

18 September

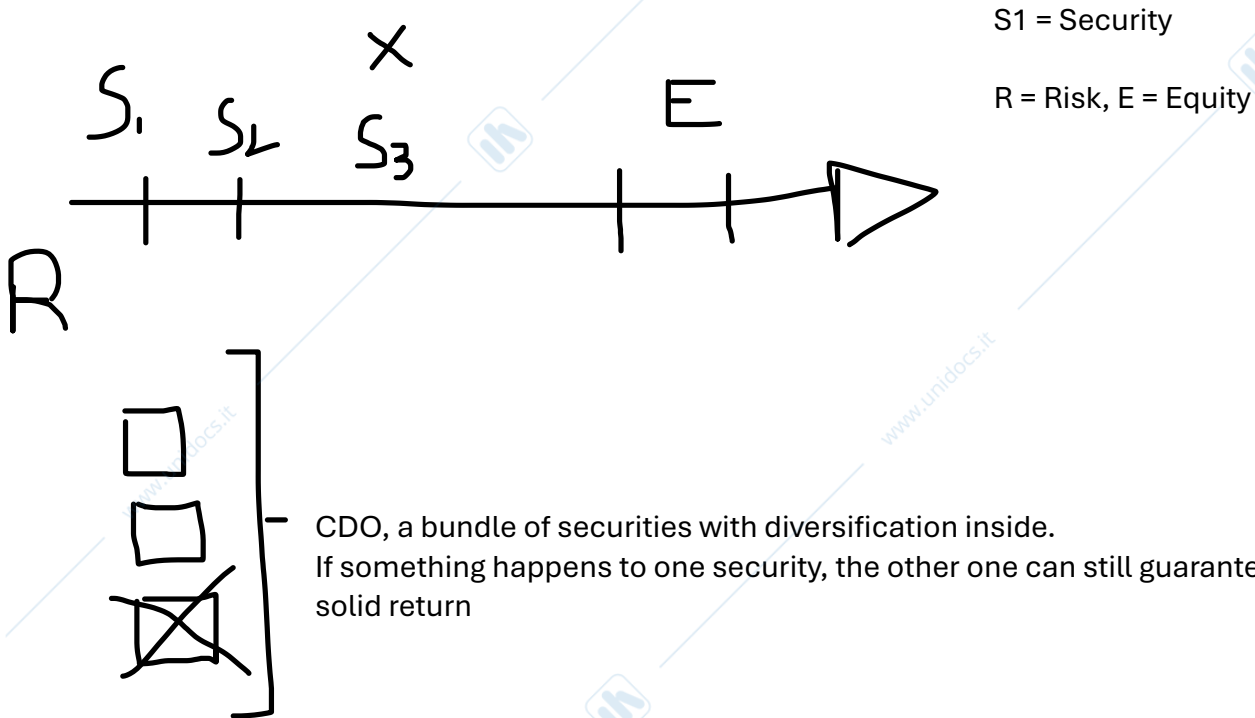
If you are investing in traditional options (securities and stocks), you know how much you can lose. With more sophisticated items this risk increases, there is a leverage that makes you unable to see the end of the trend (you can lose a lot more than the original investment).

The inability to foresee what would be the risk produces uncertainty, an obvious issue. During the 90s the idea in Europe the idea was that profit was always good, because the market could be able to balance it, but it wasn't.

Banks were looking for something safe and profitable (high return). They found out that if you create a new security with slices of previous securities, the outcome may be safer and with higher return. Diversification inside the single, so buying securities which are composed by other securities / positions with different kind of risks.

CDOs = collateralized debt obligation, a complex structured finance product that is backed by a pool of loans and other assets and sold to institutional investors.

With equities the risk is usually higher.



Rating in finance it has to do with something very specific.

→ It means in real world.

S&P = standard and poor (credit rating agency), it's a market facilitator.

The rating has a very specific way to be described (AAA is the best one, means the security has less than 1% probability of default in the next one or two years, safest with an high return).

Subprime mortgage = real estate market.

The idea was to provide everyone with their own house, even if the person is not reliable. Nobody wanted to stop that, also politicians liked this type of situation.

What's the connection between subprime mortgage and the global financial crisis?

Taking these risky loans and cutting them into slices, and mixing them with safer securities, makes the outcome the magical AAA. They were spreading them in the markets, nobody knew what was inside and nobody was interested in knowing what was inside, since it was a AAA.

In 2007 there was a slowdown of the economy, and the money coming from the subprime mortgage were decreasing, then the bubble of the house market exploded.

The weaker borrower = NINJAS = no income / no jobs and / no assets.

Financial outcome = because of the interconnection with globalization, the reduction of cash flow shows how the AAA was misgiven, and in 2007/2008 80% of AAA became junk bonds (degraded), something below the investment grade. Banks started to lose money, and to repay their debts they were forced to act on the bank capital level, they started to burn cash.

At a certain point (Lehman Brothers is the most important) they all defaulted.

When everyone understood that something was truly wrong, nobody knew exactly how many non-performing loans every bank had. (if you are filled with non-performing loans your credit awareness is very low, the credit is not performing means that nobody will repay you).

So, banks started to be pickier in lending money to other banks.

Credit crunch = nobody trusted the others, since we are a market economy, if you stop the market the whole system collapses.

That brought negative effects on the real economy.

Investment grade = AAA to BBB

Junk bonds = from BBB to the lowest

It came out that rules to protect the market were insufficient, so new rules were made, in the following decade new regulations were much more detailed (general principles like behave properly, or a very punctual regulation). After the global financial crisis, we have thousands of pages of regulations, and this was a spark to move forward the fintech (financial technology).

Suptech = technologies for supervision

Regtech = technologies used to create new regulations

Regulation should be efficient, since your dealing with something highly dynamic.