# 2.14 Financial Market Failure, the 2007-08 Crisis and Regulation: 10-minute Pack

AQA 7136 · Calculators not allowed · about 10 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

**Answer all questions. Full sentences are required for questions worth 3 marks or more. Timed guidance: 10 minutes in total.**

**1** State two immediate policy responses that governments or central banks used during the 2007-08 crisis to stabilise banks, and give one shortcoming of each response.

**(Total for Question 1 is 2 marks)**

**2** State two criticisms economists have made of post-crisis financial regulation based on Basel rules and ring-fencing reforms.

**(Total for Question 2 is 2 marks)**

**3** Explain briefly how securitisation contributed to financial market failure during the 2007-08 subprime mortgage episode.

**(Total for Question 3 is 3 marks)**


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## Question 1

policy response 1: government bank recapitalisation/bailouts - shortcoming: creates moral hazard and fiscal cost to taxpayers **B1**

policy response 2: central bank liquidity provision (e.g. emergency lending) - shortcoming: may only delay insolvency problems and can encourage risk-taking if priced below market rates **B1**

**Answer: Examples: government recapitalisation/bailouts (costly to taxpayers and can create moral hazard); central bank emergency liquidity (prevents runs but may delay restructuring and encourage risk-taking).**

## Question 2

criticism 1: complexity and procyclicality of Basel risk weights can lead to regulatory arbitrage and amplify credit cycles **B1**

criticism 2: ring-fencing may reduce contagious risk but can fragment banks operations and push risky activities into unregulated shadow banking **B1**

**Answer: Criticisms include Basel complexity and procyclicality enabling regulatory arbitrage, and ring-fencing fragmenting services or pushing risk into the shadow banking sector.**

## Question 3

securitisation pooled mortgages into asset-backed securities which were sold to investors **M1**

originating lenders had less incentive to screen borrowers because loans could be offloaded, reducing lending standards **M1**

this weakened monitoring and spread risky mortgage exposure through the financial system, amplifying systemic failure when defaults rose **A1**

**Answer: Securitisation pooled and sold mortgages, reducing lenders incentives to screen borrowers and spreading risky mortgage exposure through the system, which amplified failure when defaults rose.**


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