How the Mortgage Bubble Burst

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Pre-Reading
1. Talk about what activities take place in local banks versus Wall Street banks.
2. Look at the graphics and discuss what you see.

Buying, Selling, Trading Mortgages: The Bubble Starts to Grow

When you buy a house, you usually need a loan. This type of loan is called a mortgage. In the past, when you went to the bank to take out a mortgage, the bankers were very careful to check your credit. They wanted to make sure you had enough income to make your monthly loan payments. This bank would be holding your mortgage for many years, so the bankers wanted to make sure they were taking a good risk by lending you the money.

Around 2000, local banks started selling these mortgages to Wall Street banks. This completely changed the local banks’ behavior. Since they weren’t holding onto a mortgage, they didn’t care if it was repaid. Instead they wanted to sell as many mortgages as they could for as high a price as possible. Local banks started giving mortgages to people with no income, no job, and no money.

Wall Street Wants More Mortgages: The Bubble Gets Even Bigger

The pressure from Wall Street for more mortgages was so intense that mortgage companies started going door to door, especially in low-income neighborhoods of color, and persuading people to take out loans on houses they already owned. That is how housing debt doubled from $5 trillion in 2001 to $10 trillion in 2007.

Meanwhile, the Wall Street banks bought mortgages, repackaged them, and sold them again! (These were called Mortgage-Backed Securities.) Housing prices were going up, so it was possible to convince investors to buy mortgages at higher and higher prices. But what is a mortgage? It’s really just a piece of paper. That piece of paper is backed up by the price of a house. But can the price of that house keep going up forever?

The Wall Street bankers thought so. Or maybe they knew the bubble would burst someday, but
they hoped they would pass it on to someone else before it burst. These Wall Street bankers kept repackaging and reselling mortgages. This only happened because extremely wealthy people had so much money sitting around and they wanted a place to invest it so that they could make even more money. The Wall Street banks were getting calls every week from investors who wanted to buy more mortgage packages. Eventually, they spent $30 trillion on $10 trillion worth of mortgages. On top of that, they spent $45 trillion on complicated policies (like credit default swaps) that were supposed to insure the investments.

**Home Values Cannot Support All the Wall Street Transactions: The Bubble Bursts**

It all turned out to be a disaster, of course. In September 2008, the bubble burst. What happened? Housing values started falling, homeowners couldn’t refinance their huge mortgages, and they started defaulting in larger and larger numbers. Investors tried to cash in their investments only to find that the “value” of all the mortgages (and all the complicated buying, selling, repackaging, insuring, and swapping) was not backed up by the value of actual homes.

**Activity: Build Your Own Bubble**

**The “Safe” Version**

Print “$5 Trillion” on 17 sheets of paper. Tape one sheet to the wall: this is the total amount of mortgage debt in 2001. Tape another sheet right above it: that is total mortgage debt in 2007. Now ask students how many sheets should go on the wall if the total amount in Mortgage-Backed Securities is $30 trillion. Tape six more sheets above the “2007” sheet. Finally, ask them how many sheets they’ll need for $45 trillion in Credit Default Swaps. Add nine more sheets to the inverted pyramid.

**The “Hard Hat” Version**

For a more dramatic version, create the same pyramid using chairs (but not folding chairs): each chair represents $5 trillion. Ask people to bring up their own chairs: “Come on up. Put your chair in. There’s a boom. People are making money!” When the chairs start to teeter, you can remind them not to worry, “It’s just a market correction.” (By the way, you might not really need a hard hat, but be careful. Sometimes a “market correction” turns into a crash.)

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