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A Perspective of the Credit Foundation for Finicial Innovations from the Sub Prime Loan Crisis

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Preface

After the financial crisis in USA, the common realization among people are that market is lacking of confidence .Confidence is very important throughout the financial

transactions . However confidence is not coming from the heaven, it is coming from the credit which is more important than confidence. No credit, no confidence. The credit comes from the credibility of the consumer or the fulfillment capability of the liabilities undertaker.. It can also come from the anticipation of the financial markets participants on the future revenue, risk or controllability. Thus, the credit is the foundation of the financial stability and safety.

Under the market economy, credit is one of the extended chains, Among all these chains, the relationship between borrower and lender is the essential part for the credit. Credit environments are the prerequisite for the credit transactions. Such as, credit evaluation institutions, the government supervising on the financial derivation products, the capability and willingness of the undertakers to fulfill the liabilities. With more and more credit transactions, leverage effect is becoming more and more powerful; the influence of faith breaking also becomes more and more significant. Therefore, a third party is required to monitor the credit transactions, punish the infringement, etc. The third party is what we called Financial Supervising Bureau. Among the credit chains, any single neglection can result in a credit crisis. For the USA financial crisis, the key matter is the credit crisis. The credit crisis is due to the lack of credit foundations during the transactions of the financial derivation products.

The foundation of the financial innovation.

The Financial development history is the history of the financial innovations or the history of credit development. From the money evolution history, we can find the classic example is the birth of the bank notes and paper money. It is actually a financial innovation which is based on the credit. So the credit foundation is something like equivalent guarantee, gage or mortgage system. The foundations of the issuance of the bank notes are certain metal reserve . So bank notes are not rejected by any people or resulting in any confidence crisis, financial crisis. When the credit basis is destroyed, the foundation of the bank notes is gone, people start rejecting the bank notes which will definitely result in the inflation and financial crisis.

After the birth of the paper money, the foundation of paper money is changed. The foundation of the paper money firstly is certain reserve of metals or equivalent substances and gage such as national bonds etc. secondly is, government reputation. From the above, we can learn that the main change is the government reputations are treated as a gage in addition to the metal reserves. The government reputations come from the government credit. Moreover, the government credit can not be the sole foundation of paper money if there are no metal reserves and substantial fortune. However, under these circumstances, the disadvantage of the credit foundation is that government can lose her faith by expanding the credit unlimitedly. The inflation become more and more popular under the circulation of paper money. We would say that the inflation is the representation of losing credit or

unlimitedly expanding the credit of the government.

Under the modern financial system, bank is the center of the credit derivative products. In bank liability business, bank's capital, risk reserve and reputation are the foundations of the bank's liability activities. Instead of full foundation, only part of the foundation are the guarantees for the bank liabilities which will cause potential risk of faith breaking. For bank asset activities, specially the business of providing loans are based on the gage. Of course sometimes the borrower's reputation is equivalent to certain gage. Nevertheless, this will not change or replace the substantial mortgage. Therefore, the substantial mortgage and the mortgage system have become the foundation of releasing a loan or keeping away the risk. This is because when the bank provides a loan to somebody, it is difficult for bank to select a good borrower due to the high cost of selecting under asymmetric information and converse selections. In order to secure the bank's interest, the wise selection is that bank will provide loans according to the borrowers' credit. The game result between banks and borrowers will reach the Nash Balance between individual sense and collective senses and finally comes to the "the prisoners dilemma". The solution to this problem is how to cope with the asymmetric information. One key solution is to establish a mortgage system. Mortgage system is the crucial system to prevent credit crisis.

Under mortgage system, the mortgage products are the foundations for the banks to provide loans which can help reduce the credit risk. While, driven by the profit, banks normally will overlook the mortgage requirements and generate lots of the loans to the borrowers which do not have good credit. This has provided the possibilities to the borrowers for breaching the contract. When the economic situation change, bank will undertake the full credit risk although bank is fully aware of this route,. But the real problem is: when the banks are pursuing the profit without undertaking the credit risk,(Such as, during Chinese planned economy) or transferring the risk to others (Such as sub prime loan is converted to sub bonds), the bank will take risks in creating lots of the loans. With high ranks given by the credit evaluation institutions, less financial monitoring, the large number of financial innovative products are generated in market which can result in financial crisis when the economic situations change or one particular main body loses its capability to fulfill the liabilities.

Two main issues can be explained from the USA financial crisis

Firstly, In pursuit of financial freedom, USA is actually lacking in credit foundation for financial innovation and controllability of the financial leverage. When the financial innovation foundation is not strong or it is not enough to support the high asset value, normally mortgage system is not working effectively or not working at all. When the small possibility event occurs, mortgage is not enough to reimburse the load or other financial derivative products, financial crisis is inevitable.

Secondly, in the financial innovation activities, the innovator does not take his/her responsibilities. The innovator includes: commercial banks, investing banks etc and all of

them have neglected the risk caused by high leverage rate or bad loans or sub prime loans etc. As the key member of the credit environment, credit evaluation institute, puts high ranks on the innovative products which do not have solid foundation of credit. Financial supervisors lost their monitoring on the bad innovative products.etc. Although there are different types of losing responsibility, the common thing is less control and monitor on the financial innovative products, removing the necessary mortgage system, which is indeed the root cause for the financial crisis.

From the relationship between market economy and financial system, we can find, the financial innovative products, as fictitious economy, contradictory to the entity economy, should be based on the real entity values. The real value of the entity can be calculated by the statistical value minus bubbles. And this is the credit foundation of whole financial innovations. It also can be recognized as the realization route of mortgage system for credit. The actual situation is we can not exclude the factious ingredient which is an inevitable financial foam in the financial activities. However, the form should not be too much to affect the real entity running and financial stabilities; this is the bottom line of the financial innovations. For this line, seen from the Weksyr Credit Cycle Theories, it should be a nature interest rate or the reasonable yield rate in this industry.

The USA financial crisis caused by sub prime loan is due to the excess profit by high leverage rate and non synchronous growth of capital and profit margins. (Of course we can not know the exact the profit margin in the financial industry). The crisis has put significant influence not only on the America Finance but also on the world economy and fiancé. Thus, the moderation of financial innovation is the key principal of the modern financial systems.

The flaw of the America Credit System- lacking of credit based financial innovation.

The USA financial crisis reflects the incompetence of the America Bank, Credit Evaluation Institute, Financial Monitor Bureau on supervising the financial innovations.

The history of the financial development indicates that the level of credit system has determined the national financial development and stability to a large extent. After World War II, USA have become no 1 county in the world because of USA strong economy and mature & comprehensive credit system. In 1920's, with the influence of free economy, USA over expressed the financial freedom and mercerization and lost the control on the foundations of financial innovations, neglected the function of mortgage system to prevent the risks.

Firstly, US credit system allows the financial institutes to generate lots of estate loan which do not have solid foundations.(some loans without credit record , needless to mention or mortgage based loans). Secondly, US credit system allows investing bank or some other agent to convert the loan into sub bonds and sell the bonds at the market. Third, US credit system allows the credit evaluation institutes to give high ranks to those financial

derivative products without looking at their credit foundations, this gives wrong message to the investors. Lastly, US credit system allows unlimited financial innovations; there is almost no monitoring on financial derivative products. It is all because of these flaws on USA credit system, the finance crisis formed and spread to all over the world.

Under this kind of credit system, the chains of financial derivative products innovations are extended. The markets for all kinds of derivative products are growing bigger and bigger, no credit foundation evaluations on the derivative products no mortgage system, no professional mortality of financial innovations, no financial monitoring, all of these have masked the risk of financial innovations. With lots of high potential risk financial products coming to the market, after various complicated transactions, these risks are carried out to the whole world finance market. With the more and more fortune coming from continue amplified financial derivatives, the huge risk for America and world finance is also coming. When the environment changes, the risks for those no credit based financial innovations are emerging, credit crisis is followed by financial crisis. This is the result of financial innovations without solid credit foundations.

The construction of the credit foundation for the financial derivative products.

Financial innovations include financial system, financial market and financial products. The fastest development is the innovation of financial derivative products which are encouraged by most of the developed countries.

The precondition for the financial derivative products are the finance stability. This is also the basic requirement for the innovations of financial derivatives and implication from the financial crisis. How to keep the finance stability during the financial innovations is still a difficult problem. To resolve this, the main way is to establish a credit foundation for the financial derivative products. This is also the substantial basis and technical guarantee for the risk control during the financial innovations. The key issue is to strengthen the mortgage requirements and mortgage system during the credit derivations. Make full use of the mortgage system to prevent the risk of financial derivatives.

Firstly, it is required to establish a mortgage system based on the real value of the entity assets. During the financial transactions, one of the main ways to resolve the issue of asymmetric information and the credit of the borrower is to establish the mortgage system, especially the mortgage system based on the real value of entity assets. From the USA financial crisis, we can learn when the real estate foam is forming; the prices for houses become the statistic prices which are far away from the real prices. Getting the loans for a new house by mortgaging the existing house is exaggerating the foams. The exaggerated house mortgage loans are converted into the credit derivative products like contract securities and this kind of credit derivative product has no solid foundations to defend the risks. So the mortgage systems should be established based on the real value of credit, instead of the symbolic value of credit.

Secondly, it is required to set up the pricing and exchange system for the financial assets (or called credit derivative products). Without the effective pricing and exchange system for the financial assets, more and more financial derivative products can come easily without any credit foundation. Driven by the profit, financial assets are exchanged or mortgaged repeatedly, credit derivative product chains are extended longer and longer, and finally nobody can know exactly who is the beginning, mid way or the end, With so many transactions, liabilities undertaker, capability of fulfillment, become vague. All participants are working alone and independently, nobody thinks about the risk management. USA financial crisis indicates it is because the repeatedly exchanging and mortgaging financial assets, nominal price fluctuations are more than real prices changes, mortgage symbolic value is more than the actual value, the hurt of repeated mortgaging of financial assets are more serious than others To some extent, this can explain why the sub prime loan in USA which takes small percentage share of total financial products can put such a high influence on the whole world economy and finance. The sub prime loan derivatives in USA are generated without the credit foundation, the worse thing is these derivatives are finally taken by others as mortgage assets. It is not the real entity who comes to the mortgage assets, the credit derivatives become mortgage assets, which result in the financial foams becoming mortgage assets. The longer the mortgage chain is, the greater the potential risks are, and the more devastating the crises are.

In a conclusion, under the modern market economy, there are more and more risks forthe financial derivative products. One of the effective methods is to build a reliable credit foundation for financial innovations and an effective path is to establish a mortgage system based on the real value of the assets. This is all what we can learn from the USA financial crisis and it is also the requirements for the financial stability.

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