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Behavioral Finance and the 2007-2008 Financial Crisis

In 2007, due to a domino like effect almost all the financial markets around the globe drastically lost value. A U.S. housing bubble that burst was the epicenter of the crisis. This summary will focus on three major factors of this crisis; the surge in housing prices leading up to 2006, large volumes of subprime-linked securities held by banks and the dramatic decline in those risky assets.

The surge in housing prices can be closely related to the behavioral finance theory of representativeness heuristic. That is when people over-extrapolate the past when forecasting the future. This phenomenon can be applied to home buyers, sources of outside financing and rating agency analysts. Home buyers believed that like the others homes across the country their home could grow in value, leading them to take larger, less-sensible loans. Sources of outside financing contributed by oversupplying credit to home buyers specifically subprime loans. Analysts at the major rating agencies gave subprime loan securities AAA ratings by extrapolating past growth with future home growth. Due to these securities receiving AAA ratings banks held had large positions in that market.

Banks kept large positions of subprime loans and subprime securities because of their AAA rating but with intelligent and competent employees why did the risks they held not of more concern. We learn from Barberis (2011) that it is likely due to belief manipulation. Both members of banks mortgage groups and rating agency analysts felt victim to this. Subprime-linked financial products were often very intricate, allowing analysts to mislead themselves into thinking they were quite safe. Which led to banks to purchase these products and hold them. Housing prices had been rising for some time so it seemed reasonable that they would continue on the same trend.

Unfortunately the housing market did not continue to grow. The housing market slow down devalued these loans and even though there were a relatively small number of delinquencies among subprime loans, prices dropped rapidly. Research focused on *institutional* amplification mechanisms have produced reasons for the decline of subprime value and holdings. Banks have strict margin requirements, once a subprime product lost value the bank would have to sell some of those products. This caused a domino effect among others firms to sell their subprime products. This cycle put many companies in jeopardy and was the igniter of the 2007-2008 crisis.

There is still much research do be done to learn from the 2007-2008 financial crisis. Theories in behavioral finance like over-extrapolation, belief manipulation and ambiguity aversion are important topics to apply to such research. It will help people understand why the crisis happened and how to help prevent such a deep recession from happening again.

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References

Barberis,N. (2011), *Pyschology and the Financial Crisis of 2007-2008, Financial Innovation and Crisis*, M. Haliassos, ed., MIT Press.