An Introduction to the 2008 Financial Crisis

Background: the Sub-Prime Mortgage Crisis

Mortgages: A very short introduction

- To buy a house, many people take out mortgages from a bank and, in principle, the home owner pays to whomever holds the mortgage (the bank often sold the mortgage to a third party)
- If they cannot pay the mortgage, it is called a *default*, and they seize the property (this is called foreclosure)
- Foreclosure is the legal process by which a lender takes control of a property, evicts the homeowner, and sells the home
- Traditionally, it was hard to get a mortgage if you had bad credit or didn't have a steady job - lenders didn't want to take the risk that you might default on your loan. However, the events leading up to the 2008 Financial Crisis saw more and more of these mortgages being given out to people with bad credit.

Discrimination in the booming housing market post-WW2

- Aligning with post-WW2 Keynesian mass consumption policies (and the fear of return to recession), major US state-led programs attempted to increase homeownership amongst the middle-class
- Indeed, the middle-class was growing, so they had to satisfy the growing consumer demand for houses
- State tax subsidies for the housing industry led to the suburban construction boom
- However, these houses mainly catered for the white lower-middle class
- Whilst the booming housing market catered for the middle-classes, a state enforced **racial redlining** was occurring
- In other words, financial discrimination was occurring which barred African Americans and other racial minorities access to mortgage loans
- Furthermore, those that were unemployed or had low wages were also barred from mortgage loans
- Hence, the booming housing market only really catered to the white, suburban middle-class

Background: the 1980s savings and loans institutions (S&L) crisis

- Real estate is, by definition, local as it is spatially fixed. Mortgage lending, however, has developed from a local to a national market and is increasingly becoming a global market
- Historically, mortgage lenders were merely local institutions, but today there are national lenders who tap into the global credit market
- Before the financial crisis of the 1980s, the savings and loans institutions (S&Ls) operated in a confined localised space – they granted loans based on savings that were in their own bank
- However, after the financial crisis of the 1980s, S&Ls working in local markets were seen as problematic – i.e. what happened if savings were made available in one area, but loans were needed in another?

- Hence, markets were connected to prevent local markets going bust and to spread the risk; interest rates on loans fell as there was now a more efficient market for the demand and supply of money and credit
- So, the financial crisis of the late 1980s led to a bank merger and acquisition (M&A) wave – this would pave the way for the subprime mortgage crisis to become a spatially spread and far-reaching crisis

Background: the securitisation of mortgages

- Securitization is the process of taking an illiquid asset, or group of assets (e.g. mortgages), and through financial engineering, transforming it (or them) into a security
    - Securitisation was introduced by Fannie Mae and Freddie Mac (two government-sponsored enterprises that were meant to spur homeownership rates)
    - The S&L crisis of the 1980s led to securitisation being favoured, and mortgage lenders were able to sell their mortgage portfolio (thousands of individual mortgages) to secondary mortgage markets to investors
    - Mortgage portfolios could now be sold to investors anywhere in the world

The growth of the US housing 'bubble' in the early 2000s and securitised mortgages (Residential Mortgage Backed Securities)

- Trends portrayed the price of US houses as never falling, so people were sure that it was a secure asset and safe investment
- In the 2000s, investors in the US and abroad started looking for better investments and turned to the US housing market
    - They believed they could get better interest rates on mortgages than they could do in investing in US treasury bonds, which were paying low interest (and hence, low returns)
- To reduce complications and hassle with individual mortgages, they bought Residential Mortgage Backed Securities (RMBS) – this is where financial institutions *securitised* thousands of mortgages and combined them, and then sold them to investors

There was a surge of investments in Residential Mortgage Backed Securities (RMBS)

- RMBS looked like good investments
    - They paid more interest than other investments (i.e. US treasury bonds)
    - There was a real estate boom (house prices increasing) so investors believed if homeowners defaulted, they could sell the house for profit – there were waves of *exurban* development at the urban fringes and there was a dramatic housing price increase in areas such as the San Francisco Bay, Sunbelt cities and Florida (geographically uneven though)
    - Credit rating agencies were giving RMBS AAA ratings (the best possible)
- Hence, numerous investors invested in these RMBS and they became a very popular 'safe' investment product

Subprime mortgages supplied the investor demand and fuelled the bubble

- Investors were desperate to buy more RMBS, so lenders looked to create more of these securities
- Lenders loosened their standards and started to be more liberal with their mortgages; mortgages were given to those previously redlined through *greenlining* policies

- Greenlining saw low-income poor credit people being given mortgages – these are termed ***subprime mortgages***
    - Extremely low-quality loans, called *NINJA loans*, were given to people with **n**o **i**ncome, **n**o **j**obs, and no **a**ssets
    - However, subprime mortgages were not only given to the lowest NINJA classes, 'exotic' mortgages were designed specifically for middle-class buyers – these included *Adjustable Rate Mortgages (ARMs)* which often consisted of 'teaser' rates with 2 or 3 years or low interest, but then interest rates would quickly balloon beyond their means
        - The ARMs were more than twice as likely to default when compared to fixed-rate mortgages
- These subprime lending practices were brand new, so rating agencies could point to historical data to assure investors that mortgage securities were safe investments (all given AAA ratings)
- These subprime mortgages (i.e. ARMs/NINJAs/exotic mortgages) helped to fuel the bubble: subprime mortgage lending grew rapidly from about $35 billion (5% of US mortgages) in 1994 to $600 billion (20% of US mortgages) in 2006

These lending practices using ARMs, NINJAs and exotic mortgages are a type of 'predatory lending'

- *Predatory lending* occurs when loans (e.g. NINJAs and ARMs) are specifically targeted at a particular (usually vulnerable) group
- Predatory lending often has one or more of the following features
    - Unfair and disproportionate interest rates – higher interest and fees than are required to cover the added risk of lending to borrowers with credit imperfections
    - Abusive terms and conditions that trap borrowers and lead to increased indebtness
    - Fails to take into account the borrower's ability to repay the loan
    - Violates fair lending laws by targeting women, minorities and communities of colour

This predatory lending impacted some communities more than others

- Subprime and predatory lending have affected low-income and minority communities more than others – certain cities were thus more impacted with defaulting and foreclosure, and some neighbourhoods within cities were more impacted with defaulting and foreclosure
    - The Mortgage Bankers Association (MBA) showed that 1/3 of all mortgages in default or foreclosure were in California or Florida
    - However, official state figures obscured neighbourhood concentrations of default and foreclosure: whilst 1 in 450 mortgages were in foreclosure, this ratio rises to 1 in 130 in California, and to 1 in 25 in Stockton, California
- Subprime and predatory lending were also targeted at minority groups
    - African Americans received more than twice as many of these predatory loans compared to other racial groups; areas that were over 80% minority had more than 5x as many of these predatory subprime loans

Complex financial products amplified the risks of these Residential Mortgage Backed Securities

- Finance institutions created Collaterized Debt Obligations (CDO), which were even riskier products than subprime mortgages
    - The CDOs combined and securitised mortgage securities that had not sold (often BBB bonds) as they were deemed as too risky for investment

  - However, when these BBB bonds were combined, they were considered diversified and the risk was thought to be spread out
  - These were then given a AAA rating, which made them attractive to investors
- Another financial instrument used by financial institutions exacerbated all problems. These were unregulated over-the-counter (OTC) derivative contracts known as Credit Default Swaps (CDS)
  - CDSs were basically sold as insurance against the defaulting of Residential Mortgage Backed Securities (RMBS)
  - Companies such as AIG sold billions of dollars in CDSs without the money to back them up when things went wrong (AIG lost $500 billion due to CDS losses)
  - Credit Default Swaps were then turned into other derivative securities that essentially allowed traders to bet huge amounts of money on whether the values of mortgage securities would go up or down
- These complex financial instruments generated a complicated web of assets, risks, and liability so when something started failing, the entire financial system would be brought down with it

The Burst of the Housing Bubble, the Start of the Sub-Prime Crisis and the Impacts of Crisis

Pre-crisis growth

- In the late 2007s, the housing bubble was reaching its peak
  - The new relaxed lending requirements through subprime loans drove housing prices higher
  - House price increase was seen as a good thing: if the borrower defaulted, the bank would still have an even more valuable house to sell
- As such, people were throwing billions into Residential Mortgage Backed Securities, Collaterized Debt Obligations, and Credit Default Swaps

The housing bubble bursts: two waves of default and foreclosure led to the credit crisis for all

- Wave 1
  - Due to rapid housing price increases, people could not afford to pay for their expensive houses or keep up with ballooning mortgage payments – the use of subprime and predatory lending techniques facilitated this, and defaulting ARMs were starting to kick in
  - Borrowers started defaulting, and they underwent foreclosure…
- Wave 2
  - This put more houses back on the market for sale – however, there were no buyers – supply was up, and demand was low – as such, house prices started to collapse
  - As home prices started to fall, borrowers suddenly had mortgages for way more than their house was worth – some stopped paying, which led to more defaults
- The credit crisis started in 2007 when foreclosure and default rates went up and housing prices went down – this implied that investing in mortgages was not as low risk as people thought
- Investors that had poured money into RMBS and CDOs were rapidly losing money

Uneven geographies of defaulting and foreclosure: concentration in the US Rustbelt and Sunbelt states

- As waves of default and foreclosure spread, the impact of such was not spatially even
- Defaulting initially hit the Rustbelt states (Pennsylvania, Ohio, Maryland, Indiana, Michigan, and Illinois)
  - This was mainly in areas of concentrated predatory lending techniques and NINJA loans
  - As house prices increased, the Rustbelt populations were the first to become unable to pay their mortgages
- However, defaults then shifted to the Sunbelt states (Alabama, Arizona, Arkansas, California, Colorado, Florida, Georgia, Kansas, Louisiana, Mississippi, Nevada, New Mexico, North Carolina, South Carolina, Oklahoma, Texas, Tennessee and Utah)
  - Housing prices had been going up most rapidly in the Sunbelt states, and due to historical targeting of middle-class buyers with ARMs loans, there was an increasing rate of default in the Sunbelt states
- Previously, the top 10 foreclosure cities were Rustbelt cities, in 2007 when the crisis started, the list was a mix of sun and rustbelt cities, since the summer of 2008, the entire list was sunbelt

Impacts of the housing bubble burst

- **For financial institutions**
    - Investors stopped buying RMBS, so financial institutions were getting stuck with bad, risky loans – this led to a *liquidity crisis* which led to the collapse of major financial institutions such as **Lehman Brothers**, whilst some were forced into undergoing Mergers and Acquisitions (M&As), whilst some had to be bailed out by the government
    - Companies such as AIG lost billions of dollars due to Credit Default Swaps (CDSs) as they lacked the money to back them up when things did go wrong
    - However, the impact of bailout was not limited to financial institutions – the post-bailout debt crisis resulted in austerity policies leading to intensified inequalities
- **For the US population**
    - There was a credit crisis for all (a sudden reduction in the availability of loans) after foreclosure and default rates skyrocketed
    - Following the waves of foreclosure and default, panic set in, and the trading and credit markets froze, whilst the stock market crashed
- **Globally**
    - The housing bubble burst was linked to a wider economic crisis with devastating global impacts on wages, employment and retirement prospects

Global impacts: deepening public inequalities through financialization of foreclosed properties: Global Corporate Landlords (e.g. Blackstone and REITs)

- New global corporate landlords bought foreclosed housing and converted them into rental properties
- Hundreds of thousands of foreclosed homes in US, Spain, Ireland and Greece were bought by big institutional investors (e.g. Blackstone) and real estate investment trusts (REITs)

Global impacts: Northern Rock (NRK) in the UK

- Northern Rock was based on a business model that borrowed short-term on global money markets to write long-term mortgages – it was believed repayments from these mortgages could provide the basis for paying their debts
- During the early 2000s, Northern Rock had borrowed large amounts of money to fund the many mortgages it had given out (NRK operated on the same subprime mortgage practices as in the US – giving mortgages to just about anyone)
- After the global banking crisis around 2007-8, Northern Rock became unable to produce income as expected from its mortgage loans
- After news had spread that NRK had approached help from the government, the public lack of confidence in NRK grew, and this triggered a bank run
- Following the rush of withdrawals, NRK failed and went bankrupt

What were the responses to the crisis?

Historical governance strategies in response to financial crises

- Historical governance of previous financial crises has seen three techniques commonly used
- **1. Monetarisation of losses/last resort lending**
    - Consists of *last resort lending* by a central bank to private banks
    - For example, after the Panic of 1825 and the collapse of Overend, Gurney and Co, Walter Bagehot published a book named *Lombard Street*
    - In this book contained *Bagehot's Dictum*, which advised, during a financial crisis, the lender of last resort should lend freely, but at a high rate of interest, to solvent but illiquid banks
- **2. Socialisation/nationalisation of losses**
    - Bailout of insolvent banks using money from the taxpayers
- **3. Re-regulation**
    - For example, after the Wall Street Crash, the Glass-Stegall Act (1933) separated commercial and investment banking

Considering this, what was the response to the 2008 Financial Crisis?

- All three historical techniques were used, but this crisis was not simply a repeat of the past due to the uncertainty and debate over what precisely was the problem. This was coupled with the sheer scale of the crisis
- As such, governance of the subprime crisis involved some new and unique policies

1 – Monetisation and last-resort-lending: Troubled Asset Relief Programme (TARP)

- The Federal Reserve enacted a programme called TARP, which spent US$700 billion on bailing out banks
- US$700 billion was spent on toxic assets – assets related to and derived from repayments on subprime mortgages, namely residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs)
- Without this intervention by the state with TARP, the collapse of the financial system would have been imminent

2 – Monetisation (unconventional): Quantitative Easing – QE1-3 and APF

- Quantitative easing is an unconventional monetary policy in which a central bank purchases securities in order to lower interest rates and increase the money supply
- In the US, the Federal Reserve announced the first wave of quantitative easing, QE1, which was to pump $600 billion into the economy through purchases of US Treasury bonds
    - From 2008 to 2012, there were three waves of quantitative easing: QE1; QE2; QE3
- Similarly, in the UK, the Chancellor of the Exchequer authorised the Bank of England to set up an Asset Purchase Facility (APF) to buy assets and improve liquidity in credit markets

3 – Socialisation/nationalisation of losses: recapitalisation

- By 2008, HM Treasury spends near £80 billion of UK taxpayer money to prop up the insolvent Lloyds and RBS
- Altogether, the bailout of all institutions cost over £100 billion in UK taxes

4 – (Re)regulation

- The Dodd-Frank Bill took steps to increase transparency and to stop banks from taking so much risk
    - The Dodd-Frank Bill made banks more resilient to shocks by making them hold more equity capital (decreasing leverage)
    - 'Ring-fencing' commercial banking activities to separate high risk financial activity from low risk activity (this was recommended in the ***2011 Vickers Report***, and has been called the ***Volcker Rule*** (which was within the Dodd-Frank Bill))
    - Set up a consumer protection bureau to reduce predatory lending

5 – Contestations: Occupy Wall Street

- OWS protests began in 2011, and centred on Zuccotti Park, NYC
- The protest was on behalf of 'the people' and the '99%' to draw attention to the intensifying inequalities
- Spawned similar occupations in several U.S. cities and across the globe, including on the steps of St. Paul's Cathedral in the City of London.

Who suffers most from financial crises?: Austerity Measures vs Financial Institution Bailout

- With the exception of Lehman Brothers and Northern Rock, the major financial institutions at the heart of the crisis did not necessarily suffer the worst of consequences
- The experiences of major financial institutions contrast the relative lack of support for those facing foreclosure/repossession as a result of subprime lending
- Ballooning debt from UK bailout led to austerity…
    - The number of Emergency Food Banks increased by 100% from 2008-2011
    - Rising unemployment and increased flexibilization of work – increase from 1.6 million unemployed at the start of 2008 to 2.7 million at the end of 2011; the number of zero-hour contracts and self-employed people also increased
        - Intensified intergenerational inequalities: 20.3% of unemployed in 2011 are aged 16-24
- In essence, post-crisis austerity governance intensified the unequal socio-spatial consequences of crisis