Understanding The Basics Of The 2008 Financial Crisis

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Author Note

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**Question 1**

The financial crisis of 2008 had retail banks, hedge funds and mortgage lenders contribute to the lack of accountability amongst insurance companies and mortgage lenders. Using mortgage backed securities, that were covered them credit default swaps, they raised the demand for more mortgages in the market. This in turn led to an asset bubble in the housing sector as highlighted by Amadeo (2019). As soon as the federal fund rate was increased by the Federal Reserve, the adjustable interest rate for mortgages skyrocketed. The consequence was lack of accountability amongst banks and mortgage providers. Home prices fell to a low and borrowers became defaulters. Retail banks used the high ratings of agencies to promote mortgage backed securities like collateralized debt obligations and sell them all to borrowers which severely affected the US financial market and led to low accountability for insurance firms & issuers.

**Question 2**

Insurance Banks used different types of debt like mortgages and other as customized packages to resell them as CDO or collateralized debt obligations. Home owners who were benefitting from ATM option soon found out that they had hit a low when the house prices fell. The CDO holders included pension funds, corporations, investors and hedge funds amongst others. They were at a risk of losing their money amongst pension contributors. The risk also spread to individual contributors. Buyers had little idea how to define the prices for these CDO packages as these were new in the market and entailed complications. Amadeo (2019) states that since the stock market was thriving, all stakeholders were pressurized into buying all these CDOs in order to make profits. Since they bought large amounts of funds, they were at a risk of losing this money amongst their contributors when the house prices fell.

**Question 3**

Credit default swap is a financial swap agreement between the lender (debtor) and a buyer whereby the lender compensates the buyer for an event happening. A bank or insurance primarily uses a CDS or credit default swap like any other conventional insurance to make payments for any event occurring; but with a CDS, the insured's counterparty can lose money and even go bankrupt as with a regular OTC trade. When a certain event happens like a house getting damaged for example, the issuer of CDS protection gets the bonds. Contrary to traditional insurance, the holders of a CDS can change through a series of well-defined Counterpart or PB agreements.

**References**

Amadeo, Kimberly. (2019, Nov 20). *The Causes of the Subprime Mortgage Crisis*. Retrieved November 23, 2019, from The Balance: [<https://www.thebalance.com/what-caused-the-subprime-mortgage-crisis-3305696>](https://www.climatehotmap.org/global-warming-effects/economy.html)