U.S. Financial Crisis of 2008: Causes, Response, Consequences

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December 7, 2020

Introduction

Following the crippling Financial Crisis of 2008, housing prices were slashed, millions of Americans were left unemployed, and the United States government spent nearly $1.5 trillion to help pull the nation out of recession (Congressional Budget Office, 2012). Our country was faced with the difficult task of piecing back together our nation's economy while also implementing legislation to keep a similar financial disaster from occurring again. The Financial Crisis of 2008 brought some of the worst economic conditions experienced by the United States since the Great Depression which included unemployment rates remaining above 9%, or more than 14 million Americans out of work, two years past the crisis (U.S. Bureau of Labor Statistics, 2011). In addition to the severe unemployment rates, "consumer spending experienced the most severe decline since World War II" (U.S. Bureau of Labor Statistics, 2014).

A recession of this magnitude requires a perfect storm of contributing factors and in this case its origin can be traced back to the real-estate bubble, weak regulatory structure, and irresponsible lending practices throughout the United States (Ökte, 2012). The real-estate bubble caused millions of Americans to default or miss payments on their loans leading to several hundred billion dollars in write-offs by banks and other lending institutions. Though significant, these losses were miniscule compared to the $8 trillion lost by banks through their investments in the United States stock market from its peak in October 2007 to its lowest point in October 2008 (Brunnermeier, 2009). With that said, the Financial Crisis of 2008 exposed the banking industry around the world for their inability to self-regulate bringing about severe reform from national governments and global regulators. Spearheading the regulatory changes to accomplish the goal of avoiding any future financial disaster of this magnitude was the Dodd-Frank Wall Street Reform and Consumer Protection Act published by the Obama administration in 2010. While government intervention was necessary given the economic hardship resulting from the Great Recession, it has been debated whether the Dodd-Frank Act was too severe in its regulations, limiting the international competitiveness of United States financial and banking institutions or if it is not far-reaching enough, failing to accomplish its goal of avoiding future recessions. This paper explores the economic reasons and financial instruments that contributed to the recession, the legislation passed following the crisis, and the effectiveness of this legislation in deterring a future financial disaster.

Housing Bubble

The United States Financial Crisis of 2008 was the most significant economic disaster since the Great Depression slashing asset prices in our country, resulting from faulty lending practices and a lack of controlling systematic risk in our financial industry. The most significant fall of asset prices occurred within the housing market as it had experienced a significant boom throughout the late 1990s and well into the early 2000s. According to Ökte, the root cause of the financial crisis can be traced back to this bubble in which housing prices increased 86% over the decade spanning from 1996-2006 (Ökte, 2012). The over expansionary monetary policy in the United States during the early 2000s contributed to the growth of the housing bubble as it incentivized people to buy homes whose prices were increasing much faster than the rate at which they were borrowing (Ökte, 2012, p. 7). The enticing housing market and low interest rates combined to allure a large population of undeserving buyers who purchased homes that their incomes could not support. Consequently, homebuyers and financial institutions overlooked these economic factors as people continued to think the housing market could not fail.

However, financial analysts and market speculators were wrong in their belief that the housing market was infallible. Unfortunately, housing prices began to decline in mid-2006, “dropping by about 1.5% by 2007” (Gilreath, 2018, p.11) The decrease in housing prices caused homeowners living above their means to default as they could no longer borrow against their home equity to keep up with payments (Gilreath, 2018). The millions of undeserving buyers allured by low borrowing rates and an enticing housing market were the first to default as prices dropped. The next few sections of the paper explain why this caused such rapid destruction to our economy.

What Are Mortgage Backed Securities?

In order to understand the rest of this paper, it is critical to have a firm understanding of the financial instruments behind the housing bubble previously mentioned. First is a mortgage, or “a debt instrument secured by the collateral of specified real estate property that the borrower is obliged to pay back with a predetermined set of payments” (Gilreath, 2018, p. 2). In layman's terms, it is a way to make a real estate purchase in which the buyer can split the payment up over time, instead of paying the entire amount up front. Another financial instrument derived in the 1970s to reduce costs in home financing was the mortgage backed security (Gilreath, 2018). Created as a way for banks to free up their capital, mortgage-backed securities (MBSs) are bonds representing a pool of mortgage loans that are then sold to investors who gain the right to acquire the income from these mortgages (Harper, 2011, p.1). These financial instruments are derived when financial institutions, both public and private, purchase mortgages from initial lenders and repackage them as bonds to be sold to investors. These bonds, like any other financial investment, carry different return values associated with them based on the risk that accompanies the investment. It is the job of rating agencies to explore the risk involved in these MBSs and assign an appropriate rate to these securities, so that investors can decide which MBS they would like to invest in based on their risk tolerance.

Role of Credit Rating Agencies

Credit rating agencies played a huge role in the Financial Crisis of 2008 as their job is to provide information to investors regarding bonds and other securities. According to Harper, "they assess the creditworthiness of companies and governments that issue debt and assign ratings to various fixed-income securities, including complex structured products" (Harper, 2011, p. 6) It is important to note that these ratings are not absolute, nor do they claim to be, but investors expect a certain level of accuracy and transparency in the way these agencies rate securities. Credit rating agencies assign letter grades to securities based on their expectations of possible default and exposure to certain business conditions, the highest tier of securities being labeled AAA and lower-rated investment grade securities holding BBB labels (Harper, 2011).

MBSs labeled anywhere between this range of AAA and BBB bonds are considered reliable investments as the bulk of the package consists of prime mortgages. Bonds below this threshold are considered junk bonds as they're primarily made up of subprime or Alt-A loans which are provided to buyers with low credit scores meaning they are more unlikely to pay back the loan within the confines of their agreement given their financial histories (Gilreath, 2018). Unfortunately, with the rise in homeownership, "subprime and near-prime loans shot up from 9 percent of newly originated securitized mortgages in 2001 to 40 percent in 2006" (Gilreath, 2018, p. 9) This allowed for millions of more subprime and Alt-A loans to be packaged into the MBSs being sold to investors.

Leading up the Financial Crisis, credit rating agencies failed to do a thorough job throughout the securitization process. These agencies were not only lackluster in their screenings to determine the creditworthiness of customers, but also in their examination of the mortgages within the MBSs that they were rating. Credit rating agencies lost their objectivity because of financial incentives as they were making a majority of their profits from rating such securities. Consequently, they misrepresented the ratings on MBSs that were primarily made up of subprime and Alt-A loans taking advantage of the overconfidence by housing market investors. The result of this misrepresentation was the root of the crisis as vast missed mortgage payments led to overvalued MBSs driving investors and banks to attempt to unload these near valueless investments. According to Harper, “investors and banks lost hundreds of billions of dollars because of misguided confidence in mortgage-backed securities, particularly subprime securities” (Harper, 2011, p. 17). This loss of capital by investors and banks drove the financial meltdown as it tightened credit causing our nation’s economy to near insolvency.

Domino Effect

This misguided information from credit rating agencies culminated and began the meltdown in 2007 when borrowers of these subprime and Alt-A loans began to default. Gilreath notes this occurrence as he writes, “At the end of September 2007, about three percent of home loans were in the foreclosure process and another seven percent of homeowners with a mortgage were at least one month past due on their payments” (Gilreath, 2018, p.11) Unfortunately, this did not only impact the homeowners, but also the investors who owned MBSs that were now being defaulted on and the institutions that lend out the mortgages and MBSs. This domino effect brought well-known financial institutions to their knees, like Lehman Brothers and Bear Stearns, both of whom had recently bought subprime and Alt-A mortgage lenders in the early 2000s (Gilreath, 2018). In addition to the malpractice from credit rating agencies, banks and other financial institutions turned to faulty lending practices during this time as Smith & Fraticelli write, “Before 2008, certain banks and other financial institutions were making money by selling and repackaging mortgages that people could not afford. The 2008 crisis was driven by the sudden illiquidity of securities backed by these residential mortgage loans" (Smith & Fraticelli, 2013, p. 9). This breach in integrity across our nation's entire financial industry made it apparent that government intervention in the form of new regulations must occur.

The Dodd-Frank Act

In response to the economic disaster that ensued following the collapse of the United States housing market, our government was forced to take swift and severe action to bring the nation out of recession and keep a similar crisis from occurring again. The Dodd-Frank Wall Street Reform and Consumer Protection Act was part of the strict reform implemented following the crisis aimed at eliminating systematic risk and mandating a specific level of regulation and transparency within financial institutions. The Dodd-Frank Act sought to accomplish this goal by heightening restrictions and regulations on our financial system by installing new rules and regulatory bodies. This act aimed to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail," to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes" (Smith & Fraticelli, 2013, p. 3). The Dodd-Frank Act targeted credit rating agencies, banks, and other lending institutions for their roles in the Financial Crisis of 2008. The Dodd-Frank Act attempted to be forward-looking in its approach to both deal with the recession, while also avoiding one in the future.

Accountability and Transparency

The Dodd-Frank Act sought to increase accountability and transparency across the entire financial industry, but most importantly, within credit rating agencies. For decades leading up to the crisis, credit rating agencies were "basically exempt from legal liability" (Harper, 2011, p. 23). According to Harper, "The Dodd-Frank Act addresses the following topics in regards to

CRAs: increased accountability, conflict of interest and rating accuracy, reliance by federal agencies and public disclosure of rating methodologies" (Harper, 2011, p. 24). In addition to these topics, the act aimed to make it easier for investors to sue credit rating agencies for poor ratings resulting from malpractice. Harper also notes that Congress deemed credit rating agencies systemically important resulting from their crucial role in maintaining order throughout the debt market. With that, the Dodd-Frank Act established the Office of Credit Ratings at the SEC to increase oversight on their operations, ensuring that the topics addressed in the act are upheld in the future.

End "too big to fail"/ Protect American Taxpayers

The Dodd-Frank Act also sought to end "too big to fail" and to protect the American taxpayer by ending bailouts. These two aspects of the 2008 Financial Crisis go hand in hand as taxpayer dollars went towards bailing out institutions deemed "too big to fail." An institution that receives this label is viewed as being too systematically important to the financial well-being of our nation that the government will intervene in the event of its possible failure. Kim and Muldoon note the effort to end "too big to fail" as they write, "The Act puts a special emphasis on banks, bank holding companies, and nonbank financial institutions with at least $50 billion in assets that a new Financial Stability Oversight Council deems to be systematically important" (Kim & Muldoon, 2015, p. 6). This is an important step in ending "too big to fail" and protecting American taxpayers as the council requires and enforced higher capital requirements on these institutions, so they mitigate risk of failure during economic downturns.

Protect Consumers from Abusive Financial Services Practices

Finally, the Dodd-Frank Act set out to protect consumers from abusive financial services practices. An example of these abusive practices is noted in the Domino Effect section of the paper as it references banks and other financial institutions selling and repacking mortgages that they knew people could not afford given their incomes and creditworthiness. However, these institutions were focused only on turning a profit which turned out to be at the expense of all consumers across the country following the crisis. Fortunately, the Dodd-Frank Act addresses this issue through several different rules. The first rule being the Qualified Mortgage Rule which “requires banks to maintain higher mortgage lending standards” (Dolar & Dale, 2020, p. 1). This rule was extremely important in the wake of the Financial Crisis as it protects consumers by disallowing banks to offer them mortgages that they cannot afford, a practice that occurred far too often leading up to the recession. The implementation of the Dodd-Frank act also brought the Volker Rule which limits the banks’ abilities to invest certain amounts in hedge funds and private equity funds. The final Dodd-Frank provision made to protect consumers was the increase in required capital held by banks. This rule is significant as it limits the amount of money banks can have tied up in high leverage investments in the event of a crisis.

Successes and Shortcomings

Any and all legislation is highly scrutinized to critique shortcomings and praise successes depending on which side your opinions may fall. With that said, the Dodd-Frank Act is no different, especially given its length and widespread impact on businesses across many different industries. The Dodd-Frank Wall Street Reform and Consumer Protection Act is the most comprehensive and far-reaching legislation aimed at reforming our financial industry since the Emergency Banking Act of 1933 in response to the Great Depression. Despite a generally bipartisan agreement that the United States financial system was in need of regulation, critics of the Act have varying opinions on whether or not it successfully achieved its goals. This section of the paper will explore the different opinions surrounding the Dodd-Frank Act's successes and shortcomings.

Successes

Despite the Dodd-Frank Act being a knee-jerk response to a once in a lifetime financial disaster, the legislation did successfully address some critical issues with our financial system. The first of these issues was the lack of oversight and regulations on credit rating agencies. The Dodd-Frank Act successfully enhanced regulations on these agencies and forced them to uphold certain levels of accountability and transparency through the Act's implementation of an overseeing body in the Office of Credit Ratings (Harper, 2011). In addition to these measures, the legislation also made it easier to sue these agencies for malpractice which has previously been almost impossible. The Dodd-Frank Act also appointed the Federal Deposit Insurance Corporation (FDIC) the duty of taking over a failing financial institution in order to properly liquidate it (Kim & Muldoon, 2015) This is an effective strategy as it would limit the ripple effect across the market in the case of a future failure. Another success came from Title X of the Dodd-Frank Act as it introduced an interactive approach between federal and state officials to optimize consumer financial protection (Wilmarth, 2011). This is an important piece of the legislation because of its ability to impact the future of our financial industry. The federal and state officials can work together to make forward-looking improvements that may not have been possible prior to their partnership. Finally, taking a look at the Dodd-Frank Act on the banking industry as a whole, "A recent article published in The Economist argues that US banking institutions are far safer in the post-Dodd–Frank era as compared to the pre-Dodd–Frank era due in part to the extensive financial regulatory overhaul that took place since 2010" (Dolar & Dale, 2020, p.1).

Shortcomings

Unfortunately, the Dodd-Frank Act was not considered to be a great success by all critics as many argue that there are some significant shortcomings in the legislation. According to Smith and Fraticelli, a major problem with the "new financial legislation is that it is responsive to past market innovations without being sensitive to future innovations" (Smith & Fraticelli, 2013, p. 8). Smith and Fraticelli argue that the legislation may be effective in its addressing of the financial instruments that caused the crisis but came up short in regulating the system to avoid future crises caused by new instruments. With financial innovators constantly finding new financial instruments to exploit in order to be more profitable, the Dodd-Frank Act isn't forward-looking enough to protect new instruments from exploitation (Smith & Fraticelli, 2013). Critics also argue that fines do not serve as a suitable deterrent mechanism to breaking the new rules and regulations (Smith & Fraticelli, 2013). This is especially due to the vagueness in the threat of such fines with regards to amounts as breaking the regulations could lead to greater profits even after fines.

Additionally, the increase in regulatory costs has served as one of critics' primary arguments against the Dodd-Frank Act. Touching upon the regulatory cost issue, Dolar and Dale write, "By some estimates, the Dodd–Frank Act imposed a regulatory burden of 73 million paperwork hours and $36 billion of additional costs on the financial system between 2010 and 2016" (Dolar & Dale, 2020, p. 1). This is a significant statistic as it displays the increased cost of business brought about by the Dodd-Frank Act. Unfortunately, in complying with all of the regulations, these institutions are losing exorbitant amounts of money. Dolar and Dale conducted a study to analyze how these compliance costs impact banking institutions of different sizes. The study found that smaller banks have been disproportionately affected by the compliance costs related to the Dodd-Frank Act (Dolar & Dale, 2020). As a result, the Dodd-Frank Act stunted the growth of small banking institutions. This exists as a noteworthy shortcoming of the legislation as it provides an unfair advantage of large banking firms over smaller ones.

Conclusion

It is extremely difficult to create sweeping legislation that regulates the complex United States financial system. With that said, it was inevitable that the Dodd-Frank Act would have some great successes and unfortunate shortcomings. Smith and Fraticelli note that such legislation was made even more difficult given the laissez-faire mindset that dominated economic and financial policy throughout our nation's history. The Dodd-Frank Act took on this daunting task of reforming our financial system to avoid future economic disasters like the Financial Crisis of 2008. However, after exploring the causes of the crisis, goals of the legislation, and assessing its successes and shortcomings, it is apparent that the Dodd-Frank Act comes up short of its ultimate goal of deterring future financial disasters.

The largest flaw in the legislation that exposes the Dodd-Frank Act's inability to avoid future financial disasters is its lack of addressing new instruments that could pose a threat to our financial system. As mentioned earlier in the paper, the legislation only addresses financial instruments that have already been exploited which will fail to deter a future disaster (Smith & Fraticelli, 2013). In order for the Dodd-Frank Act to be more successful, it needed to be created in a more elastic way that can adjust to future market innovations. Smith and Fraticelli raise a possible solution to this problem stating that the creators needed to make it a less detailed law with the ability to be more flexible. Unfortunately, the need for reform was imminent and there may not have been enough time to construct the Act in such a way.

U.S. FINANCIAL CRISIS OF 2008: CAUSES, RESPONSE, CONSEQUENCES

Another shortcoming that outweighs the Dodd-Frank Act's successes is the unfair regulatory and compliance costs that fall upon smaller banking institutions. Small banks and businesses are critical to our nation's economy, so it is important that these institutions are provided a fair and equal opportunity to grow and prosper within their market. With regulatory costs crushing small banks, it is possible that they cannot keep up with these costs and begin to fail causing worse repercussions to the economy than if the regulations were not in place. Also, discovered by Dolar and Dale, it is unfair for government implemented legislation to offer large banks a competitive advantage over smaller banks. The increased and unfair compliance costs exist as another shortcoming that clearly impacts the success of the Dodd-Frank Act.

Finally, the amendment of the Volker Rule adds to the conclusion that the Dodd-Frank Act fails to deter future financial disasters. In rolling back the Volker Rule, which limits the ability of banks to make certain investments, making it less strict it is clear that the Dodd-Frank Act missed the mark on this provision. By amending this rule, banks are now allowed to make larger investments into hedge funds and private equity funds. This is significant as it allows for banks to increase their profitability through greater long-term investments. It is critical to our nation's financial health that banks can invest their capital as it allows for consumers to freely participate in the economy and allows institutions in any given industry to function properly. The strict regulations on the financial industry passed in the Dodd-Frank Act limit the overall effectiveness and profitability of our economy. While reform was definitely needed, it can be concluded that the Dodd-Frank Act was too far-reaching and strict, keeping our financial system from functioning properly. In addition to limiting the effectiveness of the system, the Dodd-Frank Act fails to avoid future financial disasters. It may be cynical, but financial disasters are inevitable and there may not be any legislation that can deter a crisis from occurring again.

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