2008 Krizi: Birleşik Krallık Prespektifi

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ÖZET

Bu makale 2008 ekonomik krizinin İngiltere bakımından temel dinamiklerini irdelemektedir. Kriz 2007 yılında ABD'deki "sub-prime mortgage" kredileriyle ilgili sıkıntılarla başlamış, 2008 yılında finansal krize dönüşerek tüm dünyaya yayılmıştır.

Önemli bir uluslararası finans merkezi olan İngiltere, bu özelliği ve ABD ile yakın ekonomik bağları nedeniyle kredi krizinden en önce etkilenen ülke olmuştur. 2008 yılının son çeyreğinde ise, önce finansal piyasalarda yaygınlaşan kriz, bilahare ekonominin reel sektörlerini de içine alan tam bir ekonomik buhrana dönüşmüştür.

Makalede 2008 ekonomik krizini tetikleyen ve yayılmasını sağlayan faktörler analiz edilmekte, İngiltere'nin bu sorunları bertaraf etmek için aldığı tedbirlere değinilmekte ve uzun vadede geliştirilmesi gereken politikalara yönelik tavsiyelerde bulunulmaktadır.

2008 ekonomik krizini tetikleyen faktörler arasında, finansal piyasaların ve kullandıkları enstrümanların küreselleşmesi; konut piyasasında görülen aşırı iyimserlik nedeniyle bankaların piyasayı daha da canlandırmak için "çarpan/kaldıraç oranları"nı (leverage ratios) yükseltmeleri; bankaların uzun vadeli krediler ve sub-prime müşterilerle ilgili riskleri küçümsemeleri; banka yöneticilerinin aç gözlü ve sorumsuz davranışları ile finansal piyasaların denetimi konusundaki boşluklar ve kredi derecelendirme kuruluşlarının yanlış yönlendirmeleri sıralanmaktadır.

İngiliz Hükümetinin 2008 kriziyle başa çıkmak için kısa vadede aldığı tedbirler meyanında ise, mevduatlara getirilen garantiler; mali sıkıntıya düşen bankalara hisse karşılığında doğrudan sermaye aktarımı; iç talebi canlandırmak için yapılan KDV indirimi ve diğer vergi kolaylıkları ile Merkez Bankası'nın temel faiz oranlarını düşürmesi ve para arzının genişletilmesi gibi tedbirler belirtilmektedir.

Makalede son olarak, küresel ekonomik krizle mücadele için uzun vadeli bazı tedbirlere ilişkin tavsiyelerde bulunulmaktadır. Bu bağlamda, uluslararası çabaların

koordine edilmesinin ve finans piyasalarının denetiminden sorumlu olan ulusal kuruluşların, bankaların mali tablolarını daha şeffaf biçimde izlenmesine yönelik yeni denetim araçları geliştirmelerinin önemi vurgulanmaktadır.

The Crisis of 2008: A UK Perspective

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Abstract

This paper discusses some of the key characteristics of the Crisis of 2008 in the UK. The 2008 Crisis has started as a sub-prime crisis in the US in 2007. It turned into a Credit Crunch in the US which spread fast to the rest of the world. UK is the first country to get hit with the credit crunch due to the international nature of its financial services sector and its close economic links with the US. During 2008 the credit crunch first turned into financial crisis spreading to the whole of the financial sector and then a full economic crisis with repercussions on the real side of the economy. I discuss the triggers and the development of the Crisis of 2008 as well as the short run reactions so far and conclude with long run policy recommendations.

What triggered the crisis?

The triggers for the Crisis of 2008 can be classified into four. The first is the globalization process we have been going through over the past three decades. The second is the high leverage not only of the household sector through sub-prime mortgages but also the corporate sector and thus the financial system as a whole. The third is the underestimation of risks especially the risks of securitized mortgages and derivatives on them. Risks were underestimated not only in newly issued assets but also in corporate sector leverage ratios. The fourth is the insufficiency of the accounting systems we use in presenting the risks involved in complex securities. I will discuss them one by one.

Globalization of financial markets and instruments

The US government was encouraging home ownership of low income households and thus mortgages were encouraged for low and volatile income households sometimes above any thresholds or background checks. Housing prices increased for about two

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decades in a row. The housing bubble burst and low quality mortgages started defaulting.

Thus the Crisis of 2008 has started in the US in 2007 as a sub-prime crisis, referring to the low quality mortgages that started defaulting. How could a housing bubble in the US turn into a worldwide financial shock? It started in one particular sector of one particular country, could have stayed that way. But it did not.

The sub-prime crisis in the US was then passed on to the rest of the world hitting countries at a speed and impact commensurate with their linkages with the US. UK had the first impact due to its close economic relations with the US, followed by the rest of Europe and the emerging markets in that order. This wave, I expect to come following the same route, back to US before we can say the global crisis is over. We are still in a stage where the sub-prime crisis has evolved into a financial crisis with repercussions for the real economy now becoming observable. It is not over.

The first trigger of the Crisis of 2008 for the UK is the connectedness between its financial institutions and markets and those across the Atlantic. Northern Rock, a very successful mortgage provider in July 2007, was the first one to initiate a bank run for more than a century. In the first half of 2007 Northern Rock revealed it had sold mortgages worth a record £10.7bn, up 47% from a year ago which was equivalent to 19% of all new mortgage policies sold in the UK making it the market leader. In three months it went bust. Northern Rock was borrowing from the short term money markets in the US and lending for long term mortgages in the UK. When faced with a liquidity run in the US money markets Northern rock had no where else to turn to but the UK government to provide the liquidity. Finally it was nationalized "…as a temporary measure .. until the market conditions improved.." as Alistair Darling, explained.

Leverage

The second trigger of the Crisis of 2008 is the increased leverage in the economy. Increased leverage introduced fragility into the economy that was unnoticed for a long time. Increased leverage makes the household and corporate sectors fragile and amplifies the fragility of the financial system. Financial institutions had been financing their portfolios with less and less capital, thus increasing the rate of return on that capital. Leverage ratios of all three sectors, households, corporations and financial institutions are all public information. Work, academic or practitioner oriented, on the fragilities imposed by high leverage ratios, is almost non existent.

What are the reasons behind increasing leverage? Of course optimism, and the underestimations of the fragilities imposed. Housing prices were increasing the UK for the past three decades. Average house price has increased more than 6 times over the past 25 years. Leverage through mortgages, sub-prime or not, increased in the household sector first due to increasing real estate values. Mortgages up to 125% of the value of the house were available and yes, sub-prime mortgages were available as well. In fact some companies were lending up to 6 times the reported incomes of the households without conducting the usual background checks. Household sector was levered.

In the UK leverage ratios in the corporate sector doubled, increasing from about 15% to 32% in the past three decades. On the real side, decline in interest rates is an important reason. Interest rates declined from about 15% to 5% over the same period, external funding became available and cheaper and firms borrowed. The availability of funds at lower rates created the illusion that one can de-lever at the same speed he levers. Benign economic conditions accompanied by optimism created another illusion, that, neither interest rates will rise again, nor liquidity, will be unavailable, in the foreseeable future. Both turned out to be wrong.

Leverage induces fragility. If, for any reason, the value of the assets became lower or more uncertain, then the higher the leverage, the higher the probability that capital would be at risk and the institution or the household will be bankrupt. During the Crisis of 2008 asset values declined for various reasons I will describe below. In corporate sector, by May of 2008, 850 UK companies went into administration; a rise of 54% from a year ago. In the household sector, despite several efforts to keep home ownerships intact repossessions increased in October 2008, the number of house repossessions had increased more than 70% to more than eleven thousand in a year. The Bank of England estimated 500,000 UK homeowners are in negative equity predicting that this number could rise to 1.2 million if house prices fall by another 15%.

The loss of asset values led to mass nationalizations. Following massive asset write downs and estimations that further write downs will follow, Lloyds took over HBOS the largest mortgage lender with about 20% market share for £ 12 billion with a deal engineered by government. But this was not enough, to restore confidence. Bradford and Bingley was nationalized in September and UK government got control of £50 billion of mortgages and loans while selling the savings side to Santander. In October the UK government had another round of nationalizations of RBS, Lloyds and HBOS. The UK financial system is now faced with a new era of nationalizations. The intention is to sell of the shares at al later date when the crisis of over and asset values recover and return tax payers money back.

Underestimation of risks

The housing bubble in the UK similar to the one that created the sub-prime crisis in the US grew that big, because we could not understand in time how speculative bubbles develop. Obviously there are all sorts of arguments putting the blame on various different parties including the sharp practice of mortgage lenders, greed in securitizers, investment bankers and fund managers, and mistakes of rating agencies and regulators including the central banks. Making long term changes to inhibit further crisis is as important as the short run steps to alleviate it. It requires a thorough understanding of how optimism was so wide-spread for so long.

Home ownership rates in the UK are one of the highest in the world. Over the past three decades home ownership increased from 57 % to 71%. This is good and democratic. However risks in such high leverage transactions were not understood well. The perception that real estate prices could only go up, led lenders to loosen their standards in assessing risks. Sub-prime mortgages only aggravated the problem. The social contagion of the boom thinking was one justification for the belief that the boom will continue. We tend to believe that we have independent minds, but contagion of thought patterns play an important role in establishing collective thinking. The optimism was based on observations of price increases and others interpretations or just observations, verifying ones' own.

One might expect home owner themselves naïve investors be prone to that kind of bias. They may be lured with teaser rates, they may be unable to understand the fundamentals. But how come well paid company executives made the same mistake and we witnessed the massive fall and nationalizations of so many UK banks? Greed is not sufficient to explain. The same mechanism of social contagion of optimism was at work among them as well. Finance professionals are one community with close links with each other. Just like any other community they exchange information and they follow each others actions. One cannot see what is inside the minds of the others but can listen to their stories and can surely observe their actions. The actions of others were optimistic, which they interpreted rationally as reflecting information on fundamentals, and acted further upon them. This was wrong. The contagion of though patterns were at work among the bankers as well.

Opacity of balance sheets

The accounting systems we use are from 1950s and do not accommodate the need to reflect the complex financial instruments we use today. Securitizations have become popular over the past two decades. This process led to complex assets that are hard to value and hard to reflect on the balance sheets. In the UK, HBOS had securitized £55 billion worth of mortgages rated AAA in 2008. Of the two other nationalized institutions, RBS had £36 and Lloyds had £23 billion of securitized mortgages. The opacity of balance sheets to reflect these and other complex assets that embed contingent liabilities is one major reason for the Crisis of 2008.

Securitization is a major improvement in risk allocation. It refers to bringing together different qualities of mortgages called tranches and putting them in one basket designed as a separate product to be sold. Shocks can be absorbed by a large group of investors rather than just one. However the complexity in the design of instruments and the lack of capacity in our current accounting systems to represent them fully led to opacity. Different tranches were combined into one security, derivative securities were constructed from derived tranches of mortgages.

After a few rounds the original mortgage was translated into a security that was very hard to value due to the large uncertainties of the values of the derived securities. These difficulties in valuation were not in any way represented by the traditional accounting practices we know of that are limited with historical costs and market values at the time of valuation. The contingencies embedded in those instruments were not reflected in any form on the balance sheets. At the time of bank nationalizations in the UK, these difficult to see on balance sheet and difficult to value toxic assets were estimated to be up to £200b. This is just an estimate, since they are not reflected fully o balance sheets we do not know the real magnitude of contingent liabilities in the system.

When faced with shortage of liquidity, as it happened during the Crisis of 2008 institutions have to sell assets. Asset values decline. But when the assets are opaque and thus difficult to value, the increase in uncertainty was much higher leading to a huger risk of solvency, and thus further bank runs. Deleveraging by reducing the size of their assets is no longer an option. Thus the one option remains is to cut their credit lines to borrowers and a sharp decline in maturity of loans. With the fear that this might lead to a catastrophe on the corporate and household sectors the UK government ensured the return to mortgage and small business lending in every intervention including nationalizations.

Immediate reactions to the Crisis of 2008: Short run policies

The lessons from the Crisis of 1929 shaped the immediate reactions of the governments. The fear that we are facing another Great Depression, led to dramatic falls in confidence worldwide and thus collapse in stock markets and cuts in consumption. Short run policies were geared towards restoring confidence and limiting the runs.

The first notable effort of the UK government to restore confidence was to facilitate interbank lending when overnight rates jumped from 3% to a record high 6.5% in October 2008. A cash injection of £40 billion was made and Gordon Brown recommended that that the Group of Seven should guarantee all interbank lending. Banks were reluctant to lend to each other overnight at 6.5% while they were lending to the Bank of England at 4%. This was successful in restoring confidence. But of course monetary base expanded. M4 increased by about one third from about £1500b to £2000b in two years ending December 2008.

The second action of UK government was to restore balance sheets. The UK government bought the assets of the banks in exchange for their shares. This method gives ownership of the banks to the tax payers and if asset prices increase returns will be transferred to tax payers. Mass nationalizations became inevitable and Northern Rock, Lloyds, RBS and HBOS are now state owned. This was successful in restoring the bank balance sheets. However ownership structures changed in financial sector. Bank nationalizations or nationalizations of any sort were thought to belong to another era. Other issues of moral hazard arose later when nationalized banks announced bonuses to their managers. Opposition was fierce to paying bonuses with tax payers' money.

The third action of UK government was to restore consumer demand and output. The immediate reaction of the Bank of England was to provide liquidity and to reduce interest rates. This was helpful in limiting house repossessions at the household sector and providing credit lines to the corporate sector. Interest rates fell from 5.5% to 1% in less than two years to provide relief. However this limits the capacity to use monetary policy any longer. Thus focus was shifted to fiscal policy. Stamp duty exemption was reduced from £175,000 to £125,000 in house purchases and VAT was reduced from 17.5% to 15%. Both measures were successful in restoring confidence and thus preventing sharper declines in consumer demand and thus output. However monetary policy cannot be effectively used any longer at such low interest rates and there will be long term repercussions.

What next: Long term policies

Long term effects of short term policy will be slowly absorbed. Some of the conditions that led to the Crisis of 2008 will not change. Some will be regulated. Behavioural factors should now be considered carefully in designing the new regulation. The regulation we use today has its roots in the U.S. regulatory frameworks which was designed more than 70 years ago in reaction to the crisis of 1929. Today the conditions that led to the Crisis of 2008 are different. Over the past fifty years, the intellectual foundations of finance has been inspired by rational expectations in economics and efficiency of financial markets. Thus regulation itself was perceived a regression and efforts for de-regulation prevented the legal frameworks we use today lag behind the needs new financial instruments and markets brought. There is need for better regulation that takes into consideration biases in human behaviour in designing the new regulation so that it can be implemented effectively.

The first trigger of the Crisis of 2008, internationalization of financial markets will not change. It provides a much better allocation of risk and boosts economic growth rates worldwide. If anything, the nature of financial markets and institutions will become more global in the future. The second trigger of the crisis, higher leverage increases investments and boosts rates of return in both household and corporate sectors. Neither securitization, nor the complex derivative securities, will disappear. They both allow for a much better allocation of risk. The challenge we face today is to provide better information flow to prevent further internationalization and complex instruments to make financial statements opaque. The opacity of financial statements should change. New regulation should take into account the people making the several financial decisions in the households, corporations and financial institutions. Human nature will not change but behavioural factors that led to the crisis can be integrated into our regulation to make it better.

G20 and G7 meetings were conducted at the onset of the crisis to coordinate efforts internationally. International organizations such as the IMF and the World Bank have assumed active roles especially with emerging markets. Coordinated efforts of the US Federal Reserve, the Bank of England and the European Central Bank, providing liquidity to their respective markets, helped to restore confidence world wide. Changes in regulation should be similarly coordinated with leading economies and international organizations.

Leverage in banking industry was under scrutiny through several Basel Accords. The main problem in the banking sector was the opacity of financial statements that the risks of newly designed complex assets were not represented. Highly levered corporations and households are also highly exposed to small fluctuations in their asset values. The Crisis of 2008 started a sub-prime crisis initiated from the household sector and attention is diverted to leverage in the household sector. Leverage in corporate sector is largely ignored. New regulation should encompass the financial decisions at the household and corporate sectors. The optimism in human nature and the decision making processes in these sectors should be considered.

UK mortgage companies reacted quickly to the sub-prime crisis by adjusting down payments upward up to 40% of equity. Mortgages of more than 100% were available before the crisis. Tax rules in the UK favour leverage in buy to let properties as interest payments are tax deductable. In other countries like Sweden tax deductibility applies to homes one lives in. We have to revisit tax rules in this sector. Tax exemptions can be given to first homes rather than buy-to-lets.

In the UK interest rates on mortgages are not linked to the leverage of the household. The mortgage products are priced according to time maturity of the product but not according to the leverage of the households. Regulation is needed to impose better pricing of mortgage products in relation to the financial fragility of households.

In the corporate sector tax rules favor leverage; debt is tax deductable. Tax deductibility of interest, need revisiting. In market oriented systems like the US, bond pricing is made by markets and rating agencies, good or bad, rate corporate bonds and financial fragility is integrated into interest rates. In bank oriented systems availability of funds may diminish due to financial fragility but leverage of the corporation is not a major consideration in determining interest rates commensurate with the financial fragility of the corporations. Regulation is needed to impose better pricing of bank products.

New and complex derivative instruments were largely unregulated before the Crisis of 2008. Regulation always lags financial innovation. This lag lead relation between the introduction of new securities and their regulation leads to a misperception that there is no need for regulation. During benign economic conditions risks will be underestimated and thus underpriced as a result of unfounded optimism. The increase in leverage both in household and corporate sectors was completely unnoticed prior to the crisis of 2008.

The FSA and the Bank of England should start following increases in systemic risk in the economy.

The FSA and the Bank of England should start collecting of a different set of information and impose a different accounting system to collect some of it. We do not yet know the extent of sometimes unbounded contingent liabilities in the UK. New accounting procedures are needed for representing the risks involved in complex assets. They are now called toxic because we cannot observe them in traditional balance sheets and we cannot asses their risks or values using the existing accounting practices we know. There is need for a new system of accounting that enables us to present those complex asset structures and the contingency of their values, sometimes imposing unlimited losses. Other measures of systemic risk must be constructed taking into account leverage ratios both at the household and corporate sectors.

The Crisis of 2008 is perceived as a result of excessive risk taking by managers who were enriching themselves via short-term bonuses, while destroying the long-term value of their companies (Zingales, 2008). The collapse of major financial institutions is perceived to be due to a lack of accountability by corporate boards (Minow, 2008). Greed is in human nature. It has to be regulated. The mismatch of the timing of profits and thus the bonuses to management and the timing of loss realizations of contingent liabilities is an important issue. Today 70% of ownership is institutional compared to less than 10% in the 1930s following the crisis of 1929 (Zingales, 2008). Financial markets are used extensively by pension funds. Unsophisticated investors no longer need direct protection as they did before 1929 but they need indirect protection through regulating the securitization process and corporate accountability. New regulation needs to restrict practices that exploit biases in human nature.