The crisis jeopardizes the expansion cycle of the international financial market

By Ernani Torres Teixeira Filho and Gilberto Rodrigues Borça Junior
Deputy Manager Director and economist in APE

The international financial crisis is about to celebrate its third anniversary.

Some believe it began in April 2007, due to the bankruptcy of the New Century Financial Corporation – the US’ second largest subprime mortgage creditor. Others would say that it was in August of the same year, when the French bank BNP-Paribas decided to suspend the redemption of some of its mortgage funds. Regardless of the month when it started, the crisis has, in fact, grown increasingly worse since then.

At first, the financial turbulence was seen as a passing phenomenon, with low impact. Ben Bernanke, the Federal Reserve president, even declared it to be an issue specific to housing subprime segment, with limited impact, and not important to the rest of the economy nor to the financial system. Since then, the US bank system – the core of the international financial system – has been heavily affected and had to be rescued by successive

The market price of financial entities lowered from US$ 1.4 trn in January 2007 to US$ 400 bn in April 2009
government financial support programs to avoid bankruptcy across the board. However, this failed to save large US investment banks, such as Bear Stearns and the Lehman Brothers. The losses accrued by the US banks are considerably high. Between January 2007 and April 2009, the market price of these entities was lowered from US$ 1.400 trillion to a little over US$ 400 billion, an amount close to the value of government support awarded to these entities.

In this context, this issue of Brazilian Insights aims at outlining a synopsis of the current financial crisis, revealing its sources, the main determining factors and its likely development for the near future.

**The golden cycle of financial expansion**

As of the early 80s, limitations to short-term capital flows, included in the international treaties and local legislations, were gradually eliminated. The mobility of financial

over the last years are jeopardized. The collaterals and pricing mechanisms for private assets must be reconstructed.

Measures taken since September 2008 are, after six months, proving their ability to contain the credit downturn. However, the return to a new cycle of financial expansion, such as that which occurred between 1982 and 2008, must be kept in check by norms, institutions and regulations other than those in effect up to now. Expectations suggest a new system which will operate with less impulse, mostly bank-oriented, with more regulated entities and strong participation of the State, whether it is direct or indirectly. This transition, however, will not be fast nor without its share of pain.

In the United States, while the FED enlarged its balance sheet by about US$ 1 trillion from September 2008, US banks, as illustrated in Chart 3, raised their deposits to the monetary authority by US$ 800 billion.

**Conclusions and expectations**

Despite all the efforts undertaken by the governments in developed and emerging countries, the banking system has been slow in recovering credit. As discussed in this article, the current phase of the financial crisis represents the end of a long cycle of credit expansion, as the institutions and agreements supporting the swift expansion of the international financial system in the central banks. For example, the collaterals and pricing mechanisms for private assets must be reconstructed.
To this effect, reforms had to be implemented with basis on three fundamental issues: i) deregulation; ii) reduction of the role of banks in banking intermediation and; iii) internationalization of financial markets. Thus, national laws and norms preventing the international activities of financial institutions, and enabling governments to limit the inflow and outflow of short-term capital, as well as foreign investments in the financial sector, were revoked. This was also the end of the limitations establishing a strict separation between the activities of banks and the capital markets, and between short-term and long-term activities.

Out of these reforms emerged a globally unified financial system, in which banks are still important actors, but with a whole new role. Instead of collecting resources from the general public and offering credit for longer terms, they became a mean of creating “structured finance credit”, connecting borrowers and final investors. Their responsibility for providing operations is now restricted to the short period of time between the beginning of a certain business (e.g., a mortgage) and the later transfer of those credits from securitizing structures (e.g., investment funds) to capital market investors. This is a new business model in the bank sector, known as “Origination and Distribution”.

The credit securitization process was also accompanied by the outsourcing of other activities that had been characteristic to banking activities until then: risk analysis of operations and raising funds from investors. Risk is now assessed by private classifying companies that, by principle, should not be involved in such operations. As the capitals market was the final destination of structured credit, the banks that organized operations had only to attain an adequate risk grade from rating entities to reach qualified investors, such as pension funds. Fundraising, even in the intermediary financing activities, were also transferred to other specific institutions, such as investment funds, and the money market funds1, in particular.

According to the foregoing, the only assets which were – and still are – considered “correctly” priced are government debts. Therefore, a desperate flight to public assets was sparked, with the severe depreciation of private assets. The government’s first reaction, especially that of the central banks, to enlarge its balances and deal with the excessive demand for public assets contributed to the stabilization of markets which has been visible since early 2009. The prolific offer of liquidity from the monetary authorities managed to prevent an across-the-board bankruptcy of the banking system. However, it is not an instrument that, by itself, is able to force banks to expand the credit offer, and at favorable rates, again. Thus, the first reaction from the banking sector, in both the US and Europe, was to leave the liquidity deposited in the US Banks Excessive Liquidity (US$ billion)

Source: Federal Reserve

1 The money market funds are a type of short-term investment fund in the US, required by law to invest in low-risk securities and, therefore, paying returns close to the short-term interest rates. These funds are usually invested in public bonds, certificates of deposit, and companies’ commercial paper or in other high-liquidity and low-risk securities.
context, sure that the placement of structured operations would meet the minimum requirements of the “best market practices”.

Banks’ earnings then basically came from the rates charged throughout the set-up and structuring of operations, rather than over the credit offered during the set-up period. High profitability offered to investors, on the other hand, rose from the banks’ capacity to retain and leverage value on assets, as the average margins practiced in financial business became increasingly lower.

The outcome of this process is illustrated in Chart 2. Between 1982 and 2009, US Private Domestic Credit ranged from 123% of the US’ GDP to almost 300%, a shift close to 180 percentage points. This entire growth is mostly due to the rise in demand in non-banking financial institutions, i.e., almost all of it is earmarked to support the securitization process. With this credit expansion, non-banking institutions, such as the investment funds, were able to leverage their portfolios up to 60 times higher than their own capital.

**The asset deflation process and the Central Banks’ reaction**

After the subprime crisis (refer to Brazilian Insights Nº. 44 and Nº. 50), US real estate depreciated for the first time in almost a decade. Between June 2006 (peak) and early 2009, the reduction was, on average, 40%.

From the second half of 2008, the deflation process spread to other assets. The first affected were stock exchanges, owing to the negative results of financial institutions. Next were commodities. They suffered a price drop as from July, after being subject to huge speculation during the first half of 2008. According to the Development Bank of Asia, asset deflation, since the peak moments, has generated accrued losses in the amount of US$ 50 trillion, about 3 times the US Gross Domestic Product in 2008.

Asset deflation was intensified by the panic following the Lehman Brothers bankruptcy in September 2008. The US government’s decision resulted in high losses in short-term investment funds, particularly in the money market funds, accelerating the flight of capital to public assets for protection.

This event was the culmination of a general assessment of how solid guarantees & collaterals and the agreements that had provided support for the securitization process for over two decades really were. Investors realized that, among others:

a) the assessments made by rating entities were based on fragile stochastic models, not resistant to conditions of general loss;

b) the split of investment funds shares into tranches with different risk-return (tranching) failed to reflect the real risk of operations;

c) credit insurers – such as AIG and others – were not capable of meeting the volume of default to come; and

d) off-balance mechanisms for credit – such as the Structured Investment Vehicles (SIV)? – failed

---

2 SIVs are a type of investment fund in the US aimed at benefiting from the differences between the rates charged in short-term fundraising and that paid for securitized financial products, such as asset-backed securities (ABS). These funds issue short-term commercial papers continuously renewed and buy papers with longer maturity dates, which have, thus, less liquidity, but pay higher rates.

---

Source: Bloomberg
context, sure that the placement of structured operations would meet the minimum requirements of the “best market practices”. Banks’ earnings then basically came from the rates charged throughout the set-up and structuring of operations, rather than over the credit offered during the set-up period. High profitability offered to investors, on the other hand, rose from the banks’ capacity to retain and leverage value on assets, as the average margins practiced in financial business became increasingly lower.

The outcome of this process is illustrated in Chart 2. Between 1982 and 2009, US Private Domestic Credit ranged from 123% of the US’ GDP to almost 300%, a shift close to 180 percentage points. This entire growth is mostly due to the rise in demand in non-banking financial institutions, i.e., almost all of it is earmarked to support the securitization process. With this credit expansion, non-banking institutions, such as the investment funds, were able to leverage their portfolios up to 60 times higher than their own capital.

Source: Bloomberg

Asset deflation has generated accrued losses up to US$ 50 tn, about 3 times the US GDP in 2008

After the subprime crisis (refer to Brazilian Insights Nº. 44 and Nº. 50), US real estate depreciated for the first time in almost a decade. Between June 2006 (peak) and early 2009, the reduction was, on average, 40%. From the second half of 2008, the deflation process spread to other assets. The first affected were stock exchanges, owing to the negative results of financial institutions. Next were commodities. They suffered a price drop as from July, after being subject to huge speculation during the first half of 2008. According to the Development Bank of Asia, asset deflation, since the peak moments, has generated accrued losses in the amount of US$ 50 trillion, about 3 times the US Gross Domestic Product in 2008.

Asset deflation was intensified by the panic following the Lehman Brothers bankruptcy in September 2008. The US government’s decision resulted in high losses in short-term investment funds, particularly in the money market funds, accelerating the flight of capital to public assets for protection.

This event was the culmination of a general assessment of how solid guarantees & collaterals and the agreements that had provided support for the securitization process for over two decades really were. Investors realized that, among others:

a) the assessments made by rating entities were based on fragile stochastic models, not resistant to conditions of general loss; b) the split of investment funds shares into tranches with different risk-return (tranching) failed to reflect the real risk of operations; c) credit insurers – such as AIG and others – were not capable of meeting the volume of default to come; and d) off-balance mechanisms for credit – such as the Structured Investment Vehicles (SIV) – failed

2 SIVs are a type of investment fund in the US aimed at benefiting from the differences between the rates charged in short-term fundraising and that paid for securitized financial products, such as asset-backed securities (ABS). These funds issue short-term commercial papers continuously renewed and buy papers with longer maturity dates, which have, thus, less liquidity, but pay higher rates.
capital then became not only legally permitted, but also encouraged. To this effect, reforms had to be implemented with basis on three fundamental issues: i) deregulation; ii) reduction of the role of banks in banking intermediation and; iii) internationalization of financial markets. Thus, national laws and norms preventing the international activities of financial institutions, and enabling governments to limit the inflow and outflow of short-term capital, as well as foreign investments in the financial sector, were revoked. This was also the end of the limitations establishing a strict separation between the activities of banks and the capital markets, and between short-term and long-term activities. Out of these reforms emerged a globally unified financial system, in which banks are still important actors, but with a whole new role. Instead of collecting resources from the general public and offering credit for longer terms, they became a mean of creating “structured finance credit”, connecting borrowers and final investors. Their responsibility for providing operations is now restricted to the short period of time between the beginning of a certain business (e.g., a mortgage) and the later transfer of those credits from securitizing structures (e.g., investment funds) to capital market investors. This is a new business model in the bank sector, known as “Origination and Distribution”.

The credit securitization process was also accompanied by the outsourcing of other activities that had been characteristic to banking activities until then: risk analysis and raising funds from investors. Risk is now assessed by private classifying companies that, by principle, should not be involved in such operations. As the capitals market was the final destination of structured credit, the banks that organized operations had only to attain an adequate risk grade from rating entities to reach qualified investors, such as pension funds. Fundraising, even in the intermediary financing activities, were also transferred to other specific institutions, such as investment funds, and the money market funds. The banks as organizers, by means of the interbank markets, were, in that

---

1 The money market funds are a type of short-term investment fund in the US, required by law to invest in low-risk securities and, therefore, paying returns close to the short-term interest rates. These funds are usually invested in public bonds, certificates of deposit, and companies’ commercial paper or in other high-liquidity and low-risk securities.
government financial support programs to avoid bankruptcy across the board. However, this failed to save large US investment banks, such as Bear Stearns and the Lehman Brothers.

The losses accrued by the US banks are considerably high. Between January 2007 and April 2009, the market price of these entities was lowered from US$ 1.400 trillion to a little over US$ 400 billion, an amount close to the value of government support awarded to these entities.

In this context, this issue of Brazilian Insights aims at outlining a synopsis of the current financial crisis, revealing its sources, the main determining factors and its likely development for the near future.

**The golden cycle of financial expansion**

As of the early 80s, limitations to short-term capital flows, included in the international treaties and local legislations, were gradually eliminated. The mobility of financial

In the central banks. For example, in the United States, while the FED enlarged its balance sheet by about US$ 1 trillion from September 2008, US banks, as illustrated in Chart 3, raised their deposits to the monetary authority by US$ 800 billion.

**Conclusions and expectations**

Despite all the efforts undertaken by the governments in developed and emerging countries, the banking system has been slow in recovering credit. As discussed in this article, the current phase of the financial crisis represents the end of a long cycle of credit expansion, as the institutions and agreements supporting the swift expansion of the international financial system over the last years are jeopardized. The collaterals and pricing mechanisms for private assets must be reconstructed.

Measures taken since September 2008 are, after six months, proving their ability to contain the credit downturn. However, the return to a new cycle of financial expansion, such as that which occurred between 1982 and 2008, must be kept in check by norms, institutions and regulations other than those in effect up to now. Expectations suggest a new system which will operate with less impulse, mostly bank-oriented, with more regulated entities and strong participation of the State, whether it is direct or indirectly. This transition, however, will not be fast nor without its share of pain.
The crisis jeopardizes the expansion cycle of the international financial market

By Ernani Torres Teixeira Filho and Gilberto Rodrigues Borça Junior

Deputy Manager Director and economist in APE

The international financial crisis is about to celebrate its third anniversary. The market price of financial entities lowered from US$ 1.4 trn in January 2007 to US$ 400 bn in April 2009.

Some believe it began in April 2007, due to the bankruptcy of the New Century Financial Corporation – the US’ second largest subprime mortgage creditor. Others would say that it was in August of the same year, when the French bank BNP-Paribas decided to suspend the redemption of some of its mortgage funds. Regardless of the month when it started, the crisis has, in fact, grown increasingly worse since then.

At first, the financial turbulence was seen as a passing phenomenon, with low impact. Ben Bernanke, the Federal Reserve president, even declared it to be an issue specific to housing subprime segment, with limited impact, and not important to the rest of the economy nor to the financial system. Since then, the US bank system – the core of the international financial system – has been heavily affected and had to be rescued by successive...