

- The problem of Americans' falling savings rate coupled with burgeoning debt reaches a climax as financial innovation and lax regulatory requirements spawned the creation of a litany of new mortgage products (sub-prime, Alt-A, etc) to feed the average household's insatiable desire for immediate consumption financed with credit. Now able to access and obtain large amounts of relatively inexpensive financing, a record number of both qualified and unqualified buyers use the new products to purchase homes and finance other consumer purchases.
- Wall Street created a new form of security (CDOs and SIVs) to synergistically bundle these new mortgages and other fixed income assets such that the value of the whole was better than the individual parts. Under the structure, assets were divided into various tranches with differing expected risk (senior, mezzanine, equity) and return. Such products were highly complex, difficult to value and, especially as time went on, predicated on the thesis that homeowners would be reluctant to default and, even if they did the underlying property value would remain stable or increase.
- Rating agencies evaluated the complex securities and came to the conclusion that a number of these securities deserved relatively high credit ratings – investment grade and higher.
- With yields on money market, CDs and T-Bills at historic lows, investors' willingness to "reach for yield" created a growing demand for higher yielding, albeit more complex investments. The high fees and profits from the creation of such complex products at early entrants such as Bear Stearns quickly attracted other investment banks to "not miss out" and compete. As the competition grew, the logic fell and, conversely, the leverage (in some cases to 34 to 1) and the pipeline of raw materials (mortgages) to create CDOs and SIVs on the firms' balance sheets increased.
- Two Bear Stearns hedge funds, notably the "Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund" (and yes, despite the obvious irony and foreshadowing, that was the actual name), suffered a loss of 23% through April, 2007 on investments in sub-prime mortgages. Within weeks the market for such securities ceased, effectively turning off the music and requiring the investment banks to sit in their chairs where they stood.
- FASB rule 157 ("mark to market" accounting), took center stage as financial companies were forced to (a) determine what marks (values) to assign to the mortgage related assets on their balance sheets, (b) make the necessary downward adjustments to the balance sheet (hurting the capital structure and crippling important ratios such as debt/equity) and (c) translating those balance sheet adjustments into losses on the income statement.

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- With equity falling sharply and fast, investment banks sought outside capital to shore up their balance sheets. While initially attractive to some, especially to large investors such as Sovereign Wealth Funds and billionaire private investors such as Joe Lewis, such access to capital began to dissipate as share prices continued to fall, making the early purchases appear like they had “caught the falling knife.”
  - With little access to the capital markets, the investment banks could only look to their own assets to create liquidity. One example was Merrill’s sale of its stake in Bloomberg. It also forced the investment banks to fire sale their now toxic assets (CDOs, SIVs) at any price. Merrill’s sale of \$30 billion of CDOs at 22 cents on the dollar set off a panic leading some distressed debt managers to negotiate the price down with other banks to even less.
  - With the story out, credit ratings in jeopardy, levered short sellers piling on, and what remained of the stock price plummeting, the credit and capital market lifelines were effectively turned off. Unable to obtain sufficient liquidity to meet creditor demands, select companies went into default becoming bankrupt.
  - Unexpected and swift bankruptcies (over the weekend) by investment grade companies caused ripple effects, one of which was the impairment of insurance company and derivatives trader, AIG.

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