

## EC371 Economic Analysis of Asset Prices

### The Financial Crisis – a brief overview

#### Sequence of Events

1. House-owners' default on mortgages, mainly in U.S., resulted in default on securities ('Asset Backed Securities', ABSs) that were issued by banks and 'Structured Investment Vehicles'(SIVs) to fund the mortgages. SIVs are companies set up specifically to create the ABSs.
2. Financial institutions – banks or bank-like corporations – that held ABS experienced financial distress, and some became insolvent. In some cases insolvency occurred because creators of SIVs retained residual holdings (essentially equity) of the ABS.
3. Northern Rock, a British bank, was nationalised in September 2007 after experiencing a bank-run as depositors feared that the bank had become insolvent.
4. Bear-Stearns, an American investment bank, on the point of bankruptcy was taken over by JP Morgan Chase (another bank) in March 2008, with US government support.
5. **September 2008:**
  - Fannie Mae and Freddie Mac<sup>1</sup>, two dominant holders and guarantors of American mortgages and ABSs, effectively came under direct Federal US control (they were already government sponsored enterprises, which enjoyed privileged status in the financial markets by virtue of implicit government backing for their debt).
  - Lehman brothers, an investment bank, was allowed to become bankrupt.
  - AIG, American International Group, an insurance company, was bailed out by the US government.
  - Regulators in US and UK prohibit, temporarily, short-sales of the shares issued by most financial organisations.
6. From September 2008 governments (especially US and UK) introduce rescue measures to support banks.
7. Autumn 2008 and beyond:
  - Discussions commenced to reform the regulation of financial organisations, with a view to making them less vulnerable to insolvency.
  - Many asset prices, especially stock prices, fell precipitately and became more volatile.
  - Many national economies enter recession, mitigated to some extent by emergency government policies that are themselves restrained by the need to fund the resulting budget deficits.

#### Main aspects of the crisis relevant for EC371 and EC372

1. The role of investors' **confidence** in determining asset prices and their volatility.
2. **Short-selling:** how short-selling works, its effects and why it is so controversial.
3. How the obligation to maintain balances in **margin accounts** impacts on solvency, and instability in the entire financial sector.
4. The role of **Asset Backed Securities, Collateralised Debt Obligations** and the **Structured Investment Vehicles** established to issue them (EC372 only).
5. The riskiness of **Credit Default Swaps** and plans to regulate them (EC372 only).

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<sup>1</sup>'Fannie Mae' = Federal National Mortgage Association; 'Freddie Mac' = Federal Home Loan Mortgage Corporation.