Collateral damage: how the housing bubble blew up global finance

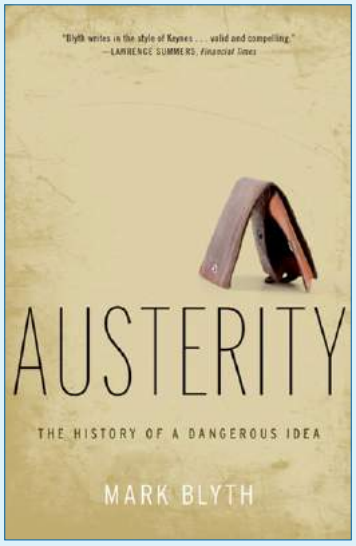
By Elisa Barwick

In his 2013 book *Austerity: The history of a dangerous idea* (Oxford University Press), Scottish-American economist Mark Blyth traced the triggers of the 2008 global financial crisis. As nations again face the prospect of collapsing housing bubbles, against the backdrop of an even bigger, farther-reaching financial bubble than at that time, it is important to review those details.

Understanding the role of the "repo" market in the 2008 crash is even more important today given its 2019 and 2020 crunches; the Fed's 2021 "standing repo facility", a permanent new liquidity spigot; and thereafter, its "reverse repo" tightening strategy. Together with revelations that speculative hedge funds have been given a much greater role in repo and US Treasury markets, this makes for a horror scenario dwarfing 2008. (Articles on these topics are available at citizensparty.org.au/australian-alert-service-feature-articles/economic)

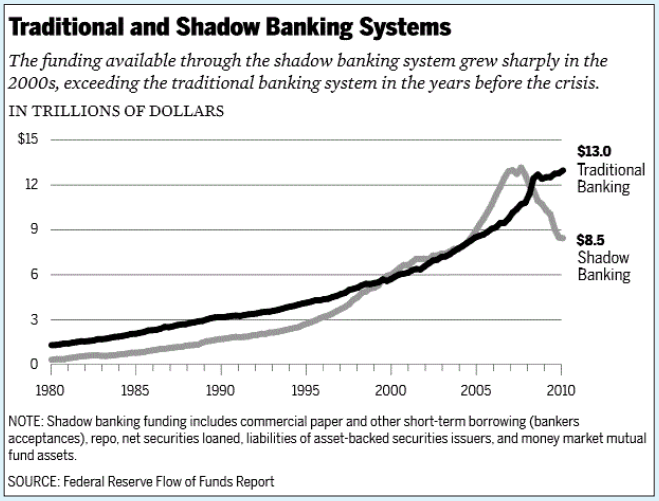
"The repo market", writes Blyth, in his chapter "America: Too big to fail?", "is a part of what is called the 'shadow banking' system: 'shadow', since its activities support and often replicate those of the normal banks, and 'banking' in that it provides financial services to both the normal (regulated) banks and the real economy. Take pay cheques, for example. It would be hugely impractical for big businesses to truck in enormous amounts of cash every weekend to pay their employees out of retained earnings held at their local bank. So companies borrow and lend money to each other over very short periods at very low interest rates, typically swapping assets for cash and then repurchasing those assets the next day for a fee—hence 'sale' and 'repurchase'—or 'repo'. It is cheaper than borrowing from the local bank and doesn't involve fleets of armoured trucks.

"What happened in 2007 and 2008 was *a bank run* through this repo market. A bank run occurs when all the depositors in a bank want their cash back at the same time and the bank doesn't have enough cash on hand to give it to them. When this happens, banks either borrow money to stay liquid and halt the panic or they go under." (Emphasis added.)



The creation of the repo market came with increased deregulation in the 1980s, Blyth explains, as part of a process called "disintermediation", meaning that large corporations bypassed banks and lent to each other directly using cash reserves.

Another major change was "securitisation" of loans. Rather than keeping loans on their books for the term of the loan, banks could "on-sell" them as an income-generating contract, such as a mortgage-backed security. At the same time this removed the risk from the bank's balance sheet, allowing it to borrow more cheaply and lend more.



These two innovations became intermingled as the mortgage risk moved on by banks ended up in repo markets. This happened because mortgage securities were increasingly posted as collateral for short-term repo loans. As Blyth explains, "repo-market investors protect their cash by receiving collateral equivalent to the cash lent. If the borrower goes bust, the lender can still get the money back, so long as, and this is critical, the collateral doesn't lose value."

Safe as houses? Not exactly. Blyth goes on:

"A decline in house prices in 2006 hit the value of these bundled mortgage securities. If you were using mortgage securities as collateral for loans in the repo market, you needed to find more collateral (which people were increasingly less willing to hold) or higher-quality collateral (alternative assets that were in short supply), or you would have to take a 'haircut' (a discount) on what you would get back, all of which affected your bottom line."

Bear Stearns was the first to be caught in this bind. As mortgage defaults rose Bear's reputation sank with the falling value of its investments, and the institutions it borrowed from made more "collateral calls". The capacity to borrow more to sustain its high debt, relative to assets, was rapidly dissolving.

Many banks, Blyth reminds readers, had leverage—the ratio of assets to equity—running at thirty times, meaning only a very small change in their asset values relative to their "equity cushion" was required to make them illiquid, if not insolvent. As securitised mortgages plummeted in value, so did the liquidity in the repo market that was secured by those mortgages.

"With everyone in the market knee-deep in mortgage securities and trying to raise money with the same devaluing collateral, they were trying to cash out what were essentially similar assets. And if they couldn't sell mortgages, they sold anything else they could to raise cash and cover their losses, even supposedly high-quality assets that had nothing to do with mortgages.

Continued page 10

Collateral damage: how the housing bubble blew up global finance

From page 12

Because the market could not absorb the volume of securities being dumped on the market all at once, asset dumping to raise cash created the very panic everyone had sought to avoid. Prices plummeted, firms folded, and trust evaporated further."

The amplifier: derivatives

But it took one further element, wrote Blyth, one further perversion of this financialisation, to blow up the global financial system. "To get there", he wrote, "you have to understand how the structure of these mortgage securities combined with [financial derivatives] … that spread the repo market crisis into the global banking system."

Derivatives are contracts, he explains, that allow banks to trade things that are not normally considered tradeable assets, like movements in interest rates or currencies. So, effectively the contract is a bet, because it pays out based on how that movement plays out.

There were two types of derivatives involved. Firstly, in order to reduce risk, "collateralised debt obligations" (CDOs) were introduced. This instrument pooled mortgage-backed securities, combining the income streams from various types of mortgages and different geographical areas, and then split them up into tranches (or tiers) which were accorded different interest rates (paid to investors) depending on their relative risk. (This is the subject of the "Jenga" scene in the 2015 film *The Big Short*, which demonstrates that if any of the layers crumble so will the whole security.)

"But where things really got interesting", Blyth continued, "was when these derivative securities were sold with an attached CDS", that is, a credit default swap. A CDS is an insurance policy. It has an associated income stream from insurance premiums collected by the issuer, and so it can also be bought and sold. The basic contract insures the purchaser against the default of the bond for which it is issued.

Insurance providers normally keep sufficient cash on hand to pay out on claims, but in this case the players thought the game they were playing in was foolproof. Noted Blyth: "With a decade of house-price increases telling everyone that house prices *only go up*, and with these new mortgage derivatives seemingly eliminating a correlation problem that was deemed small to begin with and was now insurable with a CDS, you could almost begin to believe that you had what bankers call a 'free option': an asset with zero downside and a potentially unlimited upside, and one that is rated AAA by the ratings agencies. The fact that many investment funds are legally required to hold a specific proportion of their assets as AAA securities pumped demand still further." (Emphasis added.)

Another layer of "protection" was engaged. As the mortgages involved increased in riskiness (recall robo-signed, low-doc and NINJA loans—no income, no job, no assets), the issuers of securities used special investment vehicles (SIVs), separated from the parent companies, to shift them off their books. Nonetheless, the price of MBSs collapsed as credit markets froze in 2008, then fell through the floor when all banks tried to offload them at once. All the efforts to disperse risk through the various tiers of financialisation actually concentrated the risk—into one gigantic sinkhole. As the scale of CDS protection written by and written on giant US investment bank Lehman Brothers by firms such as AIG became known, it also became known that this insurance could never be paid out if contracts defaulted *en masse*, or the whole system would implode.

The most extraordinary thing about all of this, remarks Blyth, is how such a crisis was transformed from a quintessentially private sector crisis into one that was blamed on the state. The price of accepting that this rotten edifice was "too big to fail", was accepting that the public purse must bail it out. "That's why we have austerity", said Blyth, "it's still all about saving the banks."