The Global Financial Crisis
A globalisation case study

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The Global Financial Crisis

A Globalisation Case Study
The crisis explained - the Complicated Version

1. Global Imbalances

2. It’s the Government’s fault
   a. Too little regulation and oversight
   b. Encouragement for mortgages for the disadvantaged
   c. Interest rates too low for too long

3. Short term debt problem

4. Human Frailty
   a. The Gordon Gekko thesis
   b. Incompetence
   c. Complexity

5. ‘The-efficient-markets-hypothesis-was-wrong’ realisation
The crisis explained - the simple version
The “good” old days (?)

These institutions were seen as stores of capital and essentially operated locally.

If they made bad loans the individual bank went under - that led to deposit insurance post-depression of the ‘30s

Capital was therefore highly restricted, leading to the role of investment banks, and a prominent role for governments in the economy.
Solution Number 1 - More Capital

Savings from depositors + Capital from other sources

- 1970s - Petrodollars
- 1980s - LBOs / MBOs / Restructures
- 1990s – Private Equity / VCs, etc.
- 2000s - China, New Petrodollars, Hedge Funds

Bank

Loans to borrowers
Solution Number 1 still needs to unblock the pipeline?

Savings from depositors  +  Capital from other sources

Out = $100,000

Return = $707 pm for 25 yrs
or $8,500 pa for 25 yrs
(At an interest rate of approx 7%pa)

or total of $212,000

Loans to borrowers
Enter the Hero

Asset = $705 pm for 25yrs
With 1,000 loans = $705K pm
But this takes $100m in capital from the bank

Securitisation of loans
Then sold to investors as low risk bonds

an Investor could pay as much as $103m for these monthly flows if they are low risk

Master of the Universe
The Hero sells new products to:

- Retail Investors
- City Councils
- Businesses
- Banks
- Moody’s / S&P
A good idea gets copied ... and sold globally

Mortgage Originator
Securitization becomes the norm

Percent US Mortgages which were securitized 97-06

Source: Amit Seru, Univ Chicago lecture, 4/11/08
Eventually a good idea goes…
As sub-prime mortgage holders begin to default, investors the world over realise that they had ‘worthless’ assets not the AAA they thought…
...and no one is really sure exactly what they have inside their bonds

AAA Mortgage Bond

AAA   AAA  AAA  AAA
AAA   AAA  AAA  AAA
AAA   AAA  AAA  AAA
AAA   AAA  AAA  AAA
AA    AA   AA   AA
AA    AA   AA   AA
AA    AA   AA   AA
A     A    A    A
C     C    A    A
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Global Imbalances

IMBALANCE
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Short Term Debt

[Graph showing yield curves for different terms and countries, with notes for UK Gilts and US Treasuries, dated November 17, 2003, and April 23, 2007.]
Human Frailty - The “Gordon Gecko” thesis

Number of loans securitized at each FICO score

Source: Amit Seru, Univ Chicago lecture, 4/11/08
Human Frailty - Incompetence

• Benmelch & Dlugosz (2008) looked at CDO ratings by S&P
  – A portfolio of B+ average ratings gets 70% AAA rated tranches
  – Can only explain the ratings given by implausibly low default correlations AND very high recovery rates once defaulted

• UBS: If investors buy 2% coverage of Super Senior sub-prime CDO, makes it risk free
Human Frailty - Complexity

Percent US Mortgages which were securitized 97-06

Do you need more evidence?
‘The-efficient-markets-hypothesis-was-wrong’ realisation

“At the time the Wallis committee was deliberating [1980s], this was the high point of what ‘s known as ‘efficient markets theory’, a theory in financial economics that markets are possessed of all the information they need to make rational and efficient decisions…we built a regulatory framework based upon [that]”

Ian Harper, Fair Pay Commissioner, former Wallis Committee member

“Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity (myself especially) are in a state of shocked disbelief”

Alan Greenspan, former US Federal Reserve Chairman
What does this mean for you?

1. Don’t become a Banker

2. Do become a banker

3. Speak up for change!
The crisis explained