HCMUN

March 3rd, 2018

2008 Financial Crisis

Background Guide

Chair: Caroline Cui
Director: Leila Koohi

Dear Delegates,

I extend to you all a very warm welcome to the fourth Havergal Model United Nations Conference. My name is Caroline Cui and I am delighted to be your chair for the 2008 Financial Crisis Committee this year. This is my fourth year in Model UN. Our director this year is the wonderful Leila Koohi. This is her second year being involved in Model UN. We both anticipate an exciting day of for this fast-paced committee.

Your topic is the 2008 Financial Crisis. Delegates from different backgrounds will need to work together to solve, or at the very least, alleviate the economic crisis that crippled the US economy. The committee will start the day after the collapse of the Lehman Brothers, on September 16, 2008.

Please do keep in mind that this background guide is only supposed to serve as a basis for your research. Delegates are highly encouraged, and also expected, to conduct their own independent research with respect to their assigned person's stance and their own solutions.

Position papers are mandatory to be eligible for awards, and are due on March 1st, 2018. They can be submitted to ccui@havergal.on.ca. If you have any questions, please don't hesitate to contact me at this email as well. We look forward to meeting you!

Best of luck,

Caroline Cui
Chair
2008 Financial Crisis, HCMUN IV

Timeline

January to December 2007

- **February:** Freddie Mac states it will not buy risky subprime mortgage loans anymore.[1]
- **April:** New Century Financial, a subprime mortgage specialization lender, files for bankruptcy.[2]
- **June:** Two hedge funds run by Bear Stearns come into contact with huge losses. They have a large holding of subprime mortgages.
- **August:** American Home Mortgage Investment files for bankruptcy.[3] The US Federal government cuts "rate at which it lends to banks by half a percentage point to 5.75%, warning the credit crunch could be a risk to economic growth."[4]
- **September:** "The rate at which banks lend to each other rises to its highest level since December 1998."[5] The main interest rate is cut by another half a percentage point by the US Federal Reserve at 4.75%.[6] Northern Rock, a British bank, faces a liquidity crisis. It borrowed large amounts of money for customer mortgages, and planned to resell (securitize) them on the international market. However, the demand for securitized mortgages had fallen, and Northern Rock found itself in debt.[7]
- **December:** "US President George W Bush outlines plans to help more than a million homeowners facing foreclosure."[8]

January to December 2008

- **January**: The World Bank predicts that global economic growth will slow in 2008.[9] US home sales experience largest single-year drop in 25 years. Global stock markets experience biggest falls since September 11, 2001. The US Federal government, specifically Federal Open Market Committee, cuts rates (fed funds rate) again, down to 3.5% in an effort to prevent a recession.[10] The rates are lowered again on Jan. 30 to 3.0%.[11]

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[1] Timeline: Key events in the Financial Crisis, *USAToday,* (2013). https://www.usatoday.com/story/money/business/2013/09/08/chronology-2008-financial-crisis-lehman/2779515/
[2] Ibid.
[3] Ibid.
[4] Mauro F. Guillén, The Global Economic and Financial Crisis: A Timeline, *The Lauder Institute*. https://lauder.wharton.upenn.edu/wp-content/uploads/2015/06/Chronology_Economic_Financial_Crisis.pdf
[5] Ibid.
[6] Ibid.
[7] Patrick, Kingsley, Financial Crisis: Timeline, *The Guardian*, (2012), https://www.theguardian.com/business/2012/aug/07/credit-crunch-boom-bust-timeline.
[8] Ibid.
[9] Ibid.
[10] Mauro F. Guillén, The Global Economic and Financial Crisis: A Timeline, *The Lauder Institute*. https://lauder.wharton.upenn.edu/wp-content/uploads/2015/06/Chronology_Economic_Financial_Crisis.pdf
[11] Kimberly, Amadeo, 2008 Financial Crisis Timeline, *The Balance,* ed. (2017), https://www.thebalance.com/2008-financial-crisis-timeline-3305540

- **March:** A term Auction Facility is announced by government. JP Morgan buys Bear Stearns, an investment bank. 200 billion US dollars of funds are made available for banks and other institutions by the US Federal Reserve. The Term Auction Facility (TAF) program allowed banks to withhold the fact that they had a lot of subprime mortgage debt.[12] Federal reserve became the only bank willing to lend money. The Expansionary Monetary Policy was brought forth to lower LIBOR and keep mortgage rates adjustable in order to prevent a further recession.[13] The federal funds rate continues to lower.
- **April:** Federal funds rates continued to drop. Another 50 billion US dollars are added to Term Auction Facility.
- **May:** Another 150 billion is added to the Term Auction Facility.[14]
- **June:** At this time, the federal government has auctioned 1.2 trillion dollars. The Federal Reserve lent $225 billion in June to provide liquidity through the TAF, which became a permanent fixture during this crisis.[15]
- **July 12:** IndyMac fails. People are concerned about their deposits because the Federal Deposit Insurance Corp. only guarantees insuring up to $100,000.[16]
- **September 7:** US government takes over Freddie Mac and Frannie Mae. They together guarantee 5 trillion US dollars' worth of home loans. "Treasury Secretary Henry Paulson says the two firms' debt levels pose a "systemic risk" to financial stability and that, without action, the situation would get worse."[17]
- **September 15: Lehman Brothers filed for bankruptcy**. It is the largest filing in US history, for 639 billion US dollars. "Shares in European stock exchanges plunge."[18] Treasury Sec. Paulson said no more Wall Street bailouts. On the same day, Merrill Lynch is sold to Bank of America and American International Group turns to the Federal Reserve for funding.

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[12] For Term Auction Facility **read:** https://www.federalreserve.gov/monetarypolicy/taf.htm

[13] For Expansionary Monetary Policy **read:** https://www.thebalance.com/expansionary-monetary-policy-definition-purpose-tools-3305837

[14] Ibid.

[15] Ibid.

[16] Ibid.

[17] Mauro F. Guillén, The Global Economic and Financial Crisis: A Timeline, *The Lauder Institute.* https://lauder.wharton.upenn.edu/wp-content/uploads/2015/06/Chronology_Economic_Financial_Crisis.pdf

[18] Ibid.

Factors in the 2008 Financial Crisis

The Glass-Steagall Act

In June 1933, the Banking Act of 1933, commonly called the Glass-Steagall Act, was signed in by President Franklin D. Roosevelt. It was an emergency legislation passed within the first few days of Roosevelt being president. It "effectively separated commercial banking from investment banking."

"Basically, commercial banks, which took in deposits and made loans, were no longer allowed to underwrite or deal in securities, while investment banks, which underwrote and dealt in securities, were no longer allowed to have close connections to commercial banks, such as overlapping directorships or common ownership."[19]

However, the Financial Services Modernization Act of 1999, or commonly called the Gramm-Leach-Bliley Act, was signed into law by President Bill Clinton. It repealed parts of the Glass-Steagall Act and issued new changes. The primary change was the creation of the financial holding company (FHC)." "A FHC was essentially an extension of the concept of a bank holding company—an umbrella organization that could own subsidiaries involved in different financial activities. This was something of a compromise, as security and insurance underwriting and sales by depository institutions would still be restricted, but banks could be part of a larger corporation that was involved in those activities."[20]

This repealed parts of the Glass-Steagall Act but also created new laws for FHCs. For example, the law "placed size limitations on banks' financial subsidiaries." Companies had to file for certification that meet certain requirements to become FHCs. Afterwards, they would be monitored by the federal government, especially the capitalization and management of their subsidiaries.[21]

Financial institutions that faced the worst of the 2008 Financial Crisis, such as the Lehman Brothers and Bear Stearns were not part of larger banks like the Gramm-Leach-Bliley Act allowed. This act, however, did allow the Bank of America to acquire Merrill Lynch, and as a result, Merrill Lynch did not go bankrupt like it would have.

The Fall of the Lehman Brothers

Despite bailing out Fannie Mae and Freddie Mac, the US Treasury refused bail for the Lehman Brothers. With no other way out, on September 15th, 2008, the Lehman Brothers, filed for bankruptcy. With $639 billion of assets and $613 billion in debt, it was the largest US corporate

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[19] Julia, Maues, Banking Act of 1933 (Glass Steagall), *Federal Reserve History,* https://www.federalreservehistory.org/essays/glass_steagall_act
[20] Joe, Mahon, Financial Services Modernization Act of 1999, commonly called the Gramm-Leach-Bliley, *Federal Reserve History,* https://www.federalreservehistory.org/essays/gramm_leach_bliley_act
[21] Ibid.

bankruptcy and the first major bank to collapse. The bank had over 25,000 employees and its bankruptcy meant the loss of thousands of jobs.[22]

The weekend before the bankruptcy was declared, the Lehman Brothers had been searching for a potential buyer to save the bank. Treasury Secretary Henry Paulson led the efforts and went to the Bank of America on September 10th to "take another look at acquiring Lehman, assuring him that Fuld was ready to deal." However, the Bank of America refused to accept the deal without government assistance, something that the US Federal government were not going to give.[23] On September 12, a deal seemed to have been reached between the Lehman Brothers and Barclays, a British bank: Barclays would purchase Lehman. However, the next day, the deal had been declined by the United Kingdom Financial Services Authority (FSA). "The New York Fed required Barclays to guarantee Lehman's obligations from the sale until the transaction closed, much as JP Morgan had done for Bear Stearns in March." Under U.K law, the shareholders of Barclay would have to vote on this, the process which would take anywhere from 30-60 days. A waiver could be given, but the "FSA asserted that such a waiver would be unprecedented, that it had not heard about this guarantee until Saturday night, and that Barclays did not really want to take on that obligation anyway." Instead, the FSA wanted the New York Federal government to give the guarantee instead, something that Paulson could not do since it would "put the Fed on the hook for tens of billions of dollars." Paulson made a final pitch to the Treasury Secretary of the U.K which also fell on deaf ears.[24]

In the early years of 2004 and 2005, Lehman acquired 5 mortgage lenders, two of which were subprime lenders. In the beginning, it served Lehman well: "record revenues from Lehman's real estate businesses enabled revenues in the capital markets unit to surge 56% from 2004 to 2006, a faster rate of growth than other businesses in investment banking or asset management."[25] But "defaults on subprime mortgages rose to a seven-year high" by the first quarter of 2007, and there were visible problems with the U.S housing market. Lehman's stock fell with the failure of two Bear Stearns hedge funds in August of 2007. "Lehman underwrote more mortgage-backed securities than any other firm, accumulating an $85 billion portfolio, or four times its shareholders' equity." With Bear Stearns almost collapsing in March of 2008, "Lehman shares fell as much as 48% on concern it would be the next Wall Street firm to fail." From there, Lehman headed towards downfall as its stocks continued to plunge and the firm lost billions.[26]

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[22] The Collapse of the Lehman Brothers, *The Telegraph,* http://www.telegraph.co.uk/finance/financialcrisis/6173145/The-collapse-of-Lehman-Brothers.html.
[23] The Financial Crisis Inquiry Report, *United States Government Publishing Office*, (2011), https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf . pg. 332
[24] Ibid., 335-336
[25] Investopedia, Staff, Case Study: The Collapse of Lehman Brothers, *Investopedia*, ed. (2017), https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp
[26] Ibid.

Bear Stearns Failure

Lehman Brothers' bankruptcy is considered the start of the fall of Wall Street. But, it was after the Bear Stearns failure that exposed the mountains of debt that powerful banks had, showing the fragility the economy.

As the financial crisis continued, investors and clients began to withdraw from Bear, afraid of its incapability to meet obligations. Unfortunately, the clients were right. Bear Stearns hadn't distributed their funds properly, putting a large majority of it into mortgage-backed securities. The bank was relying far too much on hedge funds and its assets to stay open. The High Grade Credit Fund and Enhanced Leverage Fund owed a total of $20 billion and were becoming impossible to sell as the house prices plummeted.[27] Bear Stearns was rushing to support the hedge fund whose assets suffered an 18% loss.[28] Bears ended up selling $3.6 billion of its assets, a pledge that was considered to be the largest bailout since 1988.[29] Stearns then agreed to buy $3.2 billion worth of securities from the hedge fund as well as buyout many banks on Wall Street to protect its reputation.[30] Bear Stearns lost $854 million in the 4th quarter and announced a $1.9 billion write-down of its subprime mortgage holdings.

Subprime Market

The subprime market was a main reason why the financial crisis happened in 2008. Subprime mortgages are mortgages given to people with low credit scores or a low income. Normally, only people with good credit scores or a good income could get mortgages to ensure the money that banks lent got paid back. The creation of subprime mortgages was a direct result of the high demand for more mortgages to please investors who saw the housing market as a place to invest. Banks made loans without verifying income and often offered adjustable mortgage rates to those who couldn't afford to pay them and then inflated the price after. This is called "predatory-lending" and it is risky with lower chance of return. When the people couldn't pay back their mortgages, they defaulted, and the investors were left with houses they didn't want. They tried to sell the houses but due to high housing prices, no one wanted to buy them. This resulted in unpaid mortgages and an excessive number of houses. Housing prices started to fall, and some borrowers were left with debts greater than what their houses were worth, resulting in even more defaults. It accumulated into huge debts in firms as investors started to lose their savings.

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[27] Amadeo, Kimberly, Bear Stearns: Collapse and Bailout, *The Balance,* ed. 2017, https://www.thebalance.com/bearn-stearns-collapse-and-bailout-3305613

[28] Ibid.

[29] Creswell, Julie and Bajaj, Vikas, $3.2 Billion Move by Bear Stearns to Rescue Fund, *The New York Times,* (2007), http://www.nytimes.com/2007/06/23/business/23bond.html

[30] Ibid.

Mortgage-Backed Securities and Credit Agency Ratings

Mortgage-Backed Securities (MBS) are a form of investment that became popular in the early 2000's. Investors, who weren't happy with investing in US Treasury bonds, were looking to invest in something different. The US housing market was next big investment pool. The housing market was considered a safe investment due to low risk and high returns. Often, when people buy a house, they cannot afford to purchase the house straight from their pocket. So, they take out a loan from the bank. This loan is called a mortgage. Mortgages were only given to those with a good credit score because it showed the lender that the person was likely going to pay back their mortgage. What often happens with mortgages is that it is often not left in the hands of the bank, but given to a third party. MBSs are created by securitizing mortgages of thousands of people through banks or other financial institutions. They're sold in portions to others. So, investors would get great returns by getting a share of a pool of mortgages. If the borrower defaults their mortgage, then the investor can simply sell the house. It was a win-win for investors.

Credit agency ratings, are ratings based off a scale that tells investors how likely they are to be paid back. These ratings gave MBSs a triple A rating, which means it is of the highest credit quality and shows and exceptional level of creditworthiness.[31] Essentially saying that MBSs were the best of the best. This was true, up until a certain point. This triple A rating led to an increasing demand for MBSs from banks. However, in order to create MBSs, mortgages are required. To keep up with the demand, banks began lending money to people with low credit scores. This type of mortgage is called a "subprime mortgage" and they aren't as safe as regular mortgages as they are risky with low returns. A low credit score shows that the borrower has a history of not being able to pay back lent money. Therefore, there is a greater possibility that the mortgage won't be paid back. However, because subprime mortgages were newly introduced to the MBSs, credit agencies could still back their claim with the history of MBSs to say it is a safe investment.

Summary

To this day, the GDPs of rich countries still haven't recovered completely and the effects of the 2008 Financial Crisis continue to heavily affect our global economy. Here is a brief summary of the timeline of the crisis. First, banks conducted irresponsible mortgage lending to people with poor credit history in an attempt to draw in investors. Then, these loans were sold to investment banks that pooled them together to make MBSs (Mortgage Backed Securities). Due to the misleading, AAA rating that these investments got, investors flocked to them, believing they were low risk, high return. However, it was unknown to the investors that banks were giving out subprime mortgages. Unfortunately, after receiving the loan, many of those with a subprime mortgage could no longer afford to pay for their expensive houses and mortgages. Thus, large numbers of mortgages defaulted, making these securitized products worthless. Investment banks and firms incurred heavy losses. Then, the bankruptcy of the Lehman Brothers occurred. As this giant firm crumbled, it

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[31] The 2008 Financial Crisis: Crash Course Economics #12, *Youtube*, (2015), https://www.youtube.com/watch?v=GPOv72Awo68

nearly brought down the entire global financial system with it, resulting in the worst recession in 80 years.[32] People began to sell their stocks and everyone was too afraid to buy. Without equilibrium, the stock market plummeted. To prevent another depression, the government had to provide massive monetary and fiscal stimulus by pumping money back into the market.

[32] The Origins of the Financial Crisis - Crash Course, *The Economist*, (2013): https://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article

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