So far no Asian bank has failed as a result of global financial crisis but the outlook remains shaky because a recession in the US and Europe would dampen demand for Asia’s exports, which contribute significantly to the domestic economies in the region.

It remains to be seen whether the $700 billion bailout plan in the US and concerted efforts by governments around to world to ease the credit crunch and stimulate their economies will work. But one thing is clear: what began as a financial crisis is turning into an economic downturn that could last through next year.

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