Keynote Address

Mr. Ramesh Lakshman

Mr. Ramesh Lakshman made an attention-grabbing presentation on the World Financial Crisis. Tracing through the history of the international finance, touching Bretton Woods conference, he took the audience though Chicago Mercantile Exchange, 1972, followed by the scenario in the 1980s. He discussed the systematic emergence of investment banks over the decades. He was of the opinion that securitization is the mother of current crisis. Lack of liquidity forced firms like Bears Sterns, Lehman Brothers, Merrill Lynch, etc into distress. It all started with the collapse of the value of mortgage-backed securities. He also explained how world financial crisis would impact India.

PRESENTATION

World War II and Bretton Woods

Fixed Exchange Rate

Forex Control

Banks and Investment banks divided by Chinese wall

Then Came the shock

The Nixon Shocker

Result-Heightened Volatility in Forex markets.
Currencies started floating Chicago Mercantile Exchange introduced currency futures in 1972

Keynesian Economics has failed and markets would be better at allocating capital than bureaucrats.

Two leaders who chose to follow Friedman and introduced various liberalisation

Capital Controls Abolition

Consequences

- Easy availability of home loans against mortgages
- Both currencies appreciated sharply, exports hurt and recession in early 1980's
- Insurance companies and pension funds could move money abroad for investments

Then What?

- Big investors complained about high brokerage fee
- The Division of brokers and jobbers was burdensome
- Tiny jobbing firms had too little capital to handle big orders

What Followed

Big Bang 1986 reforms in England followed US reforms

Broker/Jobber distinction abolished

Foreign firms allowed into market

- Big firms could trade more cheaply and in greater size
- Long term decline in broking revenue. Brokers had to commit higher levels of their own capital. This made trading on their own account more lucrative
- Investment banks had to abandon their close knit partnerships and become publicly traded companies to raise capital or join commercial banks
- That eventually led to abolition of Glass Steagall Act in 1999
- For Commercial banks lending corporate's was no longer
- Retail banking was capital intensive. Result they poached on undertaking and other territories of investment banks using their strong balance sheets
- Investment bankers responded by becoming bigger

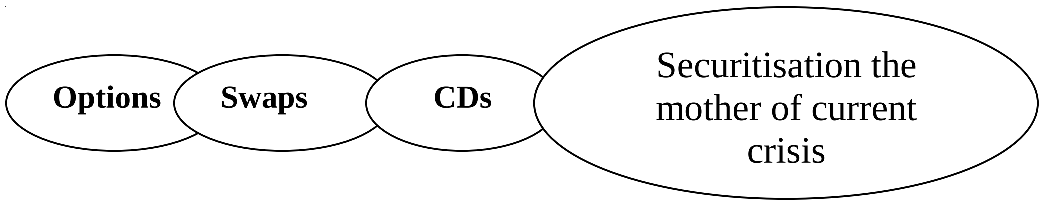
Expansion

- Inflation was tamed –Paul Volcker
- Asset prices started their ascend-2 decades
- Trading and lending against such assets was very profitable.
- Moderation was short limiting the damage to balance sheets
- Financial company's share in wall street rose from 5.2% to 23.5%

Financial Engineering

As banks grew bigger they became complex and felt the need for change

Financial Engineering became the order of the day. Dissect risk and hedge them separately. Introduce new products by combining elements of different products etc.



Securitisation-Mother of current crisis

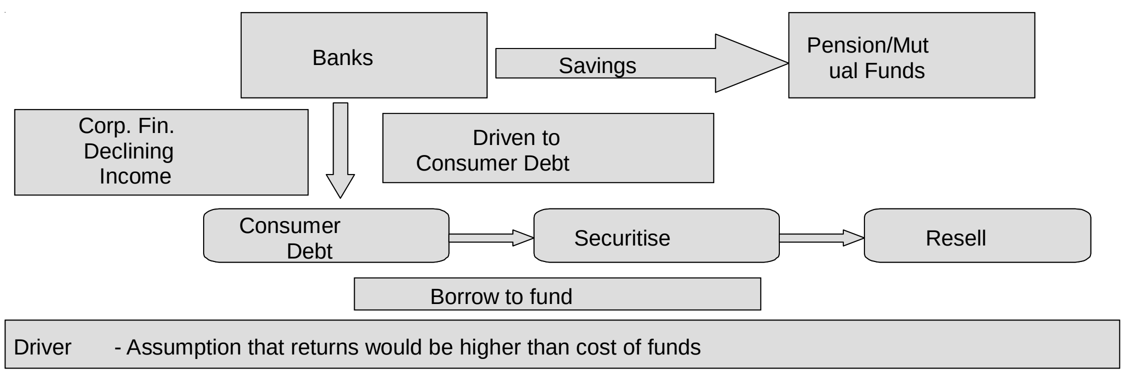
- Basel 1 & capital adequacy made loans on balance sheet of banks expensive
- Securitisation helped move them off balance via SIV
- Market dynamic induced liquidity resulting reduced volatility

<u>Why are we here ?</u>

- Need for banks to drive returns in a market where traditional business was yielding low margin
- Mortgage securities proved to be a boon. Securitisation helped reduce capital cost
- Leverage increased returns. All the borrowing needed was bridge financing till the asset are taken off their backs
- When the asset prices were increasing, more and more subprime borrowers were encouraged to borrow
- In case of default the higher asset price would pay for the loan
- Complex structures were introduced to lure the unwary-Low interest rates for some time after the borrowing, with higher rates subsequently
- When the asset prices started to fall, some of the SIV came back on the balance sheets of the banks
- That led to crisis of confidence and quickly engulfed the whole market.
- The complex structures required Insurance which dragged them also into the trouble
- The falling markets also meant banks held back lending to each other in the term money market
- Lack of liquidity forced firms into distress –Bears Sterns, Lehman, Merrill Lynch, etc.
- With that began the complete collapse of markets and the entire consequence

How it happened ?

- Started with collapse of the value of Mortgage backed securities
- Poisonous securities constituted a major portion of the ultimate asset base
- Wall Street and Investment banks haemorrhaged $ 175 billion of capital between July 07 and Mar 08
- An injection of $75 billion in capital was not sufficient to stem the tide
- Reverberations-Northern Rock in England, Soc Gen in France, Bear Sterns in US followed by Lehman and others
- Leveraged losses estimated at $ 400 Billion leading to expected drop in US GDP by 1 to 1.5%
- Gravity Defying global imbalances and asset bubbles -2001 to 2006, interest rates were low
- Bubble economies were not under control- US debt 255.3% of GDP increased to 352.6% of GDP
- Debt growth strongest in household and financial sectors
- Banks debt increased from 63.8% of GDP to 113.8% of the GDP
- Succession of asset bubbles fuelled this growth in debt
- Post 9/11 there was political motivation to encourage US consumer to spend and consume



- To fuel the growth in the business home owners were encouraged to treat their houses like ATM
- Mortgage Sales Men paid commission upfront and amount written off over the tenor
- Past attempts to put off the inevitable recognition of losses fuelled further losses

Failure of Quantitative Finance

- Quantitative Finance's measurement of risk went something like this
- In August 2007 events that models predicted can happen only once in 10000 years happened every day for three consecutive days.
- Naseem Talib was a lone voice predicting impact from black swan

What Next ?

- Increased Volatility to stay for some more time
- Paradigm shift in markets. Emerging markets to do better
- US will face recession and pains longer than others
- Markets will recover like they always have

What About India ?

- Liquidity crunch to impact India. RBI will have to act to cushion the impact. Growth will be tempered
- We expect India to recover fastest even though some sectors like IT and BPO may suffer
- The inherent strength of India will see it through. While China will also manage its dependence on exports more than India could impact it negatively
- Low exposure of Indian banks to sub prime hit institutions should also help

MMS Semester –II Students

Global Financial Crisis

We also use Workshops & Seminars as platform to showcase the talent of our students and enhance their potential.

On the eve of the Seminar, our students (Semester-II, Batch 2009-2010) presented their study, on Global Meltdown, which they prepared under the guidance of Dr. Guruprasad Murthy and Ms. Sukhada Waknis. They studied the different positive and negative aspects and impact of the global financial crisis.

PRESENTATION

Financial Crisis

"A financial crisis is a disturbance to financial markets that disrupts the market's capacity to allocate capital – financial intermediation and hence investments come to a halt"

- Richard Portes
Professor of Economics, London Business School and President, Centre for Economic Policy Research

All Crises are 'Crises of Success' (Portes and Vines, 1997)

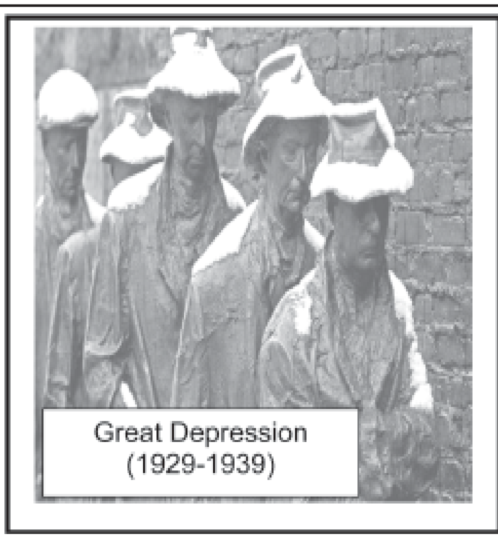
The initial capital inflow that ultimately proves unsustainable (and perhaps unprofitable) is both a sign and - for a time - a cause of economic promise and success.

Financial Crises Features

- the relative importance of bank and securitised debt
- the relative importance of private and sovereign debt
- exchange rate regimes and history
- underlying structure and dynamics

Major Financial Crises Since 20th Century

- 1910: Shanghai rubber stock market crisis
- 1980s: Latin American debt crisis, beginning in Mexico
- 1989-91: United States Savings & Loan crisis
- 1990s: Collapse of the Japanese asset price bubble
- 1992-3: Speculative attacks on currencies in the European Exchange Rate Mechanism
- 1994-5: 1994 economic crisis in Mexico: speculative attack and default on Mexican debt
- 1997-8: Asian Financial Crisis: devaluations and banking crises across Asia
- 1998: 1998 Russian financial crisis: devaluation of the Rouble and default on Russian debt
- 2001-2: Argentine economic crisis (1999-2002): breakdown of banking system
- 2008: Global financial crisis and USA, Europe: spread of the U.S. subprime mortgage crisis



Timing and Severity

- Great Depression began in the summer of 1929
- Real output and prices fell precipitously
- Industrial production in the United States declined 47 percent and real GDP fell 30 percent
- Wholesale price index declined 33 percent

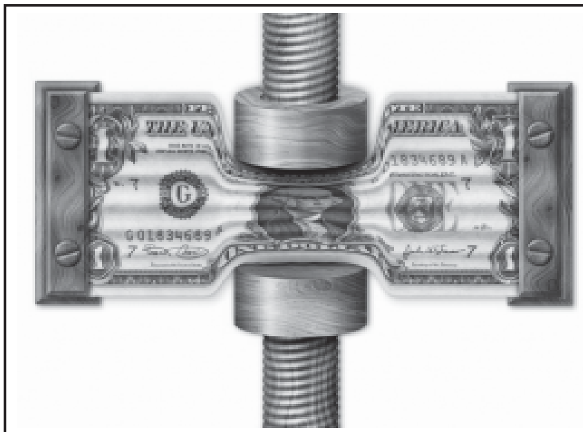
Causes

Farm Depression of the 1920s	The Stock Market Crash	Uneven Distribution of Income
Prices of farm products declined upto 40% in 1920-1921 and they remained low through the 1920s	Stock values dropped rapidly on Oct. 24,1929; now known as Black Thursday	Industrial production increased about 50% but the wages of the industrial workers rose far more slowly

German Hyperinflation

Genesis: Financial Crises 2008

- September 11/2001 – federal reserve started a long period of interest rate reduction
- Induced by declining price level as large US imports from China and other low-cost producers
- This declining interest rate had two effects: first, it induced a search for alternative investment vehicles providing higher rates of return; and, second, it allowed new homebuilders to enter the home mortgage market on lower credit ratings but with higher interest rates — this phenomenon now known as subprime credits
- The two effects lead to an increase in credit spiral



Sub Prime Crisis…… *and its rippling effects on the global economy*

"We were at the brink of something that would have made anything that's happened in financial history look pale. We were very, very close to a system that was totally dysfunctional and would have not only gummed up the financial markets but gummed up the economy in a way that would take us years and years to repair"

-Warren Buffet

What is SubPrime lending?

- Lending to borrowers with a weak or substandard credit history
- Subprime loans include the financing of homes,cars, credit cards etc.
- Lower Credit Score
  FICO less than 620
  (Fair Issac Corporation)

Inflated….

- <u>POST 2001</u>
- The boom was led by:
  - Housing prices
  - Interest rates
  - Financial innovation viz.

  MBS -Mortgaged backed securities

  CDO-Collateralized Debt Obligation

The bubble burst….

POST 2006

- Housing prices in USA began to drop:
    - Interest rates
    - Rise in subprime mortgage delinquencies
    - Resultant defaulter/foreclosure
- Result : The housing bubble burst in Aug 2006

Sequence of events