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The 2008-2009 banking crisis: The housing bubble and its causes

The financial crisis during 2008-2009 was the worst financial crisis since the Great Depression of the 1930s. The housing and financial market were all severely hurt with collapses or government bailouts for many financial institutions. Among many factors, low interest rates, the repeal of the Glass-Steagall Act, collateralized mortgage obligations, deregulation of over-the-counter derivatives (e.g. credit default swaps) are considered to have tremendously contributed to the housing bubble which was a major cause for the crisis.

The crisis can be traced back to the secular housing boom since the early 2000s that later turned into the housing bubble. A housing bubble is when the housing prices are affected by increased demand, speculation and belief for higher future prices. Consumers then try to buy more and more with expectations of selling the houses afterwards with much higher prices to gain profit. Low interest rates and loosening underwriting standards can better support the demand (Investopedia). As the bubble lasts, many people try to enter the market by borrowing money. Gradually, banks, borrowers and insurance companies and many other participants of the financial system become involved in the housing boom. When the interest rates or credit standards increase, the demand decreases and the bubble bursts. As a result, the housing prices decline sharply and numerous negative results happen for lenders, buyers and the financial system as a whole.

The housing bubble in 2007 happened in the same plot with a high expectation of increasing mortgage prices. The expectation came from the low interest rates by the Federal Reserve to provide low-income borrowers with affordable housing. Many enormous banks, namely Freddie Mac or Fannie Mae, were forced by the government to execute this affordable credit to low-income borrowers (Walton 537). Through mandating these governmental agencies, the government wanted to lubricate the housing market, extend maturities and provide lenders liquidity. Furthermore, the low interest rates of the Fed encouraged investors to contribute more to the secular housing boom. Low interest rates resulted in low return for a long time for many investors. As the investors wanted higher returns, they started to take risky actions by investing in the real estate market (Beattie). Hence, large cash flows from both individual and institutional investors were all drawn into the housing boom and created a bubble. In addition, financial innovation and deregulation further subsidized the supply of housing. Usually, a bank would keep a mortgage loan. But 2000 to 2006, more mortgage debt was "securitized" and turned into AAA-rated securities. The securitization of mortgage loans made the mortgage-backed securities one of the most popular types of traded securities in the US. All market participants were emotionally charged with "retrospect irrational optimism." Despite the fact that risks always existed, no one believed that a bad scenario would happen. New financial instruments were even believed to eliminate financial risks (Walton 537). As a result, the demand for mortgage-backed securities increased dramatically. This change in demand resulted in a 10% increase of housing prices every year for six years in a row (2000-2006). Every participant of the financial markets in 2007 strongly believed that housing prices would continue to become higher regardless of the situation. This belief continued to push the housing prices up. Gradually, the higher mortgages rates became financial burdens for many homeowners and the possibility of the bubble burst increased. The Fed

was, in fact, aware of the bad future if the bubble deflated. However, it did not have any tools to deal with it. The Fed could not decrease the required payments for mortgages. Also, it could not increase the interest rates because that policy would hinder the economy's development. Hence, letting the bubble burst on its own was considered a better choice than intervening in the market.

Finally, the bubble burst and the prices of housing decreased steeply. The mortgage-backed securities "plunged" and triggered numerous losses for financial institutions (Beattie). Many large banks and financial institutions collapsed. The peak of this sequence, which put not only the US economy but also the global financial system at the risk of collapse, was in September 2008 when Lehman Brothers, the fourth-largest US investment bank, declared bankruptcy. The liquidity of the market was severely hurt as finders and lenders were disconnected. The money needed for recovery, thus, took a much longer time to flow in the right direction. Many consumers and homeowners were heavily leveraged. The housing price breakdown also had a negative impact on other financial markets. The stock market decline more than a half of the value from 2008 through March 2009. Many fixed income markets (e.g. government bond) became so much more volatile and vulnerable. The oil price decreased roughly 70%. Obviously, the 2008-2009 financial crisis negatively affected almost every part of the US and the world's financial markets.

Regarding the cause of the 2008-2009 crisis, the repeal of the Glass-Steagall Act, which separated commercial banks and investment banks, generated a lively discussion. In 1933, considered the unwieldy power of big banks as a prime reason for bank failure during the Great Depression, the Congress passed the Glass-Steagall Act, which prohibited commercial banks from the investment business. Commercial banks then only conducted deposits and loans while investment banks would perform trade, acquisition and insurance function. This clear separation

set the limit to the power of the banks in a hope to prevent another destruction of the financial market. However, in 1999, the Gramm-Leach-Bliley Act was passed to repeal the Glass-Steagall Act. The affiliations among many financial institutions, including commercial banks and investment banks were permitted. This termination of the Glass-Steagall Act, many argued, gave banks the overwhelming power and hence led to the 2008-2009 financial crisis. Many proponents of this school of thought believe that unscrupulous lending of banks played an integral role in the crisis. Mortgage brokers could also be blamed, but these people could be hampered by more meticulous funding decisions from the banks (Rickards). Furthermore, the fact that no big banks failed in the crisis only came from the government bailouts. All the big banks were severely indebted with “underwater home equity lines of credit.” The government had to intervene because the big banks were “too big to fail.” Their collapses would result in a severe destruction for the US financial system. In fact, the big banks did not fall, but nonbanks such as Lehman Brothers, which were funded by banks in the form of repurchase agreements, lines of credit and mortgages, collapsed. Easy credit from big banks could indeed be a root of many bad consequences. Hence, the termination of Glass-Steagall could be considered a major reason for the 2008-2009 crisis.

Subprime lending with collateralized mortgage obligation (CMO) could be another critical factor regarding the 2008-2009 crisis. Subprime lending is offered for borrowers with low credit ratings (below 600). Because these borrowers have a higher chance of default, loans are issued at a subprime rate which is higher than the prime one. CMO is a type of complex mortgage-backed security that directs and repackages the interest and principal payments from a collateral pool to different categories and maturities of securities (Wikipedia). During 2008, Freddie Mac and Fannie Mae were forced by the government to buy a great deal of CMOs. As a consequence, many private lenders took advantage of the increased demand by lowering the borrowing

standards, issuing more mortgages and then selling the mortgage securities to disperse the risks (Investopedia). Unaware of the enormous amount of default risk, many credit agencies rated the CMOs really high, which boosted the confidence and demand in the real estate market. This subprime lending policy promoted demand by allowing unqualified borrowers to have money for adjustable-rate mortgages. Subprime borrowers believed that they could refinance their mortgages when the rates adjusted with increasing values. Nonetheless, when the mortgage interest rates increased and home values decreased, borrowers were incapable of refinancing their adjusted-rate mortgages. The burst of the housing bubble caused the prices of CMOs, which had got high credit ratings, to decrease tremendously. The resulted condition, called the subprime mortgage crisis, included widespread mortgage default, foreclosures and the decreased prices of mortgage-backed securities (e.g. CMOs). As a consequence, the government has passed financial reform regulations to reduce CMOs-related risks.

Credit default swap (CDS), a credit derivative, was also to blame for the 2008-2009 financial crisis. CDS was a special insurance as buyers were insured against defaults by third parties. If the loans could not be paid back, the insurance company would pay the debt. CDS was widely bought for mortgage-backed securities. By September 2008, American Insurance Group (A.I.G.), the largest insurance company in the US, had issued \$527 billion worth of CDSs. Hence, when the housing bubble burst and the mortgage market collapsed, A.I.G had to raise enough money to pay for the defaulted loans. That amount of money was, however, beyond its capability and the company was on the verge of bankruptcy. As the collapse of A.I.G would trigger severely negative outcomes, the government had to intervene by pumping \$182.3 billion into A.I.G to save the company. This massive bailout further proved that many enormous financial institutions acted wrongfully and should be more strictly regulated.

The government and central bank responded to the crisis with fiscal stimulus, which then mitigated the negative effects of the crisis on the financial system. An affected investment bank, Bear Sterns Companies, was arranged to be acquired by J.P. Morgan, a commercial bank. However, another investment bank, the Lehman Brothers, was left alone and went bankrupt. The 2008-2009 crisis was the worst recession since WW2. The aftermath of the financial crisis resulted in many new regulations and financial institutions: Wall Street Reform and Consumer Protection Act Federal agencies, Bureau of Consumer Financial Protection, Financial Stability Oversight Council and Office of Financial Research. (Walton 539). All of these actions were taken with short-term objectives of increasing regulation for financial system and protections for consumers as well as long-term goal of preventing another financial crisis. Through efforts of the government and all market participants, the economy is on its way to recover and develop in a more sustainable manner.

Obviously, many factors can be taken into account for the 2008-2009 financial crisis in the US. From the government to lenders and borrowers, all had to assume some responsibility for the burst of the housing bubble which then greatly contributed to the crisis. The low interest rates by the Federal Reserve, the repeal of the Glass-Steagall Act, subprime mortgage lending, collateralized mortgage obligation and credit default swap were definitely among key factors that demonstrated the interconnected relationship between many market participants. After suffering from the crisis, the government, banks and consumers all seemed to have learned the lesson of diversification, independent analysis and emotional effects in decision making. Another crisis with exactly the same plot is not likely to happen, but experiences from this crisis are definitely helpful for everyone to deal with problems and other crises in the upcoming years.

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