Critical Review
A Journal of Politics and Society
Volume 21, 2009 - Issue 2-3: Causes of the Financial Crisis

Essays

CAUSES OF THE FINANCIAL CRISIS

Viral V. Acharya & Matthew Richardson

Pages 195-210 | Published online: 13 Jul 2009

Cite this article https://doi.org/10.1080/08913810902952903

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 remained on their balance sheets—if those assets took the form of AAA-rated tranches of securitized mortgages. Thus, by repackaging mortgages into mortgage-backed securities, whether held on or off their balance sheets, banks reduced the amount of capital required against their loans, increasing their ability to make loans many-fold. The principal effect of this regulatory arbitrage, however, was to concentrate the risk of mortgage defaults in the banks and render them insolvent when the housing bubble popped.

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.

Related research

People also read | Recommended articles | Cited by 314