



EconoMag

The Show that demystifies Economics

2008 Financial Crisis – part 3

Crisis Erupts - How did the trail of debt unwind?

by Pierre Vercueil©

Hi there EnglishWaves listeners, and welcome back to Economag. As you'll recall, our theme at the moment is the Financial Crisis of 2008. In our first programme covering the theme, we took a closer look at the value of assets in the market, and how that value can disappear overnight. We also considered why it is not a good idea to lend money to people who aren't financially solvent. With that understanding under our belts, we then had a first look at the factors that ultimately led up to the crisis. You'll remember, we were talking about William, who took out a subprime housing loan, or mortgage, and that loan was then sold to investors as part of a CDO, or collateral debt obligation. Let's continue where we left off last time.

William has his home loan that he got from the mortgage broker, and the bank that gave the loan realized it was not a good investment, so it sold the loan to an investment bank on Wall Street. The investment bank, let's call it Wall Street & Company, is now trying to work its magic, and make money out of these bad loans by developing the CDO product. What exactly was a CDO? It was a financial product made up of mortgages split into three tranches, or three pieces: the good piece, the not-so-good-piece, and the bad piece. If some of the mortgages fail, as surely some might – any bank expects some of its loans to go bad – then investors who hold the 'good' piece of the CDO will still be paid first. The investors holding the 'not-so-good' and bad pieces will get paid next, in that order. Now an important thing to remember is that since the investors who hold the good part of the CDO get paid first, they get the lowest interest rate. That naturally also means that the investors holding the bad piece get the highest – since the risk is also higher!

So to summarize, from a pile of subprime mortgages, like the one unemployed William took out, the investment bank Wall Street & Company has created a new product with three pieces, and it seemed that the first piece, the good piece, was a very low risk investment – surely everyone wouldn't stop paying their mortgage at the same time, so there would always be money to pay back the investors with the good piece of the CDO! Right? Well, let's see.

Who bought the good pieces of the CDO products? Institutional investors, such as insurance companies, other banks, small towns in Norway, school boards in Kansas – essentially anyone looking for a high-quality safe investment. But remember, the whole CDO product, meaning all three pieces – the good, the not-so-good and the bad – were based on loans that shouldn't have been given out in the first place! So let's skip a few months ahead in our story.

Mr Anderson is the head of a pension fund in a small Norwegian village. His pension fund bought lots of the good pieces of the CDO as they thought it was a good, safe investment. Yet for the past two months he has not received any payments from the good pieces of the CDO, and so he calls the investment bank, Wall Street & Company.

The bank says, "Oh yes we're very sorry Mr Anderson, but it seems that the people who took out the mortgages (like William) backing your part of the CDO aren't able to pay anymore. We're as surprised as you are!"

Mr Anderson is shocked, and replies, "You told me that these were safe investments, and that people would always be able to refinance their mortgages because house prices will continually increase!"

The bank basically has nothing to say apart from, "Yes, well we made a mistake. Sorry." Mr. Anderson's pension fund now no longer has money coming in, so pensioners in his village no longer have, well, a pension!

This story was multiplied thousands of times over, and it's easy to see how millions of people who thought they had a safe investment, lost all of their money.

In our next programme we'll consider the consequences of lots of people losing all their money at the same time – or in other words, what happens when you have a financial crisis on your hands.