Analysis of American government policies on various banking operations after the financial crisis

EXPRESS DISSERTATION

Abstract

An accurate understanding of the global financial crisis resulting in an economic and political crisis in North America required the need to understand the global crisis and the determinants of the crisis. In the US banks are considered significant lenders. These lenders can provide funds to borrowers especially firms and households through either

financial markets such as bond markets, money markets or equity markets or to financial intermediaries otherwise known as credit institutions such as banks, insurance companies, money market funds or pension funds.

The collapse and lag of lending in the U.S has been one of the most evident and distinct outcomes of the 2007-2009 financial crisis. According to the IFS Data, the credit of the private sector from commercialized banks deteriorated from the annual rates of 8 percent or higher from 2003 to the first part of 2008, to a meagre 2 percent by the last quarter of 2008 and hence projected a negative growth for the first time in the whole decade. Also, this negative cycle was even more striking for non-banking institutions which had attained growth rates near to 19 percent in the early 2004 and in the recent months have been reduced to optimal terms by over 11 percent (Ivashina and Scharfstein, 2010). To respond to such staggering losses the government of the US adopted multiple responses to combat the recession and help identify better policies and governance measures.

The primary research question of the study was to identify with the relevance of US policies and the impact on the government banking sector. From the analysis is argued that the policies of the government were comprehensive as observed from the introduction of the multiple monetary expansion approaches as well as the interpretation of Basel III. Considering the case of sovereign debt crises, the tightening of the fiscal has been accepted and acknowledged by people as the natural cure. Under the sovereign debt crisis, the country (US) in debt often suffer from economy-based sanctions from countries that provide credit to them. Under such severe budget restrictions, governments are unlikely to utilize expansionary fiscal policy. But excluding the sovereign debt crises there is no globally accepted and accurate fiscal policy. The American case portrays that both the monetary and fiscal stimulus are utility tools for counteracting the challenge of recession. The scale and the financial nature of the crisis, however, needed more tools in the form of various financial interventions to alleviate market fears of contagion and general systemic risk in the banking sector.

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Introduction to the Study

1.1. Introduction

There is an associated economic slowdown in the aftermath of the global financial crisis spanning the past five years (2007-2012). An accurate understanding of the global financial crisis resulting in an economic and political crisis in North America required the need to understand the global crisis and the determinants of the crisis. In the US banks are considered significant lenders. These lenders can provide funds to borrowers especially firms and households through either financial markets such as bond markets, money markets or equity markets or to financial intermediaries otherwise known as credit institutions such as banks, insurance companies, money market funds or pension funds. According to Berger and Bowman (2009) an examination of the subprime lending crisis involves the characterisation of the associated turmoil faced in the international market as a result of the difficulties of selling loans by banks and the reduction in the securitisation of loan leading to an overall problem associated with the supply liquidity within the banks and in the interbank market (Taylor, 2009).

The modification in the structure of the US financial system can be assigned to the international capital movement's liberalization in order to make a common regulatory structure for the furnishing of financial services. The huge number of M&A transactions projected convergence and amalgamation of the bank market structures in the US (Krugman, 2009). The growth of pensions funds and investments were supported by credit institutions and insurance companies as the asset management composes of a significant share of their non-interest incomes. Also on the other hand, the pension funds and investment became key players in the financial industry as a result of various alterations in the saving patterns that were affected by changes in demographics and decreasing outcomes on the bank deposits and other age-old financial instruments (Mullard, 2011).

The collapse and lag of lending in the U.S has been one of the most evident and distinct outcomes of the 2007-2009 financial crisis. According to the IFS Data, the credit of the private sector from commercialized banks deteriorated from the annual rates of 8 percent or higher from 2003 to the first part of 2008, to a meagre 2 percent by the last quarter of 2008 and hence projected a negative growth for the first time in the whole decade. Also, this negative cycle was even more striking for non-banking institutions which had attained growth rates near to 19 percent in the early 2004 and in the recent months have been reduced to optimal terms by over 11 percent (Ivashina and Scharfstein, 2010). To respond to such staggering losses the government of the US adopted multiple responses to combat the recession and help identify better policies and governance measures.

1.2. Objectives

- To understand the theoretical perspectives of the links between US banking system and the financial crisis.
- To identify with established perspectives of governance of financial institutions in the US.
- To critically examine the government polices with respect to US financial markets and monetary expansion
- To understand the implications of BASEL III recommendations for US banks
- To arrive at a clear implication on the consequences of the recession, government response and the impact on the banking sector.

From the above objectives, the primary research question of this research is

What were the responses promoted by the US government with respect to banking policies and financial markets in the aftermath of the 2007-2012 recession?

1.3. Chapterisation

The study is organised into five chapters including introduction, review of literature, methodology, results and conclusion. The introductory chapter presents the objectives and research question. The review of literature sets the theoretical background while the methodology identifies with the study research design. The data analysis identifies the themes associated with the research question while the final chapter concludes the study.

Chapter Two: Review of Literature

2.1. Introduction

This chapter will present a discussion on the background literature in this research area by considering the financial crisis and US banks, the role of bank credit and the focus of governmental policies. This helps identify the theoretical basis of the study.

2.2. Financial Crisis and the US Banks

In the early times, policy actions that used to consider the effect of the crisis on commercial banks tend to target on alleviating liquidity conditions. Beginning in August 3007, the Federal Reserve adopted on a series of interest rate cuts that totals up to 225 basis points over seven months and finally toward the end of the year began a process of access expansion to already existing lending facilities and creating others, both for banks and non-banking financial institutions. Sarkar (2009) asserts that these two individual stages can be differentiated.

In the initial stage or the first stage, the Federal Reserve enacted to facilitate liquidity to institutions that were declared solvent, in response to a severe contraction in interbank markets that intimidated to usher in the financial intermediation to a stop through an “illiquidity spiral”. Then followed the second stage, in which the primary concern was the credit risk and the liquidity that was given directly to investors and borrowers (Sarkar, 2009).

As the crisis progressed, especially in the rise of the Lehman Brothers bankruptcy in September 2008, the limelight of the policy moved beyond liquidity provision and more towards capital injection. Specifically, the renowned Troubled Asset Relief Program (TARP) allotted a nominal part of its funds about \$250 billion out of the entire \$700 billion to the Capital Purchase Program (CPP), this was intended to buy an optimal quantity of preferred stock of certain financial institutions. After the first injection of \$125 billion into nine huge and methodically significant institutions on the 14th October 2008, the program has extended to include over 550 plus smaller institutions, out of which 4 with an overall injection of more than \$200 billion as of data received on October 2009 (Bernanke, 2008).

However both kinds of policies apparently have known to be beneficial to people and there are prods that the particular liquidity provision efforts have supported to throw off situations of extreme tightness in the market liquidity that became more prominent in the summer of

2007 (Nguyen and Enomoto, 2011). For example, the Term Auction Facility (TAF) that began in early December 2007 has been linked with many temporary reductions in the LIBOR-OIS spread, in the excess aberrations that range from covered interest parity that had spiked during the crisis and in the deviations of LIBOR over the Federal Funds rates (Armantier et al., 2008).

As for the capital injections done through the CPP, there is proof that the funds were well-focused , that is in terms of being distributed to huge, systematically significant banks that had suffered huge capital losses but had comparatively strong loan portfolios that maybe healthy. Also, the injections are linked with positive valuation effects for the excess stock returns in recipient banks. These were also higher for those banks that had endured higher capital losses (Gallo and Flora, 2011).

It is not evident whether there has been any positive influence of the above mentioned two types of policies: that is either focused on the liquidity or the capital investments. In short, a specific issue has come up that these policies have done almost little to restore credit and instead of which the excess reserves held by banks have grown to unexpected levels. According to Keister & McAndrews (2009), from $1.5 billion through the year 2007 and till 2008, the overflow reserves grew rapidly following the bankruptcy of the Lehman Brothers reaching $900 billion by January 2009 and remaining above $800 billion through September 2009.

This review will analyses this issue by targeting the period from1st quarter to the second quarter of 2009, during which the bank credit reduced dramatically, with the goal of assessing to what extent liquidity or capital composed the essential binding constraint for banks. It relies on the theoretical work on the bank credit determination, specifically for Peek and Rosengren (1995) and Chami and Cosimano (2010).

2.3. Bank Credit

The primary plan for bank provides a simple frame of bank intermediation that makes testable implications for bank credit that is implications that vary depending on whether capital is binding or not in the banks (Peek and Rosengren, 1995). The second plan recognizes a capital channel of money investing policy, in which the rates of interest's shocks are transferred to supply of credit through the regulatory capital restrictions and where the decision of the banks to hold back the capital is looked at as a call option for the future loans supply (Chami and Cosmino, 2010).

According to the basic structure used in this article, the constraint on the capital should directly impact bank related activities generally during the capital loss period uniformly throughout the banking system, as many banks will be required to tally their balance sheets in order to cope with the optimal regulatory capital levels. This was similar to the 1990-91 U.S recession period that put forth by Peek and Rosengen (1995).

With a simple example or a scenario the nature of influence of capital constraint on bank lending can be explained. For example, take two banks A and B, which have gone through a capital loss. Each of them has $100 million in assets and for keeping in simple they also possess $4million in equity capital shares. However, Bank A has a major share of its assets in loans ($80 million) than Bank B ($40 million). Let us assume that the assets that weigh risks are equivalent to the total loans, the ratios of regulatory capital will be 5 percent for Bank A and for Bank B it will be 10 percent.

Hence Bank A is now constrained with capital, while on the other hand B is comfortably above the regulatory minimum. Consider that both the banks A and B face an equivalent and external capital increase equivalent to $2million, thereby enabling a one-for-one asset expansion. But Bank A cannot extend their new loans due to their low regulatory capital ratios, while Bank B can even use the additional funds to increase their credit ratios. Hence, Bank A will have to deflect funds towards securities purchase, reserve increasing or by other assets with low risk weights, even as the total scale of operations expands. Thus, two main outcomes can be drawn from this: firstly the constraint in capital operates in a nonlinear method, with a higher effect on banks that near the regulatory minimum and next it impacts lending and on the contrary to the other assets in a disproportionate manner.

2.4. Governance of Financial Institutions in US

The Federal Reserve posed as the main character in supervising and governing the various financial issues under the Governance of Alan Greenspan (Chairman of the Federal reserve between 1987-2006). He usually favoured the influence of liquidity and lower interest rates as a response. The Fed, then was led by a person known as Bern Bernanke after 2006, he had succeeded Alan Greenspan. He had also made use of a similar and a broader approach using four main tools or components (Cecchetti, 2009).

According to the Monetary Policy Press releases, in the first step, the rates of interest were an essential component of the Fed's response. With the rate of Fed's funds being equal to the base rate of Bank of England fixed at 5.25% over the 2007 summer, the Federal

Reserve Board that consists of seven governors who having voting powers on interest rate-related decisions quickly had decreased rates to attain 2% by August 2008. This also included a drastic cut of 1.25% that is equal to a decrease of 125 basis points (bp), (bp will be the term that is used to refer to the points of interest rate) in January 2008 (Cecchetti, 2009).

According to the Monetary Policy Committee Decisions, the Fed had organized an international drive to lower rates of interest. The European Central Bank, however, had behaved in a conservative manner and had increased the minimum rate of refinancing by 25bp in July 2008 to almost 4.25% (Taylor, 2009).

According to Monetary Policy Press Releases, the Fed also had planned to reduce the gap between the headline interest rate (that is the fund rate) and the rate of discount (or otherwise known as primary credit rate), a rate that is directly accessible to 19 banking institutions. By reducing the credit cost for institutions, the banking system was supposed to turn more liquid. Prior to August 2007, the rate of discount stood at 100bp above the Fed Funds rate; however this gap had been reduced to only 25bp on the 16th March 2008 (Taylor, 2009).

According to Cecchetti(2008), in the recent times, there is little indication that either the high levels of credit or risk advances interacted with the Fed's principal monetary tool: because of the special nature of the financial distress, it became evident in the fall of 2007 that the age-old central bank tools were of not much use. While on the other hand, officials were able to induce liquidity into the financial system, they had no way to ensure that the funds reach the institutions that had the most necessity. Taylor (2007) had recommended that this provoked the situation by increasing the price of oil. According to the Federalreserve.gov (2007), the second policy approach adopted by the fed was to induce the TAF or the Term Auction Facility on the 12th December 2007 as a method of facilitating short-term liquidity.

According to the Federalreserve.gov (2008), the TAF allowed depository firms to bid on an anonymous basis to obtain funds by numerous collaterals over a period of 27-26 days. Starting from December 2007, auctions were organized every fortnight and engaged large sums of money ranging from about $20bn to $50bn, which increased to more than $50bn by May 2008. This was a part of the interactive action that was organized simultaneously across five institutions that included the Bank of England and the European Central Bank.

The recipients were unknown eradicated the damaging market stigma that was linked to the usage of the discount window and consequently encouraged a considerable uptake. Moreover, this approach permitted several commercial banks to obtain the funds directly, something that was uncommon and now accomplished always where generally only the primary lenders were qualified to receive funds and expected to give then to the wider financial system.

According to Cecchetti (2008) the initial few months tasted some success in decreasing the credit spreads, although such deductions generally endured only for some days and had no major lasting impact on the spreads especially after march 2008. On the 30th July 2008, the Fed had extended the TAF duration to 84 days.

According to the Federalreserve.gov (2008), the next step, the Term Securities Lending Facilities (TSLF) had stated on 11 March 2008 sold upto $200bn in the Treasury securities in an attempt to raise the bank liquidity and to decrease the spreads on the MBSs which had stopped trading abruptly due to their high-risk premiums. However this allowed banks to utilize a wider range of assets that comprises of high-rated bonds and securities as collaterals; in May 2008 TSLF had broadened to include more ABSs.

According to Federalreserve.gov (2008), the Primary Dealer Credit Facility protracted this to several investment banks and large brokers on 16 March. Again, both the schemes had failed to return the MBS risk spreads down in the longer period although it initially did taste some success. Despite this, the Fed had protracted both facilities till January 2009.

Based on the Statement on Financing Arrangement of JPMorgan Chase's Acquisition of Bear Stearns, 2008, the fourth step was the Fed had provided the orderly takeover of the Bear Stearns. This investment bank had been highly prone to the risky MBSs and needed an extraordinary loan from the Fed (1930) to sustain the weekend before being purchased by JPMorgan Chase on 14th March Monday. The Fed of New York covered up JPMorgan Chase against losses crossing the limits of $1bn in return for a fee, a clear cut point that the Fed sensed that bank could not be permitted to fail (Sarkar, 2009).

Till September 2008, the Federal Reserve had focused on raising the liquidity for all the banks. This was considered as a tool for decreasing the risks in the economy. Although Fed had committed most of its balance sheet in bolstering financial firms, it was ultimately unable to control risk spreads especially when the problems increased in September. According to Taylor (2009), the fed had misinterpreted the issues as being an outcome of restricted liquidity rather than counterparty risk, which would have needed a different approach altogether.

According to Sarkar (2009), prior to September 2008, two parts of legislation were passed that were formulated to reduce what was considered an impending mortgage crisis and financial recession. Initially, the Economic Stimulus Act of 2008 was made to effect on the 13th February 2008. The legislation provided: several tax rebates for the lower income groups; incentives and perks for business investments and a widening of the mortgaged qualifying for a purchase by Fannie and Freddie. These steps were formulated and designed at a cost of $152bn for the 2008 crisis, to restore the economy and reverse the house prices' downtrend. The effect of a stimulus on the consumer spending is always under a debate. The Broda and Parker's research analysis identifies a 3.5% increase in spending among households with incomes of less than $15000. On the other hand, according to Taylor (2009), most of the tax rebate was saved instead of being spent.

The second significant legislative action was taken in July 2008, the Housing and Recovery Act of 2008, assembled together an array of measures that targeted at alleviating the housing crisis. Especially, the HOPE for Homeowners program had guaranteed up to $300bn in the subprime mortgages if the lenders complied to jot down their principal loan balances with almost 90% of their current value of asset. In exchange the government would obtain 50% of the consequent house price appreciation (Sarkar, 2009).

On the other hand, Megan Burns of the FHA or the Federal Housing Association, an organizational body that was created in the 2008 summer to manage the Hope for Homeowners program, found that there was a reduced-uptake for the scheme: as of February 2009. Also the FHA has not insured loans under this program and the FHA-qualified lenders have received 451 plus applications and 25 loans have been closes. Further to this, the Act also provided a 10% refundable tax credit for the initial-time house buyers. The legislation also had induced capital in the Fannie and Freddie and had permitted the Treasury to buy their debt obligations (Taylor, 2009).

2.4. Conclusion

The current debates and arguments among the economists have not paid complete attention to the restrictions laid by the political and institutional conditions. Consider for an example, keeping the actual economic effects aside, it is easier to crunch the monetary policies because most of the current and new central banks have the power to restrict the money supply and increase rates of interest, although the accurate amount of power varies. This research will therefore adopt a secondary data collection approach and identify with the perspectives of US banking system and the government policy responses.

Chapter Three: Research Methodology

3.1. Introduction

The main objective of this chapter is to elucidate the manner in which this research project has been conducted. This chapter gives details about the philosophy, design and strategy that have been employed. As observed in the previous chapter, the research report is in the form of narrative literature review. It is indicated by Flick (2014) that the philosophical approach is interpretivist which suggests that the results that have been found is been analytically interpreted by the researcher.

3.2 Philosophy

As epistemology is challenging to establish, there is a need of lens for all researches to be conducted. Denzin and Lincoln (2011) claim that social world and the natural world has a significant difference between them. It is indicated by Berg and Lune (2004) that in social environment people persistently interprets epistemologies based on what is historically acceded to and there is a continuous construction and re-construction of relationships. This process is recognised by the interpretivist approach. It is argued that professed truths are informed by the social and temporal space and there is no "truth". According to Berg and Lune (2004), with the intension to draw conclusions based on extant evidence a researcher working through this philosophical lens intends to interpret the point of views articulated in the research literature.

3.3 Approach

According to Denzin and Lincoln (2011), the most suitable approach amongst the two i.e. inductive approach or deductive approach to conduct a research is decided based on the conceptual framework which is been used in the project. Inductive approach helps to explore facts which we have an elusive idea about; a study that adopts this approach intends to make generalizations rather than specifications. The objective of deductive research is to determine if the hypotheses are true or not by testing. The purpose of inductive approach is to form theories, which helps to derive future hypotheses from those theories. As in this case, the researcher intends to explore the situation with regard to role of US government in banking policies, he has adopted inductive approach. He has successfully accomplished and drawn conclusions by synthesizing the available literature.

3.4 Strategy

Archival strategy is adopted where many hours of research conducted by researchers previously who are working on the same or similar topics are utilized, in this research strategy, the main objective is to evaluate the prevalent literature base and obtain results from earlier research. Neurman (2005) reports that advantage of using this strategy is, there can be emergence of similarities and differences that have been unclear at the time when the research projects were carried out. According to Neuman (2005), there is a high validity for this kind of research strategy provided the method used is sufficiently impartial. In this instance, articles have been looked at for appropriate title later checked for theoretical and conceptual appropriateness, articles are scanned in detail and emergent themes are derived through the process of coding. Another benefit availed using this approach is that significant conclusions can be derived by bringing in sync various lines of enquiries by considering and examining various levels of evidence. Bryman (2012) reports that, any research strategy always have its own limitations. There is a probability of archival research encountering a risk of bias in subjective measures, where the researches can interpret the literature incorrectly. This has been an ethical as well as a literal concern. Bias can be limited by using key words, extensive sources and a systematic approach.

3.5 Method

Israel and Hay (2006) indicates that either a quantitative, qualitative or mixed methods can be adopted for the research that is established in the social sciences. In quantitative research numerical data is been gathered and synthesised with the intention of determining fact, or fact like generalizations. Therefore, it can elucidate if the hypothesis or true or not. In qualitative research, the main aim is to investigate the reasons behind the existence of those truths. In this particular case, qualitative approach is been adopted, to examine and critically analyse the trends and themes of the earlier research projects so as to derive implications from them. It is reported by Somekh and Lewin (2005) that, since the research question is very expansive, implementation of this approach is right. As it is considered that qualitative method usually successfully answers a broad research question.

3.6 Data Collection

In this research, the initial insight is gained through secondary data collection. This suggests that the literature which is been already published is used to substantiate. The research problem is separated into sets of keywords and is exposed to online database, following the method delineated in Flick (2014). Besides, series of articles have been followed by using the “related articles’ links on available databases. Through this, articles that have not been encompassed by the keywords are determined. The basic characteristic of qualitative research is the flexibility, and there is a need for the strategy to indicate the fact that the response can be unexpected and unpredictable to an open question like this. Several restrictions are suggested with an intention to inhibit data contamination. These include taking serious notice of article which is a decade old and including older articles only if it is considered essential to the discussion. Preference was given to the articles which are published in the last decade, including only the articles published in English within a peer reviewed journal. The articles which have been suggested as a substantial academic pedigree by having been cited by various other researchers were treated in a higher regard.

3.7 Ethics

Ethical considerations are always associated with secondary research. According to Flick (2014)The major risks in this research is the use of existing data (primary information) without the consent of the original participant and one more major aspect of risk is the misinterpretation of the information by the researcher. As none one of these problems has complete solutions a researcher working with secondary sources should ensure to respect the confidentiality of any original research participants and continue to be objective at all times.

3.8 Conclusion

Given all this evidence, it can be inferred that this chapter has delineated the research procedure that directed the research project. It has given an explanation that the philosophy is interpretivist, and also made known the fact that knowledge is not an absolute is respected. It has given a general rough description of the two approaches: inductive approach and the archival strategy. It shows that, in this case, the method followed is qualitative approach, which means the aspect which is explored is the phenomenon rather than the fact. Data collection comprised of built keywords and existing databases, followed by scanning and coding. There has been a study on ethical problems with regard to this approach. Thus with this inference the chapter concludes.

Chapter Four: Results of the Study

4.1. Introduction

This chapter will present a secondary data analysis of the different themes expressed in literature with respect to the role of government policies and their response to US banks. The different themes that have been organised include government policy response to US financial markets, government policy response to monetary expansion, analysis of BASEL III recommendations adoption in the US and a case analysis of US policy response.

4.2. Government Policies in response to US Financial Markets

According to Bordo et al., (2001); Laeven and Valencia (2008); Reinhart and Rogoff (2009), the present day commentators often guess that governments under the financial crisis would pinch the government policies to restore the lost finance from the crises. However, scholars and policy makers have argued for a long time on the policy tools to regain from the financial crunch. According to Claessens et al., (2004); Evanoff and Kaufman (2005); Honohan and Laeven (2005), they have not attained any consensus on what kind of policy (monetary or fiscal) or in which direction such as contractionary or expansionary is most beneficial for recovery purposes in such financial crises.

According to Clarida, it is well-renowned; Keynesians assert that the fiscal policy works more beneficial than the monetary policy, while on the other hand monetarists state the contrary. According to Taylor (2000); Budnevich (2002); Gordon and Leeper (2005); Alesina et al., (2008), Keynesians pinpoint to the role in motivating aggregate demand that counteracting government spending can play around specifically. According to De Long (2000), monetarists state that the attempts to regain and come back from the financial crises through the expansionary fiscal policy are at best ineffectual and are more prone to cause a long-term inflation in the market. On the contrary they are more partial to monetary-related policy responses, such as decreasing the rates of interest, which they assume to have more rapid and beneficial effects.

In general, research scholars and policy makers have contradictory viewpoints on a single concept as to whether they have to tighten or loosen the policies and of what nature such as fiscal or monetary are the most accurate way to recoup from the financial crises. Looking at the responses received for the monetary policies, economists and researchers have decided that the tightened monetary policy is more efficient to manage the financial crises. The crises in finance are more likely to rise from the sudden withdrawal of foreign investment that elaborates the process of the tightened monetary policies.

According to Eichengreen (1998); Goldstein, Kaminsky, and Reinhart (2000), in general governments that make use of the high interest rate policies in such crunch situations usually are successful in encouraging capital inflow and restricting capital flight and hence preserving the exchange rate and also the consumer prices admitting at the cost of exports. According to Hutchison and Noy (2005); Kaminsky and Reinhart (1999), the financial crises in rising markets have often been amplified into a systemic banking crisis which is also known as a twin crisis. Hence the tightening of monetary policies can work effectively against the problem resolution in the banking industry.

In fact, a high rate of interest policy utilized to deal with a banking crisis can escalate the burden to the already present borrowers from banks, leading to increasing delinquency rates and failures by the end. On the contrast, a low interest rate policy can alleviate the burden on the existing borrowers and new loan borrowers and decreasing the bank panic. According to Eichengreen and Rose (2003); Park and Lee (2003), in the recent times, there is no proper evidence to bolster the positive contribution of the tightened monetary policy.

According to Reinhart and Rogoff (2009), this inability to reach a conclusion usually applies to the use of the monetary policy to make note of the sovereign debt crises too. High inflation rates are usually linked to sovereign defaults and under such inflation rates, governments are usually required to tighten the monetary supply to the financial markets and hence increasing the rates of interest. High inflation can be both a cause and a feature of the asset and credit bubbles. However higher interest rates have disadvantages such as increasing the burden to already present loan borrowers, also challenges in bank failures and destructive growth.According to Eaton and Fernandez (1995); Manasse and Roubini (2009), on the other hand, apt fiscal policy responses to the financial crises have been all the more complicated and controversial than the government monetary policies.

4.3. Government Policy Response: Monetary Expansion

The monetary response or the reaction of the American Government to the crisis was quick and efficient. The Federal Reserve had invested about $24 billion of credit into the financial division when the interbank lending was abruptly stopped in August 2007 (Phaup, 2009). The interest rates were decreased from 5.25% (September 2007) to 2% (April 2008) by the Federal Reserve. This step had aided in alleviating the pressure on the various financial institutions and also resulted in the depreciation of dollar value and a drastic increase in the oil prices (Schwartz, 2008; Taylor 2009). The price of oil had doubled from almost $70 per barrel to $140 per barrel from August 2007 to July 2008. This had resulted in two major secondary shocks to the economy as the prices of gasoline had gone up drastically and followed by decreasing the sales of automobiles (Congleton, 2009; Marthinsen, 2010).

However, the prices of oil had decreased as the approximate global economic growth had gone worst. On the other hand, the joint increase in oil prices and other commodity prices that were a result of decreasing dollar value had aided to stretch out the crisis and indirectly impacting certain other economically significant sectors such as the automobile industry (Gray 2009). From the other viewpoint of finance researchers, the expansionary monetary policy had been used since the financial crisis had aided recovery of corporate borrowing from the drastic collapse in the period between 2007 and 2009, in which non-corporate businesses or almost all small businesses adopted no net borrowing through the first quarter of 2011 (Congleton, 2011; Pollins, 2012).

As of summer 2011, the major percentage of loan requests by both non-corporate and small businesses were being rejected or getting only partial approval or acceptance of their requests (Mullard, 2011). The rates of borrowing for such businesses have always remained quite high around 6%, and also during the period when commercial banks could afford to borrow on the federal funds market at almost zero rates since the start of 2009. Pollin had projected how the rates of borrowing for both non-corporate and small businesses have been altered mildly from the mid 2000's while the federal funds had ranged from approximately 3% to maximum of 5.25% (Pollin, 2012).

Commercial and other non-depository based financial institutions have vitally grasped the impacts of decreasing interest rates by the Federal reserve and by raising the cash reserves from $20.8 billion in 2007 to almost $1.4 trillion that is almost equivalent to (10% of the GDP) by the first quarter of 2011. On the other hand, inadequate reserves were an important aspect of the weakness of the financial firms which had resulted in the crisis; banks have now adopted the opposite way of loading cash while being cautious about lending (Taylor, 2009). The main advantage of the Fed's expansionary monetary policy, the allocation of affordable credit has majorly gathered in huge financial institutions while being tough to access by small businesses. Let us focus on the construction and retail industries, the credit market challenges along with the drastically dropping sales have continued to give more challenges to the American businesses and the economic recovery in general (Boaz, 2009).

From the above analysis it can be argued that the monetary expansion has aided in enhancing the bank's balance sheets and hence preserved the business confidence, it has not triggered the resumption of economic growth through higher investments as put across by the Keynesian theory. However, it was always a strong and powerful tool easing the financial crisis and hence averting the economic fallout of a huge financial collapse.

4.4. Critical Analysis of Basel III

On the other hand, it is politically tough to crunch the fiscal policy, because trimming the welfare benefits and increasing the tax burdens induces higher political resistance from welfare beneficiaries and taxpayers. It also takes higher time to implement new fiscal policies, even if it is really important, because any modifications in the fiscal policy usually have to be acknowledged by the legislative branch of the government. According to Dreher (2009) monetary policy can be modified within a very short duration of time. Both

Keynesians and monetarists arrived at a consensus that the policies based on fiscal have a higher policy lag than monetary policies.

According to the Basel Committee report (2013), Basel III creates a new list of global standards for sufficient capital and liquidity in banking organizations. Although generally this set of standards target banks, these set of standards are applicable to other types of financial institutions and even EU investment organizations too. The Basel Committee on Banking Supervision or otherwise known as the Basel Committee formulated Basel III to adjunct and in some aspects replaces the current Basel II standards, the version of which was declared in 2006 as an updated version to Basel I. The core components of Basel III were settled at the international level in 2010 and the new implantation rules have been issues in 25 out of 27 jurisdictions that constitute the Basel Committee.

Similar to Basel I and II, Basel III does not legal bind to any jurisdiction but rather it is asserted to form the general platform for national or regional rulemaking. As with the Basel I and II, the members of the Basel Committee have adopted various approaches to executing Basel III.

Impact of the Dodd-Frank Act: The Dodd-Frank Act had initiated various capital-based provisions that were exclusive to the US-based Financial institutions that are not in relation but tougher than the Basel III framework. Let us consider for an example:

Regulatory Capital Base: As explained earlier in detail in the comparison table between the US and the EU, the norms for capital instruments to qualify as regulatory capital are different from and are more rigid than the current qualification standards. In relation to these standards, groups exposed to these new rules should assess the outstanding instruments against the new standards and plan their schedules.

In this context, the Dodd-Frank Act (i) needs a rapid three year plan and schedule for some of the hybrid capital instruments given by the large US banks that would no longer taken into account as regulatory capital or as a similar type of capital, (ii) facilitates a permanent solution such as grandfather treatment for some of the capital investments made by the US government in banks that would not otherwise be selected, and finally (iii) needs compulsory deduction from the investment capital in hedge funds and other private equity funds ‘arranged and offered’ by the various US banking entities in correspondence to the Volcker Rule.

Removal of References to External Credit Ratings: The financial crises emphasized the various risks of over-dependency on the external credit ratings and sources which are influenced by a scanty pool of credit-rating agencies. Numerous changes and modifications to the US asset risk weightings were based on the Dodd-Frank Act requirement to detach the dependency of the US regulations from the external credit ratings. For example in the investment context in certain securitized assets for sovereign debts. The final US rules facilitate various alternatives and options to use of these ratings. For example consider the OECD or the Organization for Economic Cooperation and Development; it has formulated a set of ‘country risk classification’ codes that are used for assessing the risk weights of exposures to other non-US sovereigns and non-US banks ad also in accordance with the G20 responsibilities.

According to Articles 135 and 136 CRR, the CRD IV consists of provisions and options formulated to decrease the over-dependency on the external credit ratings, which makes institutions to tighten and strengthen their own credit-risk balance and not to be dependent totally on external credit ratings. Let us consider for an example, institutions with a certain number of exposures in a particular portfolio will be expected to establish internal ratings for that specific portfolio and to make use of external ratings to assess the outcome of the capital requirements for their internal credit viewpoints. That is, if the internal credit viewpoint projects that the external ratings are too favourable when compared, and then Pillar II discretion should be applied to require the additional capital holding with respect to these risks.

In the June 2013 publication on the updated rules on the credit ratings (MEMO/13/571), the European Commission referred to the rules of the US which supports the detachment of reference to the credit ratings in legislation and also asserted that the EU would take up a highly cautious approach by destroying the references to the credit ratings in the EU legislation by January 1st, 2020., only after the accurate alternatives have been recognized and executed.

Collins Amendment Capital Floor: The famous Collins Amendment of the Dodd Frank Act (Section 171) averts Advanced Approached Banks from possessing minimum capital needs below the normal risk-based capital needs. As an outcome, a non-US bank that employs the Advanced Approaches of Basel III and seeks a strategic method of lowering risk loans and investment grade assets may possess an inherent competitive benefit over other US institutions, as the capital floor applied under the Collins Amendment would remove any kind of ultimate capital relief that huge US banks may otherwise receive under the internal model theory of Basel III.

New Risk Weight Calculations is a Part of the US Basel III Rules: The Final US riles would to a large extent alter the risk weighted asset calculations under the "Standardized Approach", that is effective from January 2015.

Implementing the leverage ratio: The Basel III leverage ratio is also referred to as a non-risk-based ratio. This comprises of off-balance sheet exposures and is generally considered to support the capital requirements by posing as a stop valve to risk-based capital needs. In the US, Advanced Approaches Banks will be needed to act in accordance with the Basel III leverage ratio standards (3 per cent) and also the current Tier 1 capital-to-assets leverage ratio usually 4 percent. Also, the Federal reserve, the FDIC or the "Federal Deposit Insurance Corporation" and the OCC or the Office of the Comptroller of the Currency have individually from the Basel III, put across an "improved supplementary leverage ratio would make the US version of Basel III more rigid than the Final US rules.

4.5. Critical Case Analysis of Government Policies and Impact on Banking

The period of 1985-2000 witnessed a confluence in the fields of both economic theory that the monetary policy was the ultimate way to avert another crisis or the Great Depression (Ait-Sahalia, 2012). According to literary sources, "Governments believed that low inflation and rates of interests were the terminal instruments of any free market economy to maintain growth balance without any risks of booms and bursts, excluding a crisis. Investors had overviewed the housing bubble from a minor degree since it was hidden by lower interest rates, but somehow financial leaders such as Ben Bernanke and Alan Greenspan also wouldn't have enjoyed and encouraged its role in successfully terminating the recession in 2001 (Yao and Zhang, 2011).

The Federal Reserve typically reacts to recession by decreasing the rates of interest to motivate lending and hence spending followed by consumption. In the event of 1990, the rates of interest were decreased from almost 9% to 13% during the 2001 recession they dropped from almost 6.5% to 1% and in 2008 rates of interests were decreased from almost 5.25% to almost nil (Krugman, 2011).

The efficiency of the monetary policy is restricted internally, as rates of interest cannot drop down below 0% and the only period they have been this low in the history was only during the Great Depression. This highlights Keynes' view on the need for government spending through the fiscal policy when the other monetary policy options have been used up completely. The private sector banks denies on spending the public sector must come to the rescue and spend, a huge fiscal and monetary stimulus was used by the US government and did reduce the economic shock resulting from the major financial crisis. However, the crisis was of such a huge scale that no response could have been used to counteract its impact.

There was no simple policy silver bullet that could have brought the entire crisis into control. Averting such financial crises is hence the only remedy to the economic crises they trigger. The US government had procured the private financial sector to aid the government financing by increasing security and marketing more of mortgage risks. Above all this, moral hazard is the main challenge of the 'regulatory capture' of various government institutions by organizations they are intended to monitor and control. The Fed faces a conflict of interest as the lender of the last resort to banks and an instant provider of liquidity, as it holds the responsibility of rescuing banks 'too big to fail' which are impacted by rates of interests which it manages.

On the other hand, the government's viewpoint of financial firms is measured on a broader scale and the role of the Federal Reserve in the formulation of the monetary policy is highly significant. Broadening the range of various stakeholders with an enthusiasm in encapsulating the Fed policy not only induces conflicts of interest but also supports the serious repercussions of a highly politicized monetary policy. As the main agent of policy response to the crisis till September 2008, the Fed targets its legal mandate as the lender of the last resort and averts risks posed to the bank. The American case portrays the numerous roles of the information asymmetry in producing the financial crisis. An age-old policy of decreasing and standardizing low-income housing off-balance sheet terminated in a sort of real estate asset bubble with all the taxpayers finally liable when the bubble bursts.

This obscured subsidy paid only during an unexpected event of market failure, that was further triggered the bubble by making the real estate and linked securities markets appear unreal and profitable through the method of discount borrowing that was available to Fannie and Freddie. The financial industry's political impact permitted private firms to traverse the subprime market on an approximate equal footing to the GSE's and stimulate this bubble by transporting the assets and liabilities off-balance sheet. This was neglected by the government regulators who were enthusiastic to terminate the recession in the 2000-2001 period and amplified by the long period of decreased rates of interest from 2001-2004.

4.6. Conclusion

This chapter clearly identifies the themes in secondary literature which relate to the research questions of the study.

Chapter Five: Conclusion

5.1. Implications of the study

The primary research question of the study was to identify with the relevance of US policies and the impact on the government banking sector. It is argued that the policies of the government were comprehensive as observed from the introduction of the multiple monetary expansion approaches as well as the interpretation of Basel III. Considering the case of sovereign debt crises, the tightening of the fiscal has been accepted and acknowledged by people as the natural cure. Under the sovereign debt crisis, the country (US) in debt often suffer from economy-based sanctions from countries that provide credit to them. Under such severe budget restrictions, governments are unlikely to utilize expansionary fiscal policy. But excluding the sovereign debt crises there is no globally accepted and accurate fiscal policy.

The non-monitored ‘shadow banking’ sector in the over-the-counter securities refer to the innate asset values that began to drop, the opacity of the counterparty risk managed all the financial institutions to control lending irrespective of the quality of potential borrowers.

Finally, the decline of the Lehman Brothers and the randomness of the initial response in the form of TARP aggravated the systemic uncertainty and sent the financial markets into a tailspin, which had spread on a global scale through various transnational financial networks. Failures usually occurred as a result of regulators, corporate leadership and individual borrowers who could not bear to pay their mortgages on a long-term basis. However, it was the lack of systemic transparency of information which supported each of the actors to follow short-term benefits while presuming the others were acting entirely in good faith.

The American case portrays that both the monetary and fiscal stimulus are utility tools for counteracting the challenge of recession. The scale and the financial nature of the crisis, however, needed more tools in the form of various financial interventions to alleviate market fears of contagion and general systemic risk in the banking sector. The quick deregulation, accumulation and the growth of the finance sector were the most essential conditions for producing the systemic risk which further triggered the crisis in the initial stage.

5.2. Limitations of the Study and Future Implications

The study has the inherent drawbacks of not analysing primary data. The lack of primary data clearly indicates that there is a drawback associated with immediate access to data. Similarly, secondary data analysis also involves possible drawbacks in terms of reliability and validity. However, despite these limitations the researcher proposed to adopt this type of research approach as there was a need to understand the perspectives available in literature and that given the study topic was largely specific in nature, reach of respondents was not possible. The respondents who would have been considered in the research would be high ranking members in banks who were not available for contact given the small timeline available.

The study recommends that future researchers in this area identify with different quantitative measures which can measure the impact of policies on US banking. It is argued that a comparison of pre and post government policies and the impact on lending rate, capital structure, financial structure and asset structure can be promoted.

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