GALMUN 2025

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Retorika for Multiculturalism

Special Committee
Research Report

Definitions

Mortgage: A loan used to purchase or preserve a home, or other real estate. The borrower pledges to repay the lender in the long run, often in a number of regular payments divided into principal and interest. The asset therefore functions as collateral to guarantee the loan.[1]

Subprime Mortgage: Signalizes the below-average credit score of the individual taking out the mortgage, suggested that they might be a credit risk. The interest rate connected to a subprime mortgage is often high to recompense lenders for taking the risk that the borrower will default on the loan.[2]

Mortgage Backed Security (MBS): They are investments that represent claims on the money generated by combining mortgage loans. These securities are created by grouping together many mortgages and selling shares of the resulting collection to investors. This process is known as securitization.[3]

Financial Market Freeze: Huge declines in the volume of transactions in both the primary and the secondary markets that happen over a non-trivial period of time – are typically observed during financial crises.[4]

Collateralized Debt Obligation (CDO): It pools together various types of debt, such as loans or bonds, and repackages them into tranches that are sold to investors.[5]

Federal Reserve System (Fed): The central banking system of the United States.[6]

1 Kagan, Julia. "What Is a Mortgage? Types, How They Work, and Examples." Investopedia, 19 July,2024. https://www.investopedia.com/terms/m/mortgage.asp.

2 M.Kopp, Carol. "What Is a Subprime Mortgage? Credit Scores, Interest Rates" Investopedia, 02 November, 2024. https://www.investopedia.com/terms/s/subprime_mortgage.asp.

3 Kagan, Julia. "Mortgage-Backed Securities (MBS): Definition and Types of Investment" Investopedia, 13 June, 2024. https://www.investopedia.com/terms/m/mbs.asp.

4 Benmelech, Efraim, and Nittai K. Bergman. Credit Market Freezes. In NBER Macroeconomics Annual 2017 ed, vol. 32, Eichenbaum and Parker, 2018, https://www.nber.org/papers/w23512.

5 Tardi, Carla. "Collateralized Debt Obligation (CDO): What It Is and How It Works." Investopedia, 1 October 2024, https://www.investopedia.com/terms/c/cdo.asp.

6 https://www.federalreserve.gov/

Securities and Exchange Commission (SEC): is an independent agency of the United States federal government, created in the aftermath of the Wall Street Crash of 1929. Its primary purpose is to enforce laws against market manipulation.[7]

Background

In the past years, economic conditions in the United States and other countries were praised. Economic growth was strong and stable, and rates of inflation, unemployment and interest were relatively low. In this environment, house prices grew strongly. Accordingly, multiple US banks and other banks across the world developed a new business model. Instead of collecting deposits and then lending them to house buyers, banks originated mortgages and distributed them. This simply involved selling the cash flows coming from mortgage repayments. These cash flows were then divided, and sent into mortgage-backed securities (MBS) or collateralized debt obligations (CDO), a process known as securitisation.

In 2007, this market and other credit markets froze because of fears that many MBSs and CDOs contained mortgages that had been granted to subprime borrowers, and not only that, but fraud was increasingly common – such as overstating a borrower's income and over-promising investors on the safety of the MBS products they were being sold. This had caused major losses at many banks, hedge funds, and mortgage lenders and forced even some large and prominent firms to liquidate hedge funds that were invested in MBSs, to appeal to the government for loans, to seek mergers with healthier companies, or to declare bankruptcy.

In simpler words, banks around the world were always advised not to hand out mortgages to persons who might not be able to pay back their mortgage due to their socio-economic conditions and background. However, many banks took the risk, because they could always demand that persons who take bad mortgages pay more interest on their mortgage and therefore increase the profits that they might get despite the increased risk of failure. In order to fund these mortgages, the banks receive investment from investors who put their funds into the bank who would then manage the funds in order to make a profit for themselves and for their investors. One way to hide the risks of investing in bad mortgages, they would create investment packages in which they couple together a balance of good mortgages and bad mortgages, therefore reducing the risk of the bad mortgages with the good successes of good mortgages. However, this led to many large banks directing most of their investment to bad mortgages that have a high chance of failing to be paid back. This meant that if suddenly many people failed to pay their mortgage back due to a sudden downturn in

7 https://www.sec.gov/about/mission

their socio-economic conditions or due to a change in government policy, it can lead to many banks failing to return profits for their investors who would then panic and pull out their investment from the bank in order to preserve their funds, leading to a cascading effect where the bank would be forced to declare bankruptcy. Already by early 2007 we began to see signs of this happening and the cracks have begun to be formed in the world economy that depended on these large banks.

In early August 2007, the American Federal Reserve began purchasing federal funds (in the form of government securities) to provide banks with more liquidity and thereby reduce the federal funds rate, which had briefly exceeded the Fed's target of 5.25 percent. Central banks in other parts of the world—notably in the European Union, Australia, Canada, and Japan—conducted similar open-market operations. The Fed's intervention, however, ultimately failed to stabilize the U.S. financial market, forcing the Fed to directly reduce the federal funds rate three times between September and December, to 4.25 percent. During the same period, the fifth largest mortgage lender in the United Kingdom, Northern Rock, ran out of liquid assets and appealed to the Bank of England for a loan.[8]

In September 2007, the BBC's economics editor Robert Peston broke the news that Northern Rock was in trouble. Following his report, depositors in the bank queued up outside its branches. Meanwhile, the Fed initiated another round of reductions in the federal funds rate, from 4.25 percent in early January to only 2 percent in April (the rate was reduced again in late October to 1 percent and to effectively 0 percent in December). "Although the rate cuts and other interventions during the first half of the year had some stabilizing effect, they did not end the crisis; indeed, the worst was yet to come."[9]

The 2007-2008 financial crisis was beginning to develop into a major economic downturn triggered by the collapse of the US housing market. Banks had given out many loans to people to buy homes, but many couldn't repay them. This led to a chain reaction, with banks failing, depositors and investors pulling their funds from banks, credit markets freezing, and businesses struggling. Despite the government's early attempts to make it easier for banks to get funds, this has not managed to mitigate the trajectory of the markets. The worst was indeed yet to come.

8 Duignan, Brian. "financial crisis of 2007–08." Encyclopedia Britannica, 4 July. 2024, https://www.britannica.com/money/financial-crisis-of-2007-2008.

9 Duignan, Brian. "financial crisis of 2007–08." Encyclopedia Britannica, 4 July. 2024, https://www.britannica.com/money/financial-crisis-of-2007-2008.

Treaties and Organizations

Economic and Social Council (ECOSOC): "ECOSOC conducts studies; formulates resolutions, recommendations, and conventions for consideration by the General Assembly; and coordinates the activities of various UN organizations. The council oversees regional commissions for Europe, Asia and the Pacific, Western Asia, Latin America, and Africa."[10]

The Basel Committee on Banking Supervision (BCBS): "was established in 1974. It is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Its 45 members comprise central banks and bank supervisors from 28 jurisdictions."[11]

Financial Stability Board (FSB): "The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. More specifically, the FSB was established to:

- Assess vulnerabilities affecting the global financial system as well as to identify and review, on a timely and ongoing basis within a macroprudential perspective, the regulatory, supervisory and related actions needed to address these vulnerabilities and their outcomes.
- Promote coordination and information exchange among authorities responsible for financial stability.
- Monitor and advise on market developments and their implications for regulatory policy.
- Collaborate with the International Monetary Fund (IMF) to conduct Early Warning Exercises."[12]

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10 The Editors of Britannica. "Economic and Social Council" Britannica,13 September, 2024. https://www.britannica.com/topic/Economic-and-Social-Council.

11 "The Basel Committee - overview" BIS. https://www.bis.org/bcbs/index.htm.

12 "Mandate of the FSB" Financial Stability Board, 16 October, 2024. https://www.fsb.org/about/.

Current Situation

20 September, 2008. One of the defining moments of the financial crisis just occurred when Lehman Brothers—the fourth-largest investment bank in the United States—declared bankruptcy. As 25,000 employees around the globe have lost their jobs. The bank became a symbol of the excesses of the 2007-08 financial crisis, engulfed by the subprime collapse. The downfall of Lehman Brothers followed by the closure of its London office and other international subsidiaries sent shock waves through the global financial markets with a widespread ripple effect. Many investors started pulling their funds from other large banks who had similar management policies such as Lehman Brothers. The stock markets plummeted, credit markets froze, which led to a surge in unemployment rates, a decline in consumer spending, and a drop in international trade and investment. Defaulted loans on houses in the United States, for example, could be linked to mortgage-backed securities issued to investors in Europe or Asia. Additionally, Lehman Brothers had been a major issuer of short-term debt in the form of commercial paper, and its collapse caused a credit freeze of this vital source of lending throughout the world. A decrease in both consumer spending and exports to the United States severely affected the flow of goods, manufacturing, and job growth in Europe and Asia. Stock markets plunged, resulting in the worst economic downturn in global markets since the Great Depression of the 1930s. Due to the reliance of the world finance system on these banks to insure liquidity of investment and funding which allowed the different industries and services to function. The sudden collapse of these banking systems also had an effect on the socio-economic conditions of countries around the world and many countries have faced increased unemployment rates, debt crises, and a high cost of living crisis, especially in Spain, Portugal, Greece and other countries.[13] The international community must come together to make decisions about the best ways to support the international banking system, make decisions about bank regulations and find the guarantees to prevent similar crises from occurring again.

13 "Global Impact of the Collapse" Harvard Business School, https://www.library.hbs.edu/hc/lehman/exhibition/global-impact-of-the-collapse.

Critical Events and Timeline[14] [15]

1992 - Congress enforces a law stating that government-backed mortgage entities Fannie Mae and Freddie Mac shall allocate a percentage of their loans to affordable housing.

1995 - Changes to the Community Reinvestment Act, allowed mortgage lenders to buy subprime securities to fulfill their affordable-housing lending obligations.

2001 - Prompted by the burst of the dot-com bubble and the resulting recession, the U.S. Federal Reserve lowered its benchmark interest rate eleven times. That led to an easy-credit environment.

2004 - The Securities and Exchange Commission (SEC) allowed firms with more than $5 billion in assets to leverage themselves an unlimited number of times. Qualifying firms at the time include Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley.

Start of 2007 - House prices fell, marking the most significant one-year fall in U.S. house sales in over 2 decades.

April 2007 - New Century Financial Corporation files for bankruptcy.

9 August 2007 - Credit markets come to a standstill as BNP Paribas suspends operations in three of their funds because of the illiquidity concerning the subprime mortgages they possess. Consequently, subprime mortgage problems spread worldwide.

14 September 2007 - Northern Rock ran out of liquid assets, the first on a British bank in 150 years.

17 February 2008 - Northern Rock is nationalized by the Chancellor of the Exchequer Alistair Darling.

16 March 2008 - JPMorgan Chase has committed to saving the investment bank Bear Stearns, with the US government offering a $30 billion guarantee to cover its losses.

7 September 2008 - The US government takes Fannie Mae and Freddie Mac – two entities that guaranteed mortgages – into temporary public ownership.

15 September 2008 - US bank Lehman Brothers files for bankruptcy.

14 https://www.cfr.org/timeline/us-financial-crisis

15 Duignan, Brian. "financial crisis of 2007–08." Encyclopedia Britannica, 4 July. 2024, https://www.britannica.com/money/financial-crisis-of-2007-2008.

19 September 2008 - Washington Mutual was seized by federal regulators and sold the next day to JPMorgan Chase.

IMPORTANT NOTE:

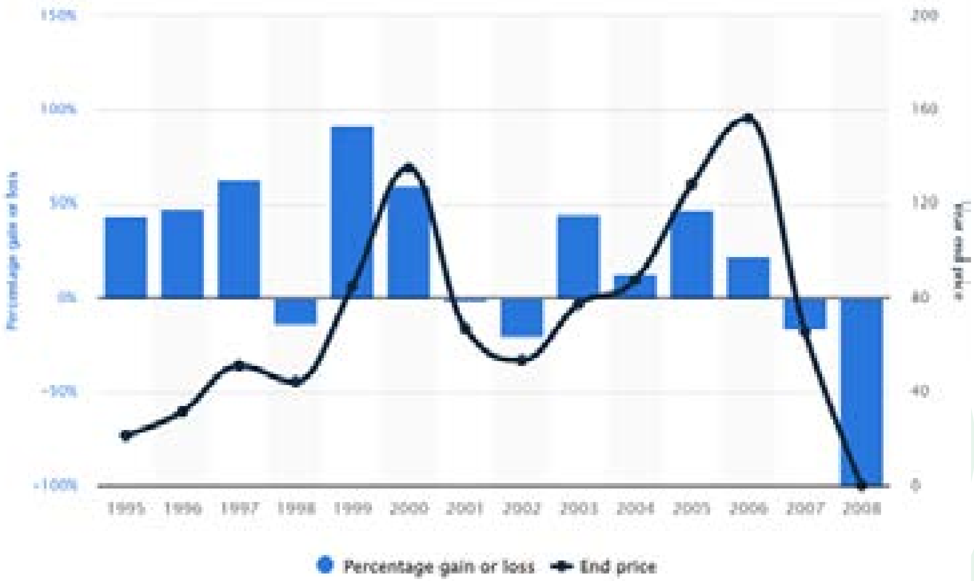
In this committee, some delegates will be representing the boards of companies and corporations along with delegates who will be representing countries. Delegates representing companies and corporations are concidered observers and are not allowed to vote on clauses and resolutions.

QUESTIONS TO CONSIDER

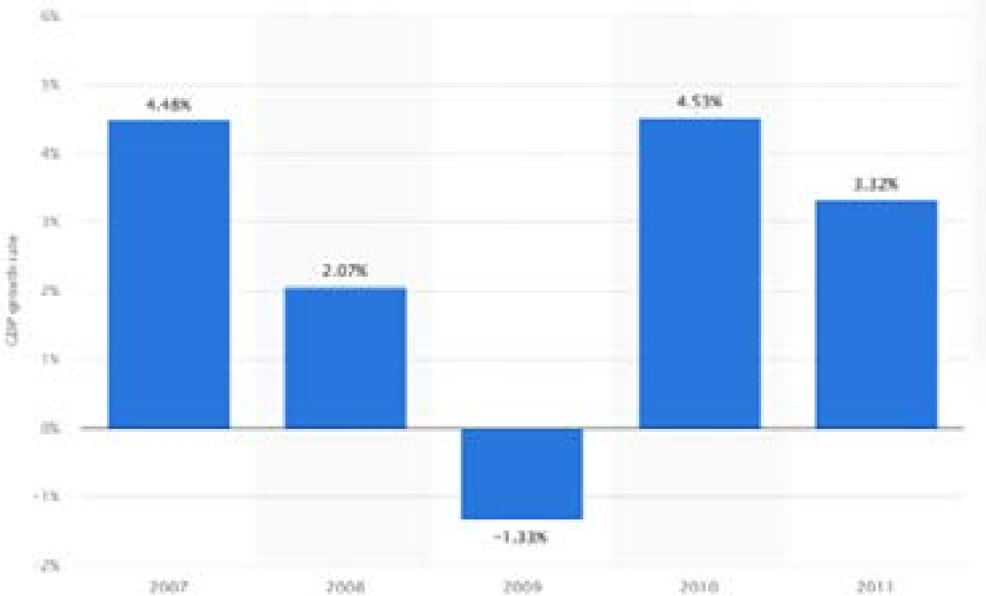
- What are the main consequences of the financial crisis on your country/ company?
- How will your government/ board respond to the crisis?
- How can we prevent the crisis from occurring again?
- How deep will the crisis affect the job market in your country?
- Will the financial crisis impact the availability of credit for small businesses and consumers in your country?
- What kind of legislation does your country have regarding mortgages?
- Should large banks be regulated? How could it be done?
- What is the best international economic decision to return investors' trust in the markets and the banking system?
- What is your country's policy on the issue and why?
- Is your country affected by the crisis? Why and how?
- How well does your country support independent banks?
- How can your country assist other countries that are deeply affected by this issue?

Relevant Media

Annual year-end stock price and percentage gain or loss in stock price for Lehman Brothers from 1995 to 2008[16]:



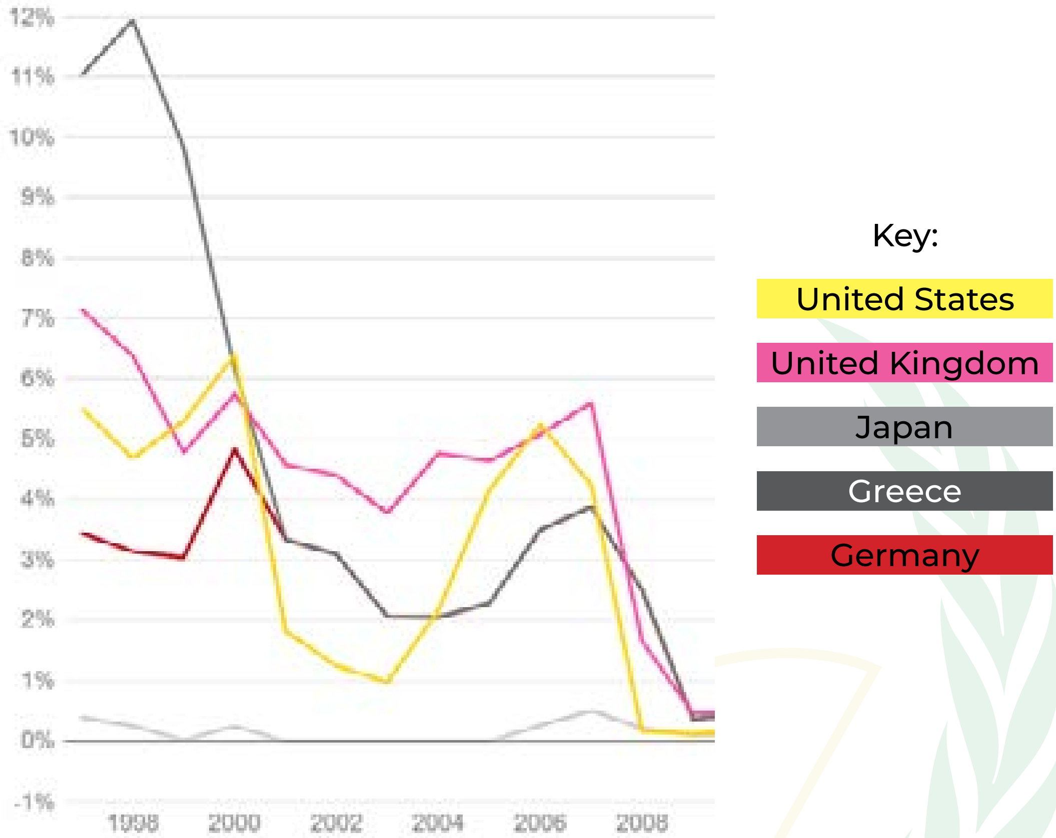
Annual global gross domestic product (GDP) growth rate during the Great Recession from 2007 to 2011[17]:



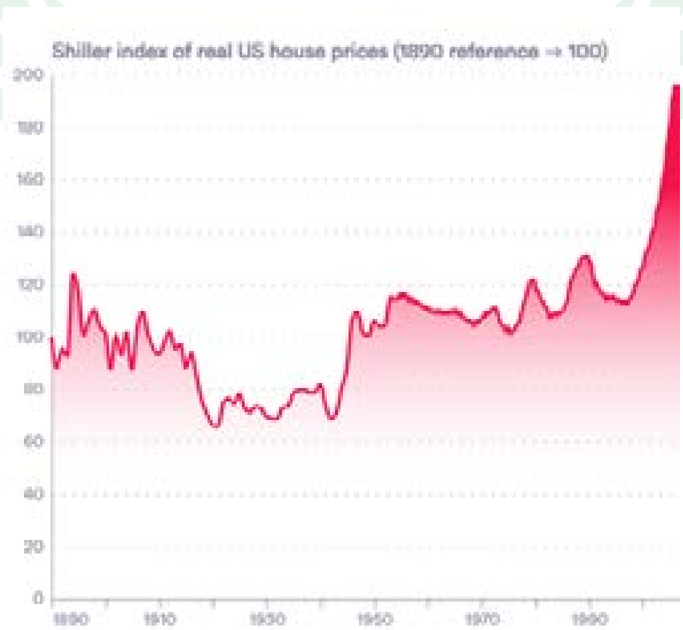
16 Statista Research Department. “Global Financial Crisis: Lehman Brothers stock price and percentage gain 1995-2008” Statista, 02 September, 2024. https://www.statista.com/statistics/1349730/global-financial-crisis-lehman-brothers-stock-price/

17 Statista Research Department. “Great Recession: global gross domestic product (GDP) growth from 2007 to 2011” Statista, 02 September, 2024. https://www.statista.com/statistics/1347029/great-recession-global-gdp-growth/

Central bank interest rates:

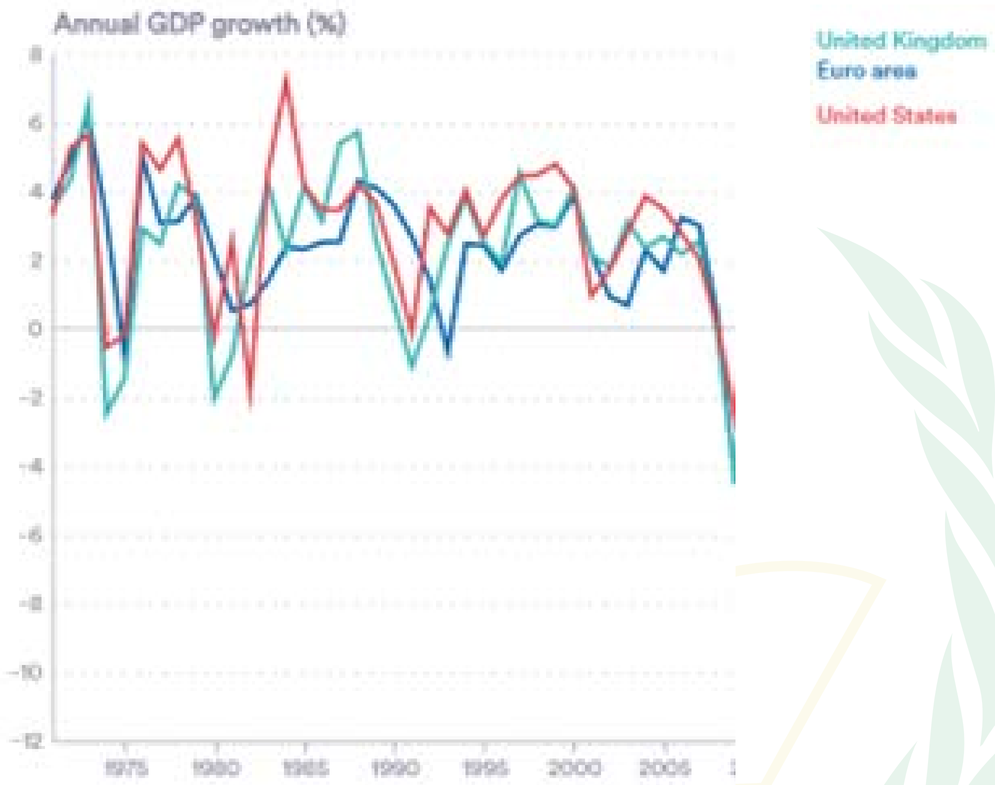


Index of real US house prices[18]:



18 Quinn and Turner, 2020. https://www.cambridge.org/core/books/boom-and-bust/D09C2E3BEA798F6EDC9D3880FC0300ED.

Annual GDP growth (%), 1971-2008:



HELPFUL RESOURCES

- The Basel Committee on Banking Supervision-https://www.bis.org/bcbs/index.htm
- The Bank for International Settlements (BIS) - https://www.bis.org/
- "Global Impact of the Collapse"- https://www.library.hbs.edu/hc/lehman/exhibition/global-impact-of-the-collapse
- Movies
    - Wall Street: Money Never Sleeps
    - The Big Short
    - Inside Job
    - Margin Call
- Great Recession: What It Was and What Caused It. By The Investopedia Team Updated December 18, 2023 https://www.investopedia.com/terms/g/great-recession.asp
- A thorough Timeline of the U.S. Financial Crisis https://www.cfr.org/timeline/us-financial-crisis

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- The Editors of Britannica. "Economic and Social Council" Britannica,13 September, 2024. https://www.britannica.com/topic/Economic-and-Social-Council.
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- Thakor, Anjan V. "The Financial Crisis of 2007–2009: Why Did It Happen and What Did We Learn?" The Review of Corporate Finance Studies, vol. 4, no. 2 September, 2015. https://doi.org/10.1093/rcfs/cfv001.