

## THE IMPACT OF THE DEBT OF THE BANKING INSTITUTIONS IN THE USA ON THE EMERGENCE OF THE 2008 FINANCIAL CRISIS

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**Abstract:** The purpose of this paper is to investigate the impact of bank indebtedness in the period before the 2008 crisis on the global financial crisis. This paper uses methods of analysis of the available literature and quantitative methods of analysis. The research in this paper has shown that investment banks in the United States, with their indebtedness, directly influenced the emergence of the crisis, due to the principle of contingency of financial institutions in the world and joint work. From this paper we can conclude that the decline in the value of speculative financial instruments securitized by investment banks in the United States, contributed to the decline of a large number of financial institutions in the world. The impact in the direction of capital destruction and disruption of investor confidence contributed to a sharp decline in financial markets and the beginning of the 2008 crisis. As a suggestion for future research, we believe that studies can be conducted on a larger scale and by more researchers, focusing on individual financial institutions and their impact on financial markets.

**Keywords:** banks, investment, debt, crisis, financial

### 1. INTRODUCTION

In order to process this topic properly and to make in-depth analyses, it is necessary to know the historical background. In this paper, we will make a detailed analysis of the emergence of sub-mortgage loans and their impact on the financial crisis of 2008, as well as an analysis of the movement of credit borrowing among banks in the United States until the emergence of the impact of the crisis on institutions in the United States.

We will explain the problem of borrowing and its impact on the emergence of the crisis and in relation to the degree of contingency of subjects in the global economy. In short, we will make a detailed analysis of the factor of indebtedness of the banks in the USA on the financial crisis, with special reference to the consequences on the global economy, but also other factors related to the indebtedness, which led to the crisis. (Hefferman S.H., 2009)

### 2. DISCUSSIONS

Because of that, a large number of these mortgages were practically worthless as securities, with the banks owning a large number of such securities for which they had borrowed on the financial markets, but also through interbank lending of funds. These banks also borrowed capital through corporate bonds in order to fund these activities.

This resulted in financial illiquidity of banking institutions as they were unable to pay their obligations, which contributed to the emergence of the crisis. According to some researchers in the USA, the destruction of capital in the financial crisis of 2008 is huge and contributes to the negation of years of progress in the financial corporate sphere. (Schwartz, M.J. Coleman, S., 2014)

When we summarize the historical development of bank indebtedness in the United States, we can see that a mature approach to risk management was replaced by an irresponsible approach after investment banks entered the mortgage securitization sector.

In table 1 we can see the historical development of the borrowing of five investment banks from the USA that were most affected by the financial crisis in the period from 2003-2007:

*Table 1: Overview, 2003-2007*

Bank	Debt to assets ratio (2003)	Debt to asset ratio (2004)	Debt to asset ratio (2005)	Debt to asset ratio (2006)	Debt to asset ratio (2006)
Leman Brothers	21-22\$ debt for 1\$ capital	22-23\$ debt for 1\$ capital	23-24\$ debt for 1\$ capital	25-26\$ debt for 1\$ capital	28-29\$ debt for 1\$ capital
Merryl Lynch	16-17\$ debt for 1\$ capital	28-29\$ debt for 1\$ capital	25-26\$ debt for 1\$ capital	21-22\$ debt for 1\$ capital	32-33\$ debt for 1\$ capital
Morgan Stanley	22-23\$ debt for 1\$ capital	26-27\$ debt for 1\$ capital	28-29\$ debt for 1\$ capital	31-32\$ debt for 1\$ capital	31-32\$ debt for 1\$ capital
Goldman Sachs	17-18\$ debt for 1\$ capital	21-22\$ debt for 1\$ capital	23-24\$ debt for 1\$ capital	20-21\$ debt for 1\$ capital	24-25\$ debt for 1\$ capital
Bear Stearns	26-27\$ debt for 1\$ capital	27-28\$ debt for 1\$ capital	26-27\$ debt for 1\$ capital	27-28\$ debt for 1\$ capital	33-34\$ debt for 1\$ capital

Source: Sternad, D. (2011). Strategic action in response to economic crises, Strategic adaptation, Springer Wien New York

### 3. METHODS

In this paper we will use the following methods:

- Research and analysis of the available literature in the field
- Quantitative data analysis

Through these methods, we will attempt to explore the effect of banking debt on the emergence of the financial crisis from 2008.

### 4. RESULTS

In the 70s, a special practice of securitization of bank loans began, which were later presented on the financial markets as safe financial placements that offer solid returns. The idea behind these securities was to make bundles of mortgages that would later be written into a single security, with most of these mortgages being of high quality, i.e. with a high probability of being repaid by the borrowers. .

This has contributed to more benefits for banks and investors. First of all, it contributed to safe investment by investors because the payment of these bonds was guaranteed by the real estate to which the bank loans refer. For the banks, there was the advantage of transferring and sharing the credit risk. But the banks could also withdraw the loans from the financial statements of the banks, they could use the funds received from the securitization to issue new loans. This also had an impact on enabling banks to increase their credit volume, without having to invest additional capital in their structures in order for their operations to be in accordance with the capitalization standards provided by banking supervisors.

Due to the need for a safe alternative to classic securities, but also due to their profitability, these securities have become attractive on the market.

During this time, systems were used where high standards were set for borrowers and they were forced to finance a large part of the real estate they bought, while the rest was borrowed from the banks. But with the emergence of investment banks in this market, the practice of safe loans and high standards has decreased. In doing so, new subclasses of sub-mortgage credit bonds developed that were of lower quality, but often received positive ratings from the agencies charged with assessing the quality of securities.

In that way, a system of operation was created where there were fewer and fewer guarantees for the owners of sub-mortgage credit bonds, which did not lead to a decrease in the volume of trading with such instruments. On the contrary, due to the attractiveness of these securities, the trading volume increased more and more and more credit arrangements were given and later securitized. (Mishkin, F.S., 2010).

The historical development of bank indebtedness in the USA before and during the crisis can be viewed through the growth of indebtedness in relation to the period before 2004 and the period from 2004 to 2007, when the financial crisis practically began, which deepened already at the beginning of next year. What is crucial to note here is that US banking institutions were heavily leveraged even before 2004, but that the rule that emerged in the US that allowed banking institutions to increase their leverage contributed significantly to the emergence of the crisis.

When the situation with the financial crisis of 2008 is analyzed retrospectively, we can see that the decision of the financial regulators in the USA to reduce financial claims from banks and enable them to take on more obligations with less capital contributed significantly to the emergence of the financial crisis.

The insufficient capitalization of the banks became evident at the beginning of 2007, but it became a very significant part of the bankruptcy of Lehman Brothers that happened the following year, as well as the forced sale of Bear Stearns. As we will show in table 1 in the next part of the paper, the growth of bank borrowings in the USA lasted for a longer period, with rapid growth in a short period from 2004-2007.

This was preceded by some economic and political decisions of the USA, as well as the work of the regulatory authorities that allowed banks to take more and more risks and carry out securitization of more and more mortgage placements, most of which were not easily collectable and which were not properly secured with funds in the form of real estate, cash and cash equivalents.

## 5. CONCLUSION

The rescue of systemically important banks in the United States once again confirms their importance for the global financial system. But it also explains the role of their indebtedness on their financial situation. Through their recapitalization, the problem arising from the billions of dollars in debt to finance assets that lost their value practically overnight was solved.

This shows us that the indebtedness of the banks and especially its evolution over the years was the main factor for the emergence of the financial crisis of 2008. Periods of deregulation of banking institutions and their gradual avoidance of strict regulations proved to be key in encouraging banks to undertake riskier banking practices. Because of this, their appetite for borrowing grew along with the growth in attractiveness of sub-mortgage credit bonds.

That combination of factors led to the emergence of strong negative influences on the markets, and with the collapse of the mortgage and real estate markets, banks were left in a situation where the assets used to guarantee the loans have almost no value. When we add to that the conditions in which mortgage loans were granted with the entry of investment banks into the market, we can say that due to such practices the crisis of 2008 was inevitable.

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