

Financial conservative policies

Introduction:

This paper aims to shed light on the phenomenon that has been seen in practice a great deal in the current financial setup whereby institutions have decided to adopt extremely conservative financial policies in light of any financial distress which has come their way during their participation in the global financial market.

The world is suffering from a crippling economic crisis as we speak, therefore, it is most appropriate to use the backdrop of the current financial crisis for the issues that will be discussed in this paper. Furthermore, specific inferences from the treatment of this financial crisis by the financial institutions will provide critical backing to the hypothesis at hand, which will be discussed in the paper.

Financial investors:

A large number of the institutional investors and hedge funds find themselves in hot waters because they undertook hedged positions which were highly leveraged in different types of bonds and which was dependent on these bonds restoring their relative value. Sadly, what has been considered the norm has been completely turned downside-up in the case of some bonds. A large number of the funds being used have foreseen alarmingly high recoveries due to their contact with the sub prime markets. On the other hand, as there is extremely less demand in the market for sub prime debt, these institutions have to sell whatever becomes a plausible option for them because to meet

the expected level of recovery which is why they have to sell their “better” debt at discounted prices. Now, it is a commonly known fact that down trading on any asset is extremely unhealthy for the valuation of the fund that is storing this asset as this fund oversees the dramatic collapse of the value of the asset. Therefore, what has been witnessed across many instances of bonds after the occurrence of the financial crisis has been that stricter policies have been implemented in the trading of these bonds over the secondary markets. This has largely been put in place because with excessive trading of bonds based on sub prime debt, many investors were chancing their ‘luck’ by purchasing riskier bonds all in the hope that their prices will rise. This ‘betting against the odds’ has been a major precursor to the financial distress that is being faced all around the world, hence, bond trading especially those which are down traded has been highly regulated which further vindicates the initial hypothesis of this paper. (Bäckström, 1997)

‘Infected’ asset market debt:

In addition to this, due to the fact that the debt is in worse conditions than that which was sold as hedge for the assets and subsequently is not seeing any trading activity at all; therefore, it sees no price attached to it which is why none of the profits of the so-called hedged trade can be witnessed since these assets cannot be demarcated as marketable. In this same scenario, investors that are underleveraged have the option of waiting a certain amount of time; be it a fortnight or a month for the proceedings to return to normal. This is beneficial to these investors as they may profit as quality of the assets will increase even in the midst of the falling valuations of riskier assets. However, till such point that a complete price can be ascertained on the hedged asset which is deemed

to be of low quality, any price cannot just be conjured up if its basis arises from the actions of normal cogent trading markets. All of this has led to extreme levels of capital flight and many institutions are claiming a severe decrease in asset market liquidity. With the suspension of three items from its funds, BNP Paribas claimed such a decrease. The reaction this brought from the credit market was that the market completely suspended activity which caused a large number of non-traded bonds. What was even worse was that every bank was adamant on not lending capital to any of the other banks even for a day as the quality of the assets in anyone's balance sheet is completely up to speculation. The response of the European Central Bank was by undertaking \$211 billion in repurchase agreements and August 9th and 10th 2007 saw central bank repurchase agreement trading worldwide of central banks worldwide of \$339 billion. (Giles, 2007)

This occurrence shows an extreme case of financial regulation in the face of financial distress which, fortunately or unfortunately cannot be depicted in any other light. Given the fact that the debt had been issued as a backing security for the assets related to the sub prime markets, its desirability quite obviously decreased with the consistently deteriorating position of the housing market. Here the European central bank decided to repurchase a portion of the 'diseased' debt that was ravaging the financial sector. However, the key thing to note here is something quite to the contrary; instead of allowing the market to find its own equilibrium with the passage of time, the central bank decided to intervene and hasten the process of debt clearing in order to restore the order in the financial markets and try and prevent the ever increasing financial crisis. In addition, the central bank also did not try to coerce the banks in the world to try to co-operate with each other; that had stopped lending any form of debt to each other at that

point in time, and try to facilitate the problem by secondary market transactions.

Therefore, instead of trying a more cavalier approach which would have been more riskier and time consuming but would have had deeper and more far reaching effects on the market and the financial crisis that was being faced, the central bank decided to take the safer option of repurchasing the bad debt, all the while not exactly discouraging but not openly encouraging any debt related transactions between banks which could have led to an increase in the valuation of the sub prime bonds amongst many other critical financial factors. Hence, the initial hypothesis is vindicated here again by the actions of the European Central Bank in 2007.

Bibliography:

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2. Giles, Chris. (2007). "Bank of England Sees Stoicism Come under Fire." *Financial Times*, September 7.