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. Money Matters

A Financial disaster to remember

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Nobody would like to recall bad events, let alone make a ceremony out of any remembrance!

Yet there are exceptions.

They are solemn anniversaries, though they are never looked forward to year after year. However, they serve the purpose: strengthening our resolve to take remedial steps for ensuring such events do not re-occur.

One example: annual remembrance of atomic bombing of two Japanese cities of Hiroshima and Nagasaki on August 6 and 9 in 1945.

Perilous journey with a single step

How about series of events, though of less intensity, the first of which took place on seventh of August five years ago? On that day, a French bank terminated withdrawals from three hedge funds citing "a complete evaporation of liquidity." That was a dangerous development, as it indicated impending deterioration in the balance sheet of banks.

A year later, Bear Stearns went bankrupt, followed by the collapse of Lehman Brothers on September 20, 2008.

A ten-member Financial Crisis Inquiry Commission (FCIC), appointed by US President in 2010, observed:

“There are more than 26 million Americans who are out of work, cannot find full-time work, or have given up looking for work. About four million families have lost their homes to foreclosure and another four and a half million have slipped into the foreclosure process or are seriously behind on their mortgage payments. Nearly US$11 trillion in household wealth has vanished, with retirement accounts and life savings swept away. Businesses, large and small, have felt the sting of a deep recession”.

The contagion spread far and wide. It became global financial crisis (GFC) in 2008 and then world recession, which is now a bottomless pit.

A combination of factors

The GFC stemmed from a combination of factors. The first and foremost was increased savings from high growth emerging economies, whose investors entered capital markets in the developed countries. The "Giant Pool of Money" led to a rise in the global pool of fixed-income securities: from approximately $36 trillion in 2000 to $70 trillion by 2007.

Such immense flow of savings into USA, UK and Europe was a challenge to regulators. Lenders and borrowers went mad with generating bubbles after bubbles. Reckless lending and risky financial adventures followed. Fancy financial products emerged and they were used by financial institutions as collaterals to borrow against.

Easy credit conditions prior to 2007 encouraged lending and risky borrowing practices; trade deficits; housing and real estate bubbles; budget deficits, and measures bailing out banks all created a financial nuclear bomb. Excess supply of housing and commercial property led to burst in the real estate market.

There was a domino effect. Asset prices began to decline. Liabilities owed by financial institutions to global investors did not go down in value, generating questions regarding the repaying ability of consumers, governments and banking systems. Thus the solvency question not only of households, business houses but also of financial institutions emerged.

A disaster

It was a disaster of unprecedented proportions. Banks cut their lending as they were scrambling for liquidity. A credit crunch followed. Households, business houses and governments were no longer able to borrow and spend at pre-crisis levels. As demand declined, firms reduced investments and cut jobs.

Unemployment compounded the sufferings of households. They failed to meet their repayment obligations to financial institutions.

As documented by FCIC, five major investment banks in 2007—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with inadequate capital. Their leverage ratios were as high as 40 to 1. For every $40 in assets, there was only $1 in capital to cover losses.

Major financial institutions collapsed, deepening the credit crunch.

In its final report submitted to US President in January 2011, FCIC did not spare US Federal Reserve and policy makers.

The Report concluded: "The crisis was caused by:

- widespread failures in financial regulation, including the Federal Reserve's failure to stem the tide of toxic mortgages;
- dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk;
- an explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis;
- key policy makers ill prepared for the crisis, lacking a full understanding of the financial system they oversaw; and systemic breaches in accountability and ethics at all levels."

As we remember the first episode of the financial disaster, which happened this month five years ago, any excuse that it was inevitable and was to happen, would not be acceptable.

The FCIC observed:

"The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done. If we accept this notion, it will happen again."

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