

# Table of Contents

**Foreword** 9

**Preface** 11

**Acknowledgements** 15

**1 Prologue: Chronology of a Crisis** 17

- I.1 The subprime turmoil included all ingredients of a severe financial markets crisis 17
- I.2 An exemplary credit crisis 18
- I.3 The chronology of a crisis – The US subprime crisis 21
  - I.3.1 What has happened so far? Prelude to the subprime turmoil 21
  - I.3.2 End of 2006: First signs 22
  - I.3.3 February 2007: Microfundamentals get affected 22
  - I.3.4 March 2007: Only a dip? 24
  - I.3.5 April 2007: The first default 24
  - I.3.6 May 2007: The impact on the banking sector 25
  - I.3.7 June 2007: Hedge funds blow up 26
  - I.3.8 July 2007: A first peak of the crisis! 28
  - I.3.9 August 2007: The infection mechanism is getting into full swing 30
  - I.3.10 September 2007: The reaction of central banks 35
  - I.3.11 October 2007: The second subprime wave hits the market 40
  - I.3.12 November 2007: The transmission channels of the crisis are getting into full swing 42
  - I.3.13 December 2007: “Hope Now” 51
  - I.3.14 2008 55
  - I.3.15 The subprime meltdown is a perfect paradigm for a credit crisis 62

## **2 Credit Instruments 65**

- 2.1 Bonds 66
- 2.2 Loans 72
- 2.3 Credit Default Swaps 76
- 2.4 CDS Indices 88
- 2.5 Tranches 92
- 2.6 Securitization 103

## **3 Credit Players 115**

- 3.1 Banks 115
- 3.2 Fannie Mae and Freddy Mac 126
- 3.3 Money Market Funds 133
- 3.4 Central Banks 134
- 3.5 Hedge Funds 137
- 3.6 Bond Insurer 143
- 3.7 Private Equity Sponsors 147

## **4 Credit Strategies 153**

- 4.1 Leverage 156
- 4.2 Leveraged Super Senior Tranches 158
- 4.3 Constant Proportion Debt Obligations 167
- 4.4 Structured Investment Vehicles 174
- 4.5 Collateralized Debt Obligations 194
- 4.6 Structured-Squared Madness 201

## **5 The Anatomy of a Credit Crisis 205**

- 5.1 Introduction 205
- 5.2 Crisis classification 206
- 5.3 A brief history of credit crises 209
  - 5.3.1 The sage of spillover effects and who is leading whom? 209
  - 5.3.2 Financial crises – some examples 211
- 5.4 What can we learn from existing crises models? 235
  - 5.4.1 Bubble theory & credit markets 235

5.4.2	The overshooting phenomenon	242
5.4.3	Financial panic in credit markets	245
5.4.4	Moral hazard in credit markets	247
5.5	The credit cycle	252
5.5.1	The impact of derivatives on the credit cycle	252
5.5.2	Credit spreads and safe-haven yields	255
5.5.3	Credit Spreads and FX movements	257
5.5.4	Excursus: Decoupling of cycles	258

## **6 Epilogue: How can we avoid Credit Crises in the future?** 265

## **Index** 275