

# The 2007-2008 Financial Crisis

## Housing boom and bust

Several different factors in the housing and financial markets produced the financial crisis of 2007 and 2008. First, there was a housing boom in the United States. This was due to low interest rates at the time and the fact that there was a lot of money available to lend. Much of the money came from the sale of mortgage-backed securities.

## Mortgage-backed securities

Mortgage-backed securities were very attractive to international investors because historically they were quite low risk. Remember, this was because the banks could always foreclose on properties and sell them to recover their losses if the borrower did not make his or her mortgage payments. Therefore, there was a lot of demand for these securities.



## High-risk mortgage loans

Eventually, everyone who was qualified for a traditional mortgage had one. To meet the demand, banks began offering more and more high-risk loans to people who previously could not qualify for mortgages or get as much of a loan amount. These included the unsuitable mortgage loan options you learned about earlier. Unfortunately, some of these types of loans invited abuse, if not outright lying about income. However, everyone believed that home prices would always go up, and people could refinance these high-risk mortgages.

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## Government policies

Government policies also contributed to the pool of high-risk loans by encouraging subprime lending to help low-income individuals buy homes.

## Mortgage-backed securities

These high-risk mortgages were packaged into mortgage-backed securities and sold to investors.

## Credit ratings

Although the mortgages were high-risk, credit rating agencies rated these securities as good, safe investments. Therefore, investors bought more and more of them. Unfortunately, the rating agencies underestimated the risk. Part of the problem was that the way the securities were packaged made it difficult to judge how risky they actually were. The other part of the problem was that the credit rating agencies were using computer models based on the performance of more traditional mortgages, not the new high-risk mortgages.

## Government policies

Furthermore, government policy reduced the amount of supervision and regulation of these mortgage lending and securitizing practices. However, everything was fine as long as homeowners could pay their mortgage loans and investors made money.

Then homeowners started missing mortgage payments and going into foreclosure around 2005-2006. The housing market fell. Banks could not recover their losses and began to fail. In early 2007, investors all over the world began to realize that their mortgage-backed securities that they thought were safe investments were not so safe. Banks and other investors did not know how much their investments were worth. Therefore, they lost confidence in their investments, held onto their money, and did not want to lend it out. This led to financial panic and a near freeze of credit markets in mid-2008.



Why does this matter? It matters because businesses rely on credit lines from lenders to pay employees and make new investments. Therefore, the problems in the housing and financial markets affected the entire economy.