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MIRACULOUS FINANCIAL ENGINEERING OR TOXIC FINANCE? THE GENESIS OF THE U.S. SUBPRIME MORTGAGE LOANS CRISIS AND ITS CONSEQUENCES ON THE GLOBAL FINANCIAL MARKETS AND REAL ECONOMY

In the fall of 2008, the U.S. subprime mortgage loans defaults have turned into Wall Street's biggest crisis since the Great Depression. As hundreds of billions in mortgage-related investments went bad, banks became suspicious of one another's potential undisclosed credit losses and preferred to reduce their exposure in the interbank markets, thus causing interbank interest rates and credit default swaps increases, a liquidity shortage problem and a worsened credit crunch condition to consumers and businesses. Massive cash injections into money markets and interest rates reductions have been assured by central banks in an attempt to shore up banks and to restore confidence within the financial system. Even Governments have promoted bail-out deal agreements, protections from bankruptcies, recapitalizations and bank nationalizations in order to rescue banks from disastrous bankruptcies.

The credit crisis originated in the previous years when the Federal Reserve sharply lowered interest rates (Fed Funds at 1 %) to limit the economic damage of the stock market decline due to the 2000 dot.com companies' crisis. Lower interest rates made mortgage payments cheaper, and the demand for homes began to rise, sending prices up. In addition, millions of homeowners took advantage of the rate drop to refinance their existing mortgages. As the industry ramped up, the quality of the mortgages went down due to poor credit origination and credit risk assessment. Delinquency and default rates began to rise in 2006 as interest rates rose (Fed Funds at 5,25 %) and poor households across the US struggled to pay off their mortgages. Many of them went bankrupt and lost their homes but the pace of lending did not slow.

Banks have transformed much of the high-risk mortgage debt (securitizations) into mortgage-backed securities (MBS) and collateralized debt obligations (CDO), and have sold these assets on the financial markets to investment firms, hedge funds, and insurance companies around the world, transferring to these investors the rights to the mortgage payments and the related credit risk. With the collapse of the first banks and hedge funds in 2007 the rising number of foreclosures helped speed the fall of housing prices, and the number of prime mortgages in default began to increase. As many CDO products were held on a "mark to market" basis, the paralysis in the credit markets and the collapse of liquidity in these products let to the dramatic write-downs in 2007. When stock markets in the United States, Europe and Asia continued to plunge, leading central banks took the drastic step of a coordinated cut in interest rates and Governments coordinated actions that included taking equity stakes in major banks.

This paper aims to demonstrate, through solid and fact-based assumptions, that this global financial crisis could have been addressed and managed earlier and better by many of the stakeholders involved in the subprime mortgage lending process

such as, banks' and investment funds management, rating agencies, banking and financial markets supervisory authorities. The paper somehow "prophetically" anticipated also the potential threat of a Eurozone crisis, as a consequence of the 2007–2009 crisis. It reported that a number of European countries with slow GDP growth rates, high level of sovereign debt and/or budget deficits, and structural economic and social problems, would certainly have a very hard time coping with the aftermath of the global financial crisis. The underlying assumption being that, due to the global economic slowdown in international trade and consumptions, any form of massive government bailout of financial institutions or prolonged intervention to support economy growth and to avoid recession, through the use of automatic stabilizers, would have resulted in a totally unbearable and systemically risky situation for the entire Eurozone. Without appropriate and timely structural reforms, and coordinated pan-European policies/reforms (monetary, fiscal, and banking/financial markets) the private debt risk of the financial sector would be transferred to the public sector, thus generating the sovereign debt crisis and its potential spillover to other economies.

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