Reflections from the 2008-2009 Financial Crisis

During the financial crisis of 2008, total over the counter (OTC) derivatives outstanding were about $600 trillion, about 9.5 times the world's $63 trillion Gross Domestic Product (GDP) for that year. The U.S. GDP in 2008 was $14.7 trillion, incidentally, about 23% of the world's GDP. Derivatives outstanding were about 40 times the sum of total annual U.S. economic activity.

For me, a former international corporate banker, it was difficult to understand how the derivatives markets had become so extensive. Essentially, the derivatives market had become a series of back-to-back, counter-party to counter-party and bank to bank transactions well-beyond the scope of total annual economic activity.

What if counter-parties began to default? Where was the substance behind all these financial commitments?

While the Federal Reserve regulated the "capital adequacy" and the lending limits of the banks, they did not regulate banks' activities in derivatives. During the height of the 2008-2009 financial crisis the Federal Reserve secretly pumped *trillions* into the banking system, and the Federal Deposit Insurance Corporation increased the insurance on non-interest-bearing deposits in the U.S. from the $250,000 limit to unlimited insurance.

Smart multi-millionaires moved the funds in their interest bearing accounts to checking accounts for safe (totally Federally insured) haven. The banks had a bonanza of new interest-free checking deposits for many months, while they loaned funds to very few credit worthy companies at much higher than normal rates during the continuing crisis.

The bailout of the U.S. banking system was vastly more extensive than the $700 billion Troubled Asset Relief Program (TARP) the public and Congress were aware of.

Alan Greenspan, the former Chairman of the Federal Reserve said in 2008:

"The crisis had shaken his very understanding of how markets work."

He agreed then that certain financial derivatives should be regulated -- an idea he had long resisted in formal Federal Reserve decisions. The Chairman of the Basel Committee on Banking Supervision, Stefan Ingves, said as he strove to implement controls on derivatives in 2013:

"one of the things that history has taught us is that when you look at episodes ex-post, when things fall apart, the conclusion is almost always that there was somehow too much leverage in the system and it was found out way too late."

Today, total over-the-counter derivatives are still about the same total amount they were in 2009, $600 trillion, but the world's GDP has grown to about $79 trillion. Derivatives are now about 7.6 times the world's GDP. It appears banks' off-balance sheet leverage has decreased somewhat.

The Basel Committee measures are expected to help to regulate off balance sheet transactions, but many of the world's biggest banks are now bigger than they were in 2008.

What do you think? Is the world's financial system any safer?

To put this question in context, you may recall the shocking Congressional inquiry with the Federal Reserve Inspector General a year after the last financial crisis began in 2008. https://www.youtube.com/watch?v=cJqM2tFOxLQ

We can thank Bloomberg LLC for suing the Fed under the Freedom of Information Act, and for getting the truth out to the public and to the Congress about the scope of the last bailout.

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