Figure 1

Subprime exposures by type of institution

	Total reported sub-prime exposure (US$bn)	Percent of reported exposure
Investment Banks	75	5%
Commercial Banks	418	31%
GSEs	112	8%
Hedge Funds	291	21%
Insurance Companies	319	23%
Finance Companies	95	7%
Mutual and Pension Funds	57	4%
Leveraged Sector	896	66%
Unleveraged Sector	472	34%
Total	1,368	100%

Source: Greenlaw et al (2008).

1. Introduction

The current financial crisis has the distinction of being the first post-securitization crisis in which banking and capital market developments have been closely intertwined. Historically, banks have always reacted to changes in the external environment, expanding and contracting lending in reaction to shifts in economic conditions. However, in a market-based financial system built on securitization, banking and capital market developments are inseparable, and the current crisis is a live illustration of the potency of the interaction between the two.

Securitization was meant to disperse credit risk to those who were better able to bear it, but in the financial crisis the risks appear to have been concentrated in the financial intermediary sector itself, rather than with the final investors. To understand the true role played by securitization in the financial crisis, we need to dispose of two pieces of received wisdom concerning securitization - one old and one new. The old view, now discredited, emphasized the positive role played by securitization in dispersing credit risk, thereby enhancing the resilience of the financial system to defaults by borrowers.

But having disposed of this old conventional wisdom, the fashion now is to replace it with a new one that emphasizes the chain of unscrupulous operators who passed on bad loans to the greater fool next in the chain. We could dub this new fashionable view the “hot potato” hypothesis, since the bad loan is like a hot potato passed down the chain. The idea is attractively simple, and there is a convenient villain to blame, and so has figured in countless speeches given by central bankers and politicians on the causes of the subprime crisis.

But the new conventional wisdom is just as flawed as the old one. Not only does it fall foul of the fact that securitization worked well for thirty years before the subprime crisis, it fails to distinguish between *selling* a bad loan down the chain and *issuing liabilities* backed by bad loans. By selling a bad loan, you get rid of the bad loan and it’s someone else’s problem. In this sense, the hot potato is passed down the chain to the greater fool next in the chain. However, the second action has a different consequence. By issuing liabilities against bad loans, you do not get rid of the bad loan. The hot potato is sitting on your balance sheet or on the books of the special purpose vehicles that you are sponsoring. Thus, far from passing the hot potato down the chain to the greater fool next in the chain, you end up keeping the hot potato. In effect, the large financial intermediaries are the last in the chain. While the investors who buy your