D Exercise 2 (Track 22)

Vincent: Good morning.
Timo: Hi, Vincent – this is Timo. Listen, I've just got a question. This housing market collapse, the credit crunch and these talks about depression – what is it all about? I am thinking about buying a flat here in Germany, so I'd like to know what went wrong with all these houses in America.
Vincent: Well, that is a long story – and it is a long way from the American housing market to Timo Brand's flat. Where do you want me to start?
Timo: Where it started?
Vincent: Okay. It all started about 2001, when the interest rate set by the Federal Reserve Bank, the American central bank, was very low. This is why there was a lot of cheap money on the market.
Timo: Sounds good to me ...
Vincent: Yes, and to many banks as well. New products were invented and markets explored. One of these were subprime loans, the idea, that any American, especially the lower classes, might own their own house.
Timo: So they financed homes for everybody?
Vincent: Yes, nearly. American banks introduced subprime loans, loans to people who have a poor credit rating – because of their low income or a bad credit history.
Timo: That sounds really adventurous! So how do people with a low income pay back their loans?
Vincent: That is a very good question. There were different kinds of subprime loans on the market, but all these loans had one thing in common: They were based on the rising prices on the housing market – so people could easily finance their houses during the housing bubble when the value of the property rose by about ten per cent every year.
Timo: So they even made a fortune when they sold the house after some years?
Vincent: Yes. In the meantime within these three years the banks kept pretty busy as well. Since everybody wanted to build and finance, the banks had much more demand for credit than they could supply. So they had to find a way of refinancing themselves to be able to sell more loans.
Timo: ... so they might earn more commission as well.
Vincent: Yes. Since many potential buyers are not interested in subprime loans, new products were invented. These loans were securitized, which means they were converted into tradable bundles. These bundles were assessed by rating agencies, which judged on their risk.
Timo: But subprime loans have a very high risk; I can tell you that without a rating agency.
Vincent: Yes indeed. And this is exactly why the banks had created the bundles. Subprime loans were mixed with prime loans to improve the rating of the subprime loans. This way the subprime loans were made tradable. Even better: In most instances the risk was not assessed properly – for example some funds which included subprime loans received the best ratings – so customers who would never have touched subprime loans invested in these funds.
Timo: ... but what happened then? I would like to own a house there. Money is cheap, everybody can afford a loan to buy a house, house value is increasing by about 10 per cent every year, the banks get their loans refinanced on the international market – this is no crisis, this is just great!

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Vincent: That's right. But what happens if the Fed starts increasing the interest rates – which they did in 2004 – and the money is not cheap anymore?
Timo: The house owners have to pay more for their loans?
Vincent: Yes, but think about the kind of people who take out subprime loans: They cannot sell their daughter's horse and cut back on violin lessons – they wonder how their job as a chef or a waiter will both feed their family and pay for the higher house rates.
Timo: Oh well. I see. The house owners default on their loans because they cannot afford to pay them any more – so their houses are repossessed by the banks.
Vincent: Yes. Unfortunately. And what happens to the housing market if there are lots of houses on the market?
Timo: Prices go down?
Vincent: Yes. And at that point even repossession does not cover the loans the banks had given out to people – even worse because there is hardly any market for these houses – because loans are expensive and house prices are falling, so the entire housing market collapses.
Timo: So this is why many international funds and banks which had invested in these subprime loans are going down.
Vincent: And there might be some more problems ahead – because some banks don't know how many of their investments will crash in the future ...
Timo: I understand.
Vincent: And there are even countries which are in trouble, because their banks have invested too much in this market.
Timo: Okay. So I should maybe think twice about buying a house I can hardly pay for – and I should definitely think twice about investing in something I don't understand. Is that what you are trying to tell me?
Vincent: Yes, I think that is what this whole story is telling us all.
Timo: Okay. But apart from that this does not really affect my personal choice of buying a flat after all, does it?
Vincent: Well, interest rates have been lowered following the crisis – this is quite good for you. Apart from that many banks have changed their subprime loan policies. But I don't think German banks offer any subprime loans anyway, do they?
Timo: I have never heard of any. Well thanks a lot. I'll call round next time when I know the exact date of my housewarming party, OK?
Vincent: Yeah, good idea. Looking forward to seeing you then.

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