



ECO.MAC12 Financial Market Failure, the 2007-08 Crisis and Regulation

AQA 7136 · Calculators not allowed · about 90 minutes

Total Marks

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Name: _____ Date: ____ / ____ / ____

Answer all questions. Full sentences are required for questions worth 3 marks or more. Timed guidance: 90 minutes in total.

- 1** Multiple choice question on asymmetric information in financial markets, context: mortgage lending before 2007 in the UK and US.

- ☐ A: Lenders had better information than borrowers about borrowers' true ability to repay
- ☐ B: Borrowers had better information than lenders about their own repayment risk
- ☐ C: Regulators had perfect information about bank balance sheets
- ☐ D: Investors and banks had symmetric information about mortgage risk

(Total for Question 1 is 1 mark)

- 2** Define the term 'moral hazard' as it applies to banks and the expectation of government bailouts during the 2007-08 crisis.

(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)

- 4** Explain what an asset price bubble is and how speculative behaviour can sustain such a bubble in housing markets prior to 2007.

(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 the role of excessive leverage in banks' balance sheets as a cause of financial market failure in 2007-08.

(Total for Question 6 is 2 marks)

- 7** 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 7 is 3 marks)

- 8** Explain two ways in which the credit crunch after 2007-08 affected the wider economy.

(Total for Question 8 is 3 marks)

- 9** 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 9 is 9 marks)

- 10** 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 10 is 2 marks)

- 11** Explain briefly the purpose of the Bank of England's Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) created after the crisis, in terms of reducing systemic risk and improving microprudential supervision.

(Total for Question 11 is 2 marks)

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

(Total for Question 12 is 2 marks)

- 13** 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 13 is 25 marks)

Mark scheme · ECO.MAC12 Financial Market Failure, the 2007-08 Crisis and Regulation

Question 1

- **B1** Correct option B
- **Answer: B**

Question 2

- **B1** an increase in risk-taking when an economic agent does not bear the full consequences of its actions
- **B1** applied: banks may take excessive risks if they expect government bailouts, shifting losses to taxpayers
- **Answer: Moral hazard is increased risk-taking when agents do not bear full costs; banks expecting bailouts may therefore take excessive risks.**

Question 3

- **M1** 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
- **A1** this weakened monitoring and spread risky mortgage exposure through the financial system, amplifying systemic failure when defaults rose
- **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 4

- **M1** an asset price bubble is a sustained and large positive deviation of asset prices above fundamental values
- **M1** speculative behaviour occurs when buyers purchase expecting future price rises rather than for underlying value
- **A1** expectations of continuing price rises can become self-fulfilling, sustaining the bubble until a shock or loss of confidence triggers a collapse
- **Answer: A bubble is prices far above fundamentals; speculation buys on expected price rises, which can sustain prices until confidence collapses and the bubble bursts.**

Question 5

- **M1** 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
- **A1** together these mean failure can cause widespread disruption and motivate government intervention to avoid contagion
- **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

- **M1** excessive leverage means banks held large amounts of assets funded by relatively small equity, magnifying losses when asset prices fell
- **A1** large losses relative to capital meant banks became insolvent or illiquid quickly, spreading fear and triggering a credit crunch
- **Answer: High leverage amplified losses when housing assets fell, rapidly eroding bank capital and helping turn mortgage defaults into systemic insolvency and a credit crunch.**

Question 7

- **M1** 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
- **A1** limitation: capital requirements can be circumvented by risk-weighting choices, they impose costs that may reduce lending, and do not prevent liquidity runs
- **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 8

- **M1** reduced lending led to lower investment and consumption, causing a fall in aggregate demand and output
- **M1** tightened credit increased borrowing costs and business failures, raising unemployment and deepening recession
- **A1** together these channels explain how a banking-sector shock transmitted to a prolonged real-economy downturn
- **Answer: Reduced lending cut investment and consumption, lowering AD and output; higher borrowing costs and credit constraints caused business failures and unemployment, transmitting the banking shock into a recession.**

Question 9

- **Level 1** (1-3): 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.
- **Level 2** (4-6): 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.
- **Level 3** (7-9): 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.
- **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

Question 10

- **B1** 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
- **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 11

- **M1** FPC: macroprudential body tasked with identifying and addressing system-wide financial risks, for example by adjusting countercyclical capital buffers or using sectoral tools to curb credit booms
- **A1** PRA: microprudential regulator supervising individual banks to ensure safety and soundness, setting capital and liquidity requirements and enforcing resilience of firms
- **Answer: The FPC monitors and acts on system-wide risks using macroprudential tools like countercyclical buffers, while the PRA supervises individual banks to ensure safety and enforce capital and liquidity standards.**

Question 12

- **B1** 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
- **Answer: Criticisms include Basel complexity and procyclicality enabling regulatory arbitrage, and ring-fencing fragmenting services or pushing risk into the shadow banking sector.**

Question 13

- **Level 1** (1-5): Basic statements about regulation with little development or application. Limited or no use of examples, few evaluative points, conclusion absent or unsupported.
- **Level 2** (6-10): 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.
- **Level 3** (11-15): 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.
- **Level 4** (16-20): 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.
- **Level 5** (21-25): 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.
- **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