Quantitative Easing – QEase or Die! Part II

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The meltdown of the world financial system, called by some economists the late 2000's credit crunch, induced such a strain in the money supply of the world's leading economies, that conventional expansionary measures for stimulating them were not enough to get the desired results. Indeed on September and October of 2008 the US economy stood on the brink of total collapse, and this triggered a series of responses from the Federal Reserve System to save it at all costs.

This historical turn of events was fueled by a series of variables that need to be discussed and understood. For us this is fundamental to really come to terms with the fact that the Federal Reserve System, when all was said and done, had no other option but to use quantitative easing or run the risk of letting the financial system die.

So for the sake of providing a comprehensive background for the imperative QEase or die, we mention the following forces that induced the crisis:

1. THE RISE OF TOO BIG TO FAIL FINANCIAL INSTITUTIONS – As late as 1990's the banking industry was composed of more than 15,000 modest-sized banks tied to local communities. By 2009 this amount has shrank to 8,000 at the same time 13,000 credit unions were reduced to 7,500. The initial charter of the US banking system promoted small scale financial institutions for distributing systemic risk. In the case that a bank had problems the FDIC could quickly close its doors, protect its depositors, and avoid significant damage to the U.S. banking system or economy. The next changes in financial regulation accelerated the coming of Too Big To Fail, during 1994 interstate banking was authorized, in 1999, Congress repealed

the Glass-Steagall Act of 1933, which had generally required banks, investment banks, securities firms, and insurance companies to operate separately, and allowed them to merge operations. In 2000, Congress enacted the Commodity Futures Modernization Act which barred federal regulation of swaps and the trillion-dollar swap markets, and which allowed U.S. banks, broker-dealers, and other financial institutions to develop, market, and trade these unregulated financial products, including credit default swaps, foreign currency swaps, interest rate swaps, energy swaps, total return swaps, and more. In 2002, the Treasury Department, along with other federal bank regulatory agencies, altered the way capital reserves were calculated for banks, and encouraged the retention of securitized mortgages with investment grade credit ratings by allowing banks to hold less capital in reserve for them than if the individual mortgages were held directly on the banks' books. In 2004, the SEC relaxed the capital requirements for large broker-dealers, allowing them to grow even larger, often with borrowed funds. In a little over ten years, the creation of too-big-to-fail financial institutions had become a reality in the United States. By 2005, as U.S. financial institutions reached unprecedented size and made increasing use of complex, high risk financial products, government oversight and regulation was increasingly incoherent and disjointed. By the end of 2008, Bank of America had purchased Countrywide and Merrill Lynch; Wells Fargo had acquired Wachovia Bank; and JPMorgan Chase had purchased Washington Mutual and Bear Stearns, creating the largest banks in U.S. history. By early 2009, each controlled more than 10% of all U.S. deposits.

2. HIGH RISK MORTGAGE LENDING - Lenders were required to keep a certain amount of capital for each loan they issued, which effectively limited the number of loans one bank could

have on its books. To increase their capital, some lenders began selling the loans on their books to other financial institutions that wanted to service the loans over time, and then used the profits to make new loans to prospective borrowers. Lenders began to make money, not from holding onto the loans they originated and collecting mortgage payments over the years, but from the relatively short term fees associated with originating and selling the loans. To make home loans sales more efficient and profitable, banks began making increasing use of a mechanism now called "securitization." In a securitization, a financial institution bundles a large number of home loans into a loan pool, and calculates the amount of mortgage payments that will be paid into that pool by the borrowers. The securitizer then forms a shell corporation or trust, often offshore, to hold the loan pool and use the mortgage revenue stream to support the creation of bonds that make payments to investors over time. Those bonds, which are registered with the SEC, are called residential mortgage backed securities (RMBS) and are typically sold in a public offering to investors. Investors typically make a payment up front, and then hold onto the RMBS securities which repay the principal plus interest over time. The amount of money paid periodically to the RMBS holders is often referred to as the RMBS "coupon rate." The problem that triggered the crisis was the wave of defaults household started to experiment during the 2001-2004 increase of the interest rate by the Federal Reserve System, then investors saw their return on investment and investments disappear.

3. CREDIT RATING AND STRUCTURED FINANCE - Despite the increasing use of high risk loans to support mortgage related securities, mortgage related securities continued to receive AAA and other investment grade ratings from the credit rating agencies, indicating they were judged to be safe investments.

> Those credit ratings gave a sense of security to investors and enabled investors like pension funds, insurance companies, university endowments, and municipalities, which were often required to hold safe investments, to continue to purchase mortgage related securities. From 2004 through the first half of 2007, Moody's and S&P provided AAA ratings to a majority of the RMBS and CDO securities issued in the United States, sometimes providing AAA ratings to as much as 95% of a securitization. Beginning in July 2007, however, Moody's and S&P issued hundreds and then thousands of downgrades of RMBS and CDO ratings, the first mass downgrades in U.S. history. By 2010, analysts had determined that over 90% of the AAA ratings issued to RMBS securities originated in 2006 and 2007 had been downgraded to junk status.

When all these variable's effects were felt across the whole financial system the nightmare scenario became a reality. Then the Federal Reserve and the Treasury Department started dozens of programs to salvage the US financial system, from bailouts to quantitative easing, the Federal Reserve aggressively expanded its balance sheet from about $900 billion at the beginning of 2008, to more than $2.4 trillion in December 2010, to provide support to the U.S. financial system and economy.

In conclusion, the financial system situation required unconventional responses to the worst crisis since the 1930's Great Depression. In our next article we will focus on the effectiveness of quantitative easing.

God bless you all!

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