

"The Truth about the Global Financial Crisis"

The subprime mortgage crisis is an ongoing economic problem manifesting itself through liquidity issues, which accelerated in the United States in late 2006 and triggered a global financial crisis during 2007 and 2008. Global economic growth is expected to decelerate due largely to a sharp slowdown by the subprime crisis. The subprime cycle is unique mainly in the lack of clarity regarding the distribution of mortgage default risks, especially in the failure to recognize that even the mortgage trusts might suffer enough write offs that their own securities could be wholly or partially defaulted. The principal lesson from each of these cycles is that risk control needs to be tougher during the upswing of the cycle, just when everyone believes it to be unnecessary. If the industry cannot control risks on its own – regardless of how confusing the allocation of the risks might be – then regulators must ensure they do so.

The 2007/2008 crisis is the product of two crises, the “subprime” mortgage and credit crunch, resulting in a perfect financial storm. It is no co-incident that at the heart of the crises lay the balance sheets of the investment banking sector. Certainly, the decision making process influencing the balance sheet of the investment banking sector is at the centre of many researches and analysis by economists and professors within the central banking and university environments. The issue appears to be central to the understanding of the crisis in the investment banking sector.

At the heart of the crisis lay the decision making process influencing the balance sheet and the microeconomic behavioural theories underpinning it. The main factor is the assumption of profit maximization being key to the corporation survival and while there is certainly evident of the investment banking sector portraying profit maximization behaviour in the decisions influencing the balance sheet during an economic upturn. The trend towards fair value accounting, which has been ongoing since the late 1970's and the 1974 oil crisis, has been given a fresh impetus with the circumstances surrounding the 2007/8 banking crisis and the collapse of mortgage-linked financial derivative markets. While clearly the crisis itself is the product of a cavalier attitude to risk among senior bankers, the fear of widespread bank failures led to massive pressure being brought to bear on the accounting standards bodies, particularly the Financial Accounting Standards Board.

Capital Adequacy is the cornerstone of Basel II but despite this, some banks around the world collapsed or were brought to their knees as a result of the recent Credit Crunch. Regardless of the stringent requirements of Basel II, banks and financial services firms that were considered healthy were on the verge of collapse and even the bank failure prediction models could not foresee their impending doom. Why did adequately capitalized banks collapse? Did capital adequacy requirements contribute to the collapse? Why did bank failure prediction models fail? Were off-balance sheet derivatives the ‘hidden risks’ that destroyed the banks.

It has been often cited that the Credit Crunch was ignited by the sub-prime mortgage crises but this in itself does not explain why banks collapsed. Banks continually engage in scenario analysis to gauge the impact of global financial decisions or events. Further still, only a few

banks collapsed in the major financial centres of London and New York. Without looking at each individual bank, it would be difficult to ascertain why they withstood the impact of the Credit Crunch. However, what is clear is that bank failures were the result of combining off-balance sheet derivatives positions with out of date bank failure prediction models and derivatives that had no consistent or uniform rating methodologies. The combination of these factors, to a lesser or greater degree, and the reactions of those at the helm of these banks, was the catalyst of their collapse.