

A brief account of the financial crisis

By Andreas Whittam Smith, First Church Estates Commissioner

The deep recession now under way differs in two respects from anything we have experienced in our lifetimes:

1. It is totally global in nature. It affects both the West and the rest of the world. I emphasise this aspect because there is a tendency in Britain to think that it is only the US and Europe that are facing difficulties. Thirty years of globalisation means that every country, from China to the tiniest African state, is caught up in it.
2. Its proximate cause is a sudden withdrawal of credit by banks that has reduced business activity. This crisis developed spontaneously and was not the result of direct action by governments to cool their economies as has often happened in the past.

The over-trading by the banks that created simultaneous bubbles in housing, in consumer credit and in the financial industry itself - driven by greed - finally collapsed under its own weight in the second half of 2007. These booms were not confined to the West. There have been unsustainable rises in residential property values all over the world - from the United States and Britain to Eastern Europe and from India to Thailand and Vietnam.

Governments unwittingly created the conditions under which unbridled speculation could race ahead. Two policy changes have proved to be highly significant. In a pattern that repeats itself in this story, they were expected at the time to bring large benefits to the world economy and have done so; their perverse consequences have arisen only recently:

- a. The first was the removal of external barriers to trade. The promotion of free trade through international agreements began soon after the end of World War II. In the 1930s, protectionism had prolonged the Great Depression. In contrast free trade benefits developed and developing countries alike. Each undertakes those activities in which it has an advantage. This expansion of free trade was a continuous process and a succession of free trade pacts was still being signed in the 1990s.
- b. The second was the lowering of internal barriers to trade, or deregulation by another name, comprising the removal, reduction, and simplification of restrictions on business and individuals. Promoted originally by Mrs. Thatcher and President Reagan from 1980 onward, a wide variety of businesses in many countries benefited including banking. The rationale was similar to that put forward to support free trade - that fewer and simpler regulations would lead to a raised level of competitiveness and thus bring higher productivity, more efficiency and lower prices overall.

The negative consequences arose as follows:

- a. As far as free trade is concerned, industrial groups in recent years have used it to move work from their own countries to less developed countries in order to cut costs. At the same time poorer countries, having signed up to free trade in the expectation that it would bring jobs, have been forced in return to deregulate their capital markets. This was the bargain. The new arrangements have precipitated a dramatic increase in capital flows. Higher output in Asian countries, in oil exporters and in other developing countries created excess savings that flowed into the financial markets of the industrialized West. Jobs have been going one way and savings the other. And it is these excess savings deployed by the banks that have created financial bubbles.
- b. Deregulation of the banks removed restrictions on what activities they could undertake. As a matter of fact, contrary to what many suppose, it didn't weaken prudential regulation as such. Prudential regulation specifies how much capital banks should hold to support a given volume of lending. The most striking aspect of banking deregulation in Britain was that building societies, mutual organisations, could transform themselves into shareholder owned banks specialising in mortgage lending as well as in providing other financial services previously forbidden to them. They did not make a success of their new freedom. Every building society that demutualised has either been taken over by a bigger bank or rescued by the Government. None has remained independent. Northern Rock and Bradford & Bingley are examples.

Meanwhile the banks had invented a business technique that improved the workings of financial markets but, like free trade and deregulation, it had a dark side. Towards the end of the 1980s banks learnt to take the individual loans they had made, each underpinned by a legal agreement between the bank and the borrower, and combine them together so that the bundle became a security that could be traded. The process is known as securitisation. It started with mortgage loans extended to homebuyers.

The banks would place these packages into specially created companies or trusts, not subject to prudential regulation, which new investors would be invited to finance in return for the interest that the underlying loan agreements provided. In this way the banks could clear their books of their old loans and then make fresh commitments, earn fresh fees and finally repeat the process all over again. The advantage was that risks were widely dispersed.

As a matter of fact, the unregulated bodies were still engaged in banking even though it was never described as such. For they borrowed short-term in order to finance longer-term business. This was shadow banking, more akin to nineteenth century practice than late twentieth century. The ratio of borrowing to capital supporting the loans was often well beyond best practice. It was legal only in the sense that ways of avoiding tax are legal until the Government closes the loophole. While it lasted the banks had found a way of escaping prudential regulation. They exploited the gap.

Ten years later, in the late 1990s, the banks devised a second method of removing risk from their books and freeing up reserves. Credit default swaps were invented. A third party would assume the risk of a debt going sour and in exchange would receive regular payments, similar to insurance premiums, from the bank concerned.

Again on first appearance credit default swaps seemed like an excellent idea. They were an additional way of cutting risk up into small pieces and spreading it widely. Banks became enthusiastic consumers of credit insurance, as did the investors buying the loans that banks were securitizing.

Once more problems appeared. The idea got about that, paradoxically, risk was nothing to worry about. It could be split up, passed on, sold off.

Rather than being placed at the centre of financial transactions, where it ought to be, risk was banished to the sidelines. It was a detail that could easily be handled. At the same time, banks became careless about the standing of the counterparties to whom they were handing off risk. The USA's biggest insurance company, AIG, had to be bailed out by American taxpayers after it had defaulted on \$14 billion worth of credit default swaps it had made to investment banks, insurance companies and scores of financial entities.

Consider then where we had got to by 2003. The excess savings of vigorous Asian economies, oil producers and other developing countries that had flowed into Western banks had pushed interest rates to very low levels.

Globalisation had removed bargaining power from workers in the West with the result that inflation was only a percentage point or two per annum. In real terms interest rates were more or less zero. For banks, in other words, money was free. Furthermore now that loans could be securitised and removed from banks' books so that they no longer needed the backing of their capital, lending activity had begun to appear costless. In addition, lending had acquired the extra virtue of appearing riskless because credit insurance would ensure that others would bear the cost of defaults. The upshot was clear. When money is free, and lending is costless and riskless, the rational lender will keep on lending until there is no one left to lend to.

To reach this Eldorado, the means were at hand. Automated credit scoring speeded up the processing of applications for loans. Trimming back on documentation brought more borrowers into the fold. A proliferation of products offering credit on easy terms was devised. Moreover it didn't seem to matter if such hastily written business wasn't always of a high quality. After all the loans were to be packaged up and sold on. In other words, the banks originating the loans would have no stake in the borrower's continued solvency. At the same time, pay levels in the financial services industry were topped up with bonus schemes that gave very high rewards to those managers who could 'shift product'. New borrowing was piled on old borrowing, risk on risk.

Whereas the sum of all financial assets - stocks, bonds, loans, mortgages and the like, which are claims on real things - used to be about equal to the total of the world's output of goods and services, by 2007 financial assets were approaching four times global output. In 1990, only 33 countries had financial assets whose value exceeded that of their respective outputs.

By 2006, this number had more than doubled to 72 countries. Brazil, Russia, India and China were among those with financial assets worth far more than their gross national products.

In the high summer of 2007, the first cracks appeared in the great edifice of credit that had gradually been built up over twenty years. The beginnings of a decline in US property prices were the cause. The most over-gearred borrowers were asked to repay their loans. They became forced sellers. This produced a triple whammy effect. As asset prices had fallen, borrowers made losses. If they couldn't fully repay their loans and went bankrupt, the banks that had financed them likewise suffered. At the same time, the values of similar assets had been put under pressure. This meant that the credit standing of fresh ranks of borrowers had been damaged. As a result a further cohort was forced to go through the same process with the same results. And then there followed another cohort and another cohort and so on.

Some 18 months since it began, this de-leveraging process is still under way and, if anything, gains in momentum. It is a doomsday machine. In my view, it explains almost everything: -

- a. Why property prices continue to fall
- b. Why any gains in stock market prices are quickly swamped by fresh selling
- c. Why the banks find there is no end to the losses that they are incurring and that they thus constantly need re-financing
- d. Why banks remain terrified and will engage in fresh lending only if the government forces them to do so or if it removes the risk.

The recession will continue until this process is over.