

# Financial Crisis – from the US to the EU

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## *Abstract*

*The origins of the financial crisis that created chaos in the entire world starting with the year 2007 were the speculative bubbles that interacted with new types of financial innovations that aided in hiding different financial risks. This paper aims to analyze this phenomenon and the transmission mechanism from the starting point (US) towards the EU.*

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The origins of the financial crisis which caused chaos among the entire world starting with August 2007, are the bubbles that interacted with new types of financial innovations which helped in covering the risk.

To that purpose, some companies failed in following their own risk politics, and also managers, that failed at restraining themselves in taking some excessive risks. Thus, a bubble formed in the housing market, bubble that was fueled with increases in prices from day to day. As any traditional bubble, the expectations played an important role in fueling it. As time was passing by, people saw with their own eyes the prices going up in their own towns, and started to expect that these prices will keep their rising near the trend line, continuing to believe so, even in the last moments.

The increase in the number of loans to people classified as subprime only helped the increase of the bubble, just like throwing gas onto the fire that was already burning. Before the year 2000, the subprime mortgages were almost inexistent, but with the passing of time, these mortgages had seen an impressive growth.

The continuing rising in prices in the housing market together with the financial innovations basically transformed subprime clients that were invisible to the mortgage market, into quite attractive customers. This is how products known as ARM's started to appear. Products in which an advance payment was rarely

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necessary and even allowed clients to postpone an instalment if the situation demanded it, these facilities being based as well on increase in prices. Even so, the access of subprime clients to mortgages wouldn't have had such success without other financial innovations such as mortgage securitization or adding them together in a pool of mortgages in order to be AFS to other investors that received pro-rata payments out of the principal and interest. Thus, the Wall Street investors financed a large number of clients, wishing a mortgage. In this way, the private sector created new ways to pack these subprime loans, known as CDO`s in order to share the cash flow to different classes of investors, depending on their risk appetite.

Furthermore, insurance companies that guaranteed the payments on these loans in case they went non performing. In other cases, an equivalent appeared on the market, known as CDS`s, which were similar to the insurance products mentioned above, the difference being that the CDS sellers came with a very small capital. The CDS can be defined as a contract by which the seller offers to eliminate the risk derived from the possibility that the respective asset which they insured goes into default.

These financial innovations, allowed Wall Street to realize with the subprime clients what already was happening with the conforming clients. Thus, through channeling the investor funds towards this sector, lots of non-conforming people managed to obtain a mortgage. These policies practiced in the market, prospered under an expansionist monetary policy practiced by the Federal Reserve and weak market legislation. With low interest rates and with regulators that weren't able to observe potential market problems, the financial institutions borrowed more and more. Furthermore, banks created entities held in the Off balance sheet known as SIV`s (Structured investment vehicles) in order to acquire mortgage assets that weren't subdued to the capital requirements. At that moment, it was pretty clear that a successful system was created. As prices increased, the short-term debts could be rolled over as they were never there in the first place. The situation though was getting close to completely different path starting with the year 2007, when panic struck the financial markets. The first ones that went bankrupt were the non-banking loaners, followed closely by the investment and hedge funds, all of them being affected by massive financial withdrawals from the system. Towards the end of 2008, the effect extended to countries like Japan and Ireland, no country being able to truly resist the shockwave (Roubinin&Mihm -2010).

A fact that sustained this pandemic state was technology and innovation, being one of the pylons of globalization. In 2010, Stiglitz talked about the successful recipe for a financial crisis: Weak regulations, lots of liquidity with low interest rates, a speculative bubble and policies that support borrowing, subprime borrowing.

Though some time has passed, we can certainly say that considering the irresponsibility that money was being borrowed at that time, there is nothing surprising that consumers, people that wanted a house, and banks that follow profit maximization, borrow more and more when the housing prices are increasing.

What is truly shocking is the lack of capacity coming from the banks implicated in the securitization chain to correctly assess the risk associated with the mortgage assets that they held. From the direct buyer and the sales agent to the institutions trying to earn more following the CDO's and CDS's trade, nobody stopped for a second to think about the lifespan of this way to earn money.

The effects of this were rapidly felt in Europe as well, the contagion effect being very strong. A lot of British and European banks had high exposure to these subprime financial products, repacked as CDO's. Also, another strong transmission channel was the banking system that is connected at an international level. The principle is quite simple actually, as a bank is in need of liquidity for various reasons, it has the possibility of borrowing from another bank. Thus, with the newly risen liquidity problems, banks stopped borrowing from each other that resulted in a much lower credit granting rate. This was directly visible in the lower available income of firms and people, thus, a lower consumption. Looking at a global level, this thing had an impact on exports as well, as they went down. The commercial deficit became harder and harder to be kept under control. Even so, the major problem of the crisis, a problem that still exists, is the lower confidence in the financial system. Lower trust leads to lower economic growth rates than the potential. Europe's problems were actually identical with those of the United States, weak risk management.

The concept of risk is tied to uncertainty and incentives. Considering the risks that private companies have taken, we have to consider the reasons behind their decisions. All private companies have one goal, and that is to maximize profits. In order to obtain higher profits for the shareholders, there are certain incentives for the employees. For example, if we consider a sales department, usually the incentives come under the form of various bonuses. If we consider top management, the incentives usually come either as bonuses, or share percentage of the company.

These incentives have had a great impact on decision making. Consider a company headed by a manager which negotiated their salary as a percentage of the revenues. As the company earns more, this manager's salary goes up. That manager has every incentive to apply pressure on other people in order to bring revenues up. Thinking abstractly, this is normal, but the moment that the company starts taking more and more risks in order to bring those revenues higher, without thinking of the long

run, the spiral starts. The core business of a bank for example, are loans, and its income is mostly derived from interest and other fees applied on the customer's account. Separately, the bank makes transactions on the financial market, earning large amounts of money as well. Normally, if managed correctly, the bank will almost always earn profits, depending on the class of financial assets their willing to invest. For example for an amount of 1m EUR invested in a A+ rating bond, the bank may earn a 3% interest. But investing the same 1m EUR in a D rating bond, the bank may earn a 15% interest. (Numbers picked randomly) . The lower rating bond, will pay more, but it pays more due to the fact that the buyer doesn't have the same chance to actually get the principal and the interest back. This bond example is actually the most representative for what happened in the market with the financial crisis.

The D rating bond is the perfect example of risk taking beyond common sense, as it was a good way to earn larger profits. Tie that to the incentive scheme presented earlier and you got the perfect storm. Something similar happened in the housing market as well, as the subprime mortgage market, was the perfect opportunity to earn higher profits, this being in the best interests of the managers.

From the moment that the crisis started, up until now, a lot of things have changed. Various companies have changed their bonus systems. For example, a solution that has been found was to tie managers salaries to the long term performance of a company. For example, if a company earns high profits for 5 years, the managers may receive a large bonus. They would still have incentives for pushing the profits up, but this time, they will have in mind the impact on the long run as well, as it is directly tied to their bonus.

Other safeguards set in place, were made by the regulators as well. One example would be the IFRS 9 introduction, which pretty much aims to simplify the financial instruments accounting and also reduce perceived deficiencies which were visible during the financial crisis. For example, from a prudency point of view, IFRS 9 sets a sole impairment model across all financial instruments for which impairment may be applied while under the old regulation (IAS 39) different impairment models were accepted. Through this more unitary approach the companies will find it harder to increase assets artificially. In addition to that, under IFRS 9, reasonable forecasts affecting the collection rate are also considered when determining the impaired amount, and not only past and current events. Another point touched by this standard also better reflects the risk management of hedging operations.

Even though a lot of things have changed from when the crisis started up until the present, one core problem remains. This problem would be more difficult to solve through laws, or prudent business models. The problem in discussion would be the

people's trust in the economy and the financial systems. As Adam Smith points out in his work - *The Wealth of Nations*, a certain level of trust in the economic system is required in order for economic growth to exist. "If we didn't trust the butcher to give us quality meat without having to inspect the cow every time — or worse yet, if we needed to litigate after every grocery run — the whole system would come to a screeching halt."

Since the crisis in 2007 has started, the public's trust in the financial system has declined. This lower level of confidence, isn't only related to the financial crisis though, but also to corruption, to the quality of the governments: eg Horvath -2013 and Bjørnskov and Méon - 2013 . In other words, in order to restore the economy, and the public's confidence, a series of variables need to be done, from lowering the corruption level to better political governance, and last but not least, strong regulations that allows businesses to undergo their activity and also promote competition, but in the same time, limiting the amount of risks that they can take.

The market has evolved, and the circumstances have changed as well. The market still does not present the credibility that it used to have. It is difficult to predict the behavior of the investors and that of the consumers considering the past crisis, but it is expected that the same problem will not arise again in the near future.

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