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Origins of the Financial Crisis

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Dick K. Nanto, Coordinator
Specialist in Industry and Trade
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The origins of the financial crisis point toward three developments that increased risk in financial markets. The first was the originate-to-distribute model for mortgages. The originator of mortgages passed them on to the provider of funds or to a bundler who then securitized them and sold the collateralized debt obligation to investors. This recycled funds back to the mortgage market and made mortgages more available. However, the originator was not penalized, for example, for not ensuring that the borrower was actually qualified for the loan, and the buyer of the securitized debt had little detailed information about the underlying quality of the loans. Investors depended heavily on ratings by credit agencies.

The second development was a rise of perverse incentives and complexity for credit rating agencies. Credit rating firms received fees to rate securities based on information provided by the issuing firm using their models for determining risk. Credit raters, however, had little experience with credit default swaps at the "systemic failure" tail of the probability distribution. The models seemed to work under normal economic conditions but had not been tested in crisis conditions.

Credit rating agencies also may have advised clients on how to structure securities in order to receive higher ratings. In addition, the large fees offered to credit rating firms for providing credit ratings were difficult for them to refuse in spite of doubts they might have had about the underlying quality of the securities. The perception existed that if one credit rating agency did not do it, another would.

The third development was the blurring of lines between issuers of credit default swaps and traditional insurers. In essence, financial entities were writing a type of insurance contract without regard for insurance regulations and requirements for capital adequacy (hence, the use of the term "credit default swaps" instead of "credit default insurance"). Much risk was hedged rather than backed by sufficient capital to pay claims in case of default. Under a systemic crisis, hedges also may fail. However, although the CDS market was largely unregulated by government, more than 850 institutions in 56 countries that deal in derivatives and swaps belong to the ISDA (International Swaps and Derivatives Association). The ISDA members subscribe to a master agreement and several protocols/amendments, some of which require that in certain circumstances companies purchasing CDSs require counterparties (sellers) to post collateral to back their exposures.[24] The blurring of boundaries among banks, brokerage houses, and insurance agencies also made regulation and information gathering difficult. Regulation in the United States tends to be functional with separate government agencies regulating and overseeing banks, securities, insurance, and futures. There is no suprafinancial authority.