

# Housing crisis in the usa of 2007 term paper example

[Finance](#), [Investment](#)



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## **Executive Summary**

This paper is aimed at discussing the Housing Crisis in the USA during year 2007 and it's after effects. This paper starts with a brief introduction of the topic and then proceeds to the causes which lead to the housing crisis in USA during year 2007. After discussing the causes of the crisis, the early stages of the crises are briefly described which is followed by the actual development of the crisis. The effects of the crisis on US economy are mentioned afterwards which is followed by a brief conclusion of the paper. This paper has been prepared using several credible sources which have been properly cited and referenced in the paper while following APA referencing guidelines.

## **Introduction**

United States of America faced a huge economic crisis in the year 2007 which led to financial turmoil and a severe crisis in the nation and its economy. This severe crisis was the result of a lot of borrowing and blemished financial modeling which was designed on the basis of assumptions that the prices of homes and land would only rise and not decrease. Another reason for this turmoil was the bad intentions, fraud and most of all greed. These, among other authorities which were responsible for this crisis were financial institutions, government housing policy makers, credit agencies and consumers. Subprime lending became the contiguous cause where the percentage of subprime that was of lower quality increased more than double that is from 8% to 20% during the year 2004 to the year 2006. More than 90% of the percentage of it was adjustable. These factors also were responsible for lower standards of lending and high risk products for the mortgage. Moreover, United States' households became indebted more than ever. The increment in percentage of their personal income and ratio of debt rose from 77 percent to 127 percent in related to mortgage .

## **Causes**

The causes have, including high level of debts including personal and organizational, increasing power of originators of mortgage, predatory lending, excessive borrowing, resetting of adjustable rates of mortgage, depraved monetary policies, bad housing policy, unsuitable government regulations, imbalances of international trade, introduction of risky products of mortgage and false speculation. Consumers' debt of housing increased

rapidly which was the result of security backed by mortgage itself, default of credit and due to the sub sectors of finance industry was collateralizing debt obligation and offered comparatively very low rates. The level of approval was certainly high to subprime the potential consumers, as they were scheming combined risk on the basis of Gaussian formula. This Gaussian formula assumes the individuality of the component mortgage whereas the worthiness of credit was highly linked with the spending level of consumers and subprime mortgage. All those consumers who were in debt were considering their interest rationally due to the reason that they can't audit the finance department, industry and faulty methodology of risk pricing . One of the major causes of the housing crisis is that the inflow of money especially from the large private sector. The banks also entered in the institution of mortgage bond and the greedy practitioners of lending this mortgage especially adjustable mortgage loans, where the lenders dealt directly and indirectly through mortgage brokers.

In 2008, U. S held a summit on the topic of financial markets & economy of the world where 20 developed countries participated. There was a declaration that issued on the 15th November which stated that when the economy in the world was strong, capital flow was growing and stability existed in the last decade than participants of the market required higher profits without a proper appreciation of risks and were unsuccessful to work out proper persistence. Moreover, the scrawny standards of underwriting, improper risk management policies and practices, ever rising impervious and complex financial products along with too much leverage given to create a vulnerability in the whole system. All those authorities that were involved in

making policies and rules and regulations along with their supervisors did not appreciate the risk building in financial hubs and even didn't pay any heed to address it. They should have updated financial innovation and must have taken into account the difficulties in the system through domestic regulation .

In the year 2010, great investors such as Paul Volcker and Warren Buffet defined disputed assumptions and judgments based on the United States' economic and financial system that was responsible for this crisis. The assumptions that were discussed by these great professionals were; the prices of houses would never decrease so dramatically, financial market would get a huge financial support by the engineers in order to make the market efficient and stable and the funds that are directed would be productive and profitable. Other assumptions include that concepts embedded in physics and math are adapted to practical markets in the shape of several models of finance that are used for the purpose of evaluating credit risk. Moreover, imbalances of the economy such as increasing rates of deficit of trade and declining rate of savings were maintainable and proper rules and regulations regarding shadow banking and derivate was not required .

There was a commission set so as to define the real reasons behind the crisis. This financial inquiry team concluded in January 2011 that the crisis which occurred was preventable and happened due to the improper rules and regulations, dramatic failures of corporate governance, excessive borrowing, unprepared policy makers, lack of understanding of the system

and failure in ethical responsibility and accountability at all corporate and government levels.

### **Few further reasons are mentioned below:**

#### - The American Goal

The terms and conditions were satisfying for the people in the early 21st century and the mortgage rates were convenient which enabled them to have a loan for financing their own house with lesser monthly payments. In response, Home asking rates increased rapidly and financiers started lending more frequently. This Situation gave rise to Mortgage catastrophe.

#### - Cash Out

When home prices increased in intensity, homeowners considered their homes as huge wealth. They had a lot of equity to spend so they took subsequent mortgages and refinanced their homes while on the other hand salaries remained constant which eventually back fired.

#### - Uncomplicated Funding before major crisis

Financial institutions provided smooth access to the borrowers for their home financing and reduced the documentation work for obtaining loans even the personnel with poor credit rating would be eligible to borrow loans easily.

#### - Minor Attestation Loans

Lenders started providing loans with minimum documentation which gave rise to fraud among the home buyers and credit agent. Mortgage claims were not checked properly for accuracy purposes.

#### - Splashing Liquidity

Banks and other financial institutions used to maintain mortgage bonds on

their bank accounts. Banks use to work on this model for e. g. if somebody borrows a loan from the financial institution X then he need to make repayment to that particular bank and if that person unable to make repayment for his loan then the Bank X would lose money. However, now a day's bank may sell loans easily to other investors which are called rediscounting of loans. These types of investments may result in more complexities so number of investors just trust rating agencies have information regarding such investments that how safe they are without proper understanding. The financial institutions and credit agents put some negative impacts on the market as they sell loans before they lost their credibility and went bad.

#### - Homeowner speculation

Speculation in the borrowing regarding the residential estate and property has been mentioned as a factor of contribution to the crisis of the mortgage. During the year 2006, the purchase of residential property which was approximately 22%, was for the purpose of investment which was approximately 1.65 million houses in total. There was a purchase of vacation homes too. In the year 2005, the percentage was 28% & 12%. It can be said that 40% of these purchases were not for the purpose of residences. NAR's economist namely David Lereah said that the decline in the year 2006 in investment was estimated because the speculators withdrawn the investment and thus the investment sales decreased so rapidly than usual. The prices of houses almost got doubled from the year 2000 to 2006, which was quite an opposite tendency than the previous appreciation of the inflation rate. Residential buildings and homes were not previously

considered as investments but this trend changed due to the boom in housing purchases. Media also claimed that the houses were bought when it was not even fully constructed and then sold for a higher rate even without using it. Some companies recognized this risk in the year 2005, after knowing the fact that these investors assumed high leverage positions while considering multiple properties .

## **Early Phases of Housing Crisis**

When the interest rate was low and inflow of funds especially from foreign was in greater number then the credit conditions created a boom in the housing market and supported debt finance up to a greater extent. The ownership of homes in the USA rose from 64% to 69. 2%, from the year 1994 to 2004 respectively. A major cause of this increment was the subprime lending which increased the demand of houses which ultimately increased its prices .

The price of an American house increased up to 124% dramatically between the years 1997 to 2006. The median of the home price with that of household income during these two years increased from 2. 9 to 3. This median further increased to 4 in the year 2004 and then it increased to 4. 6 in the year 2006. This scenario resulted in minimal homeowners who were refinancing their property at a low rate of interest, or funding the spending of consumers compelling second mortgage by the appreciation of price. United States of America's debt as % of yearly disposable income rose from 127% in 2007 as compared to 77% in the year 1990 .

Unfortunately, the crisis started due to these rapid changes and property



prices stopped increasing at all. The borrowers who borrowed home especially more than one and could not afford, stopped paying for the mortgage. Therefore, monthly payment increased at the rate which was adjustable when the interest rate increased. As the property owners got to know that they are unable to afford their property, they had few choices to make. They either have to face the bankruptcy, or negotiate and revise the loan program once again or just leave their property. Definitely, many of the house owners worked harder to increase their income and reduce the spending but that didn't work out pretty well. Usually, as a common practice banks can recover the mortgage property when the borrower is not paying his dues but the value of homes decreased badly that the banks faced heavy losses on those loans.

## **Development of Housing Crisis**

The Housing Crisis boosted up when the borrowers started defaulting in a huge number. Investors and banks started to lose money. Banks and other institutions related to finance decided to decrease their disclosure of such risks and they also avoided lending money to other banks because of the uncertainty of receiving back their loan. Of course, every bank and business is run to make money and to keep cash for the day to day operations. The weakness of banking structure actually proved to be a failure. There occurred downsizing to a greater extent and many of the banks were almost shut down. When people witnessed this failure of such reputed and experienced institutions, they panicked.

## **Impact on the United States of America**

- GDP started to shrink in the year 2008 and never rose at all till the year 2010. The rate of gross domestic product was 5.5% and remained same for the next two years which is below the potential level or an estimate of \$850 billion. The Congressional Budget Office also claims that the GDP would not come back to previous level till the year 2017.
- The unemployment in the United States of America also increased to 5% in the year 2008 before the crisis took place up to 10% after the crisis in 2009. It started to decline by 7.6% in the first quarter of 2013.
- Investments in housing decreased in the year 2006 from 800 billion dollars to 400 billion dollars in the mid of 2009 and remained in declining position. These investments were resident but non-residential investment was at its peak at \$1700 in the year 2008 and decreased to \$1300 billion in the year 2010, but started increasing for the current year.
- The prices of houses decreased to 30% from mid-2006 to 2009 and kept constant till March 2013.
- Stock market point of 500 indexes also declined to 57% from 2007 to 2009. The prices of stocks started to increase at a slow pace so as to return to the record level in the year 2013.
- The total worth of households of America NGO's also decreased from dollar 67 trillion during the year 2007 to dollar 52 trillion during the year 2009. This decline of dollar 15 trillion/ approximately 22%. The recovery started in 2012 and was approximately \$66 trillion.
- The national debt of the USA also increased from 66% in 2008 to 103% till

the year 2012. Paul Krugman and Martin Wolf said that this rise in saving and decrease in investment powered the private sector.

## **Conclusion**

Consumers, businessmen, and lawmakers scampered to lower down the effect of mortgage and housing crisis. It was none less than a drama or a chain of dramas and will keep on affecting the economy for several more years to come. The domino effect of the downfall of the economy in the United States due to the Housing Crisis was severe and its repercussion would be witnessed for several decades yet to come. The common man witnessed the rise and fall of the investment and financial institutions and the consequences of the ill policies, greed and lack of foreseeing. This whole tragic turmoil in the mortgage business is a great lesson for many businesses yet to be planned and even for those that are successful. No business or economy sustains in the crisis where the impact of one dilemma leads to another and the chain grows to be stronger and longer. This crisis is also a lesson for the household which taught them to save more for the rainy days and earn better so that the crisis doesn't stay for long.

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