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Essays

CAUSES OF THE FINANCIAL CRISIS

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ABSTRACT

Why did the popping of the housing bubble bring the financial system—rather than just the housing sector of the economy—to its knees? The answer lies in two methods by which banks had evaded regulatory capital requirements. First, they had temporarily placed assets—such as securitized mortgages—in off-balance-sheet entities, so that they did not have to hold significant capital buffers against them. Second, the capital regulations also allowed banks to reduce the amount of capital they held against assets that rem … A-rated tranches … ortgage-backed … ed the amount … ke loans man… concen… olvent when the hous…

Notes

1. Coval, Jurek, and Stafford 2009, therefore, calls these kinds of tranche products "economic catastrophe bonds."

2. See Rajan 2008 for an early hint of this problem with bankers' pay. Acharya and Volpin 2009 provides a model explaining why pay may have risen in the banking industry, and why at the same time risk-management (governance) quality deteriorated, due to greater mobility of risk-takers across financial institutions. Acharya and Richardson 2009 provides a detailed account of such governance failures (see, especially, chs. 7 and 8).

3. The following account is taken from UBS's "Shareholder Report on UBS's Write Downs," prepared for the Swiss Federal Banking Commission, 18 April 2008.