1. The financial crisis of 2007/2008 and its impact on the UK and other economies

Do you still feel vague about the causes and the effects of the financial crisis of 2007/8?
Are you preparing for a job interview in either the private or public sector?

The events of 2007/8 have shaped both the current UK commercial and business scene and are now having a massive effect on the public sector. Similar impacts are being felt across Europe and the wider world. Knowing a bit more about what happened might give you more confidence going into the interview!

This leaflet will give you a basic understanding of the causes of the financial crisis of 2007/2008 and the impact which it had on the UK and other economies. Topics covered are:

- ✓ UK history which led up to the financial crisis
- ✓ The effect on mortgages
- ✓ The banks' reaction
- ✓ The effect on the world market
- ✓ The effect on the UK market

This leaflet concludes with self assessment questions.

The financial crisis of 2007/2008 and its impact on the UK and other economies

What were the root causes of the crisis?

The roots of the financial problems of the last two/three years can probably be traced back to the **deregulation** of financial markets in the US, the UK and the Western European economies that started in the 1970s and gathered pace in the early 1980s. Deregulation swept away many of the governmental/regulatory controls and freed up organisations to trade across a wider range of activities and territories.

Prior to 1970, banks, investment banks (known as merchant banks in the UK at that time), building societies, stockbrokers and insurance companies operated very much in their own specialized trading spheres. In some countries there were also geographical constraints allied to these sector trading constraints: in the US, institutions were often restricted to trading in certain states and in Europe, to trading in their own country.
In the case of banks, there were tight controls on cash and capital ratios and, specifically, on what percentage of depositors' funds could be lent out to customers.

As these controls were relaxed and governments allowed these different financial institutions to raise funds from money markets across the world and not solely from depositors, financial services businesses were able to grow much more rapidly than had been previously possible.

The effect was to liberalise credit (i.e. make it easier to borrow money) and effectively to fuel a massive expansion of personal debt, including mortgage debt.

Why did problems initially come to light in the property sector?

With almost unbroken rises in property values since deregulation the home mortgage markets and the 'buy to let' markets became both very large and very profitable to banks worldwide.

Thus some lenders, anxious to retain and expand market share, offered loans that were often more than the face value of the underlying property and were sometimes as high as six or seven times the borrower's income.

This ratio compares to one that generally pertained in the tighter regulatory era where lenders would typically only lend a couple with two incomes an amount equal to twice the higher income plus the lower income.

With high returns available on this type of business but, perhaps underestimating the higher element of risk involved (see **Leaflet 8 - Risk and Reward**), some organisations started to raise funds by selling off 'bundles' of their mortgage and loan deals to other lenders, who were largely unaware of the original, underlying, transactions.

This process was known as **'securitisation'**.

During early-mid 2007 the oil price began to rise sharply, causing worldwide fears of a trade recession. Rising unemployment triggered the beginning of a sharp rise in mortgage defaults, especially in the US, where many mortgages were secured on run-down inner city properties and mobile homes.

These poorer quality mortgages were styled, in the money markets, as **'sub-prime' mortgages** (these are a type of mortgage characterised as being taken on by a borrower with a low credit rating and often secured on a low value property. Lenders will charge higher interest rates than for conventional mortgages as they seek to compensate for carrying higher risk).

Banks became increasingly worried about both the value of their own mortgage books and particularly the value of the mortgage-securitised investments they had bought from other institutions As a result they became reluctant to lend to other banks in the short-term money markets.

This crisis of confidence led to major **liquidity** problems for many banks and insurance companies worldwide. Liquidity means the ability of institutions, including banks, to meet their short term obligations including repayment of short term loans.

The oil price eventually peaked at $147 per barrel in mid 2008.

How did the crisis develop during 2008?

The Bank of England had to provide financial support to the Northern Rock Building Society in the latter part of 2007, to prevent a run on the society's cash by depositors. It became necessary to formally nationalise Northern Rock in February 2008 (i.e. the Government became its major shareholder, having used taxpayers' money to support it).

Early in 2008 a major US investment bank, Bear Stearns, had to be rescued by J.P. Morgan with US Government support.

The crisis deepened in the summer of 2008 and on the 7th September 2008, two major US mortgage finance operations, Fannie Mae and Freddie Mac, also had to be rescued by the US Federal Government.

Then, on the 15th September 2008, the biggest bankruptcy in the world to date took place when Lehman Brothers Bank failed with liabilities of US $600 billion.

The US Government declined to step in to save Lehman Brothers, in order to show markets that they could not and would not rescue every troubled financial institution.

Figure 1 illustrating some of the events which occurred when the US markets opened on the 16th September 2008

What was the effect on UK banks and other banks worldwide?

In the UK, the Bradford and Bingley Building Society was effectively nationalised in late 2008 and then partially sold to the Spanish Grupo Santander Bank. Also late in 2008 the UK Government partially nationalised the struggling Royal Bank of Scotland Group, initially taking a 58% stake, but eventually by late 2009 raising this to some 84%.

The UK Government also effectively forced the UK's largest mortgage lender, Halifax Bank of Scotland (HBOS), which was in deep trouble, into the Lloyds TSB group and, in January 2009, took a 43.4% stake in the combined business. Other UK banks, such as Barclays and HSBC, although not nationalised, were forced to raise capital by new share issues to preserve their capital ratios.

Governments in Belgium, France, Germany, Ireland, Spain and Switzerland took similar actions to the UK to save several of their now illiquid and undercapitalised banks. Iceland effectively lost its previously heavily aggressive banking sector. In the US, a total of 25 banks failed in 2008.

Despite a sharp cut in central bank interest rates worldwide, interbank lending rates remained stubbornly high (showing the banks' lack of confidence in each others' financial security), which in turn lead to a severe reduction in both personal and corporate credit and a rapid downturn in the housing and construction markets.

What were the effects in the UK?

In the UK there was a large fall in retail sales, especially in the furnishing and DIY sectors. Businesses, already hit by falling sales and profitability, faced increasing problems in securing bank support for continued trading. Several well known brands either went out of business or had to close a substantial number of outlets, for example MFI, Woolworths and Blacks. Unemployment rose, especially in the 18-24 age groups.

Falls in retail sales and rises in unemployment mean falling taxes revenues for governments worldwide. The UK was no exception. In the 4th quarter of 2008 UK Gross Domestic Product (GDP)* fell by 1.5% and the country officially entered a period of recession.

The recession continued through 2009. However signs of recovery became apparent in the final quarter of the year, with GDP growth of just 0.3% although many commentators still have concerns about the robustness of the recovery.

Perhaps one of the most reflective and incisive comments on the crisis period as a whole was that, at the time of their respective failures, the Northern Rock was building society trying to act like an investment bank and Lehman Brothers was an investment bank trying to act like a building society!

Self assessment questions.

1. What was the trigger that effectively started the banking crisis in mid 2008?
2. Can you describe the two main characteristics of a sub-prime mortgage?
3. Which was the first UK financial institution to be hit by major liquidity problems in late 2007 and which two British banks were forced to seek UK Government support?
4. When did the UK officially come out of recession?

*Gross Domestic Product: The total monetary value of all goods and services produced domestically by a country in each year. GDP growth is an indication of a country's economic health (See **Leaflet 2, UK Government Debt and Borrowing**).