



EconoMag

The Show that demystifies Economics
2008 Financial Crisis – part 2

Understand the Subprime crisis ©

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Hi there EnglishWaves listeners, and welcome to another edition of Economag. As you'll remember, our current theme is the Financial Crisis of 2008. In our last programme, we started off by considering a simple analogy involving apples and pears, which showed us three things. First, the market value of assets can be extremely volatile, subject to the whims and wishes of the people trading in that market. Second, it's a very, very bad idea to lend money to people who aren't financially solvent – in other words, people who ordinarily wouldn't have the means to pay back a loan – and third, lenders or creditors stand to lose a lot of money when things go wrong.

We're all aware the world economy didn't come to a near standstill in 2008 because of apples and pears, so what then happened? Now that we have a framework for thinking about markets, credit and the value of assets, we turn our attention to the origins of the crisis itself.

The Financial Crisis started as a subprime crisis, meaning loans were given at interest rates below the prime rate (crudely speaking, the prime rate is the average interest rate in the entire economy). As is usually best in trying to understand the economy, let's tell a story. Our first character is William. William lives in the United States, and he'd love to buy a house so he goes to his local mortgage broker. William hasn't saved any money for a down payment, and he knows that he won't be able to afford the monthly installments on a loan. The mortgage broker knows this too, but doesn't seem worried. Sure he'll help William! The mortgage broker reasons he'll simply put down the house William is about to buy - with the money he'll borrow - as the collateral. A down payment on the loan isn't necessary since the value of the collateral – the house William is going to buy – will continually increase. What about the monthly payments? No problem either! The mortgage broker agrees to give William a really, really low interest rate, and doesn't even require William to verify that he's employed.

Too good to be true? Well, at the time no. The mortgage broker is happy to give out loans to almost anybody, because he isn't the one lending the money. He works for the big banks, and gets a commission for every loan he underwrites. So if William doesn't pay back the loan, it's not the mortgage broker's problem. The bank will have to chase him for the money. This was the first crack in the wall underpinning the crisis: a problem of incentives, or as we call it in economics, a moral hazard dilemma.

Let's skip to a few weeks later in our story. The bank that gave out the loan to William realizes that it wasn't the best idea. On top of that, it's now stuck with thousands of loans like the one it gave to William, so the bank is getting a bit nervous and wants to make these loans someone else's problem. Thankfully there's an easy solution: the really smart guys in the investment banks in New York are willing to buy them and perform their financial magic!

The investment banks decide that they'll create a new financial product called a Collateral Debt Obligation, more commonly referred to as a CDO, and the bad loans, including William's, can be the collateral for these products. So essentially, the investment bank plans to sell a CDO to an investor, and the monthly installments on the mortgages will also go to the investors. Individually each loan might be bad, or risky, but if the bank pools them together only some of them will go bad – or in other words, only some people will not repay their loans. Also, since the houses that back the loans, the collateral, always go up in value, there is nothing to worry about. Everyone wins.

Well, actually no. Join us again in our next programme where we'll look in greater detail at what exactly constituted a CDO, to whom precisely it was sold, and why this turned out to be so deeply problematic.