- $62 trillion CDS Market
- $22 trillion US Stock Market
- $7 trillion US Mortgage Market
- $4.4 trillion US Treasury Market
- 6 million subprime loans originated between 1998 and 2004 alone

Subprime/ Exotic (e.g., Option ARM)

Lowers value due to fire-sale (and may impact entire neighborhoods)

Home Price

Initially increases value due to increased buying/selling activity

Cheap Money & Deregulation

LENDING BANKS
"I want my money from the Hedge Funds, but they have no cash so we have to take the underlying CDO assets. But wait, there's no market for CDOs and they're worthless! Halt all lending!!

May be

In bad times are more likely to

Default

Hedge Funds (highly leveraged – 15 to 1)

Loan money to/contribute to

Lending Banks & High Net Worth Investors

Lowers value of

Homeowners

Start here

May

May purchase the riskiest "slices" of

- A financial "derivative" bought to "hedge" against a borrower defaulting. E.g., AIG sells a CDS to Party A so that Party A would be paid by AIG if a borrower defaults.
- Provides insurance against default so that companies who buy them can borrow more (issue more bonds)
- Not regulated (AIG $446 billion)
- Bought and sold with no proof that the seller can even cover a default of the insured security
- May be purchased by speculators who don't even hold the target company's debt (i.e., Delphi's bonds insured for 10 times value of original bonds)

HOMEOWNER
"My payment increased or I owe more than it's worth! I'm outta here!!"

Mortgage

Seek homes, bigger homes, and equity in homes through

Securities & Bonds

Originated & sold to

Mortgage Meltdown

Mortgage Backed Security (MBSs)

Other Corporate Bonds

Protect/hedge against defaults of

INSURER
"All those Mortgage Backed Securities and bonds and Credit Default Swaps are going bad and now I need to cover them, but I don't have enough money! And I can't raise more through stock since my stock is dropping. And, we're having problems writing new insurance since my credit rating has tanked, and I can't borrow since no one is lending money!"

Investors (mort. banks, Fannie, Freddie)

May be bundled and sold as

Collateralized Debt Obligations (CDOs)

have

Valuation (that rises and falls)

Upon change in valuation, may require

Credit Default Swaps (CDS)

Purchase

May sell

Purchased by

Slice up MBSs into various

CDS Meltdown

Insurers (AIG, Chubb exited in 2003)

Mark to Market Valuation

May further depress

Deleverage (sell assets, pay off debt, raise capital)

Stock Price

Investment Bankers (Lehman)

Become very aggressive trading CDS's and in some cases selling

Impacts stock price, and thus ability of firm to raise capital

If negatively affecting business, companies may

Did not necessarily apply to

May requires owners to restate value of assets, thus impacting

Leverage/ Indebtedness

Significantly impacts lending decisions made by

1991 Regulation

S&L Crisis

Regarding appropriate levels of

Leads to

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