TOPIC GUIDES
PIMUN 2018

The Global Financial Crisis

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Danger and Opportunity

PIMUN 2018

Letter from the Director

Dear Delegates,

On behalf of the crisis team and the PIMUN Secretariat, I'd like to extend a very warm welcome to you all. I am excited to introduce a scenario that I have always wanted to see simulated in a crisis committee - the Global Financial Crisis of 2008.

Unlike many crisis simulations, the main action will be in the offices, committee rooms and trading floors. However, just because you are dealing with bankers and politicians does not mean that you can't play dirty. Both intra- and inter-cabinet interactions promise much intrigue and scheming, with millions of dollars at stake.

However, keep in mind that your ultimate goal is to prevent the meltdown of the global financial system, or, failing that, to minimise the effects to the US economy. To that end, cooperation between both cabinets is a must, and regular inter-cabinet meetings will take place throughout the course of the simulation.

The content within this study guide should act as a basis for your own research. It outlines the structure which you can act within, but you should also realise that there is always potential to think outside the box. As delegates, you are encouraged and expected to research areas your assigned character will be proficient in. For example, if you are assigned a legislator role, it would be wise to make familiarise yourself with some of the legal infrastructure surrounding finance.

Whether you are a dogged legislator hellbent on taking on Wall Street or a master dealmaker, I am sure that you will find that this simulation has more than adequate scope for you to make a play and achieve your goals.

Yours truly,

Perth Ophaswongse

Crisis Director, The Global Financial Crisis
PIMUN 2018

Background

The 2008 financial crisis was the worst economic disaster since the Great Depression of 1929. It occurred despite the best efforts of the United States Federal Reserve and Treasury Department to prevent it and led to the Great Recession. One of the most obvious reasons for the 2006 housing market crash and eventual global financial crisis is the financiers themselves who claimed to have found a way to banish risk when in fact they had simply lost track of it. Central bankers and other regulators meanwhile simply turning a blind eye. The Federal Reserve operated under the misguided belief the subprime mortgage crisis would remain confined to the housing sector. What they failed to recognise or understand were the actual causes of the subprime mortgage crisis until later.

The macroeconomic backdrop that this was all played off against was equally important. The “Great Moderation”- years of low inflation and stable growth fostered complacency and risk-taking and a “savings glut” in Asia pushed global interest rates comfortably down. Other research also implicates European banks that borrowed unreservedly in American money markets before the crisis and used these funds to buy dodgy securities. All these factors came together to foster a surge of debt in what seemed to have become a less risky world.

Crash of The American Housing Market To Global Financial Crisis

The marker that was widely identified as putting the economy in jeopardy was in 2006, when housing prices began to fall (turn of the housing market). At first, realtors applauded, they were convinced that the overheated housing market would inevitably return to a more sustainable level. What was blatantly ignored however, was that there were too many homeowners with questionable credit that banks had allowed to take out loans for 100% or more of the value of their new homes. Many blamed the Community Reinvestment Act, a 1977 act that sought to eliminate bank “redlining” of poor neighborhoods, that had contributed to the growth of ghettos in the 1970s and encourages bank lending to low- and moderate-income neighborhoods (subprime areas). The Gramm-Rudman Act however was the real villain. Also known as the Omnibus Budget Reconciliation Act, it refers to several different laws enacted under presidents Ronald Reagan, George HW Bush and Bill Clinton, ultimately allowing banks to engage in trading profitable derivatives that they sold to investors. These mortgage-backed securities needed home loans as collateral, the derivatives creating an insatiable demand for more and more mortgages.

The years before the crisis saw a plethora of eye wateringly irresponsible mortgage lending in America. Loans were doled out to “subprime” borrowers with poor credit histories who objectively would be unlikely to ever be able to repay them. These risky mortgages were passed on to financial engineers at the big banks, who turned them into supposedly low-risk securities by putting large numbers of them together in pools. Pooling was effective when the risks of each loan was uncorrelated. The big banks argued that the property markets in different American cities would rise and fall independently of one another. But this proved wrong. Starting in 2006, America’s housing market began to turn, prices slumping.

The pooled mortgages were used to back securities known as collateralized debt obligations (CDOs), which were sliced into tranches by degree of exposure to default. Investors bought the safer tranches because they trusted the triple-A credit ratings assigned by agencies such as ‘Standard & Poor’s’ and ‘Moody’s’. Investors sought out these securitised products because they seemed to be relatively safe while simultaneously yielding higher returns in a world of low interest rates. The agencies however were paid by, and so beholden to, the banks that created the CDOs and as such were catastrophically generous in their assessments of them.

When America’s housing market turned, the Fire-sale prices that CDOs were now selling at, instantly dented banks’ capital thanks to “mark-to-market” accounting rules, which required them to revalue their assets at current prices and thus acknowledge losses on paper that might never actually be incurred. Trust, the ultimate glue of all financial systems, began to dissolve in 2007- a year before the Lehman Brothers bankruptcy, as banks started questioning the viability of their counterparties. Most sources of wholesale funding began to withhold short-term credit, causing those most reliant on it to capsize. Northern Rock, a British mortgage lender, was an early casualty in the autumn of 2007.

Complex chains of debt between counterparties were vulnerable to just one link breaking. Financial instruments such as credit-default swaps that were meant to spread risk thin turned out to counterproductively concentrate it. The whole system was revealed to have been built on flimsy foundations: banks had allowed their balance-sheets to bloat, but set aside too little capital to absorb losses. In effect they had bet on themselves with borrowed money, a gamble that had paid off right up until it imploded into itself and proved catastrophic.

The question then arises as to why such risky assets became such a popular commodity. The majority of that reasoning lies in an insurance product called credit default swaps that was perceived as a neutraliser of risk. A traditional insurance company known as AIG sold these swaps and when the derivatives lost value, AIG didn't have enough cash flow to honor all the swaps and banks began to panic when they realized they would have to absorb the losses. They stopped lending to each other on account of not wanting other banks giving them worthless mortgages as collateral. Essentially, no one wanted to be stuck holding the bag. As a result, interbank borrowing costs (known as Libor) rose exponentially.

Regulator Oversight

The most notable oversight by regulators was their tolerance of global current-account imbalances and the housing bubbles that they helped inflate. Central bankers long expressed concerns about America's big deficit and the offsetting capital inflows from Asia's excess savings. A year before taking over as chairman of the Fed from Alan Greenspan, Ben Bernanke highlighted the savings glut in early 2005. But the focus on net capital flows from Asia left a blind spot for the much bigger gross capital flows from European banks. The purchase of a large amount of dodgy American securities, financed in worryingly large part by borrowing from American money-market funds.

In other words, although Europeans claimed to be innocent victims of Anglo-Saxon excess, their banks were actually in the thick of things. The creation of the Euro prompted an extraordinary expansion of the financial sector both within the Euro area and in nearby banking hubs such as London and Switzerland. Essentially, the glut that caused America's loose credit conditions before the crisis, was arguably in global banking rather than in world savings.

Central banks could have done more to address the issue. The Fed made no attempt to stem the housing bubble. The European Central Bank did nothing to restrain the credit surge on the periphery, convincing themselves that current-account imbalances did not matter in a monetary union. The Bank of England, having lost control over banking supervision when it was made independent in 1997, took a mistakenly narrow view of its responsibility to maintain financial stability.

Central bankers continue insist that it would have been difficult to temper the housing and credit boom through higher interest rates. Perhaps so, but the other regulatory tools at their disposal cannot be ignored, such as lowering maximum loan-to-value ratios for mortgages, or necessitating that banks set aside more capital.

Lax capital ratios proved the biggest shortcoming. Since 1988 a committee of central bankers and supervisors meeting in Basel has negotiated international rules for the minimum amount of capital banks must hold relative to their assets. But these rules did not define capital strictly enough, which let banks smuggle in forms of debt that did not have the same loss-absorbing capacity as equity.

Under pressure from shareholders to increase returns, banks operated with minimal equity, leaving them vulnerable if things went wrong. And from the mid-1990s they were increasingly allowed to use their own internal risk assessment models- in effect setting their own capital requirements. Predictably, they judged their assets to be ever safer, allowing balance-sheets to balloon without a commensurate rise in capital.

The Basel committee also did not make any rules regarding the share of a bank's assets that should be liquid. And it failed to set up a mechanism to allow a big international bank to go bust without causing the rest of the system to seize up.

But regulators and bankers were not alone in making misjudgments. When economies are doing well there are powerful political pressures not to rock the boat. With inflation at bay central bankers could not appeal to their usual rationale for spoiling the party. The Great Moderation and it's reassuring stability over which they presided encouraged risk-taking. And as so often in the history of financial crashes, humble consumers also joined in the collective delusion that lasting prosperity could be built on ever-growing piles of debt.

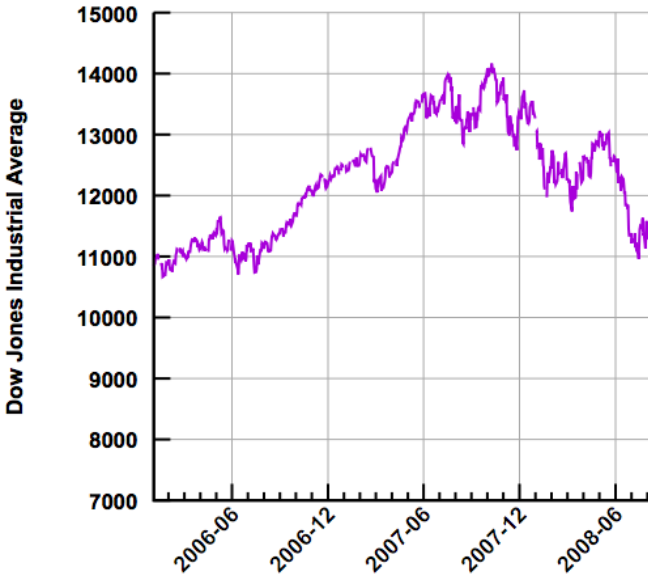
There is still debate amongst economists over whether these low rates were the result of central bankers' mistakes or broader shifts in the world economy. Some accuse the Fed of keeping short-term rates too low, pulling longer-term mortgage rates down with them. The Fed's defenders shift the blame to the savings glut, the capital from which flooded into safe American-government bonds, driving down interest rates. Low interest rates created an incentive for banks, hedge funds and other investors to hunt for riskier assets with higher returns. They also made it profitable for such outfits to borrow and use the extra capital to amplify their investments, on the assumption that the returns would surpass the costs of borrowing. The low stability of the Great Moderation increased the temptation to "leverage" in this way, with short-term interest rates being low but unstable, investors hesitate before leveraging their bets. But when rates appear stable, investors devalued the risk of borrowing in the money markets to buy longer-dated, higher-yielding securities.

Current Situation

Early September 2008

As the third quarter of the year comes closer, the investment market was anxious to see how the real estate situation would continue. In the beginning of the year, signs of bad times were starting to arise - a public statement by the National Association of Realtors (NAR) stated how 2007 was one of the worst years in the industry, with existing home sales reaching its biggest drop in 25 years, and prices declining "the first … in many, many years, possibly going back to the great depression."

The sentiment of a bearish market apparently also spread into the market as a whole, as Dow Jones Industrial Average hit its lowest level since November 2006 only two months after in March 10th. Taking into account that this happens just five months after the Dow reached its peak. The index was slashed 20% of its peak value of October 2007.



The condition was worsened by the cash crunch at Bear Stearns, US fifth-biggest investment bank during the same week. Bear Stearns had been one of the biggest buyers mortgage-backed securities, leveraging from the suspension of net

capital requirements the SEC has given them 3 years prior in 2005.
Rumours was already abound about Bear Stearns' financial health, as in the June of prior year they had halted payments for its two CDO funds. Not long afterwards, the funds imploded and Merril Lynch seized over $800 Million in Bear Stearns assets as a compensation.

By the end of the same week, their stocks have plummeted 45.7%, even once touching $28.42 - their lowest price since 1998 Asian Financial Crisis. Its CEO Alan Schwartz then announced "Our liquidity position in the last 24 hours had significantly deteriorated." And with it, Bear Stearns was given 28-day emergency financing line through the Federal Reserve Bank of New York and its rival JP Morgan-Chase. Two days after, JP Morgan acquired Bear Stearns for $2 a share. The deal was backed by the Feds' $30 Billion provision on covering possible Bear Stearn losses.

While the market was going into an uproar, the men in Capitol Hill were not idle either. Enter June, FBI has then detained 406 people nationwide on charges of fraud. This included Bear Stearns' two former CDO hedge funds that failed in 2007. They were accused of misrepresenting their funds true condition to investors; both are acquitted. Nobody in the industry was safe.

June 18th, the Senate Banking Committee Chairman Christopher Dodd proposed a housing bailout bill for troubled subprime mortgage lenders. In the same day as well however, Dodd admitted to having received campaign donations and perks from Countrywide Bank - one of the aforementioned troubled lenders. The perks even included a $75,000 reduction in mortgage payment for Dodd himself. Some other senators later were also known to have received similar perks, for having "special" relationships with Countrywide CEO Angelo Mozilo.

By the end of July, President Bush then signed into law the Housing and Economic Recovery Act of 2008 also known as HERA. Through the legislation the government authorized a guarantee of up to $300 Billion for new mortgage subprime borrowers through the Federal Housing Administration. It also created the Federal Housing Finance Agency (FHFA), an independent agency tasked with supervising the lenders such as Freddie Mac and Fannie Mae.

The third quarter saw US fourth-largest bank failure through IndyMac; the largest savings and loan associations in Los Angeles Metro Area, and seventh-largest mortgage lender in the country. And in September, FHFA took over Fannie Mae and Freddie Mac. This effectively nationalized half of US mortgage market.

It is also important to note, however, that through all these times there remained statements of confidence. One of them was Office of Thrift Supervision Director John M Reich, who supervised IndyMac, had noted back in March that the savings and loan associations remained prudent due to its regulators effectiveness. Barney Frank, the Democratic chairman of House' Financial Committee, even noted that Freddie Mac and Fannie Mae future remained "solid" back in July.

Timeline of Key Events

End of 2006
Housing market turns- More than 1.25 million foreclosure notices were filed on more than 800,000 properties during the year.

April 2007
New Century Financial files for Bankruptcy.
July 2007
Bear Stearns tells investors they will get little, if any, of the money invested in two of its hedge funds after rival banks refuse to help it bail them out.
9 August 2007
BNP Paribas freeze three of their funds, indicating that they have no way of valuing the complex assets inside them.
4 September 2007
The rate at which banks lend to each other rises to its highest level since December 1998. The so-called Libor rate is 6.7975%, way above the Bank of England's 5.75% base rate; banks either worry whether other banks will survive, or urgently need the money themselves.
14 September 2007
British bank Northern Rock faces a liquidity crisis and it needs a loan from the British government. This sparks fears that the bank will shortly go bankrupt – prompting customers to queue round the block to withdraw their savings. It is the first run on a British bank for 150 years.
18 September 2007
The US Federal Reserve cuts its main interest rate by half a percentage point to

4.75%.

1 October 2007

UBS announce losses - $3.4bn - from sub-prime related investments.

30 October 2007

Merrill Lynch's chief resigns after the investment bank unveils a $7.9bn exposure to bad debt.

6 December 2007

US President George W Bush outlines plans to help more than a million homeowners facing foreclosure.

6 December 2007

The Bank of England cuts interest rates by a quarter of one percentage point to 5.5%.

13 December 2007

The US Federal Reserve coordinates an unprecedented action by five leading central banks around the world to offer billions of dollars in loans to banks. The move succeeds in temporarily lowering the rate at which banks lend to each other.

9 January 2008

The World Bank predicts that global economic growth will slow in 2008, as the credit crunch hits the richest nations.

21 January 2008

Global stock markets, including London's FTSE 100 index, suffer their biggest falls since 11 September 2001.

22 January 2008

The US Fed cuts rates by three quarters of a percentage point to 3.5%.

17 February 2008

Alistair Darling announces Northern Rock will be nationalised.

14 March 2008

Bear Stearns is bought out by JP Morgan.

8 July 2008

British Chambers of Commerce (BCC) suggests that the UK is facing a serious risk of recession within months.

7 September 2008

US government bails out Fannie Mae and Freddie Mac.

15 September 2008

American bank Lehman Brothers files for bankruptcy.

The Bankers

Meet the Banks

JP Morgan Chase are one of the worlds largest banks at this point (and still are today). With an enormous market capitalisation before the crisis, JPM stand to lose enormously from a crash in the stock market. They are relatively undiversified, and have a strong exposure to American sub-prime mortgages. They also have significant asset management, private equity, and hedge fund divisions. JP has a strong position as a market leader, due to its enviable forecasting unit.

Big, Bad, and British, **Barclays** wasn't always the behemoth that it was during our crisis. One of the oldest banks still in existence (with a heritage traced back to the 17'th Century), Barclays shifted from being a primarily domestic lender in the 80's, and acquired a string of businesses through mergers and acquisitions. For our purposes, we will assume

Barclays acts as a single institution, rather than a holding company with a number of boards. Barclays is a relative newcomer to the world of transnational finance, a path it was taken on by boss Bob Diamond, once dubbed “a law unto himself” (Andrew Tyrie, former chair of the House of Commons Treasury Select Committee).

Originally the Bank of Italy, **BOA** started off as a lender to immigrants seeking mortgages or business loans, but developed through the 20’th century into one of the “Big 4” American banks, again through a series of mergers and acquisitions. Going into the crisis, BOA had very heavy exposure to sub-prime mortgages, as a lender, owner, and underwriter of vast sums of debt obligations.

AIG had a particularly large exposure to the crash, for two main reasons. Firstly, AIG was the market leader in credit default swaps at the time (insurance against loan defaults in certain classes), meaning that even small levels of defaults triggered high costs for AIG, who had to repay the debt owner. The second reason was that AIG purchased a large stake in Blackstone, which specialised in leveraged buyouts, meaning when markets turned bearish, they could only close a fraction of the transactions they previously had.

Prepare to be in the room where it happens - this bank dates from 1784, when a number of American Founding Father, led by Alexander Hamilton, established the Bank of New York, later **BNY Mellon**. The “Mellon” comes from 2007, following a merger with the Mellon financial corporation. This bank is not a particularly large lender, but rather specialises in management - it’s seen as a premier “custodian”, and manages private funds, endowments, pension funds. A reliance on index-linked investing in the decade preceding the crash means BNY’s core funds are highly exposed to the stock market.

The “Morgan” isn’t an accident - both this bank and JP further up were founded by members of the Morgan banking dynasty. **Morgan Stanley** has a similar field of interest, and were heavily involved in sub-prime lending before the crash. Morgan Stanley also ramped up their leverage prior to the crash, under pressure to increase their dividends at the same rate as their competitors. They are almost uniquely vulnerable, given their lack of diversification.

“*A great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money*”

So wrote Matt Taibbi in Rolling Stone, and the moniker stuck. **Goldman Sachs** is the only bank with the same leadership then as now, for the simple fact that under the leadership of Lloyd Blankfein, the firm actually made some profits during the crisis by betting heavily against mortgage derivatives. However, goldman relies on reasonable liquidity to be able to make trades, and spooked investors create an illiquid atmosphere. Goldman has plenty to lose in a crisis.

Citigroup failed to diversify from CDO’s before the crisis, and had “shocking risk management” - (Richard Bowen, former Senior Vice President, and whistleblower). Shockingly, even after the whistleblowing, Citigroup refused to include CDO’s in their risk profile.

Wells Fargo was the world's 2nd largest bank before the crisis (and third today). With an enormous subprime exposure before the crisis, WF stand to lose enormously from a crash market confidence. They leveraged more aggressively than a number of rivals, including JP Morgan, and were in breach of standard liquidity rules.

Washington Mutual was one of the main victims of the Crisis. The largest bank failure in the history of America, WaMU expanded aggressively to offer loans to subprime borrowers across the United states, and were tremendously successful in this endeavour. More of a local bank than the others, WaMU took the view that most banks had mispriced the risks of lending, and focussed aggressively on mortgage lending.

Merrill Lynch was a fully autonomous bank back then, before their crisis sale to Bank of America. It grew rapidly before the crash due to the “thundering herd” (a reference to the bull logo) - a network of thousands of brokers with diverse specialisations which allowed it to underwrite a far larger range of assets than its rivals, and to keep the contracts and all the profits in-house. This increased revenues, but massively increased exposure to defaults, since a crisis and subsequent underwritings would not hit independent brokers, but Merrill Lynch itself. And of course, Merrill Lynch was highly exposed to subprime CDO’s, as a leading underwriter.

Quite possibly the most prolific offender during the credit crunch, **Deutsche Bank** had a leading role in structuring and selling CDO's, even as their own analysts realised that the bonds were nowhere near as stable as they had promised to investors. One division even started to bet against CDO's when the market started to slump, even as Deutsche continued to sell the bonds they had constructed. Deutsche was also exposed through an index led investment strategy to the stock.

Crashes and regulation through history

Regulators and banks are inextricably linked.

During the latter half of the 1800's, due to better management practices, the output of US manufacturing companies continued to rise year on year, which pushed up corporate profits, dividends, and therefore the stock market. Investors became increasingly speculative and participated in higher and higher volumes of trades. Investors were loaned large sums of money from financial institutions to capitalize their trading. But this intensive speculation and excessively loose lending by banks led to the Panic of 1907, when a crash in the Copper markets caused a rapid collapse in investor confidence and a further crash in stock prices. After this, J.P. Morgan was contracted by the US government to restore market liquidity, but the recovery was slow and Congress was starting to call for better regulation. By this time, most Americans were calling for reform of the banking system and there was a growing consensus among all Americans that a central banking authority was needed to ensure a healthy banking system and provide for an elastic currency. The Federal Reserve was founded by Woodrow Wilson in 1913 after a lengthy series of negotiations between the President, Congress, and banks.

The Federal Reserve accrued more and more powers over time, but retained a decentralised system, especially in contrast to European central banks like the Bank of England or the Bundesbank. It could not effectively manage the Great Depression, which began in 1929 and stretched to 1939, the second worst economic downturn in the history of the industrialized world (after the credit crunch). It started after a huge stock market crash in October 1929, which sent investors into a panic and wiped out billions of dollars of value as they cashed in and took their deposits out. Over the next decade, consumer spending and investment slumped, causing rapid declines in commercial output and employment as weakened companies sacked their employees. By 1933, when the Great Depression was at its most severe, almost 16 million Americans were unemployed and a little over half of the country's banks had gone bust.

From the 80's, the Fed started to take a different view on inflation. After Reagan got into office, the Federal Reserve began to constrict monetary policy (leading to the recession of 1981). However, once a rise in inflation was brought down, the Federal Reserve started to loosen their financial grip on the economy. As interest rates were allowed to fall, the economy began to grow and the Fed doubled down and loosened ever more regulations on banks - setting the scene for this crisis.

The Legislators

Role of Legislators and the Fed

The Federal Reserve System or the Fed is the central banking system of the United States. After a series of financial panics, through the creation of the Federal Reserve Act, the fed was founded on December 23, 1913. The three key objectives for monetary policy in the Federal Reserve Act, as established by Congress are as follows: maximizing employment, stabilizing prices, and moderating long-term interest rates, although the duties have expanded since the enactment of the act.

Although an instrument of the U.S. Government, the Fed considers itself "an independent central bank because its monetary policy decisions do not have to be approved by the President or anyone else in the executive or legislative branches of government, it does not receive funding appropriated by the Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms."

The two main tools of the central bank are the lender of last resort and its monetary policy. As a lender of last resort, they are where institutions go for lending credits when interbanking transfer was not possible. The purpose of this is to guarantee financial stability. Central banks provide liquidity or short-term loans to financial institutions or markets to help calm financial panics. This is especially important if the collapse of said institutions would have created serious implications for the economy. The Fed's Monetary policy on the other hand, is to guarantee macroeconomic stability. In normal times, central banks adjust the level of short-term interest rates to influence spending, production, employment, and inflation.

The enactment of the Gramm–Leach–Bliley Act of 1999 recognised the Fed as the 'umbrella regulator' of the financial system. This also meant that the Fed was well placed to assess potential problems, given its unique access to information from the US financial sector via 2,500 supervisory staff, top officials with multiple contacts, and approximately 500 professional economists.

Legislators are the lawmaker and the politician. In simple terms the legislature performs three basic roles namely: law making, representation and overseeing the executive arm of government which include Ministries, Departments and Agencies (MDAs) to ensure that government is held accountable to the people from where it derives its sovereignty. Furthermore, sustainable socio-economic growth is a process and content of legislation. It demands accountability, transparency, certainty, competitiveness, continuous improvement, efficiency, innovations, integration, evidence-based decision making, and responsibility. The problem with the Legislative bodies is that they are not built for speedy action, but emergencies require them to act with dispatch. In times of crisis, presidents often urge Congress to legislate quickly. When Congress does so, more often than not it defers to administration experts and enhances executive power.

The Legislators and the Fed, 2005-2007

There was a multitude criticism toward the legislator's failure to anticipate the crisis. The problem regarding the legislators involves; regulatory capture by special interest groups, free-market ideology, overuse of abstract academic models, and narrow focus on inflation targeting. All this clashing of interest could have created a distort their perception, be it intentionally or unintentionally.

The fed seems to have faced similar to the Legislators. Although there is no evidence of corruption or bribery, they may still face a similar cognitive bias. Greenspan, however, is well known for his flexibility . This might have helped them to break free of ideological constraints. Furthermore, Federal Open Market Committee (FOMC) members expressed a diversity of views. Therefore, the case of an ideological trap might not play that much of a factor for the shortcomings of the Fed.

However, the fed has one large shortcoming. It is well known, that single greatest contributor to financial crises is the Fed manipulating interest rates in ways that distort the true price of capital. Economist Friedrich Hayek noted, prices play an important role in the economy, transmitting information that allows market participants to coordinate their plans. The Fed's distortions create the boom and bust cycle by distorting the information that the price signal conveys to consumers and producers. It may seem like businesses are overinvesting, but they are simply responding to false economic signals sent by the Federal Reserve. An inevitable bust occurs due to all of the bad investments made.

The Bush Treasury supported a cheap dollar in response to business lobbyists in Washington. The government is now more than willing to sacrifice the long-term economy to their short-term export goals. During the recession of 2001, the Fed began to aggressively expand the U.S. money supply. This policy was accompanied by the Fed repeatedly lowering its target for the federal funds (interbank short term) interest rate. The federal funds rate began 2001 at 6.25 percent and ended the year at 1.75 percent. From early 2001 until late 2006, the Fed pushed the actual federal funds rate below the estimated rate that would have been consistent with targeting a 2% inflation. The Fed's loose monetary policies during the Bush Administration generated sharp declines in the dollar. The cheap dollar monetary policy further inflated the housing bubble because it generated flight into real assets to escape the depreciating greenback.

There were also other serious financial System vulnerabilities that is occurring in the economy before the crisis. There were a plethora of vulnerabilities present in private sector. There was excessive debt and reliance on short term funding. The banks' failure to adequately monitor and manage risks. There was also an increased use of exotic financial instruments that concentrated risk. There was also no shortage of problems public sector. There were gaps in regulatory structure. This logically led to failures of regulation and supervision. As a result, there was insufficient attempt to paid to the stability of the financial system as a whole.

The SEC

The SEC, or Securities Exchange Commission, was created in 1934 by section 4 of the Security and Exchanges Act of 1934. Its purpose was to enforce federal securities law.

The SEC is split into five divisions; Corporation Finance, Trading and Markets, Investment Management, Enforcement and Economic and Risk Analysis. Corporation Finance is the division that oversees the disclosure made by public companies, as well as the registration of transactions, such as mergers, made by companies. The division is also responsible for operating EDGAR, the SEC maintains an online database called EDGAR (the Electronic Data Gathering, Analysis, and Retrieval system) online from which investors can access this and other information filed with the agency.

The Trading and Markets division oversees self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB) and all broker-dealer firms and investment houses. This division also interprets proposed changes to regulations and monitors operations of the industry.

In practice, the SEC delegates most of its enforcement and rulemaking authority to FINRA. In fact, all trading firms not regulated by other SROs must register as a member of FINRA. Individuals trading securities must pass exams administered by FINRA to become registered representatives. The Investment Management Division oversees registered investment companies, which include mutual funds, as well as registered investment advisors. These entities are subject to extensive regulation under various federal securities laws.

The Division of Investment Management administers various federal securities laws, in particular the Investment Company Act of 1940 and Investment Advisers Act of 1940. This division's responsibilities include; assisting the Commission in interpreting laws and regulations for the public and SEC inspection and enforcement staff, responding to no-action requests and requests for exemptive relief, reviewing investment company and investment adviser filings, assisting the Commission in enforcement matters involving investment companies and advisers and advising the Commission on adapting SEC rules to new circumstances.

The Enforcement Division works with the other three divisions, and other Commission offices, to investigate violations of the securities laws and regulations and to bring actions against alleged violators. The SEC generally conducts investigations in private. The SEC's staff may seek voluntary production of documents and testimony, or may seek a formal order of investigation from the SEC, which allows the staff to compel the production of documents and witness testimony. The SEC can bring a civil action in a U.S. District Court, or an administrative proceeding which is heard by an independent administrative law judge. The SEC does not have criminal authority, but may refer matters to state and federal prosecutors. Among the offices of the SEC the Office of Compliance, Inspections and Examinations, which inspects broker-dealers, stock exchanges, credit rating agencies, registered investment companies, including both closed-end and open-end (mutual funds) investment companies, money funds and Registered Investment Advisors.

In 2004 an amendment to the rules let banks double their debt however also saw the beginning of where the SEC could investigate the entire corporate structure of Broker Dealers. This meant the majority of the big names on Wall Street such as JP Morgan would now be audited and inspected the same way a traditional bank would.

Current Financial Legislation and Regulation

US financial legislation and regulation has historically been the product of a perpetual shift in perceived national interest between either financial Innovation and competitiveness, or stability and consumer protection. The immediate economic crucible for such shifts often came after a slowdown of economic activity due to overregulation, or a financial bust due to under regulation. Political considerations for less regulation includes the fear of economic power being concentrated too much in the hands of the government, e.g. leading to the 1863 National Banking Act, while that for increased regulation a result of perceived threat of such concentration in private financial sectors, e.g. leading to the 1913 Federal Reserve Act and the 1927 Mc Fadden Act.

The 1929 Stock Market Crash exposed the weaknesses of these laws, leading to unprecedented banking regulations during President Roosevelt’s New Deal, most importantly in the form of the 1933 Glass-Steagall Act which created the Federal Deposit Insurance Corporation (FDIC) Up until the 1980’s, the normative model for economic oversight led to financial stability but also a recognised limitation of banking competitiveness and innovation. Thus in 1980, in line with prevailing Neo-Liberal policies, Congress adopted the Depository Institutions Deregulation and Monetary Control Act which substantially deregulated Financial Institutions while reinforcing the Federal Reserve’s authority over monetary policy. The 1994 Riegle-Nea Interstate Baking and Branching Efficiency Act repealed many of the regulatory measures of the aforementioned 1927 Mc Fadden Act, while the 1999 Gramm-Leach Biley Act repealed many comparable regulations from the 1933 Glass-Steagall Act. Investment banking and Insurance Serves were previously prohibited from merging with Commercial Banking, while these repeals allowed such

possibilities. These measures have led to an increased complexity of the financial system in the form of new techniques such the packaging together of mortgages through securities, and derivatives. At the same time, it has allowed for the merging of successful banks under large conglomerates since the early 1980's to 2008. The total number of banking organisations has consolidated from 15.000 to 8000 over this period.
In short, the current financial legislation in place in the United States is the product of an intermediate policy focus on deregulation and market competitiveness since the 1980's. It has allowed for increased financial activity, innovativeness and credit investments, but also the increased power and uncontrollable activity of large banks that might reinforce unhealthy policies (such as the packaging of subprime mortgages) encouraged by maximum profit goals. Some of these banks are deemed by experts to be dangerously ''too big to fail'' in case of financial turmoil. As the Treasury Department and Federal Reserve meets with the embattled representatives of Lehman Brothers, these legal limitations and paradigms are important to keep in mind.

External Factors

Due to the wide reaching impact of the sub-prime mortgage crisis in 2007 and early 2008 the majority of European banks were severely hit by their falling stock price. As a result of globalization, the majority of banks in Europe and the United States were closely linked. The major banks in Latin America and Asia were not so severely affected by the US mortgage crisis as Latin American Banking regulations are far stricter than those in the US, and Asian Banks were far better suited to take the economic hit as the majority of countries in Asia had more income from manufacturing and labor intensive work rather that which is more service orientated. The issue is that the world at the time was under a long recession since the early 2000s and many banks did not have excess reserves to purchase failing companies whether at home or abroad so when small lenders in the US began to fail there was little Foreign banks could do.

International organizations such as the IMF and World Bank were not designed to handle issues of individual banks failing. The purpose of the World Bank at its creation was to help setup long term loans to help develop human resource rich countries. The IMF or International monetary fund was designed in 1947 with three primary objectives in mind, which were to oversee the fixed exchange rate arrangements between countries, thus helping national governments manage their exchange rates and allowing these governments to prioritise economic growth, and to provide short-term capital to aid the balance of payments. This assistance was meant to prevent the spread of international economic crises. The IMF was also intended to help mend the pieces of the international economy after the Great Depression and World War II. In order to achieve this, it provided capital investments for economic growth and projects.

However as a result of the Nixon Shock in 1971 where Nixon had pulled the US out of one of the key components of the Bretton woods system where he had uncoupled the US dollar from gold it led to the IMF changing from observing and policing exchange rates to enacting wider economic policy and it did not restrict individual banks and their freedoms. This meant there was little the IMF could do to solve a regional problem other than to offer loans to the failing bank's host country.

Furthermore there are no specific laws which regulate banks by the IMF as it is an international organization it could be seen by regulating them the world is in fact meddling in countries internal affairs and a violation of national sovereignty. It is in fact up to individual countries to legislate and regulate their own banks in the US the belief was that Banks did not require regulation as it would hamper their ability to be competitive in the free market and that banks would be fine with policing themselves as the memory of the great depression would not be forgotten. That being said, there still exist basic laws which applied to all companies which banks had to abide by.

Laws in Europe were fairly similar with an example of the UK having all companies conform to the companies act of 2006 where the articles of incorporation for an British bank state the procedure and law on how things are done and by extension there are separate Anti-trust laws to ensure that there are no unfair practices occurring, as there are in the US. The US has the Sarbanes–Oxley Act of 2002 which added on to laws enacted in 1934 to prevent fraud and other illegal and immoral business practices. However the G 10 established the Basel committee on banking supervision in 1974 and the committee has published the Basel Accords to which members of the G10 should adhere to however it is up to each country to implement them.

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