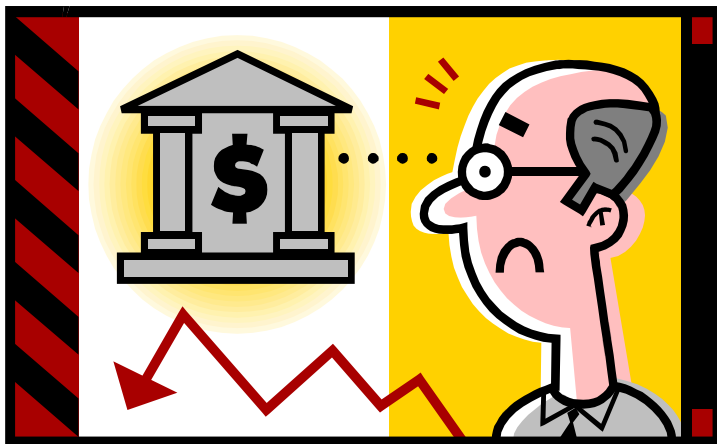


SUBPRIME CRISIS & INVESTMENT BANKING

**Could the FED low interest rate
policy be the only responsible
factor for the US financial crisis?**

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This report has been written on the basis of a research proposal.

VRS Research Team

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Could the FED low interest rate policy be the only responsible factor for the US financial crisis?

INTRODUCTION

This proposal aims to provide an overview of the more specific aims and objective of a potential research assignment that would analyze the role of the FED low interest policy in the US financial crisis.

Most of the literature written so far converges to the acceptance of the House market crisis, the Banking sector and the Derivative market's immunity as the main reasons leading to one of the most significant financial crisis in the US history. Even though most of the literature refers to the excess liquidity prevailing in the market at the beginning of the House market crisis (2006), few of them though express a certain view on the role of the FED's monetary policy and the timing of the actions taken; whereas these specific views deviate from each other. Therefore, the aim of the proposed research assignment is to analyze the role of the FED low interest rate policy on the economy. This will be conducted through the analysis of this policy's effect on the US economy in the past. In addition, similarities will also be made with the latest crisis while the views expressed in literature written so far will be also discussed. The research will also include the views of professionals on the issue as additional evidence (interviews).

Since though most of the literature names the House market crisis, the immunity of the Banking sector and the Derivatives market as the main reasons which led to the US financial crisis, an analysis of these factors will be also included in the proposed research assignment in order to provide a holistic view on the actual question about the factors causing the crisis.

The aim of this research is to examine FED's low interest policy and the role it played on the US financial crisis. In order to assess the role of the specific monetary policy on the US financial crisis, the effects of the specific policy and as this has been implemented in the past are considered. In more detail, the FED has implemented a low interest rate policy within the last two decades four times including the last one which was initiated in 2006. The effect of this policy in the past will be examined as to how it has affected the development of the US economy; whilst simulations will be also made with the latest crisis.

In order to support the views expressed, the relevant literature will be discussed while the opinions of financial professionals, having evidenced the whole issue, will be included in the report and discussed.

Since though most of the literature argues that the House market crisis, the Banking sector and the Derivatives market are the main responsible factors for the crisis, reference will be also made to these factors.

LITERATURE REVIEW

Since the appearance of the financial crisis, a lot of academics and professionals have attempted to pinpoint the reasons which led to the US financial crisis. Even though there is a low dispersion amongst the opinions expressed regarding the reasons causing the US financial crisis, few of them name the FED monetary policy as one of the factors responsible for the financial crisis, whilst the specific views are contradictory.

According to Boyd et al (2010), the financial crisis happened because of the wrong incentives that affected the behavior of financial institutions and investors. Such incentives set in motion the US government's reluctance to let large financial institutions fail. In addition, Boyed et al (2010) support that bank regulation became essentially ineffective due to the rise of "quasi-banks" (large financial intermediaries that perform banking functions but are not chartered or regulated as banks).

According to Fratianni et al (2009), the low-quality mortgages acted as an accelerant that spread through the entire financial system. This means that the financial crisis emerged from the way that the financial system was regulated. For example, the transfer of assets from the balance sheets of banks to the markets; the creation of complex and opaque assets, the failure of ratings agencies to properly assess the risk of such assets and the application of fair value accounting are examples of activities that resulted to fostering the crisis. The failure of regulators and supervisors in spotting and correcting the emerging weaknesses should be added to the above factors while the accounting data failed to reveal the full extent of the financial maelstrom.

Seneviratne (2009) argues that the more important factors responsible for the financial crisis are the House market bubble, the easy credit conditions, the sub-

prime lending and securitizations and the majority of institutions-lenders which are considered as the main responsible for the crisis.

According to the U.S. Financial Crisis Inquiry Commission (January 2011), indicative causes of the crisis are the widespread failures in financial regulation, including the Federal Reserve's failure to stem the tide of toxic mortgages; the dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk; the lack of auditing; the explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis; unprepared key policy makers for the crisis, lacking a full understanding of the financial system they oversaw; systemic breaches in accountability and ethics at all levels.

Rizov (2009) argues that fundamentals of the credit and home market suggest that the credit crisis was not caused merely by subprime lending. Rather, the credit crisis was caused by overtrading in the lending capital markets. The overtrading was caused by excess inventory; excess money supply from financial intermediaries, and historically low interest rates. Furthermore, the author alleges that the Government responded to the credit crisis by maintaining high money supply and lower interest rates in the credit markets.

Hellwing (2008) mentions the looseness of the monetary policy in the years 2002 to 2004 as responsible. According to the author the low money market rates and steep yield curves that the United States had in these years made borrowing to be very attractive and contributed to the push of US investment banks into the business of securitizing subprime mortgages. Based on the author's view, the Federal Reserve Bank should have known that this constellation was bound to make the financial system vulnerable, so that a reversal of monetary policy would be difficult to achieve without endangering financial institutions.

On the contrary though, Gokhale et al (2009) argue that FED could not be able to foresee the House market bubble and the crisis following and even if it could, it wouldn't be able to make relative decisions and take measures as multiple side-effects would have occurred to the economy.

PROPOSED METHODS

This proposed assignment intends to examine FED's low interest policy on the US financial crisis through the macroeconomic analysis and effects of the policy in the past. In addition, discussion will be also made based on the views of the previous authors on the FED low policy responsibility for the issue while the testimonies of financial professionals will be also included.

The analysis of the effect of the FED low interest rate policy on the US financial crisis can only be made through a qualitative analysis as there are no variables to be measured or examined in order to build a quantitative model.

The US monetary policy is being implemented by the Federal Reserve. This is done by influencing the conditions in the market for balances that depository institutions hold at the Federal Reserve Banks. Over time, the FED Open Market

Committee has sought to achieve a specific quantity of balances, while currently, it sets a target for the interest rate at which those balances are being traded between depository institutions, the federal funds rate. Through the conduct of open market operations, the impose of reserve requirements, permission of depository institutions to hold contractual clearing balances, and by extending credit through its discount window facility, the Federal Reserve exercises considerable control over the demand for and supply of Federal Reserve balances and the federal funds rate.

The FED throughout the past has implemented a low interest policy in order to tackle the macroeconomic issues of the US economy. In general, according to the Macroeconomic theory, a low interest policy will be implemented by a Government in order to assist to the development of an economy or its recovery if the economy is in recession. The low interest rate policy will enhance the investment and the consumption of the country, through the cheap cost of money, while the exports will be also favored through the depreciation of the country's currency value against the other currencies. The effect though of the above policy differentiates in each case as other factors may occur simultaneously. Inflation is also favored by the low interest rate policy and its effect on the economy should also be taken into account.

Ceteris paribus, after a low interest policy implemented, the country's GDP will be enhanced and the whole economy will be back on the "wagon" of healthy development. The Federal Reserve has responded to a potential slow-down of the US economy by lowering the target federal funds rate during recessions and other periods of lower growth.

- ❖ 1990-1992: the Fed had decreased the target rate from 8% to 3%. After the gradual decrease of the interest rate within the aforementioned period, the US GDP rose in 1992 (real annual change excluding the effect of the inflation) by 3.4% after posting a marginal decrease of 0.1% in 1991 (<http://www.bea.gov>, US Department of Commerce). In 1993 the US GDP rose by 2.9% y-o-y and 2.5% and 3.7% in 1994 and 1995 respectively.
- ❖ 1995 – 1998: the Fed decreased gradually the target interest rate from 6.00% to 4.75%. The US GDP increased in real terms in 1998 by 4.4% and by 4.8% and 4.1% in 1999 and 2000 respectively.
- ❖ 2000 – 2003: the FED decided to gradually reduce the target interest rate from 6.50% to 1.00%. The US real GDP rose by 3.5% in 2004 and by 3.1% in 2005.
- ❖ 2006 to Oct 2008, the FED reduced gradually the target interest rate from 5.25% to 1.00% and as of December 2008 until currently the target interest rate has been set to 0.00%-0.25%. The real US GDP decreased by 3.5% in 2009 while for 2010 it has reported an increase of 3.00%.

Therefore, the aim of this proposed research will be to fully examine the effect of the FED low interest rate policy in the aforementioned cases on the US economy as well as making any relevant simulations with the latest financial crisis.

Moreover the opinions expressed in the literature will be also discussed. The aforementioned methodology will be considered as the primary data for the analysis of the research assignment's topic.

A certain example of the views expressed in the literature which will be included in the dissertation is the opinions formulated in the Gokhale et al (2009) research. In more specific, with respect to the pre-House market crisis, the FED raised the interest rates gradually at the beginning of 2004 until 2006 from 1.00% to 5.25%. According to Gokhale et al (2009), If FED had raised the interest rates earlier and at a speed consistently faster especially during the 2003–2005 period it would have increased foreign savings flows into the United States This would have worsened the already severe global financial imbalance. In addition, according to the specific research, if FED had initiated interest-rate increases earlier, it could have directly triggered a recession by constraining aggregate spending. According to Alan Greenspan if economists had foreseen the House market bubble in real time, assuming that the technical and political tradeoffs between inflation and deflation had been resolved, the Fed would not be able to stop the House market bubble through its control of short-term interest rates. The housing bubble is attributed by Greenspan to the massive increases in saving relative to investment in developing countries such as China, and the oil-exporting countries of the Middle East. Net international capital inflows to the United States, were near zero from 1987 through the mid 1990s, and grew in the late 1990s and early 21st century. On the contrary though, Taylor suggests that the blame is with monetary excesses by the Fed arguing that the explanation of financial crises is that they are caused by excesses-frequently monetary excesses-which lead to a boom and an inevitable bust.

As it has already been mentioned in the literature review section, most of the literature conveys the latest US financial crisis to the House market crisis, the banking sector and the Derivatives market. In order to present a holistic view on the question about what caused the latest US financial crisis, it will be included in the proposed research assignment a section analyzing the aforementioned factors and their significance in the US financial crisis.

US HOUSE (HOME MARKET)

With the house market being in the core of the US financial crisis between 2007 and 2009, the analysis of the “mechanics” and the historical performance of the US home market are important for the comprehension of the deeper causes of the crisis.

At a first glance, it looks like the capacity of the home market is one of the main drivers of the US economy. This is because it has helped generate growth which was nevertheless overestimated by all interested parties, including lenders, borrowers, investors, banking institutions. The question posed is as to whether the FED could have tamed efficiently and in time the apparent bubble of the home market with its monetary policy.

The home market's low operation / supervision standards led to high home prices and an excess housing inventory in middle 2006 amid an environment of

relatively high interest rates. When the FED decided to initiate a cycle of higher rates to tackle inflation fears, the market succumbed to the tighter credit conditions. Demand for home purchases dropped substantially, home prices went further down and mortgage delinquencies soared. By that time, it was proven that the whole home market system had been “built” on weak foundations one of which was certainly the regulatory authority and supervision of the market.

In summary the factors that led to the ultimate fall of the US home market in 2007 include: a) the relation between the US home market and the FED’s interest rate policy, b) the house supply development throughout the period examined, c) the structural inefficiencies of the market, d) the concept of the adjustable rate mortgages, e) the refinancing conditions of the mortgages, f) the home-owner speculation-foreclosures syndrome, and g) the wrong incentives affecting the behavior of financial institutions.

THE US BANKING SECTOR

The banking sector is one of the factors that exaggerated the size and growth dynamics of the US home market. Although not intentionally, it played a major role in the dramatic collapse of the US house prices and led to the unprecedented surge of home foreclosures starting in 2007 and beyond.

The banking sector acted from both its traditional role as a home lender as well as its more sophisticated role as an investment banker. It helped the structuring of derivative products based on the original assets of the home market and promoted the sale of the products to investors and other financial institutions domestically and overseas.

The banking sector’s reckless approach in financing the growing US home market can be attributed to various factors. The FED’s low interest policy for a prolonged period and the emergence of too much liquidity in the system could also be blamed for their impact on the financing policy of the US banks. The central bank’s relaxed supervision and auditing procedures as well as various forms of insurance of the banking system’s money, allowed for an ever more careless refinancing of the home market.

The poor supervision and the moral hazard issue led to “relaxed” lending / borrowing practices which along with the strong loan incentives formed a high-risk mortgage (loan) market. This was not only fostered via the officially regulated banks but also the so called “quasi banks” (unofficial entities operating as intermediaries / loan originators between the banking system and the borrowers). In this high-risk market, banks had to be compensated by relatively higher rates (ARM), with the result of increasing the impact of interest rate changes on the home market’s functioning and overall performance.

THE DERIVATIVES MARKET AND THE SUBPRIME CRISIS

The formation of the high risk mortgage / loan market offering higher rates to lenders appeared as a first-class opportunity for financial innovation. Wall Street

entered the game and US investment banks began structuring new products that could be passed to domestic and international investors who were in search of higher yields. The securitization of mortgage loans led to the formation of the high risk / high return mortgage backed securities (MBS). Moreover, it led to other related derivative products which were instantly offered in the market after being granted with attractive ratings by the US credit agencies.

The market appeared to assume that these products were not as risky as they should be accounted for. Demand grew rapidly and there was a constant downward pressure on underwriting standards for mortgage loans in order to maintain the supply of these “attractive” investments. The structure of those derivative products was in any case complicated thus making it difficult for investors to contemplate the actual underlying risks. According to Gorton and Metrick (2009) “...70% of subprime originations in 2005 and 2006 were securitized into Residential Mortgage Backed Securities (RMBS). That typically involved pooling several individual mortgages, selling them to a special purpose vehicle, which in turn financed those mortgage holdings by issuing different tranches of bonds with credit ratings ranging from AAA to BBB and selling them to investors...”

When the home market collapsed and loan repayments by the original borrowers could not be made, these structured products lost all their value. This eliminated the value of investors’ bond portfolio and in some cases left underwriters, major US investment banks, with huge in value tranches of such products unallocated and without being able to sell them. The existence of the derivatives market based on the US home assets was definitely the factor that led to the unavoidable collapse or bail out of major US banks.

REFLECTIONS AND CONCLUSIONS

The analysis of a factor's responsibility for an event on an ex-post basis always carries a high degree of uncertainty as the occurrence of the events and the decisions made each time can change the flow of the history.

As most of the literature does not mention the FED monetary policy as a possible reason leading to the US financial crisis, whilst the reports referring to its role in the recent financial crisis are contradictory, any conclusions drawn will be open to further discussion.

The economy of a country is been affected by several factors and any macroeconomic policies applied could not always lead to the projected outcome as numerous factors are being affected simultaneously. In addition the conditions prevailing each time in the economy can vary from time to time.

As simulations will be included in the proposed research between the effects of the policy implemented in the past and that on the latest financial crisis, it should be kept in mind that the effect the globalization and its evolution through the year can play a significant role which can't be easily measured. The above argument is been mentioned in the sense that a certain macroeconomic measure implemented in an economy could have a stronger or weaker effect than anticipated due to the interaction of the global markets amongst them.

In the proposed research could be also included interviews taken by financial professionals. These interviews could include their personal opinion which might be subjective to certain points. Last but not least, as this proposed research will only involve a qualitative approach regarding the role of the FED low interest rate policy on the US financial crisis there won't be provided any numerical evidence or proof to support the outcomes and conclusions made. The researcher will support though any conclusions made well-documented.

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