SUBPRIME MORTGAGES AND THE MBSs IN GENERATING AND TRANSMITTING THE GLOBAL FINANCIAL CRISIS

Michał Jurek, Paweł Marszałek,
Poznań University of Economics
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Aim

• to provide a critical survey on the factors which generated and transmitted the global financial crisis, with the special attention paid to phenomena observed in the subprime mortgages and MBSs markets

• linkages among all factors!
Subprime mortgages

- Lower quality
- Bubble in the US house market
- Extended lending (USD 650 bn in 2005)
- More funds required – new types of passive operations
- All involved..
Insurers (provide tranche insurance on CDOs, ABS, and some SIVs)

CDOs (buy mortgage-related ABS as well as CDS on such ABS and issue tranched debt)

Lenders

Debt tranches and equity

CDOs pay banks market value of ABS collateral

More risk-seeking investors including hedge funds

ABS SIVs pay banks market value of ABS collateral

ABS (SPVs buy loans including subprime mortgages and issue tranched debt)

Less risk-seeking investors

ABCP conduits/SIVs (buy ABS and issue debt including short-maturity paper)

Short-maturity paper and SIV debt tranches

Banks

Senior debt tranches

Senior debt tranches

Loan proceeds

Loan cash flows

Loan proceeds

Loan cash flows

Borrowers

Conduits/SIVs pay banks market value of ABS collateral

Banks provide credit lines to conduits/SIVs

Pooled loan cash flows
9 factors generating the collapse of subprime mortgages and MBSs markets and transmitted the crisis

1) Dependence of the US mortgage market on state-sponsored entities
2) Low quality of credit standards
3) Inappropriate credit rating policy and valuation of structured credit products
4) Lack of market transparency
5) Extent and speed of rating downgrades of asset backed securities
6) Panic in the financial market
7) Off-balance sheet entities’ activity
8) Banks’ liquidity commitments and speed of liquidity runs
9) Financial institutions’ forced deleveraging
Intrinsic logic of the process

Liquidity plays a key role in the dynamics of financial distress

Poor understanding of financial risk both at the level of the single firm and at the level of the financial system
Policy responses – areas of interest

• Risk management
• Liquidity management
• Leverage management
• Business model
• Off balance sheet vehicles activity
• Rating activity
• Due diligence
• Safety of financial instruments, institutions and markets
Main conclusions

• The crisis has undermined(?) prevailing in the mainstream economics conviction that mature economies with sophisticated financial markets are naturally self-equilibrating

• Limitations of the analytical approaches that had guided policy

• Main structural problems at the threshold of the crisis: insufficient surveillance over financial institutions, limited experience among financial institutions in risk management, poor corporate governance

• Inability to learn from past mistakes

• A proper and fast response of the State appears to be necessity, as financial crises tend to converge worldwide
Thank You

michal.jurek@ue.poznan.pl
pawel.marszalek@ue.poznan.pl