2.14 Financial Market Failure, the 2007-08 Crisis and Regulation

Total Marks

AQA 7136 · Calculators not allowed · about 75 minutes · Write-in edition

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 3 marks or more. Timed guidance: 75 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 Evaluate the view that post-2008 financial regulation has reduced the risk of another global banking crisis. In your answer consider capital and liquidity rules, macroprudential tools (such as countercyclical buffers), institutional changes (FPC, PRA), and possible remaining vulnerabilities, and give a supported judgement.

(Total for Question 3 is 25 marks)

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

(Total for Question 4 is 3 marks)

5 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 5 is 3 marks)

6 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 6 is 3 marks)

7 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 7 is 9 marks)

Mark scheme · 2.14 Financial Market Failure, the 2007-08 Crisis and Regulation

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

Level 1 Basic statements about regulation with little development or application. Limited or no use of examples, few evaluative points, conclusion absent or unsupported. **1-5**

Level 2 Clear description of some reforms and plausible arguments about their likely benefits, with simple evaluation. Some development and limited use of examples, but analysis is not comprehensive. **6-10**

Level 3 Well developed analysis considering several reforms, their strengths and weaknesses, with good examples and some balance. A reasoned conclusion is present but may lack depth or wider context. **11-15**

Level 4 Thorough analysis of multiple reforms with evaluation of effectiveness, considering timing, implementation issues and trade-offs. Good use of empirical or theoretical examples and clear, balanced judgement. **16-20**

Level 5 Comprehensive evaluation covering capital and liquidity rules, macroprudential frameworks, institutional changes and remaining vulnerabilities. Strong, well-supported judgement that weighs evidence, acknowledges uncertainty and discusses distributional or international coordination issues. **21-25**

Indicative content:

- Arguments that regulation has reduced risk: higher common equity Tier 1 ratios, introduction of leverage ratios, improved liquidity standards (LCR, NSFR) increase resilience to shocks
- Macroprudential tools allow authorities to lean against credit booms and build buffers in good times, reducing procyclicality and systemic risk
- Institutional reforms created the FPC and PRA to separate macroprudential oversight from microprudential supervision and central banking, improving focus and coordination
- Evidence of improved stress-test frameworks, living wills and stricter supervision that reduce probability of disorderly failures and lower systemic contagion
- Counterarguments and remaining vulnerabilities: regulatory arbitrage and shadow banking growth may move risks outside the perimeter, risk-weight manipulation can weaken capital adequacy in practice
- Implementation and timing issues: buffers may not be built in booms due to political pressure, and international coordination is imperfect so cross-border banks still pose resolution challenges
- Liquidity and market risk can still create runs in non-bank sectors; moral hazard from implicit backstops may persist if authorities still bail out systemically important firms
- Costs and trade-offs: higher capital may raise lending costs and slow growth, and strict rules can push risky activity to less-regulated venues, reducing transparency
- Judgement should weigh stronger bank resilience and better tools against regulatory gaps in the shadow banking system, enforcement challenges and international coordination limits, concluding whether reform likely reduces but does not eliminate crisis risk

Question 4

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.

Question 5

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 6

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 7

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