Causes and Consequences of the Wall Street Crisis

The Wall Street market crisis has been building for some time. It is essentially a <u>credit crisis</u>. It's roots are deep but connected to the real estate bubble. The bubble burst in mid 2006 and the fall-out has been the "subprime" mortgage lending crisis. This resource is an attempt to take a closer look at the causes and connections between the following:

- ☑ Credit Crisis
- ☑ Mortgage Crisis – "Subprime Mortgages"
- ☑ Deregulation and/or Lax Regulation
- ☑ Investment Bank Failures
- ☑ Commercial Bank Failures
- ☑ Changing role of Government
- ☑ Economic Market Ideologies

Bail out: A situation in which a business, individual or government offers money to a failing business in order to prevent the consequences that arise from a business's downfall. Bailouts can take the form of loans, bonds, stocks or cash. They may or may not require reimbursement.

I. The Big Picture – The Wall Street Bailout: The Credit Crisis

Crisis Consensus: "Historic," "Watershed," "Extraordinary"
Consensus on the current situation falls into one of two categories:

- This is the biggest thing that has happened to the U.S. Financial System…
    1. Since the Great Depression.
    2. Ever.

The 700 Billion Dollar Questions:

- How much are the failed mortgage securities at the heart of this crisis worth? (No one knows yet.)
- Will this solve the underlying problem and root causes? (No, but it may stop it from spreading or getting worse.)

Effects of the Bailout:

- it is an implicit acknowledgment of the failure of economic models and the unregulated free market
- it will fundamentally reorder the economy
- it will significantly change relationships between the private sector (businesses) and the government.
- it will create an entirely new economic model for financial institutions
- it will give unprecedented power to the executive branch of the government and the treasury secretary particularly.

Dangers of the Bailout Deal:

- Some experts warn that Secretary of the Treasury, Henry Paulson, is seeking too much unregulated cash and power in his effort to stabilize the economy and buy up bad mortgage-backed securities.
- Should the bailout go through, it will mark the largest transfer of power from congress to the administration – more so than the Patriot Act, more so than the War Powers Act.
- The Government's massive new financial commitments will severely restrict the next president on several fronts: meeting voter expectations relative to the economy, determinations about government spending choices on things like health care, Medicare and social security, and on his ability to cut taxes.
- The dynamics of the bailout move the country closer to a socialist economy
- Anger and opposition of American citizens towards using taxpayer money to bail out Wall Street banks will have ripple effects in Congress and on corporate America.

Dangers of the Bailout Deal (cont'd)

- Further erosion of trust in the president and politicians will continue to undermine the flourishing of our democracy. The credibility gap widens.
- The implications for the rest of the world require us to ask larger questions than just domestic considerations. It is one global trading system and solutions need to keep this in focus.
- As a result of the recent government rescues and fire sales, three of the largest commercial banks are now even larger: Citigroup, JPMorgan Chase and Bank of America. Now that there are no surviving investment banks, the three commercial banks are also becoming too large to allow to fail. What now?

Alternatives to the 700 Billion Dollar Bailout?

In the face of fear and panic, seemingly too little attention has been paid to the exploration of real alternatives. The bailout seeks to rescue the financial institutions that caused the crisis to begin with. Other alternatives exist. Here are three:

1. Begin from the bottom-up rather than the top down. Use the 700 Billion to pay off the delinquent mortgages and address the underlying causes. Re-frame the debate as a foreclosure crisis *first* that has led to a credit crisis. (See Washington Post 10/1/08 "The Trickle-Up Bailout")
2. Enact bankruptcy reform to help Americans write down the value of the mortgage on their overvalued home and avoid foreclosure. (See "Here's a Better Bailout Plan, by Joseph Stiglitz, at TheNation.com. Posted 10/1/08)
3. Enact stronger regulations for loan origination, securitization, and pricing structures to restore market confidence. Extend FDIC guarantee thresholds to protect depositors. Provide tighter regulation of the market.

What was the immediate cause of this Bailout?

In a nut shell:

- A real estate bubble and lax regulations lead to high risk mortgage loans being written without sufficient collateral.
- Financial institutions got into trouble by taking big risks on investments backed by these mortgages.
- As homeowners with Adjustable Rate Mortgages (ARMs) were faced with rising loan payments, defaults and foreclosures increased and assets were written down.
- Several large financial institutions failed to have enough assets on hand or access to credit to conduct their business. The U.S. Government stepped in to rescue some but not all.
- When the failures continued, the Government chose not to come to the rescue of Lehman Brothers. The market reacted violently.
- The credit market froze, [mutual funds, hedge funds, commercial paper, borrowing and lending]
- Business activity came to a grinding halt.
- Panic ensued.

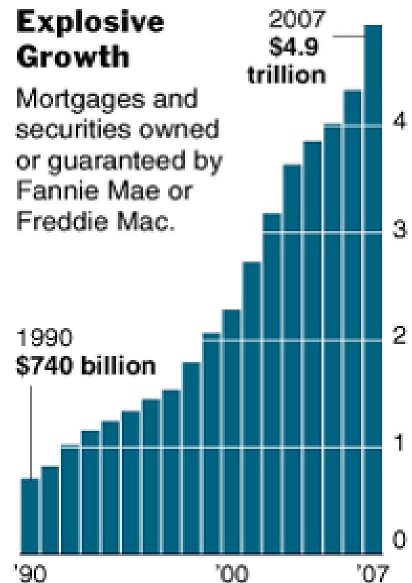
Adjustable Rate Mortgage (ARM): a type of mortgage loan where the interest rate changes periodically, usually in relation to an index. Loan payments may go up or down accordingly. You get a lower initial rate with an ARM in exchange for assuming more risk over the long run.

If the interest rate goes up, homeowners can be faced with mortgage payments beyond their means to pay.

Background

Causes:

- Market deregulation in the 80's and 90's led to weakened oversight and greater risk-taking.
- Low interest rates fueled a new home building boom and encouraged existing home owners to refinance with adjustable rate mortgages (ARMs)
- The looser lending practices led banks to approve new high risk loans that were not worth the collateral behind them.
- Banks took a risk in making the loans in order to reap the origination fees. They would sell off the risky loans as "mortgage-backed securities," but rake in the fees as profit.
    - Mortgages were approved on shaky grounds.
    - Higher interest rates were charged to risky clients with weak or poor credit ratings.
    - High risk mortgages were packaged together in bundles and sold as investment instruments.
- Investment houses and banks saw an opportunity to generate revenue and profits with these investment instruments.
- Corporate salaries and high flying profits lead to more greed, greater risk-taking and less attention to safeguarding assets.
- As the economy weakened and interest rates climbed defaults on subprime mortgage loans increased.
- The real estate boom was followed by a massive decline in home values after the bubble burst in mid-2006 and revealed that the loans made on inflated housing values were not collectable.
- Many of the underlying mortgage loans were proven rotten. Collateral was insufficient. Foreclosures mounted.
- During this same period, there was a noticeable rise in consumer debt. Most Americans are heavily indebted beyond their earnings. During periods of low interest rates, many homeowners borrowed against the values of their homes and became further indebted.
- In May 2008 the government reported that the current U.S. Savings rate is at one of its lowest points in history, leaving no cushion to fall back on in bad economic times.
- As investments backed by mortgages became less reliable, credit ratings dropped and the market began to react. Institutions with too many of these investment instruments could not meet their profit margins. Share prices fell. Credit got tighter.



LIBOR : The London Inter-Bank Offer Rate. The interest rate that the banks charge each other for loans.

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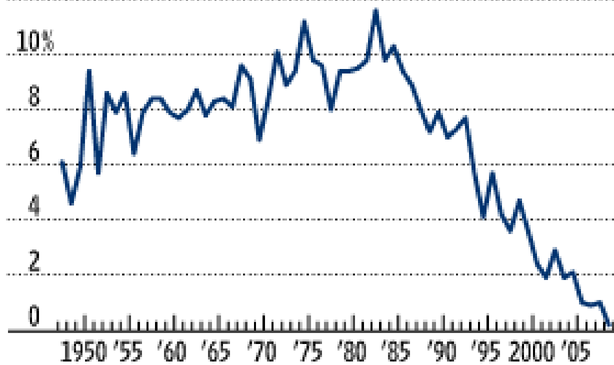
 by Katherine Feely, SND



Consumer spending is at the heart of economy
Consumer spending, at 70% of Gross Domestic Product (GDP), has long been a driver of economic growth. But when credit is hard to get or interest rates are too high, consumers cut back on spending.

When consumers cut back on their spending, the economy slows down (particularly when other sectors do not pick up.)

- Early in January 2008 we saw a spike in food prices, spikes in energy costs and a reduction in consumer spending. Additionally, people were saving less than at any other point in history leaving them without any real cushion –and leaving a majority of people dependent on credit.
- The U.S. Dollar was also losing value and weakening. So the dollar did not go as far as it used to.

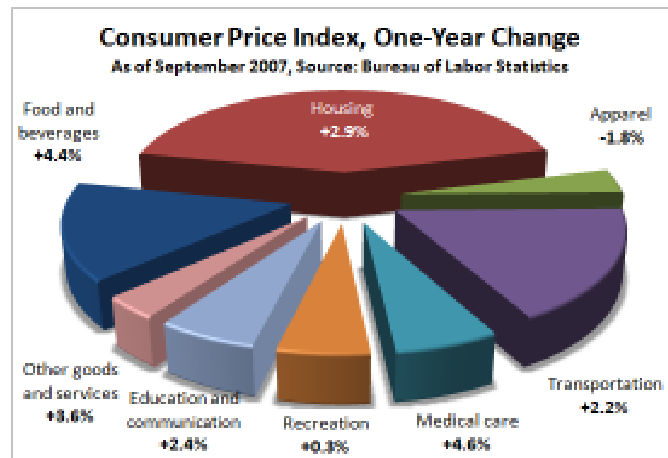
Credit makes the whole capitalist economy run

- Credit is the life blood that makes the economy run.

A Double Punch
The credit crunch and deteriorating labor market has taken a major toll on the economy.

Credit Connection:
Even highly credit-worthy businesses are paying unprecedented premiums for borrowing. A large fraction of businesses are shut out of the credit market altogether.

Company	Total 2007 Compensation	Name
Morgan Stanley	$41,790,854	John J. Mack
Goldman Sachs Group	$70,324,352	Lloyd C. Blankfein
Bear Stearns	$40, 004,315	James E Cayne
Lehman Brothers	$34,382,036	Richard S. Fuld
Merrill Lynch & Co.	$24,306,586	E. Stanley O'Neal



A Catholic View and Focus on the Crisis

Catholic Social Teaching has gradually moved to embrace the market system but recognizes its limits and remains vigilant in its critique because the human person should be at the center of the equation. When the market becomes too powerful or takes on a role that has little concern for human flourishing, Catholic Social Teaching is clear in its critique; the economy must serve the human person.

On September 26, 2008 the United States Conference of Catholic Bishops issued a statement calling on Congress and the White House to find a moral response to the financial crisis. In the letter to Congress, Bishop William Murphy of Rockville Centre, New York, chairman of the United States Conference of Catholic Bishops' Committee on Domestic Justice and Human Development, highlighted the following considerations based on the social teaching that should guide the bailout plan:

- **Human and Moral Dimensions**: Economic arrangements, structures and remedies should have as a fundamental purpose safeguarding human life and dignity. The scandalous search for excessive economic rewards even to the point of dangerous speculation that exacerbates the pain and losses of the more vulnerable are egregious examples of an economic ethic that places economic gain above all other values. This ignores the impact of economic decisions on the lives of real people as well as the ethical dimension of the choices we make and the moral responsibility we have for their effect on people.

- **Responsibility and Accountability:** Clearly, effective measures are required which address and alter the behaviors, practices and misjudgments that led to this crisis. Sadly, greed, speculation, exploitation of vulnerable people and dishonest practices helped to bring about this serious situation. Many blameless and vulnerable people have been and will be harmed. Those who directly contributed to this crisis or profited from it should not be rewarded or escape accountability for the harm they have done. Any response of government ought to seek greater responsibility, accountability and transparency in both economic and public life.

- **Advantages and Limitations of the Market:** Pope John Paul II pointed out that the free market is the most efficient instrument for utilizing resources and effectively responding to needs. ¦But there are many human needs which find no place on the market. It is a strict duty of justice and truth not to allow fundamental human needs to remain unsatisfied. Both public and private institutions have failed in responding to fundamental human needs. A new sense of responsibility on the part of all should include a renewal of instruments of monitoring and correction within economic institutions and the financial industry as well as effective public regulation and protection to the extent this may be clearly necessary.

- **Solidarity and the Common Good:** The principle of solidarity reminds us that we are in this together and warns us that concern for narrow interests alone can make things worse. The principle of solidarity commits us to the pursuit of the common good, not the search for partisan gain or economic advantage. Protection of the vulnerable workers, business owners, homeowners, renters, and stockholders must be included in the commitment to protect economic institutions. As Church leaders we ask that you give proper priority to the poor and the most vulnerable.

- **Subsidiarity:** Subsidiarity places a responsibility on the private actors and institutions to accept their own obligations. If they do not do so, then the larger entities, including the government, will have to step in to do what private institutions will have failed to do.

(Note: For the complete statement please refer to: http://www.usccb.org/comm/archives/2008/08-140.shtml)

Quotes from Catholic Social Teaching

Economic initiative is an expression of human intelligence and of the necessity of responding to human needs in a creative and cooperative fashion. Creativity and cooperation are signs of the authentic concept of business competition: a "cumpetere", that is, a seeking together of the most appropriate solutions for responding in the best way to needs as they emerge.

Compendium of the Social Doctrine of the Church, #343

The sense of responsibility that arises from free economic initiative takes not only the form of an individual virtue required for individual human growth, but also of a social virtue that is necessary for the development of a community in solidarity.

Compendium of the Social Doctrine of the Church, #343

The free market is an institution of social importance because of its capacity to guarantee effective results in the production of goods and services.

Compendium of the Social Doctrine of the Church, #347

A truly competitive market is an effective instrument for attaining important objectives of justice: moderating the excessive profits of individual businesses, responding to consumers' demands, bringing about a more efficient use and conservation of resources, rewarding entrepreneurship and innovation, making information available so that it is really possible to compare and purchase products in an atmosphere of healthy competition.

Compendium of the Social Doctrine of the Church, #347

The free market cannot be judged apart from the ends that it seeks to accomplish and from the values that it transmits on a societal level. Indeed, the market cannot find in itself the principles for its legitimization; it belongs to the consciences of individuals and to public responsibility to establish a just relationship between means and ends.

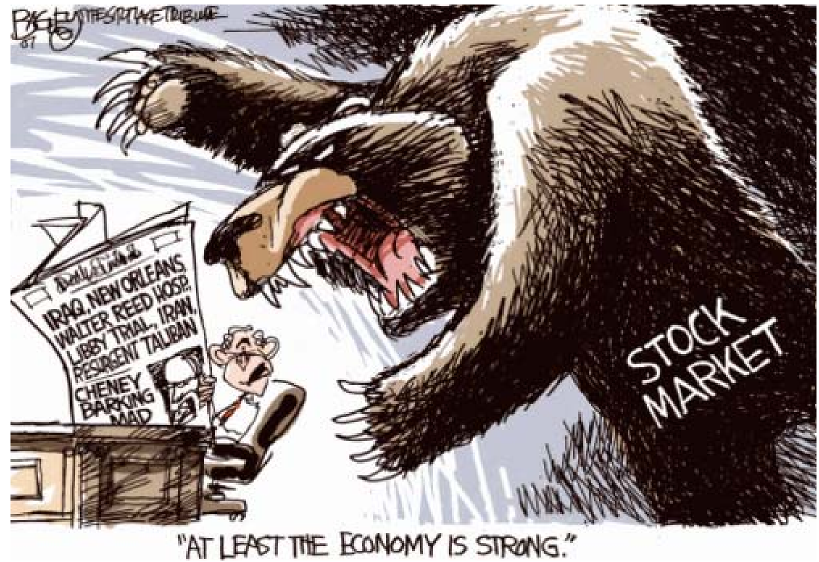
Compendium of the Social Doctrine of the Church, #348

There are collective and qualitative needs which cannot be satisfied by market mechanisms... Certainly the mechanisms of the market offer secure advantages: they help to utilize resources better; they promote the exchange of products; above all they give central place to the person's desires and preferences, which, in a contract, meet the desires and preferences of another person. Nevertheless, these mechanisms carry the risk of an "idolatry" of the market, an idolatry which ignores the existence of goods which by their nature are not and cannot be mere commodities.

-John Paul II, Centesimus Annus, #40

The Lehman Connection

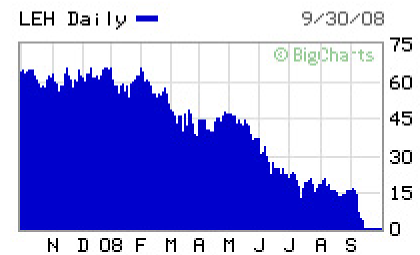
Lehman Brothers Inc., the 158 year-old investment bank, had bet heavily on investments in overheated real-estate markets, used large amounts of borrowed money to supercharge its returns, then was slower than others to recognize its losses and raise capital when its bets went wrong.



On Monday, September 15, 2008, The safest and most reliable money market mutual fund, the Reserve Primary Fund failed to provide a return of capital. It "broke the buck" (a dollar investment worth less than a dollar) which created a crisis in the credit market and began a domino effect of consequences.

That fund, one of the nation's biggest and oldest, owned Lehman bonds that were revalued by The Reserve as worthless. That caused the fund to be worth less than $1 a share and caused investors to panic and try to redeem their shares.

The Government was seeing a dangerous pattern and had already bailed out Fannie Mae, Freddie Mac and Bear Stearns Cos. Judging them as too big to fail, officials committed billions of taxpayer dollars to prop them up. Not so Lehman. Concerned that bailing them out would result in "moral hazard" or reckless risk taking by other firms that could likewise take risks then be bailed out, the U.S. Government did not bail out Lehman Brothers. Lehman filed for bankruptcy.



Stock investors in Lehman have also suffered. Shares crashed from their high of $84.13 in January 2007 to about 15 cents. Lehman filed for bankruptcy. Because the U.S. Government chose not to bail Lehman out much of what unfolded during the credit crisis was a reaction to the shakiness of other similar firms.

Causes:
Economists often disagree about the causes of financial crises, including the present one, though many believe that **declining housing prices** and **mortgage practices** that amplify the effects of those price declines are central factors today. But there is near-universal agreement that the federal government must take aggressive steps to protect workers and businesses from the harmful effects of a financial crisis. **The great majority of those deserving this protection had no role in causing the crisis**.

(Continued on next page)

Why a Bailout?

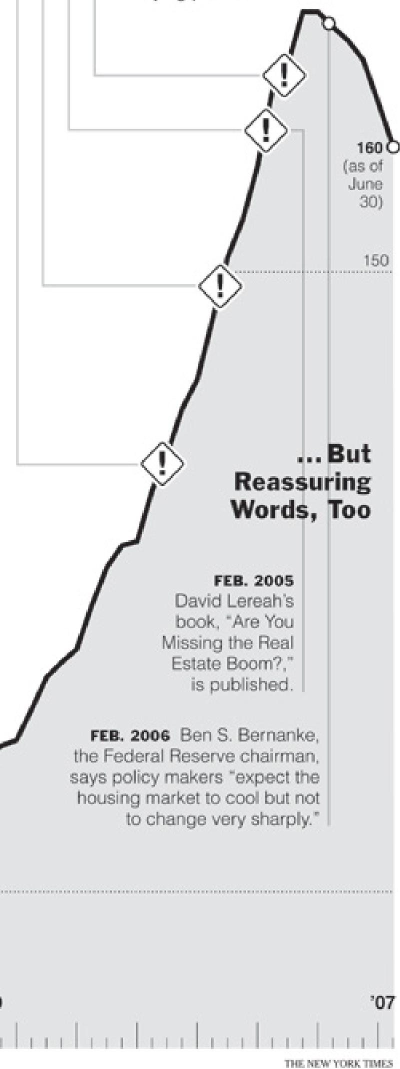
Experience has shown that the essential first step in heading off a crisis is to maintain the functions of critical financial institutions—banks and others performing bank-like functions. These institutions become disabled in a crisis when other institutions lose confidence in their ability to meet their payment obligations. As a practical matter, at the current stage of the crisis, the only way that financial institutions can continue to function is for the government to provide financial support. The traditional form of that support calls for the government to buy assets from the institutions, swapping questionable assets for obligations of the government that are universally regarded as sound.

Why mortgage-backed securities are a problem:

During the housing boom earlier in the decade, many lenders relaxed standards and made subprime loans to homebuyers. These loans were risky and had interest rates that rose over the life of the loans, driving up payments. Wall Street bought up these subprime loans, put them into pools, repackaged them, and sold them.

Investors poured at least $1 trillion into these securities backed by subprime mortgages. Then the housing market slowed and home buyers defaulted in record numbers because they couldn't keep up with mortgage payments. The value of mortgage-backed securities plummeted.

These losses are at the root of today's crisis. As the housing market continues to decline and the economy slumps, losses are spreading to the traditional mortgage market and threaten to deepen the economic downturn. Investors - pension funds, hedge funds, mutual funds, and banks - have so far lost about $600 billion on securities backed by prime and subprime mortgages.



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