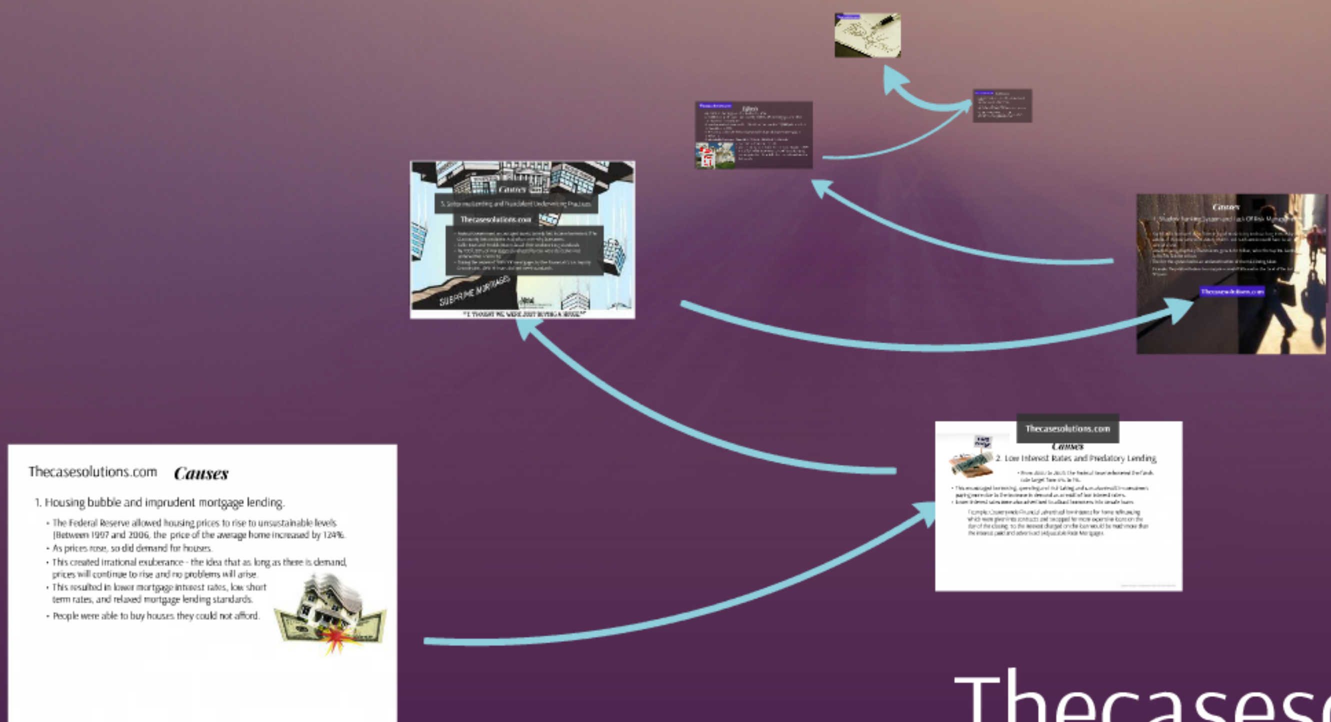
The Financial Crisis of 2007-2009: The Road to Systemic Risk



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The Financial Crisis of 2007-2009: The Road to Systemic Risk

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Causes

2. Low Interest Rates and Predatory Lending

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1. Housing bubble and imprudent mortgage lending.
   - The Federal Reserve allowed housing prices to rise to unsustainable levels (Between 1997 and 2006, the price of the average home increased by 124%.
   - As prices rose, so did demand for houses.
   - This created irrational exuberance - the idea that as long as there is demand, prices will continue to rise and no problems will arise.
   - This resulted in lower mortgage interest rates, low short term rates, and relaxed mortgage lending standards.
   - People were able to buy houses they could not afford.

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Causes

2. Low Interest Rates and Predatory Lending

- From 2000 to 2003, the Federal Reserve lowered the funds rate target from 6% to 1%.
- This encouraged borrowing, spending and risk-taking and can also result in consumers paying more due to the increase in demand as a result of low interest raters.
- Lower interest rates were also advertised to attract borrowers into unsafe loans.

Example: Countrywide Financial advertised low interest for home refinancing which were given into contracts and swapped for more expensive loans on the day of the closing. So the interest charged on the loan would be much more than the interest paid and advertised (Adjustable Rate Mortgage).

Causes

3. Subprime Lending and Fraudulent Underwriting Practices

- Federal Government encouraged banks to help low-income borrowers (The Community Reinvestment Act) who were risky borrowers.
- Sallie Mae and Freddie Mac relaxed their underwriting standards.
- By 2007, 80% of mortgages purchased by Citi were defective (not underwritten correctly).
- During the review of 900,000 mortgages by the Financial Crisis Inquiry Commission, 28% of loans did not meet standards.

"I THOUGHT WE WERE JUST BUYING A HOUSE!"

Causes

4. Shadow Banking System and Lack Of Risk Management

- Such banks borrowed short-term in liquid markets to purchase long term, risky assets. If the economy went down, which it did, such assets would have to be sold at a loss.
- Assets financed by risky investments grew to $4 trillion, while the top five banks in the US held $6 trillion.
- Trust in the system led to an underestimation of the risks being taken.

Example: They did not believe housing prices would fall based on the trend of the last 50 years.

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Effects

- By 2008, US housing prices had declined by 20%.
- 2.3 million properties were foreclosed by 2008. 14.4% of mortgages were either delinquent or in foreclosure.
- Unemployment rate increased to 10% (11.1 million people), 533,000 jobs were lost in November of 2008.
- GDP contracted to 5.5% below its potential level and did not return to growth until 2010.
- National debt increased from 66% of GDP in 2008 to 103% by 2012.

- Stock market prices fell by 57%
- After adjusting for inflation, median house income in 1999 was $53,252 while in 2010 was $49,445 virtually wiping out any gains that the middle class has achieved over the last decade

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Thank You!