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Causes and Consequences of the 2008 Financial Crisis: A Critical Review

Jingyi Ying[1,a,*]

[1] *University of British Colombia, Vancouver, BC Canada V6T 1Z4*
a.yjingyi@student.ubc.ca
**corresponding author*

Abstract: The analysis of the financial crisis is crucial for the growth of the world economy, particularly given the complicated economic environment that COVID-19 is currently experiencing and the war in Ukraine. This paper will discuss the most significant financial crisis that happened in 2008, which was brought on by the financial authorities' shoddy implementation and upkeep of their policies. The collapse of several major banks and financial institutions, high unemployment, government bailouts, the collapse of the real estate market, regulatory reforms, and economic recession were the main consequences of the crisis. It is essential to research and examine the factors that led to the financial crisis of 2008 and its consequences. First, research of this kind enables us to comprehend the underlying causes of the financial catastrophe. Secondly, financial crisis research helps to identify early warning signs of impending crises. Third, the study of financial crises can provide valuable insights into the behavior of financial markets and financial institutions. Fourth, research on financial crises can help inform public policy debates. Finally, research on financial crises can help improve transparency and accountability in the financial sector. Such research can inform public policy, promote transparency and accountability, and help ensure a more stable and sustainable global economy.

Keywords: subprime mortgage, mortgage-backed securities, financial regulation

1. Introduction

The winners of the 2022 Nobel Prize in Economic Sciences are Ben S. Bernanke, Douglas W. Diamond, and Philip H. Dybvig, whose findings have greatly improved society's comprehension of the role of banks in the economy and the financial crisis [1]. Their analysis is of great relevance to the regulation of financial markets and the response to the financial crisis. Therefore, the study of the Financial Crisis is important for the development of the global economy, especially in the present complex economic situation of COVID-19 and the Ukraine Conflict. Global financial markets witnessed significant instability as the new crown pneumonia expanded around the globe, with U.S. stocks collapsing four times in less than two weeks. In recent years, there has been a noticeable slowdown in the development of world commerce. The CPB Global Trade in Goods Index indicates a drop in global trade volumes in 2019 compared to 2018, the first drop since the global financial crisis of 2008, and the New Crown epidemic is anticipated to further slow the rate of global trade development [2]. The economic consequences of the war in Ukraine have been severe. Spikes in energy and commodity prices have further exacerbated inflationary pressures stemming from supply

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chain disruptions and the post-epidemic recovery. The price shock has been felt globally, with a particular impact on poor households, due to the larger share of food and fuel in their expenditures. The resulting economic loses will be even more devastating if the war worsens. The worldwide economy and financial markets would be significantly impacted by sanctions against Russia. The most influential 2008 Financial Crisis would be selected as the object of study.

The financial crisis of 2008 started on August 9, 2007, and it is a financial catastrophe. Investors started to lose faith in the value of mortgage assets after the start of the subprime home credit crisis, which led to a liquidity crisis. The central banks of numerous nations frequently poured sizable sums of money into the financial markets, but they were unable to stop the outbreak of this financial crisis. Lehman Brothers' bankruptcy in September 2008 marked the beginning of the financial crisis' uncontrollable spiral, which eventually resulted in the failure of numerous significant financial organizations or the government's seizure of them. The global financial catastrophe got its start. Between 2008 and 2009, the actual economy, banking sector, and employment markets all suffered from significant drops in GDP growth or even negative growth, including those in China, Europe, the United States, and many other nations. Banks that had extra reserves and were lenders or placers in the market abruptly became more risk averse, causing the interbank credit market to freeze. To avoid having to reduce their debts and other assets, banks that had participated in this market as takers or borrowers had to find alternative means of funding [3]. The 2008 global financial crisis started a recession that resulted in the worst decline in output, employment, and global commerce since the early 1930s during the Great Depression [3]. In the United States, the United Kingdom, Ireland, Spain, the Netherlands, Germany, and Belgium, hundreds of banks and other financial institutions collapsed [3].

2. Causes

Financial authorities' careless implementation and upkeep of bad policies led to the financial catastrophe that took place in 2008. It started when the American government implemented housing-related policies, encouraging lenders to give mortgages to risky debtors [4]. Through the acts of government-sponsored organizations, this strategy was sending the message that these organizations would buy mortgages with subprime traits. This resulted in the proliferation of "subprime" mortgages, which were then bundled as CDOs and sold on the market [4]. Credit default swaps, which resulted in a lack of openness and a very flimsy financial system, brought this issue to light.

2.1. The Fed’s Monetary Policy

Lenders who financed mortgages by repackaging them into groups and selling them to investors in the early and middle 2000s offered high-risk mortgages [4]. Most of the financing for subprime mortgages came from private-label mortgage-backed securities, which were new financial instruments used to spread these risks. Because the less vulnerable of these securities were insured using new financial instruments or because other securities would absorb any losses on the underlying mortgages first, they were perceived as less risky, which made it easier for more first-time homebuyers to obtain mortgages and raised homeownership rates. House prices have increased because of the ensuing demand, particularly in regions with a limited housing supply. This increased anticipation of further price rises, driving up home demand and costs even more. Private-label mortgage-backed securities buyers originally made money because rising home values shielded them from losses. High-risk mortgage holders who were unable to pay back their debts either sold their houses for a profit and cleared the debt, or they took out new loans at higher market rates. Such escalating housing costs and growing mortgage options were comparatively unheard of at the time, which fueled the development of subprime mortgage subprime loans.

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2.2. Subprime Mortgage

Most experts agree that subprime mortgages were an important part of the financial crisis [5]. A subprime credit is one that is less desirable than a standard loan. When a person or business needs a loan but has bad credit or a low income, this form of loan is typically given to them. Due to the usually poor credentials and higher failure rates, banks typically charge higher interest rates on these loans, and the majority of subprime loans have flexible interest rates that are constantly changing based on market rates. Due to the passing of laws like the Federal Housing Enterprises Safety and Soundness Act, U.S. government-backed businesses, headed by Fannie Mae and Freddie Mac, have started lending to more low- and moderate-income people since the 1990s. Loans with extremely cheap down payments are also growing in popularity. In 2000, subprime lending was essentially nonexistent, but by 2006, it accounted for about 20% of all mortgages [6]. Everyone is content when the business is doing well. But if something goes awry, the banks won't be able to manage the incredibly high failure rates on these subprime loans. Even worse, the massive subprime loans have created a new, enormous financial market. Wall Street financial organizations packaged subprime loans and other riskier assets into collateralized debt obligations to increase their ability to benefit from the subprime market. Additionally, credit default swaps, another derivative created because of subprime loans, are another derivative.

2.3. Credit Default Swap

An insurance product is a CDS. A credit derivative known as a CDS enables a provider to provide insurance against shifts in a borrower's credit ranking. An insurance premium-like payment is made by the buyer in the case of a CDS, and the vendor promises to reimburse the buyer if the underlying loan or security fails. The default risk, or credit risk, is transferred to the CDS vendor by the payment of a charge by the CDS customer. Collateral is used to reduce the counterparty's risk during the exchange. The fundamental tenet of the CDS is to segment the workload into various domains of knowledge to distribute resources more effectively. On September 16, 2008, the Federal Reserve Bank of New York, the nation's central bank, made a unique $85 billion credit to the American International Group [7]. The largest insurance firm in the world, American International Group, was on the brink of bankruptcy as it sold CDS worth $500 billion [7]. Because credit default swap deals were not apparent on U.S. balance sheets, investors were unable to determine the actual risk that financial institutions were taking. The entire system is impacted by the absence of openness, which increases its vulnerability as counterparty confidence erodes. Credit default swaps on the debt of Lehman Brothers contributed to the 2008 financial catastrophe.

3. Consequences

The worldwide financial crisis of 2008 had a significant effect on people, companies, and governments all over the globe. Here are a few of the most significant effects of the financial disaster of 2008. First, one of the most serious consequences of the crisis was the collapse of several large banks and financial institutions. Lehman Brothers was one of the biggest financial firms in the United States to fail, while Bear Stearns and AIG needed government subsidies to escape a complete failure. Numerous institutions in Europe, including the Bank of England, the Swiss National Bank, and the European Central Bank, also experienced financial problems [8]. Second, the financial crisis also led to a significant increase in global unemployment. Companies had to reduce expenses as they battled to stay afloat, which frequently required firing employees. In 2010, the jobless rate in the United States reached 10%, while it reached 25% in many European nations, including Greece and Spain [8]. Third, to prevent a complete collapse of the financial system, governments around the world provided financial support to many large financial institutions and companies. To assist the financial

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system, recover, the US government authorized a $700 billion rescue programmed known as the Troubled Asset Relief Program (TARP) [9]. Fourth, the failure of the U.S. housing market, which resulted in a drop in house values and a rise in foreclosures, was the primary cause of the financial crisis [10]. Many homeowners found themselves underwater on their mortgages, meaning that they owed more than the value of their homes [10]. This led to a wave of foreclosures, which in turn led to the financial crisis. Fifth, the financial crisis sparked calls for greater regulation of financial institutions, and many countries introduced new regulations to try to prevent similar crises in the future. The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in the United States in 2010, strengthened financial institution oversight and established the Consumer Financial Protection Bureau [11]. In Europe, Basel III was introduced, requiring banks to hold more capital to reduce the risk of failure [12]. Finally, the financial crisis led to a severe economic downturn that spread to several countries around the world. The global economy contracted as businesses struggled and consumer spending fell. Many countries experienced negative GDP growth and economic recovery was slow in many places. The consequences of the 2008 financial crisis were far-reaching, affecting individuals, businesses, and governments around the world. The collapse of several major banks and financial institutions, high unemployment, government bailouts, the collapse of real estate markets, regulatory reform and economic downturns were among the major consequences of the crisis. While many countries have recovered from the crisis, its effects continue to this day.

4. Regulatory Responses

4.1. Dodd-Frank Act

The government intervenes in the property market because of the 2008 financial crisis by passing laws like the Dodd-Frank Act. The Dodd-Frank Act, also known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, was enacted as comprehensive financial reform law in 2010 [11]. The act was created to handle several the structural issues, such as the absence of monitoring and regulation of financial institutions and the complexity and secrecy of the financial tools they use, that contributed to the crisis [11]. The measure has a broad variety of provisions, including new rules for trading in derivatives, the establishment of the Consumer Financial Protection Bureau (CFPB), and increased oversight of financial organizations. The Dodd-Frank Act's primary objectives included enhancing financial market openness and lowering the likelihood of future financial crises [11]. The legislation mandates that most derivatives be sold on controlled platforms as opposed to in secret, unregulated over-the-counter markets. It also requires financial institutions to hold more capital to protect against losses and creates a new regulatory framework for large financial institutions that are considered systemically important.

Another key aspect of Dodd-Frank was the creation of the CFPB [11]. The CFPB is an autonomous organization whose goal is to shield customers from unjust, dishonest, or abusive financial industry practices [13]. Mortgages, credit cards, and payday loans are just a few of the financial services and goods that the Bureau has the power to control. It also has the authority to investigate and penalize financial institutions that violate consumer protection laws. The Dodd-Frank Act has generated debate ever since it was passed, despite its goal of enhancing the safety and justice of the financial system. Critics argue that the bill imposes excessive regulatory burdens on financial institutions, which could limit their ability to lend and inhibit economic growth. Some also argue that the bill fails to achieve its intended goals, citing continued systemic risk and the persistence of predatory financial practices. Despite these criticisms, Dodd-Frank remains a landmark piece of financial reform legislation that has had a significant impact on the financial industry. Its provisions have reshaped the regulatory landscape and established new standards for transparency and consumer protection. Whether it

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succeeded in reducing the risk of another financial crisis remains an open question, but the act has undoubtedly had a lasting impact on the U.S. financial system [11].

4.2. Basel III

The Basel Committee on Banking Supervision established Basel III, an international regulatory structure for the banking industry, after the global banking crisis of 2008, when banking authorities reevaluated their regulations [12]. The objective is to increase the stability and safety of the international financial system. Several new rules and reserve standards are part of Basel III, which is intended to strengthen banks' resilience and lessen the likelihood of future financial crises. A rise in the minimal capital standards for banks is one of the main elements of Basel III. A minimal amount of high-quality Tier 1 capital, which consists of common equity and retained profits, must be maintained by banks under the new structure. Increased from risk-weighted assets with an extra safety buffer, Tier 1 capital's minimal requirement [14]. This mitigates possible losses and lowers the danger of bankruptcy. Basel III also contains new financial regulations in addition to the updated capital standards. To guarantee that they can fulfil their financial commitments in stressful situations, banks must maintain a minimal amount of high-quality liquid assets, such as cash and government bonds. Under duress, the liquidity coverage ratio (LCR) mandates that banks maintain enough liquid assets to cover anticipated net cash withdrawals for a 30-day period [14]. Basel III also includes the establishment of a new debt ratio [14]. An indicator of a bank's overall assets in relation to its Tier 1 capital is the debt ratio. The new leverage ratio requirement of 3% is intended to limit the amount of leverage a bank can assume, thereby reducing the risk of large losses and improving the stability of the banking system [14]. Basel III has received acclaim for its efforts to increase the stability and safety of the financial system, but it has also come under fire from a few sources. Some critics argue that the new regulations place excessive burdens on banks, which could limit their ability to lend and inhibit economic growth. Others contend that some of the fundamental systemic issues that contributed to the 2008 financial crisis are not sufficiently addressed by the new laws. Despite these criticisms, Basel III is an important step forward for the global banking industry. Its provisions have increased the resilience of banks and reduced the risk of another financial crisis. The framework continues to evolve as discussions and debates continue the appropriate balance between regulatory oversight and economic growth.

5. Conclusion

The study and analysis of the 2008 financial crisis is of great significance. First, research of this kind enables us to comprehend the underlying causes of the financial catastrophe. Researchers can identify the primary factors that contributed to the crisis by delving into the events that occurred, such as excessive risk-taking, a lack of adequate oversight, or faulty economic policies. This knowledge can assist policymakers in developing better laws and policies to avoid future crises. Second, financial crisis study can aid in identifying early warning indications of impending crises. Researchers can create models and markers to warn lawmakers to possible problems before they become serious by analyzing the patterns and trends associated with financial disasters. This can help prevent or mitigate the effects of future crises. Third, research on financial crises can provide valuable insights into the behavior of financial markets and financial institutions. By studying the behavior of banks, investors and other participants during a crisis, researchers can gain a better understanding of how financial markets function and how they respond to shocks. This understanding can inform the development of better financial models and investment strategies. Fourth, research on financial crises can help inform public policy debates. By providing evidence-based analyses of the causes and consequences of financial crises, researchers can help policymakers make informed decisions about financial

regulation, fiscal policy, and other economic policies. Finally, research on financial crises can help improve transparency and accountability in the financial sector. By revealing the factors that led to the crisis, researchers can help hold financial institutions and policymakers accountable for their actions. This can help promote more responsible behavior in the financial sector and reduce the likelihood of future crises. Overall, research and analysis of financial crises is critical to improving our understanding of how financial markets work and how to prevent and mitigate the effects of future crises. Such research can inform public policy, promote transparency and accountability, and help ensure a more stable and sustainable global economy.

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