2.14 Financial Market Failure, the 2007-08 Crisis and Regulation: 30-minute Pack

AQA 7136 · Calculators not allowed · about 30 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 3 marks or more. Timed guidance: 30 minutes in total.

1 Explain two features of 'too big to fail' institutions that create systemic risk in a modern financial system like that in 2007-08.

(Total for Question 1 is 3 marks)

2 Explain briefly how Basel-style capital requirements are intended to reduce the risk of bank failure. Give one limitation of relying solely on capital requirements.

(Total for Question 2 is 3 marks)

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3 Data extract for the 2007-08 crisis timeline, fictional simplified figures for a banking system's indicators in Country X, 2006-2009. Table: 2006 non-performing mortgages 1.5% of stock, 2007 3.2%, 2008 8.9%, 2009 12.4%. Bank lending to households annual growth: 2006 9%, 2007 7%, 2008 -3%, 2009 -6%. Interbank lending rate spread over base rate: 2006 0.2 percentage points, 2007 0.4 pp, 2008 3.1 pp, 2009 1.8 pp. Using these data, explain how the figures show the development from rising mortgage stress to a credit crunch in Country X. Use the data in your answer.

(Total for Question 3 is 9 marks)

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Mark scheme · 2.14 Financial Market Failure, the 2007-08 Crisis and Regulation: 30-minute Pack

Question 1

feature 1: high interconnectedness, where the failure of one large institution spreads losses to many counterparties	**M1**
feature 2: concentration of critical services, where a large bank provides payment, clearing or lending services that others depend on	**M1**
together these mean failure can cause widespread disruption and motivate government intervention to avoid contagion	**A1**

Answer: High interconnectedness and concentration of critical services cause a single large bank failure to spread losses and disrupt payments/credit, creating systemic risk and raising the likelihood of government rescue.

Question 2

Basel-style requirements force banks to hold a minimum ratio of high-quality capital to risk-weighted assets, absorbing losses and reducing insolvency risk	**M1**
higher capital buffers make banks more resilient to shocks and reduce moral hazard by increasing shareholder stake at risk	**M1**
limitation: capital requirements can be circumvented by risk-weighting choices, they impose costs that may reduce lending, and do not prevent liquidity runs	**A1**

Answer: Capital rules require minimum equity against risk-weighted assets, absorbing losses and reducing insolvency risk, but they can be evaded via risk-weighting, raise lending costs, and do not address liquidity runs.

Question 3

Level 1 Simple assertions using one or two data points, with limited linkage. May state that non-performing mortgages rose and lending fell, with little explanation of transmission.	**1-3**
Level 2 Reasonable explanation using several data points, showing how rising mortgage defaults and falling bank lending coincided with higher interbank spreads. Some reference to mechanisms, such as loss of bank capital and reduced willingness to lend.	**4-6**
Level 3 Detailed, well-structured answer using the data across years to explain the sequence: mortgage defaults rose sharply (giving exact figures), bank lending growth turned negative, and interbank spreads widened dramatically showing funding stress, with clear analysis of how these elements combined to create a credit crunch and transmission to the real economy.	**7-9**

Indicative content:

- Non-performing mortgages rose from 1.5% in 2006 to 8.9% in 2008 and 12.4% in 2009, indicating severe deterioration in loan quality and rising borrower defaults
- Household lending growth fell from 9% (2006) and 7% (2007) to -3% (2008) and -6% (2009), showing banks retrenching and demand for credit collapsing as the crisis unfolded
- Interbank lending spreads widened from 0.2 pp (2006) to 3.1 pp in 2008, signalling a loss of trust and higher funding costs for banks, consistent with a freeze in wholesale funding markets
- Mechanism: rising defaults reduced banks' capital and increased perceived risk, causing banks to reduce lending and hoard liquidity, while interbank markets priced in counterparty risk, producing a credit crunch
- 2008 peak in interbank spread coincides with the first year of negative lending growth, linking funding stress to a drop in credit supply
- By 2009 non-performing loans rose further while lending fell further, illustrating an entrenched credit contraction rather than a short shock

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