

From Modigliani Miller to the 2008-2009 Financial Crisis

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Abstract.

The subprime financial crisis, started in the early 2007, affects strongly the financial markets and the global economy so far. This paper addresses the essential question of the impact of the financial theory, of the standards, and regulation policy measures on the recent crisis. First, we explain the incidence of the securitization mechanisms on Modigliani-Miller's capital structure and firm valuation theory by means of the computation of two study case examples and their accounting incidences. Second we show that on the one hand capital reserves requirements through Basel Committee 1988, European Directive and Basel II 2004, had a negative effect on the equity multiplier ratio (assets over equity ratio). On the other hand, since the first use of securitization in 1982 by Exxon, and Xerox in the USA, regulation requirements made banks more and more interested in securitization mechanisms through special purpose vehicles as to lower the amount of risky assets in their balance sheets. Securitization was a marvellous tool that helped them to manage their level of capital reserves without lowering their return on Equity (ROE) ratio. It ensued in immoderate development of structured finance industry over the last 25 years and finally in the current global chaos. Third, this mechanism is linked to valuation of the firm in consideration of its debt. Through the model developed in Jehlen [2009a, 2009b], we show that securitization, in the 2003-2007 bull market framework, acted as an accelerator on the bank and firms market values ensuing positive gearing. Then this gearing became negative in the 2007-2008 bear and low liquidity market, amplified by the globalization of the economy. In bear market securitization turned out to be similar to a global Put option on the financial economy, provoking heavy losses for the financial institutions and credit crunch for firms. However, the model opens the way to implement an inventive regulation tool, to watch markets and financial systems. It confirms that excess borrowing or other types of financial imbalances can be identified before they may lead to stress. As a result, this paper contributes to the timely debate of financial markets policy and regulation means.

Key words: Financial crisis; Securitization, Accounting and Capital and Ownership Structure; International Finance Forecasting and Simulation; Financial Risk and Risk Management.

JEL Classification: G01, G18, G32.

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