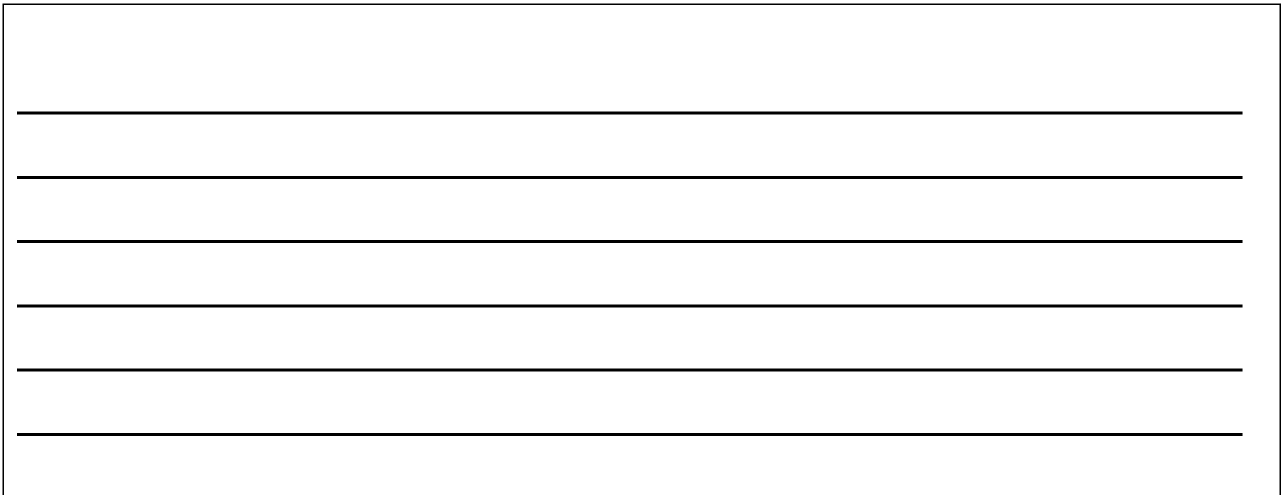
Activity 1
Comparing Crises

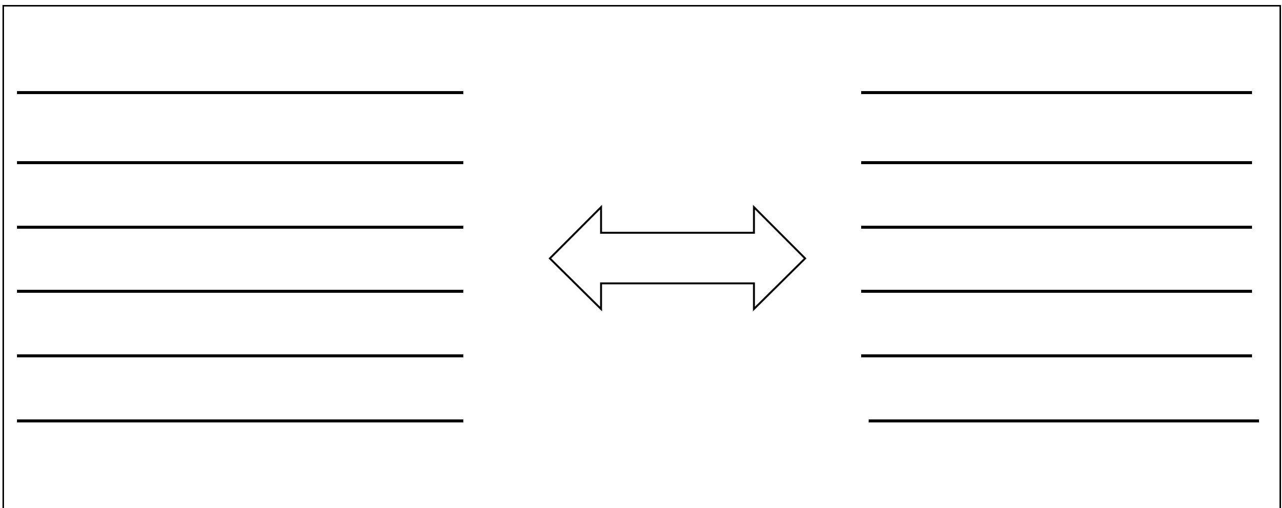
Directions: Use this compare and contrast organizer to explore similarities and differences between the Panic of 1907 and the crisis of 2007-2009.

THE PANIC OF 1907 **THE CRISIS OF 2007-2009**

How are they alike?



How are they different?



ACTIVITY 2
CATALYSTS FOR ECONOMIC DECLINE

The San Francisco Earthquake of 1906 and the toll exacted on New Orleans of Hurricane Katrina in 2005 are both American disasters of unprecedented proportions. The events were similar in the scope of damage. But they also are linked because the initial natural disasters were exacerbated by physical failures that caused even more losses. The earthquake caused numerous natural-gas lines to rupture, resulting in massive fires fed by the vast amounts of wood-frame construction common in that day.

Hurricane Katrina was a Category 3 storm when it made landfall on the outskirts of New Orleans. Though the winds were powerful, it was the storm surge that breached the man-made levees and engulfed the low-lying city in as much as 20 feet of flood water that wrought great suffering.

Both events are also connected because they occurred in advance of destructive economic crises that gripped the nation and much of the world. The earthquake in San Francisco is credited with being the external shock that weakened the economy so greatly that it became vulnerable to events leading to the Panic of 1907. Hurricane Katrina, although in proximity to the credit crisis that began in 2007, is not considered as a catalyst for economic decline. Why did the San Francisco earthquake play such a large role in prompting financial crisis while Hurricane Katrina was largely benign?

SAN FRANCISCO

- 7.8-magnitude earthquake
- Over 80 percent of the city destroyed
- Over 3,000 deaths (an estimated 500 shot as suspected looters)
- 250,000 left homeless
- 25,000 buildings destroyed on 490 city blocks
- 90 percent of the destruction resulted from subsequent fires
- Many buildings destroyed by firefighters using dynamite to create fire breaks
- Water main breaks depleted the means to fight the fires
- Overall cost of the property damage was about $10 billion in 2009 dollars, an amount equivalent to 1.50 percent of the nation's GDP in 1906

NEW ORLEANS

- The third-most-intense U.S. land-falling hurricane on record, Category 3 with 125 mph winds
- Levee breaches and overtopping resulted in floodwaters of 15 to 20 feet covering about 80 percent of the city
- An estimated 1,353 direct fatalities and 275,000 homes damaged or destroyed
- An estimated total of $81.2 billion in damage, slightly more than 0.5 percent of GDP in 2006
- Tens of thousands of jobs were lost due to severely damaged or destroyed businesses and supporting infrastructure
- Major highways in and around New Orleans were damaged or destroyed, disrupting commerce
- Katrina also affected the oil and gas industry by damaging platforms and shutting down refineries and interrupting operations at two major U.S. ports in Louisiana

ACTIVITY 3
CHARACTERS IN THE FINANCIAL CRISIS

"I need money for my kid's college tuition now, in 2006," said Joe. "The problem is that I don't have steady employment, I don't really have any money in the bank, and I already have a mortgage on my house with a big monthly payment. Is there any hope for me?"

"No problem!" said Bruce, the mortgage broker, "I don't need you to verify employment, and you can simply tell me how much you earn. I won't be checking whether you have money in the bank. I'll get you your money from the equity in your house."

Our announcer asks, "How can that be? Doesn't Joe need to prove he's a worthy borrower? Doesn't Bruce want to know what kind of risk he's taking by making this loan? How does he know that Joe will repay, and how does he know that the value of Joe's house will always be there?" He pauses and then asks, "What happened to the rules of banking?"

Mortimer, the old-time banker says, "Since World War II, the U.S. housing market has continued to go up, bankers made safe loans to thoroughly vetted borrowers and then serviced the loans until they were paid off. Many people stayed in those homes for decades, and less than 1 percent of borrowers defaulted."

Uncle Sam said in 2001, "Nothing is safer than the American housing market and nothing is more important than making sure every American is a homeowner. We're going to lower interest rates and keep them low so that home ownership becomes an affordable dream. We want to see the ownership rate rise. How can they lose? Prices never go down!"

ACTIVITY 3, CONTINUED
CHARACTERS IN THE FINANCIAL CRISIS

(Announcer) "Meanwhile, the rest of the world was getting a lot wealthier. The global pool of cash had doubled to a whopping $70 trillion between 2000 and 2006. Formerly poor countries like China, Brazil and India were now making things the world wanted to buy. Add that to the dollars from oil-producing nations and the world needed new places to invest. What would keep this money safe and generate a nice return?"

"Why, mortgages of course!" said a Wall Street banker. "We'll buy mortgages from the loan originators, bundle them in large quantities so that we mix in the very few bad ones with all of those good ones and sell shares in these investments to people around the world. There's a constant stream of income because what we see is that prices always go up and homeowners always pay. We'll call them mortgage-backed securities or MBS."

By 2003, Bruce (the mortgage broker) said, "We're running out of people interested in mortgages. Rates have been low for so long and everyone who qualifies under our guidelines has gotten a loan. There are a lot of people who have asked but they seem too risky for mortgage financing."

Uncle Sam says, "We really want people to own homes and we want to continue to stimulate the economy. We're going to keep interest rates low."

"Gosh" said the Wall Street banker, "we're getting gloriously wealthy from the fees generated by mortgage-backed securities and I would hate to see the gravy train end. Hmm, let me look at those statistics again. As I thought, we can loosen our guidelines for mortgage qualification. The way these mortgages are bundled, when we mix the risky ones with the sound ones, even if 10 percent of the borrowers default, the investor will still make a tidy profit.....I think?"

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Activity 3, Continued
Characters in the Financial Crisis

"Wow, what a lovely village you have here in Narvik, Norway, and so close to the Arctic Circle," said the investment salesman in the Armani suit. "Yes, these investments are absolutely safe…look, they come with an 'AAA' rating from Wall Street rating companies. What more do I have to tell you? Look at these statistics, housing prices always go up and borrowers always pay."

The village treasurer responded, "Alright, it looks good. The people of my village trust me to make our nest egg grow so that we can have more school buses, care for our elderly population, and provide more services. I'm not really sure what an MBS is, but the American borrowers always pay and Wall Street says that it's a 'AAA' investment, the safest in the world. Where do I sign?"

"This doesn't seem right, I don't have to ask for tax returns or pay stubs?" asked Bruce. "I don't need to access bank records or look at existing debt? I can accept a borrower with a 500 to 600 credit score? I thought we liked to see at least 700? I don't feel comfortable selling these mortgages; if they don't pay, won't I get in trouble? What do you think, boss?"

"Don't worry Bruce, we're going to sell these things to Wall Street, we'll pass the risk on to them," said Bruce's boss. "Our hands are clean and you will make a nice income. The more you sell the more you will earn. Besides, if we don't sell them, somebody else will. The financial customers are clamoring for them."

(Announcer) "So, lenders kept lowering the guidelines for mortgages. First it was state your income, then no income but state your assets, then it was no income, no assets, then something called a "NINJA" loan…no income, no job or assets. Most of these were adjustable rate or deferred interest deals where the interest rate was low in the first months of the mortgage but then increased dramatically to a much higher rate."

"Uhh, I can't make my mortgage payment anymore," said Joe. "The rate jumped and the value of my house is plummeting because builders built more houses and everyone with an adjustable mortgage is trying to sell at the same time. Now I can't refinance my home. The last I read, a huge number of borrowers were delinquent on their mortgages and many of those were entering or close to foreclosure."

AARRRGHHH!!!!!

ACTIVITY 3, CONTINUED

CHARACTERS IN THE FINANCIAL CRISIS

QUESTIONS FOR DISCUSSION

A. Based on the surprised response of the announcer in frame three, speculate on the types of documentation requirements borrowers might have been subject to in more regulated times.

B. What financial innovation, popularized over the last 10 years, might have allowed lenders to accept a greater amount of risk?

C. In retrospect, former Fed chair Alan Greenspan has admitted that keeping interest rates low for so long was not a sound policy for housing markets. What was the effect on housing markets? What might have been the motivation to keep interest rates so low?

D. Why were investors as far away as Narvik, Norway, willing to invest in U.S. mortgage-backed securities?

E. What financial move by the Federal Reserve had a dramatic impact on borrowers holding adjustable rate mortgages?

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