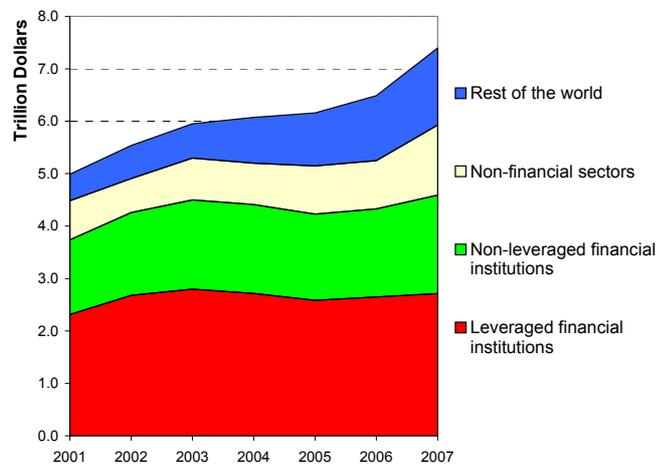


As balance sheets expand, new borrowers must be found. When all prime borrowers have a mortgage, but still balance sheets need to expand, then banks have to lower their lending standards in order to lend to subprime borrowers. The seeds of the subsequent downturn in the credit cycle are thus sown.

When the downturn arrives, the bad loans are either sitting on the balance sheets of the large financial intermediaries, or they are in special purpose vehicles (SPVs) that the financial intermediaries sponsor. This is so, since the bad loans were taken on precisely in order to utilize the slack on their balance sheets. Although final investors such as pension funds and insurance companies will suffer losses, too, the large financial intermediaries are more exposed in the sense that they face the danger of seeing their capital wiped out. The severity of the credit crisis of 2007/2008 lies precisely in the fact that the bad loans were not all passed on to final investors. Instead, the “hot potato” sits inside the financial system, on the balance sheet of the largest and most sophisticated financial intermediaries.

A complete disaggregation of the funding source for the banking sector is not possible due to the lack of detailed breakdowns in the data between funding from leveraged and unleveraged creditors. However, we can gain glimpses from different perspectives. One way is to examine the identity of the holders of US agency and GSE-backed securities.

Figure 1. Holdings of GSE-Backed Securities



Source: Flow of Funds Accounts, Federal Reserve.

The above figure plots the total holdings of US agency and GSE-backed securities broken down according to the identity of the creditor. The data are from the US Flow of Funds Accounts (table L.210). Leveraged financial institutions include commercial banks, broker dealers and other securitization vehicles. The non-leveraged financial institutions include mutual funds, insurance companies and pension funds. The “non-financial sector” includes household, corporate and government sectors. Finally, the “rest of the