



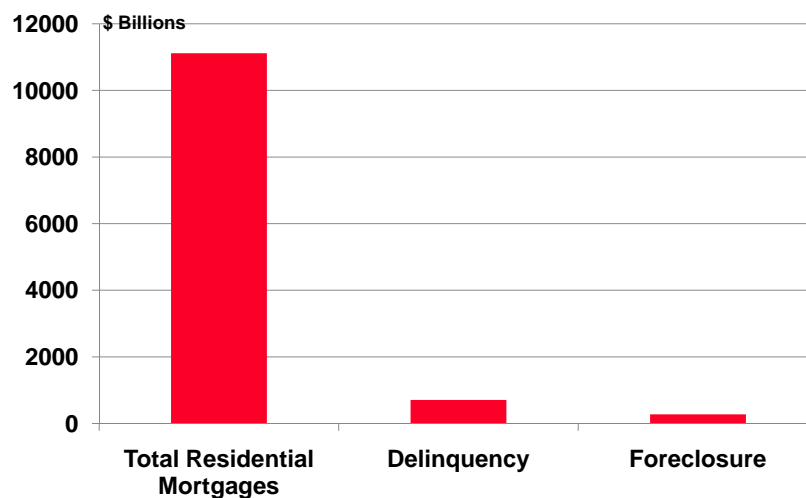
Mortgage Credit Market Crisis: Leverage, Counterparty Risk, and Asymmetric Information

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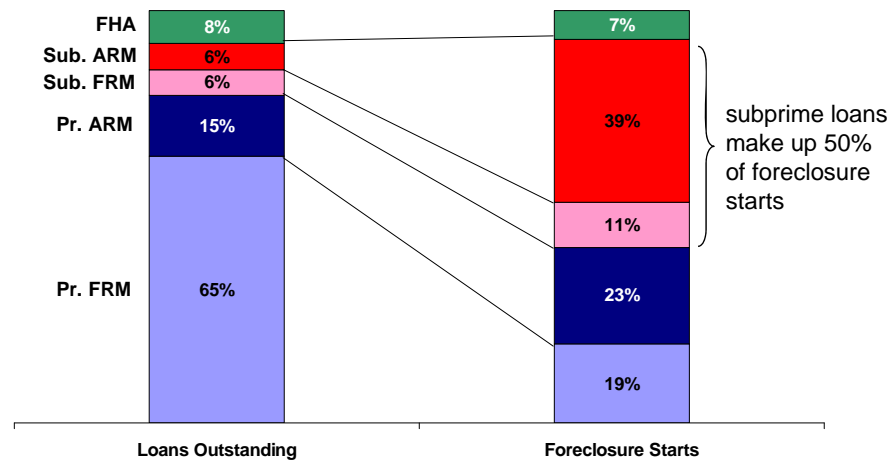


Perspective on the U.S. Mortgage Crisis



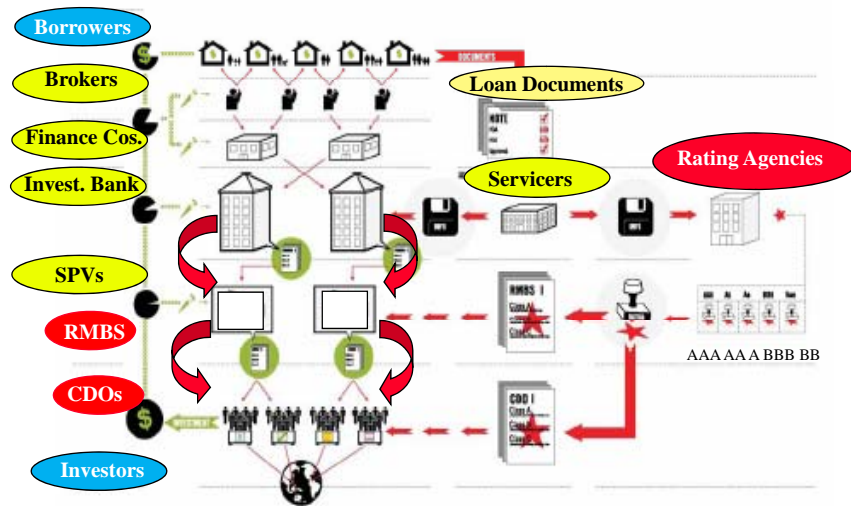
Source: Author's calculations, Federal Reserve Flow of Funds,
Mortgage Bankers Association.

Foreclosures Are Highly Concentrated in Subprime



Source: Mortgage Bankers Association, 2008

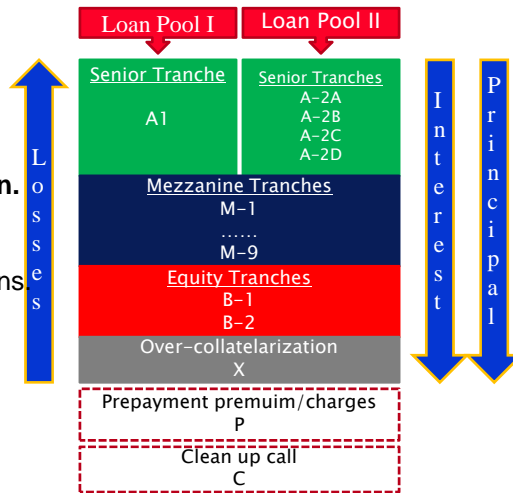
Subprime Market Supply Chain: *Fee businesses with inadequate capital*



(Adapted from: "Six Degrees of Separation," Andrew Davidson)

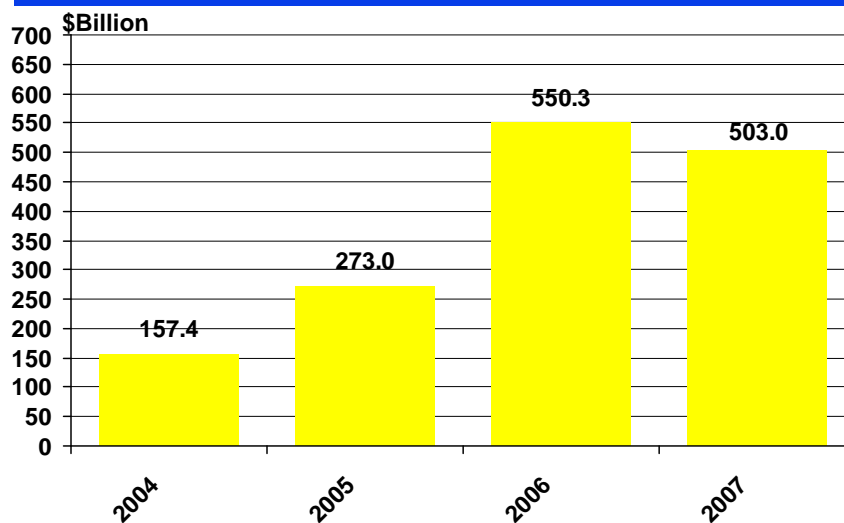
GSAMP 2006-NC2: A Subprime RMBS Special Purpose Vehicle (SPV)

- **IB: Goldman Sachs**
 - 3,949 subprime loans
 - \$881 Million
- **Finance Co: New Century Fin.**
 - Bankruptcy, April 2007.
 - 3rd largest subprime orig.
 - \$51.8 billion originations
 - Internet-based lender.
 - 14,000 brokers.



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Global CDO Issuance



Source: Securities Industry and Financial Markets Association

Addition of Counterparty Risk: *Credit Default Swaps*

The Life of a Swap

How financial players transfer their risk in an opaque market:



Credit Default Swap

1. A company raises cash by selling bonds



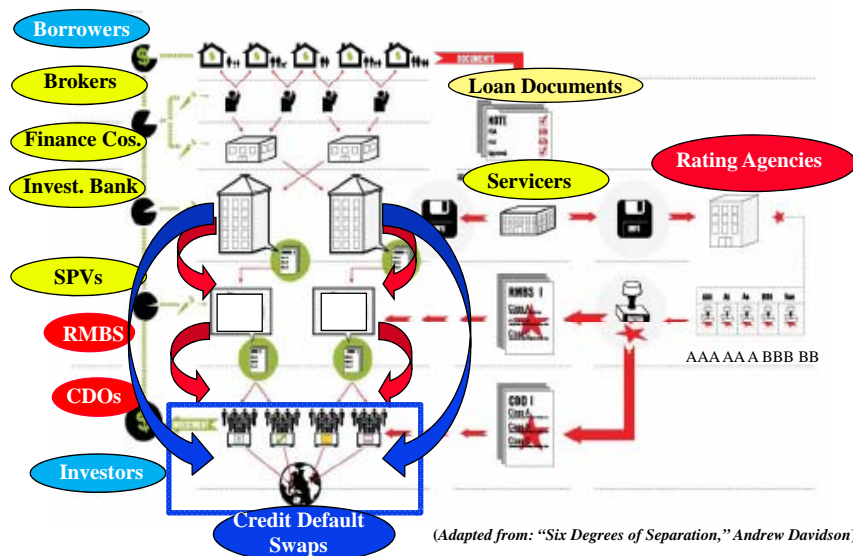
2. The buyer of a credit default swap—a pessimist in this scenario—does so to insure against a default on a bond or simply to bet that default risk will rise.



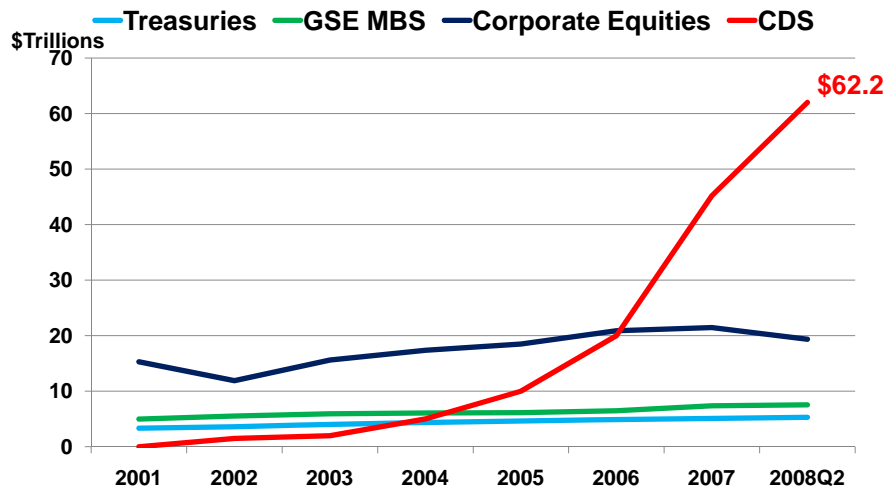
3. In exchange for regular payments over a fixed period of time, a seller of the credit default swap agrees to make a large payout to the buyer if the specific bond defaults.

Source: wsj.com

Insuring Mortgage Bond Default Risk: *Credit Default Swaps*



Credit Default Swaps: Significant Counterparty Risk



Source: Authors calculations, New York Times, Federal Reserve Flow of Funds, L.4
Credit Market Debt, International Swaps and Derivatives Association

CDS Counterparty Risk

- ◆ Completely unregulated, privately negotiated bi-lateral trading structure.
 - » No standardized capital requirements, no standardized valuation methods, no standardized contract structure.
- ◆ No central clearinghouse or system for recording trades.
 - » Do not know where it all is!!
- ◆ CDS positions are long and can only be “unwound” with countervailing positions.
- ◆ Bears Stearns, AIGFPC, Lehman are all important ‘**sellers**’ of CDS – fee businesses with inadequate capital!
- ◆ Many CDOs are ‘**sellers**’ of CDS!