This is an excerpt from <u>A Random Walk Down Wall Street</u> by Burton G. Malkiel, which provides a concise summary of what happened during the 2008 financial crisis.

The New System of Banking

If a financier had awakened from a thirty-year nap during the early 2000s, the financial system would have appeared unrecognizable as well. Under the old system, which might be called the "originate and hold" system, banks would make mortgage loans (as well as loans to businesses and consumers) and hold these loans as assets until they were repaid. In such an environment, bankers were very careful about the loans they made. After all, if a mortgage loan went into default, someone would come back to the loan officer who made the loan and question the original credit judgment. In this environment, both substantial down payments and documentation were required to verify the creditworthiness of the borrower.

This system fundamentally changes in the early 2000s to what might be called the "originate and distribute" model of banking. Mortgage loans were still made by banks (as well as by big specialized mortgage companies). But the loans were held by the originating institution for only a few days, until they could be sold to an investment banker. The investment banker would then assemble packages of these mortgages and issue mortgage-backed securities -- derivative bonds "securitized" by the underlying mortgages. These collateralized securities relied on the payments of interest and principal from the underlying mortgages to service the interest payment on the new mortgage-backed bonds that were issued.

To make matters even more complicated, there was not just one bond issued against a package of mortgages. The mortgage-backed securities were sliced into different "tranches", each tranche with different claim priority against payments from the underlying mortgages and each with a different bond rating. It was called "financial engineering". Even if the underlying mortgage loans were of low quality, the bond-rating agencies were happy to bestow an AAA rating on the bond tranches with the first claims on the payments of interest and principal from the underlying mortgages. The system should more accurately be called "financial alchemy," and the alchemy was employed not only with mortgages but with all sorts of underlying instruments, such as credit card loans and automobile loans. These derivative securities were in turn sold all over the world.

It gets even murkier. Second-order derivatives were sold on the derivative mortgage-backed bonds. Credit-default swaps were issued as insurance policies on the mortgage-backed bonds. Briefly, the swap market allowed two parties -- called counterparties -- to bet for or against the performance of the mortgage bonds, or the bonds of any other issuer. For example, suppose I hold bonds issued by General Electric and I begin to worry about GE's creditworthiness. I could buy and hold an insurance policy from a company like AIG (the biggest issuer of credit default swaps) that would pay me if GE defaulted. The problems with this market lay in the fact that the issuers of the insurance such as AIG had inadequate reserves to pay the claims if trouble occurred. And anyone from any country could buy the insurance, even without owning the underlying bonds. Eventually, the credit-default swaps trading in the market grew to as much as ten times the value of the underlying bonds, pushed by demand from institutions around the world. This change, where the derivative markets grew to a large multiple of the underlying markets, was a crucial feature of the new finance system. It made the world's financial system very much riskier and much more interconnected.