**Financial Crisis: Participants/players and Major Contributing Factors**

**Banks:**

Advertising and marketing, performs credit evaluations, issues/approves mortgages based primarily on credit criteria of borrowers and appraisal of property (e.g., loan to value ratio)

Credit evaluation criteria was relaxed as time went on – priority on originating and then selling and packaging these mortgages (MBSs). In return, able to remove assets from their balance sheet (and related P&L accounts) –> less concerned with performance of loans. Additionally, the bank can earn fees for securitizing the mortgages and can earn servicing fees for processing payments. Revenue moves from an interest earning entity to a fee based entity.

**Non-bank banks** (shadow banks): Financial firms that do not accept deposits, and were/are not under the purview of the bank regulatory and supervisory regime. Examples include investment banks and insurance companies

**For Banks and Non-bank Banks:**

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| **Originate to distribute model:** |
| **Loan origination →servicing →bundling → distribution** |

**Mortgage Brokers** (state licensing): fees earned based on approval/assignment of loans. Motivation is to close the deal

**Appraisers of the property:** valuations increased above fundamental value due to high turn-over/re-sellingof properties

**Fed Reserve – Monetary Policy:**

Low interest rates for extended period encouraged borrowings. Additionally, investors “reached for yield” by investing in riskier/higher yield assets – specifically MBSs

Followed by tightened monetary policy -i.e., increasing short term rates 🡪 For borrowers who held subprime mortgages (variable/adjustable rate), monthly payments increase as rates increase.

**Legislation/regulation – Deregulation:**

**The Banking Act of 1933 (Glass Steagall Act)** separated investment banking from commercial/retail banking. This law was repealed with the passage of  the **Financial Services Modernization Act in 1999 (Gramm-Leach-Bliley Act)** allowing the merger of investment banks and commercial banks with minimal firewalls. For example, banks could use deposits to invest in derivatives 🡪 Unintended Consequences.

In **2000,**[**Commodity Futures Modernization Act**](http://www.huffingtonpost.com/paul-blumenthal/how-congress-rushed-a-bil_b_181926.html) exempted credit default swaps and other derivatives from regulations and oversight by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). This federal legislation overruled existing state laws. (Ultimately, while the unregulated market in derivatives and swaps did not cause the economic downturn itself, it was a propellant of the crisis, accelerating the collapses of major financial companies across the globe.)

**Bank Supervision and Examination:**

Financial innovations (e.g., CDOs, CDSs, CRA implementation of rating each tranche (tier) within a security) was “a step ahead” of laws, regulations, and bank examination procedures.

Bank oversight generally had a micro-prudential perspective – i.e., examinations primarily focused on the specific bank being examined. Process did not follow the flow of the product (loans) through transformation and subsequently, the financial markets. To note: subsequently, macro-prudential examination perspective implemented and Financial Stability Oversight Council (FSOC) established.

**Credit Rating Agencies (CRAs):**

Conflict of interest in structuring securities (MBS) and then rating the securities

As credit quality of borrowers deteriorated (based on relaxed credit evaluation models), the CRAs did not update their models and their ratings to incorporate the changing market conditions.

**Insurance Companies - Credit Default Swaps** **(CDS):**

Insurance companies and other non-bank banks sold credit default swaps. A CDS is an insurance product where the seller of the CDS compensates the buyer in the event of a debt/security default (e.g., MBS default). For example, AIG was a primary issuer/seller of CDS products for MBSs, abandoning its diversified insurance strategy to focus primarily on this product. Given the lack of diversification, AIG was dependent on the continued performance of the underlying mortgages. When the mortgages started to default, the MBS products defaulted and all the buyers of the insurance wanted pay-out for their losses.

**Government Sponsored Enterprises (GSEs):**

Fannie Mae and Freddie Mac purchase mortgages from banks as long as the banks follow their established credit criteria. These mortgages were subsequently packaged into MBSs. As time went on, the GSEs also lowered their credit standards. These GSEs were subsequently bailed out by the Treasury Department and put into conservatorship by the Federal Housing Finance Agency (FHFA)

**Special Purpose Entities (SPE/SPV):**

Source: <https://www.pwc.com/gx/en/banking-capital-markets/publications/assets/pdf/next-chapter-creating-understanding-of-spvs.pdf>

Securitization – SPVs are the key characteristic of a securitization and are commonly used to securitize loans and other receivables. This was the case with the US subprime housing market whereby banks converted pools of risky mortgages into marketable securities and sold them to investors through the use of SPVs. The SPV finances the purchase of the assets by issuing bonds secured by the underlying mortgages.

For example:

Bear Stearns (2008): Having taken on huge amounts of exposure to mortgage-backed assets, via SPFs, Bear Stearns collapsed after a failed emergency rescue and was finally sold to JP Morgan Chase in 2008.

Lehman Bros (2008): The insolvency of Lehman Brothers in 2008 highlighted significant structural weaknesses in SPV documentation, particularly in structured finance transactions where Lehman acted as swap counterparty. This vagueness stress-tested the SPVs often leaving them with unforeseen liabilities.