

## **The Financial Crisis in Summary**

*An explanation of the current financial crisis*

The housing bubble caused by low interest rates and reduced credit requirements for borrowers created an economic environment that encouraged Wall Street firms to develop complex financial products. As home prices declined and loan foreclosures increased, some well-known and large financial institutions sponsoring these financial products imploded, contributing to the financial crisis we are experiencing today.

### **On Main Street —The Housing Bubble**

In response to the dotcom bubble and the market downturn, the Federal Reserve cut an important short-term interest rate (fed funds target rate) to 1% in 2004,<sup>1</sup> its lowest level since 1958. As a result, mortgage rates fell to an all-time low. The demand for mortgages exploded, and lenders responded by extending credit to borrowers with low credit ratings. Indeed, mortgage companies were issuing exotic mortgages to borrowers who had no money for down payments and on whom they did little due diligence. Individual debt as a percentage of disposable income reached nearly record levels. The value of subprime loans, higher-rate loans issued to borrowers with troublesome credit histories, went from 2% of total loans in 2002 to 30% of total loans in 2006.<sup>2</sup> This caused the demand for real estate – and home prices – to increase.

Meanwhile, the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), publicly traded government-sponsored agencies, were buying loans from mortgage originators, such as banks and non-bank mortgage firms. They then repackaged the loans as mortgage-backed securities and sold them on the secondary mortgage market with a guarantee that the interest and principal would be paid, whether or not the original borrower paid.

Fannie Mae and Freddie Mac, mortgage-backed securities, and credit derivatives all contributed to obscuring the very real risks inherent in these poor-quality loans and the complex investments that were based on them.

### **On Wall Street — Poor Ratings, Complex Securities**

Investment banks repackaged subprime loans into complex financial securities such as collateralized debt obligations (CDOs), investment-grade securities backed by a pool of bonds. Purchased en masse by financial institutions, these securities were expected to mitigate the risk of these loans through a process known as securitization. However, credit ratings agencies like Standard & Poor's and Moody's Investors Service had difficulty assigning credit ratings to these multi-layered financial products. The instruments' complexity and the mispriced risk embedded in them caused the crisis to accelerate as foreclosures increased.

Initially, the companies affected were those with direct exposure to the housing industry and mortgage lending, such as Countrywide Financial, and financial institutions that had securitized the mortgages (Bear Stearns being a prime example).

The crisis accelerated in late summer after the federal government placed Fannie Mae and Freddie Mac into conservatorship. Ultimately this crisis restricted the general availability of credit and began to undermine larger financial institutions not directly connected with mortgage lending but which had exposure to mortgage-backed securities (e.g., Lehman Brothers and Merrill Lynch) or were responsible for insuring them (e.g., American International Group).

1. Source, Board of Governors of the Federal Reserve System

2. Stephen Schwarzmann, "Maybe Someone Does Have a Clue", *The Wall Street Journal*, September 25, 2008

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