CONCEPT: FINANCIAL CRISIS OF 2007-2009

● The financial crisis of 2007-2009 was caused by risky home lending and a crash of the real estate market

□ Two types of banks:

> ***Commercial Banks*** – depository banks that accept deposits and are FDIC-insured

> ***Investment Banks*** – create and trade financial assets, such as stocks and bonds, not insured

□ Traditional home loan → Bank loans money to homebuyer, bank collects money with interest over time

> ***Securitization*** – creating a secondary market purchased in a financial market

> Groups of home loans were bundled together and sold as a security

- Investors bought shares in a *mortgage-backed security*
- When the homeowners made a payment on their mortgage, the securities saw a return
- MBS became very popular because they showed higher returns than other investments
- However, MBS securities only did well because homeowners were making their payments…

□ The real estate market was booming in the early 2000s

> ***Sub-prime mortgage loans*** – high-interest rate loans to riskier home buyers

- These loans also required little down payment, so "Why Not?!"
- These loans were bundled with lower-risk loans in MBS to make the investments "seem safe"
- However, when the risky loans began to default, the entire MBS suffered…

□ The biggest holders of MBS were large investment banks trying to show big profits to their investors

> ***Shadow Banking System*** – unregulated financial activities that also loosen credit in the financial system

> As housing prices fell, homeowners learned that their mortgage was higher than the value of home

- With little incentive to make payments, many mortgages defaulted
- As mortgages defaulted, MBS failed
- Investment banks suffered huge losses from the failure of MBS

□ ***Troubled Asset Relief Program (TARP)*** - $700 billion dollar "bailout" of emergency loans to investment banks

> By saving the investment banks (and other large corporations), a "domino effect" was considered avoided

- These institutions were considered "too big to fail"
- ***Moral hazard*** – tendency to take riskier positions because of insurance
- TARP was essentially government-provided insurance to banks that never paid the premiums