SECTION I

CAUSES of the FINANCIAL CRISIS of 2007-2009

Overview

There is almost universal agreement that the fundamental cause of the crisis was the combination of a credit boom and a housing bubble. It is much less clear, however, why this combination led to such a severe financial crisis. The common view is that the crisis was due to the "originate to distribute" model of securitization which led to lower quality loans being miraculously transformed into high-rated securities by the rating agencies. To some extent, this characterization is unfortunately true. That is:

- There was a tremendous growth in subprime loans. Many of these loans were highly risky and only possible due to the clever creation of products like 2/28 and 3/27 adjustable rate mortgages (ARMs). Chapter 1, "Mortgage Origination and Securitization in the Financial Crisis", looks at these issues in detail and lays out principles and proposals for future regulation of the mortgage market.
- Moreover, this growth in subprime lending was only possible due to the ability of securitization to pass on the credit risk of loans faced by the lender to the end user investor in asset backed securities (ABSs). Chapter 2, "How Banks Played the Leverage Game", documents that a substantial portion of these securitized assets were held by banks – rather than transferred to rest of the financial sector – and explains the regulatory arbitrage that led to such bank behavior.
- The end users – banks or otherwise – were only willing to invest because the Rating Agencies had rubber stamped a large portion of these securities as AAA by creating a chain of complex structured products. Chapter 3, "The Rating Agencies: Is Regulation the Answer?" describes the history of how the Rating Agencies were formed, their role in the current crisis and suggestions with respect to future regulation.