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The Influences of Global Financial Crisis on Financial Markets and Countermeasure Proposals

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Abstract: The global financial crisis caused issues in the U.S. stock market and a liquidity crunch that spread from the United States to other countries globally. The financial disasters have profound implications for the global financial market. Many prior scholars studied how one single factor, such as bank regulations, affected the financial system. This paper uses a broader and more comprehensive perspective to review the implication of the global financial crisis on the financial revolution. It mainly discusses four most prominent changes to the financial system, involving changes in risk management and regulation of banks, regulation of derivatives market, the "too-big-to-fail" problem, and the credit rating system. Innovative ways to prevent such major failures in the financial system and strategies to better regulate the banking sector will also be discussed. The balance between mandating banks to take reasonable risks and encouraging financial innovations is a key consideration for the future design of regulation system. This paper finds that the insurance requirement on low-risk financial products and increased regulations of the Securities and Exchange Commission (SEC) are indispensable to improving the financial markets worldwide. In order to prevent another global financial crisis, the federal government and financial market should consider establishing independent rating agencies that give transparent evaluations of investment banks and financial products, and they also need to strike a balance between mandating banks to take reasonable risks and encouraging financial innovations. This paper may offer some references for the government to take countermeasures when facing another global financial crisis.

Keywords: Financial crisis, financial system, Global economy, bank regulations

1. Introduction

When the housing bubble burst in 2008, the economic recession and financial crisis started from the United States to the whole world. Because the stock markets in Central Europe are heavily reliant on the stability of the U.S. market, the stock market crash in the United States caused the European stock market to become more volatile, and many investors lost a significant amount of money in Europe. The failures of major banks like Lehman Brothers caused the stock market returns of most countries in Asia and Europe to plummet [1].

The U.S. economy suffered catastrophic economic damages during the Great Recession, which, had far-reaching social ramifications. This recession was caused by a combination of factors, including subprime mortgage crisis and problems surrounding the credit default swaps. When the

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housing bubble burst, the recession started. As many Americans lost their jobs, a significant number of families lost their homes due to inability to pay back their mortgages. The devastating consequences of this recession caused many economists to realize that significant disruptions in the financial sector, including the credit market, could lead to problems, including unemployment and even loss of homes, in the real economy [2]. To prevent such economic catastrophes from happening again in the future, many policymakers also started considering the proposed changes that need to be implemented in the financial sector to prevent another significant economic downturn from happening [3].

This paper mainly discusses four prominent changes and the arguments for and against the changes involving changes on risk management and regulation of banks, regulation of derivatives market, "too-big-to-fail" problem, and credit rating system. It further talks about the far-fetched and significant impact of the global financial crisis on the financial market, and the actions and policies of the federal government and society to prevent financial crisis from recurring. This paper contributes to the literature by offering a compressive synopsis of the impact of the global financial crisis and provides potential solutions to prevent the inception of another crisis.

2. Four proposed changes to the financial market

2.1. Changes on risk management and regulation of banks

The first proposed change is to increase the government's power to supervise the financial sector with more stringent regulatio*ns*. Global leaders discussed ways to decrease ways to help decrease the moral hazard issues in the financial sector [4]. Both the Treasury and the Federal Reserve wanted to make it mandatory for banks to experience stress testing in an effort to ensure financial stability in the U.S. economy. To ensure that stress testing could happen on a national level, the Congress would need to approve the Fed and Treasury to have additional oversight over the financial market [5]. The Financial Stability Board points out that the government needs to increase its capacity to absorb losses of the financial sector. The government should be permitted to increase the scale and scope of regulatory oversight in the financial market; the Fed should be allowed to perform more stringent evaluations of the major banks to make sure that the banks are not taking excessive risks at the expense of their depositors. One example of an increase in global regulation of banks' conduct is the *Basel Treaty*. It was established to ensure that banks decrease the amount of risky assets, increase their liquidity, and prevent stakeholders from losing trust in the risk-adjusted capital ratios. From 2012 to 2016, the Basel Committee also evaluated the risk management standards of banks globally to ensure that they are following the international standard of holding enough capital to prevent insolvencies [4].

Banks also should to be mandated to implement more effective ways to manage their business risks, have a good balance between their assets and liabilities, and hold adequate capital reserves so that banks can absorb their financial losses when some depositors suddenly withdraw their money from the bank [4]. This proposal was implemented after the 2008 crisis; in the United States, 18 major banks decreased the amount of risky assets after the *Troubled Asset Relief Program*.

To explain further, *Title I of the Dodd-Frank Act* allowed the federal government to have more supervisory power to regulate large banks in an effort to improve the risk management of large banks and to ensure the financial stability of the United States. The aim of this policy is to make sure that large banks will not take excessive risks when they expand their businesses. The proposed changes should have gone through, because maintaining the well-being of the financial sector is essential to ensuring that the real economy is doing well. If the financial sector is not functioning properly, many people may also lose their jobs in the real sector, because financial sector's problems can cause the unemployment rate to increase significantly. *The Dodd-Frank Act* also allowed the government to supervise "nonbank financial companies" as well as "smaller bank holding companies" that were not previously subject to governmental supervision. With more governmental regulation, the financial sector will likely become more stable, and this may reduce the chance that another large-scale crisis will occur [6].

2.2. Changes on regulation of derivatives market

The second proposal is that the government should better regulate the credit default swap market and mandate banks to remove high-risk investments from their balance sheets and order banks to hold enough capital to back these investments [7, 8]. Under *Title VII of the Dodd-Frank Act*, the government can increase its regulation of "OTC swaps markets"; before this law's implementation, the SEC was not allowed to ask banks to adhere to the "reporting, recordkeeping, or disclosure requirements" that help prevent deceitful acts of large financial institutions [9]. One of the suggestions was to prevent financial institutions from engaging in the sales of "complex securities" that are over-the-counter products, because such securities have the potential of causing damage to the financial system by adding additional risks to the balance sheets of the banks. Improving banks' risk management techniques has the potential of preventing another global financial crisis. Moreover, over-the-counter securities should not be complicated, and they need to be presented in a way that makes it easy for the investors to evaluate the risks of these securities. Concerning securities that can be purchased relatively easily by the consumers, an increase in regulation is necessary to avoid excessive investment in risky securities that can trigger issues in the stock market. The aim of this proposal is to make sure that the investors can purchase securities with less money and to make it easier for the government to regulate trading in the financial market. Nevertheless, the argument against this proposal is that investment banks make a significant amount of money from selling "complex derivatives" [8]. In other words, many big banks may argue that too many regulations will decrease their financial innovations and prevent them from making enough profits [10]. If the government makes it illegal for all the over-the-counter derivatives to be traded, it will likely become easier for the government to regulate the financial market. If the government does not completely forbid this trading and still allows some specific types of derivatives to be traded, investment banks could still escape from governmental regulations by producing similar derivatives that essentially function in the same way as the forbidden ones [8].

Besides regulations of the usage of derivatives for banks, the government also can make prudential assessment of derivatives products and exert more stringent regulations on derivatives market. With the implementation of stricter policy regulations of derivatives, the government also must expand its oversight over the production and sales of other complex securities, such as asset-backed securities (ABS) and mortgage-backed securities (MBS). That way, banks will become less likely to take excessive risks with all kinds of high-risk security products, and investors will feel more reassured to participate in the financial market. When the confidence level in the market increases, the financial market will become more stable and attractive to investors worldwide.

2.3. Changes on "Too-big-to-fail" problem

The third proposal is to address the "too-big-to-fail" problem in the financial sector. Historically, the U.S. government often rescued big banks during the recessions and enabled big banks to keep expanding [10]. The financial crisis caused a liquidity crunch in at least 41 countries, such as the United States and China. To address the liquidity issue, the government purchased stocks from nine influential banks, including JP Morgan Chase and Citigroup, to prevent them from insolvencies. The Fed decreased the discount rate and increased market liquidity to make it easier for banks to make loans in response to the financial problems faced by Bear Stearns who was having issues with their hedge funds mismanagement and the subprime mortgage crisis. Over time, financial markets

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expanded significantly, and a financial crisis may have a greater negative impact on the economy [8]. However, the size of the bank itself will not cause vulnerabilities in the financial sector; instead, he argues that the interdependency among different banks may increase the chance that a financial crisis will happen in the future. Further, the "too-big-to-fail" problem cannot be solved by enforcing an upper limit on the size of banks. Simon Johnson argues that it is important to prevent banks from becoming too large to ensure financial stability. However, reducing bank size itself will not forestall financial from happening, because the relationships among different banks and the intricacy of financial institutions also contribute to vulnerabilities in the system [11]. Because risk-taking allowed many banks to make an excessive amount of money and the government's frequent rescues also encouraged such behavior, the moral hazard issue must be addressed [2].

To address the "too-big-to-fail" problem, the *Dodd-Frank Act* established the "orderly liquidation authority" (OLA) that authorized regulators, such as the Federal Deposit Insurance Cooperation (FDLC)and the Federal Reserve, to rescue the banks whose failures could wreak havoc in the entire financial system without placing any financial burdens on the taxpayers; this law also forbid mergers that would cause a bank's liabilities to go above "10% of U.S. financial liabilities." Unfortunately, no ideal solution to this problem exists currently, and policymakers need to design and implement more effective policies to make a balance between addressing the moral hazard issues, associated with the "too-big-to-fail" problem, and encouraging banks to innovate [12].

2.4. Changes on credit rating system

The fourth proposal is to set up independent rating agencies that give truthful and accurate evaluations of investment banks and financial products [8]. If the investment banks are paying for the service fee of the credit rating agencies, the rating agencies may feel pressured to give an overly good, yet dishonest, rating to the investment firms and their financial products. If the rating of the investment firms is not an accurate representation of the quality of their financial services, individual investors will be harmed by this asymmetry of information. If a significant number of investors are purchasing securities that will cause them to lose a lot of money, there will be significant problems in the financial market. When the financial market is not functioning properly, the real economy will also be negatively impacted, and this can potentially lead to unemployment issues and decrease in the economic growth rate [13]. *The Dodd-Frank Act* aimed to address this proposal by enabling the U.S. Securities and Exchange Commission to give more severe penalties to credit rating agencies that give inaccurate and dishonest evaluations of investment banks. However, this law failed to achieve its aim. After it was passed, many credit rating agencies gave many inaccurate ratings that were lower than what the banks deserved due to fear of getting penalized for giving overly high ratings. Thus, the government still needs to figure out more effective strategies to encourage rating agencies to care more about their reputation and to give honest ratings to protect the well-being of the financial sector and consumers [6].

3. Conclusions

This paper provides a comprehensive summary of the main impact that the global financial crisis brings to the financial market and four possible solutions to prevent another global financial crisis from occurring and harming the world economy. The first solution is to change the management of risky investment options of the banks. The government needs to increase its power to supervise the financial sector with more stringent regulations. Banks also need to be mandated to implement more effective ways to manage their business risks. The second is to better regulate the derivative market. The state needs to better regulate the credit default swap market and mandate banks to remove high-risk investments from their balance sheets and order banks to hold enough capital to back these

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investments. The third is to address the liquidity issues of the major U.S. banks and prevent them from bankruptcy by improving regulations of the banks that are historically considered as "too-big-to-fail". Policymakers should design and implement more effective policies to strike a balance between addressing the moral hazard issues associated with the "too-big-to-fail" problem and encouraging banks to innovate. The fourth is to improve the credit rating system and make ratings more transparent to investors. The federal government and financial market must consider establishing independent rating agencies that give transparent evaluations of investment banks and financial products. There is a need to strike a balance between mandating banks to take reasonable risks and encouraging financial innovations. The limitation of this research is that it does not use empirical evidence to support the feasibility of the potential solutions, and future research should address this weakness.

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