

DAY 9?

2019/11/01

ECO 2115

Financial Crisis

- **Financial Crisis:** is a disruption of financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities
 - The economy declines because financial markets do not function efficiently in a financial crisis
- Financial system is vital to the economy but finance in modern economies is inherently fragile
 - Vulnerability exists because banks borrow short term and lend long term
 - World will always face the threat of financial crisis as long as risk taking and maturity transformation are prevalent

2007-2009 Financial Crisis

- Started with intentions of letting poor people own houses to help improve neighbourhoods and other things
 - Subprime mortgage
 - Aimed at providing housing finance to people with spotty credit histories, a lack of documentation, lack of income
 - Was structured to make maturity 2-3 years
 - This happened with a fixed period interest rate initially, then at the reset date the rate rose significantly basically requiring people to refinance
 - With rising prices borrowers would build equity in their homes
 - Mismanagement of financial liberalization
 - Deregulation Subprime Mortgage market
 - Very high leverage ratios
 - Ratio of total assets to equity
 - New structured credit products
 - Made it easier to securitized subprime mortgages
 - Helped spread risk through the global economy
 - Large pool of funds from abroad
- Housing prices peaked in 2006
 - As prices fell mortgages were in default → the structure of these loans were damaged

Repos

- A repurchase agreement (repo) is a financial contract used by market participants as a financing method to meet short-term liquidity needs
 - 2 part transaction
 - The transfer of a security by one party (bank or borrower) to another party (depositor or lender) for cash
 - Depositor holds the bond
 - Bank holds the cash
 - Bank agrees to repurchase the securities at the original price + an additional amount at a later date
- Repurchase agreements don't end up in bankruptcy court if one party defaults, the non default party walks away keeping the cash or bond
 - Demand for repos grew rapidly
 - At the end of 2007 the repo market is estimated to be \$6-10 tril, half of the IB were funding half of their assets with repo markets