The Causes of the Financial Crisis 2008

Reading Test

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Student

Time: *Approximately 1hour*

Two types of lesson

Lesson#1: [Easy] ***** [B2/C1]
1. Try to predict the content of text / write down key terms / ideas
2. Read text – check words and meanings with a dictionary
3. Answer questions
4. Check answers (pass mark is 70%)

Lesson #2: [Hard] ***** [C1]
1. Read text – no dictionary
2. Answer questions
3. Check answers (pass mark is 70%)

Teacher

Two types of lesson

Lesson#1: [easy] ***** [B2/C1]
1. Give out text a week before the test – students read, check vocabulary and meaning.
2. Test day – give out a new copy of text and the questions (no dictionary or notes)
3. Set 1 hour to read text and answer the questions
4. Take in and correct or go through answers in class (pass mark is 70%)
5. Extra activity – students write the summary* (add 30 minutes to test)

Lesson #2: [hard] ***** [C1]
1. Test day – give out text and questions
2. Set 1 hour to read text and answer the questions
3. Take in and correct or go through answers in class (pass mark is 70%)
5. Extra activity – students write the summary* (add 30 minutes to test)

Summary writing
Link: www.academic-englishuk/summary

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The Causes of the 2008 Financial Crisis

C. Wilson [2017]

1) In 2008 the world experienced the worst financial crisis since the Great Depression (1930s). The severe **magnitude** of the financial disaster became fully evident towards the end of 2007. It had, however, begun years earlier through what many claimed to be the main factor in the crash; sub-prime mortgage lending. The financial crisis of 2007-08 and the aftershocks of the US subprime mortgage crisis of 2007-09 is now considered to be 'The Great Recession'. The US Financial Crisis Inquiry Commission [FCIC] (2011) reported the crisis was avoidable and was caused from widespread failures in regulation of financial institutions and the reckless actions in risk and borrowing. It concluded that key governmental policy makers were ill-prepared and lacked understanding and accountability in the financial systems they oversaw. This article will examine how subprime mortgage lending led to the Great Recession.

2) Towards the end of the 1990s property purchases began to rise. With such growth, lending money for house buying became a profitable business in both mortgages and remortgaging. Traditionally, the house buyer saves up a deposit (down payment – usually between 10% of the house cost) and contacts a bank or mortgage broker, who connects them to a lender, who in turn provides a mortgage based on the grounds of specific criteria (permanent employment, no previous financial **defaults** (a positive credit-score), and the repayment plan being achievable). This is characterized as a 'Prime-mortgage' and the level of risk in lending is extremely low.

3) Throughout 2000 as home ownership became more popular and house prices rose significantly (1997 – 2006 house prices rose by 124% in the US and 186% in the UK (US Spindices, 2016)), lenders began to securitise these mortgages into mortgage-backed securities (MBS) and Collateralized Debt Obligations (CDOs) and then sold them to the investment banking sector. These mortgages were rated by credit agencies into three areas, 'safe', 'ok' and 'risky', and then sold on to the Shadow Banking Sector or investors, non- depository bankers, and hedge funds respectively. However, the prime mortgage market began to become **saturated** due to those who qualified had one.

4) Therefore, sub-prime mortgage lending was introduced in 2002/3 based on the presumption that as house prices continued to rise, if a borrower defaulted on payment, the lender would reprocess the house as equity. Lenders began to add risk to these new mortgages in that no deposit, no proof of income, or no documents were required to obtain a mortgage. An estimated $3.2 trillion loans were issued to homeowners with bad credit and undocumented incomes between 2002-2007 (FCIC, 2011), and with such a rise deregulation of banking policy occurred to include **fraudulent** automated underwriting processes and credit agencies' standards falling. At the same time 'predatory lending' offered loans at low interest rates or Adjustable Rate Mortgage (ARM) rates, where the consumer was unaware of the contract and associated rates (Krugman, 2009). The sub-prime mortgage process actively encouraged a rise in house prices and a phenomenon known as the **'housing bubble',** where house prices rose much faster than wages making housing unaffordable or people borrowing more than they can repay.

5) The shadow banking sector of Investment bankers, hedge funds and insurance firms all bought into the highly profitable world of sub-prime mortgage backed securities. These highly profitable credit instruments (CDOs), were traded internationally through derivatives and foreign exchange trading and spread across the global financial community. By 2006, 80% of U.S mortgages were subprime loans with an estimated value of $1.4 trillion (FCIC, 2011) Shadow banking often referred to as **parallel** banking, were not subjected to the same banking regulatory controls. These institutions were vulnerable as they borrowed short-term in liquid markets to purchase long term,

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illiquid and risky assets. This meant disruptions in credit markets creating rapid deleveraging, selling long term assets at depressed prices.

6) Interest rates began to rise in 2007, and this was the beginning of the end. The default rates began to increase with many borrowers unable to meet the monthly payments and this in turn meant that MBS and CDOs began to lose value with higher default rates. Concurrently, the housing bubble burst and house prices fell 40% (FCIC, 2011), leaving many people in **negative equity**. However, the most serious effect was a crisis of liquidity and trust that occurred across banks. Lehman Brothers went bankrupt and many more (Merrill Lynch, AIG, Freddie Mac, Fannie Mae, HBOS, Royal Bank of Scotland, Bradford & Bingley, Fortis, Hypo and Alliance & Leicester) were on the verge of bankruptcy and needed to be **bailed out** by Governments. In fact, 21 Banks and 61 hedge funds had been forced to declare bankruptcy in the US alone (Morris & Song, 2008). The remaining banks rose interest rates and stopped lending money which became known as the **'Credit Crunch'** and the led the world into 'The Great Recession'.

7) Since 2008, a number of measures have been created in response **to rectify** the problems. These include financial rescue plans, central bank's monetary policies of lowering interest rates, and Governmental public **stimulus packages**. There are calls for improved market regulation and supervision, which have been met through the Dodd Frank Act (Krugman, 2009). This was the largest reform of the U.S banking sector since WW2. In addition, a new global financial system regulated by the IMF, who should have a broader role in the regulatory system of the world economy, is being implemented.

8) Overall, the financial crisis of 2008 was not just the sub-prime mortgage lending sector. There are a number of other contributing factors that this article has not discussed, but primarily fraudulent greedy banking practice seems to lie at the heart of it. To identify who is exactly to blame is incredibly difficult because the results of **toxic assets** from fraudulent underwriting processes, easy credit conditions, predatory lending, deregulation and over-leveraging all had a significant effect on creating one of the biggest crashes of all time. It seems that everyone was responsible, from government's inability to regulate innovative banking practice, Economists unable to forecast economic collapse, financial institutions exploiting the **complexity** of MBS and CDOs and even homeowners taking on loans they were unable to pay back. The questions that exist, however, are whether it will happen again and are the measures in place sufficient to control and regulate banking practice.

[1003 words]

Reference List

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Us.spindices.com. (2016). *S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index - S&P Dow Jones Indices*. [online] Available at: https://us.spindices.com/indices/real-estate/sp-corelogic-case-shiller-us-national-home-price-nsa-index [Accessed 24 Dec. 2016].

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Comprehension Questions

1. Headings – *choose a subtitle for each paragraph*

1	**B**	*Background history*	**A**	Profitable Trading
2			**B**	~~Background history~~
3			**C**	Sub-prime mortgage
4			**D**	~~Conclusion~~
5			**E**	A Prime mortgage
6			**F**	A new regulatory system
7			**G**	Mortgage securitisation
8	**D**	*Conclusion*	**H**	The collapse

___ / 6

2. True / False / Not Given – one question per paragraph

		T/F/NG
i.	The financial crisis began in 2007	
ii.	Prime-mortgages are high-risk	
iii.	In 2000, mortgages were packaged and made into marketable products	
iv.	Credit Agencies were unqualified in underwriting processes	
v.	Shadow Banking sector is the main reason for the financial crisis	
vi.	The government had to take over banks to save them from bankruptcy	
vii.	The rescue packages have worked in regulating the banking sector	
viii.	The subprime mortgage sector was the main reason for the financial crisis	

___ / 8

3. Data - fill in box below– what do the numbers connect to?

10%	i)
186%	ii)
3.2	iii)
80%	iv)
1.4	v)
40%	vi)

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4. Acronyms: write the words for these acronyms

FCIC	
MBS	
CDO	
ARM	

___ / 4

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Paragraph 1

5. What were the main causes of the crisis according to the FCIC? (2 key reasons)

1	
2	

___ / 2

Paragraph 2

6. Three key criteria for a traditional mortgage.

1	
2	
3	

___ / 3

Paragraph 3/4

7. Why did the sub-prime mortgage sector lending rise?

1	
2	

___ / 2

Paragraph 4

8. What is 'predatory' lending?

___ / 1

Paragraph 5

9. How is shadow banking different from traditional banking?

___ / 1

Paragraph 6

10. What was the most serious effect of the financial crisis to the banks?

___ / 1

Paragraph 7

11. What are the two measures being put in place after 2008?

1	
2	

___ / 2

Conclusion

12. What were the key problems associated with toxic assets?

i	
ii.	
iii.	
iv.	
v.	

___ / 5

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Conclusion

13. The overall key problems with these groups were:

Governments	i. *inability to regulate innovative banking practice*
Economists	ii.
Financial institutions	iii.
Homeowners	iv.

___ / 3

14. Key language – *explain these terms from the context / use synonyms (where appropriate)*

magnitude	*A great size / immense / vast*
i. Defaults	
ii. Saturated	
iii. Parallel	
iv. Fraudulent	
v. ‘housing bubble’	
vi. Negative equity	
vii. Bail out	
viii. The ‘credit crunch’.	
ix. To rectify	
x. stimulus packages	
xi. toxic assets	

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Overall Score: ____ / 55

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Comprehension Questions ANSWERS

1. Headings – *write a subtitle for each paragraph*

1	B	~~**Background history**~~
2	**E**	A Prime mortgage
3	**G**	Mortgage securitization
4	**C**	Sub-prime mortgage
5	**A**	Profitable Trading
6	**H**	The collapse
7	**F**	A new regulatory system
8	D	~~**Conclusion**~~

___ / 6

2. True / false / not given – one question per paragraph

i.	The financial crisis began in 2007 [P1: begun years earlier]	**F**
ii.	Prime-mortgages are high-risk [P2: low risk]	**F**
iii.	In 2000, mortgages were packaged and made into marketable products	**T**
iv.	Credit Agencies were unqualified in underwriting processes	**NG**
v.	Shadow Banking sector is the main reason for the financial crisis	**NG**
vi.	The government had to take over banks to save them from bankruptcy	**T**
vii.	The rescue packages have worked in regulating the banking sector	**NG**
viii.	The subprime mortgage sector was the main reason for the financial crisis [P8: There are a number of other contributing factors]	**F**

___ / 8

3. Data - (fill in box below– what do the numbers connect to?)

10%	i) deposit
186%	ii) UK house price rise in UK 1997 - 2006
3.2	iii) $3.2 trillion bad credit loans issued (2002 – 2007)
80%	iv) the total of US subprime loans
1.4	v) $1.4trillion value on sub-prime mortgages
40%	vi) house price fell in 2007

___ / 6

4. Acronyms: write the words for these

FCIC	i) Financial Crisis Inquiry Commission
MBS	ii) Mortgage-Backed Securities
CDOs	iii) Collateralized Debt Obligations
ARM	iv) Adjustable Rate Mortgage

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5. What were the main causes of the crisis according to the FCIC? (2 key reasons)

1	widespread failures in regulation of financial institutions
2	reckless actions in risk and borrowing

___ / 2

6. Three key criteria for a traditional mortgage.

1	Permanent employment
2	A positive credit-score
3	Achievable repayment plan

___ / 3

7. Why did the sub-prime mortgage sector lending rise

1	Saturated due to those who qualified for a mortgage had one.
2	House price rise meant house as equity

___ / 2

8. What is 'predatory' lending?

lending' offered loans at low interest rates or Adjustable Rate Mortgage (ARM) rates, where the consumer was unaware of the contract and associated rates. [key terms]

___ / 1

9. How is shadow banking different from traditional banking?

Not banking regulatory controls, these institutions were vulnerable as they borrowed short-term in liquid markets to purchase long term, illiquid and risky assets [key terms]

___ / 1

10. What was the most serious effect of the financial crisis to the banks?

The crisis of liquidity and trust that occurred across banks.

___ / 1

11. What are the two measures being put in place after 2008?

1	the Dodd Frank Act
2	a new global financial system regulated by the IMF

___ / 1

12. Conclusion: What were the key problems associated with toxic assets?

i	fraudulent underwriting processes
ii.	easy credit conditions
iii.	predatory lending
iv.	deregulation
v.	over-leveraging ___ / 5

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14. The overall key problems with these groups were:

Governments	i. *government's inability to regulate innovative banking practice,*
Economists	ii. unable to forecast economic collapse
Financial institutions	iii. exploiting the complexity of MBS and CDOs / homeowners taking on loans they were unable to pay back
Homeowners	iV. taking on loans they were unable to pay back

___ / 3

15. Key language – *explain these terms from the context / use synonyms where appropriate)*

i.	magnitude	A great size / immense / vast
ii.	Defaults	Anon payment of money owed
iii.	Saturated	Supply beyond demand
iv.	Parallel	Occurring or existing at the same time
v.	Fraudulent	Dishonest. Corrupt, deceitful
vi.	'housing bubble'	where house price rise much faster than wages making housing unaffordable
vii.	Negative equity	Property value falls below the mortgage value
viii.	Bail out	To give financial assistance
ix.	The 'credit crunch'.	Banks stop lending money
x.	To rectify	Put right or correct
xi.	stimulus packages	A package of economic measures to stimulate a floundering economy
xii.	toxic assets	A bad financial asset whose value has fallen and no longer a functioning market

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Overall Score: _____ / 55

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