A brief analysis of subprime crisis

Literature, Russian Literature

A Brief Analysis of Subprime Crisis Introduction The US subprime mortgage crisis was one of the first indicators of the late-2000s financial crisis, characterized by a rise in subprime mortgage holes and foreclosures, and the resulting decline of securities backing mortgages. Approximately 80% of U. S. mortgages issued to subprime borrowers were adjustable-rate mortgages. After U. S. house sales prices peaked in mid-2006 and began their steep decline forthwith, refinancing became more difficult.

As adjustable-rate mortgages began to reset at higher interest rates, mortgage crisis soared. Securities backed with mortgages, including subprime mortgages, widely held by financial firms, lost most of their value. Global investors also drastically reduced purchases of mortgage-backed debt and other securities as part of a decline in the capacity and willingness of the private financial system to support lending. Concerns about the safety of U. S. credit and financial markets led to tightening credit around the world and slowing economic growth in the U.

S. and Europe. 1. Background—mortgage market The immediate reason or trigger of the crisis was the bursting of the United States housing bubble which peaked in approximately 2005–2006. High default rates on " subprime" and adjustable-rate mortgages , began to increase quickly thereafter. An increase in loan incentives, such as simple initial conditions and long-term trend of rising housing prices encouraged borrowers to increase the commitment that they will be able to quickly re-financing more favorable conditions for mortgage difficulties.

Additionally, the economic incentives provided to the originators of subprime mortgages, along with outright fraud, increased the number of subprime mortgages provided to consumers who would have otherwise qualified for conforming loans. However, once interest rates began to rise and housing prices started to drop moderately in 2006–2007 in many parts of the U. S. , refinancing became more difficult. Defaults and foreclosure activity increased dramatically as easy initial terms expired, home prices failed to rise as expected, and adjustable-rate mortgage interest rates reset higher.

Falling prices also resulted in 23% of U. S. homes worth less than the mortgage loan by September 2010, providing a financial incentive for borrowers to enter foreclosure. The ongoing foreclosure epidemic, which part of subprime loans, that began in late 2006 in the U. S. continues to be a key factor in the global economic crisis, because it drains wealth from consumers and erodes the financial strength of banking institutions. In the years leading up to the crisis, significant amounts of foreignmoneyflowed into the U. S. from fast-growing economies in Asia and oil-producing countries.

This inflow of funds combined with low U. S. interest rates from 2002-2004 contributed to easy credit conditions, which fueled both housing and credit bubbles. Loans of various types (e. g. , mortgage, credit card, and auto) were easy to obtain and consumers assumed an unprecedented debt load. As parts of the housing and credit booms, the amount of financial agreements called mortgage-backed securities, which derive their value from mortgage payments and housing prices, greatly increased. This financial innovation so that institutions and investors around the world to invest in the U.

S. housing market. With falling house prices, is to use the world’s leading investment mortgage-backed securities severe financial institutions to report significant losses. Defaults and losses on other loan types also increased significantly as the crisis expanded from the housing market to other parts of the economy. Total losses are estimated in the trillions of U. S. dollars globally. While the housing and credit bubbles were growing, a series of factors caused the financial system to become increasingly fragile.

Policymakers did not recognize the increasingly important role played by financial institutions such as investment banks. Some experts believe these institutions had become as important as commercial banks in providing credit to the U. S. economy, but they were not subject to the same regulations. These institutions and some regulated banks was also a significant debt burden, while providing the loans, there are not enough financial cushion absorb large amounts of loan default or mortgage-backed securities losses. These losses impacted the ability of financial institutions to lend, slowing economic activity.

Concerns regarding the stability of key financial institutions drove central banks to take action to provide funds to encourage lending and to restore faith in the commercial paper markets, which are integral to funding business operations. Governments also bailed out key financial institutions, assuming significant additional financial commitments. The risks to the broader economy created by the housing market downturn and subsequent financial market crisis were primary factors in several decisions by central banks around the world to cut interest rates and governments to implement economic stimulus packages.

Effects on global stock markets due to the crisis have been dramatic. Between 1 January and 11 October 2008, owners of stocks in U. S. corporations had suffered about $8 trillion in losses, as their holdings declined in value from $20 trillion to $12 trillion. Losses in other countries have averaged about 40%. The value of the stock market and housing losses further down the local consumer spending, an important economic engine downward pressure. The larger developed countries and emerging nations in November 2008 and March 2009 met with state leaders to develop strategies to resolve the crisis.

A variety of solutions have been proposed by government officials, central bankers, economists, and business executives. 2. Causes The crisis can be attributed to a number of factors pervasive in both housing and credit markets, factors which emerged over a number of years. 2. 1 Boom and bust in the housing market The housing bubble in the United States grew alongside the stock of the late1990s. High stock wealth induced families to spend more of their new disposable income and save much less. This " consumption boom" was largely focused on housing.

The increase in damand for housing had multiple effects. First, the value of houing increased, which in turn increased demand of housing and jump-started the bubble. Second, the supply of housing decreased and more housing had to be built to meet the rising demand. The rising housing prices created an expectation that housing values would continue to rise, leading home buyers to pay more for housing than the housing was actually worth. This self-fulfilling cycle continued until the median price of housing outgrew median incomes, peaking in about 2005.

When the growth became unsustainable in 2006, the housing bubble " burst". Before the rapid rise, followed by a sharp fall in housing prices, which will greatly exceed the mortgage debt, the translation of the value of the property. 2. 2 High-risk mortgage loans In the years before the crisis, the behavior of lenders changed dramatically. Lenders offered more and more loans to higher-risk borrowers, including undocumented immigrants. Subprime mortgages amounted to $35 billion in 1994, 9% in 1996, $160 billion in 1999, and $600 billion in 2006.

A study by the Federal Reserve found that the average difference between subprime and prime mortgage interest rates declined significantly between 2001 and 2007. Decline in risk premiums and credit standards are common to the combination of the credit boom and bust cycles. In addition to considering higher-risk borrowers, lenders have offered increasingly risky loan options and borrowing incentives. In 2005, the median down payment for first-time home buyers was 2%, with 43% of those buyers making no down payment whatsoever. By comparison, China has down payment requirements that exceed 20%, with higher amounts for non-primary residences.

The mortgage qualification guidelines began to change. At first, the stated income, verified assets loans came out. Proof of income was no longer needed. Borrowers just needed to " state" it and show that they had money in the bank. Then, the no income, verified assets loans came out. The lender no longer required proof of employment. Borrowers just needed to show proof of money in their bank accounts. The qualification guidelines kept getting looser in order to produce more mortgages and more securities. This led to the creation of NINA. NINA is an abbreviation of No Income No Assets.

Basically, NINA loans are official loan products and let you borrow money without having to prove or even state any owned assets. All that was required for a mortgage was a credit score. 2. 3 Mortgage fraud In 2004, the Federal Bureau of Investigation warned of an “ epidemic” in mortgage fraud, an important credit risk of nonprime mortgage lending, they said, could lead to “ a problem that could have as much impact as the S&L crisis”. The Financial Crisis Inquiry Commission reported in January 2011, that: “... mortgage fraud... flourished in anenvironmentof collapsing lending standards and lax regulation.

The number of suspicious activity reports—reports of possible financial crimes filed by depository banks and their affiliates—related to mortgage fraud grew 20-fold between 1996 and 2005 and then more than doubled again between 2005 and 2009. One study places the losses resulting from fraud on mortgage loans made between 2005 and 2007 at $112 billion. Lenders made loans that they knew borrowers could not afford and that could cause massive losses to investors in mortgage securities. ” New York State prosecutors are examining whether eight banks hoodwinked credit ratings agencies, to inflate the grades of subprime-linked investments.

The Securities and Exchange Commission, the Justice Department, the United States attorney’s office and more are examining how banks created, rated, sold and traded mortgage securities that turned out to be some of the worst investments ever devised. In 2010, virtually all of the investigations, criminal as well as civil, are in their early stages. 2. 4 Credit default swaps Credit default swaps are financial instruments used as a hedge and protection for debtholders, in particular MBS investors, from the risk of default.

As the net worth of banks and other financial institutions deteriorated because of losses related to subprime mortgages, the likelihood increased that those providing the protection would have to pay their counterparties. This caused the system uncertainty, investors did not know which company would be required to pay to cover the mortgage defaults. When investment bank Lehman Brothers went bankrupt in September 2008, there was much uncertainty as to which financial firms would be required to honor the Credit default swaps contracts on its $600 billion of bonds outstanding.

Merrill Lynch’s large losses in 2008 were attributed in part to the drop in value of its unhedged portfolio of collateralized debt obligations after AIG ceased offering Credit default swaps on Merrill’s collateralized debt obligations. The loss of confidence of trading partners in Merrill Lynch’s solvency and its ability to refinance its short-term debt led to its acquisition by the Bank of America. 2. 5 Boom and collapse of the shadow banking system The securitization markets supported by the shadow banking system started to close down in the spring of 2007 and nearly shut-down in the fall of 2008.

More than a third of the private credit markets can not be uesd as a source of funds. According to the Brookings Institution, the traditional banking system does not have the capital to close this gap as of June 2009: “ It would take a number of years of strong profits to generate sufficient capital to support that additional lending volume. ” The authors also indicate that some forms of securitization are “ likely to vanish forever, having been an artifact of excessively loose credit conditions. ” 3. Impacts 3. 1 Impact on the US

The credit market is likely to respond with tighter lending standards, fewer warehouse subprime mortgage lines, fewer subprime lenders, and greater self-regulation and reformation, most of which will be driven by the securitization market to the extent that it still exists. There may be an urge to proactively modify loans that would likely result in default. The increased pressure from the government and consumer groups, combined with new subprime lending standards, will decrease lenders' willingness to lend to nonprime borrowers and investors' willingness to participate in subprime loan securitization.

The result has been and will continue to be a " credit crunch" for subprime borrowers. The result will decrease availability of subprime lending, which in turn, will decrease homeownership among low-income or minority borrowers. When the housing bubble began to deflate in 2006, borrowers saw a sharp reduction in the value of their homes, and found themselves in a position of " negative equity", or a mortgage debt that far exceeded the value of the mortgaged home. Because homeownership is the single most important source of wealth, this meant many Americans experienced a dramatic loss in personal wealth.

The decline in home prices has cost American homeowners more than 4 trillion dollars in wealth, and as previously noted, has cost African Americans alone between $71 and $122 billion. The decrease in home values not only caused homeowners, but also communities, to lose wealth. As a result of foreclosure, surrounding house values have declined. Neighbors matter when it comes to putting a value on homes. Appraisers use comparable sales data to calculate the value of a home, which lenders require for selling and refinancing.

Comparable sales in the community to reduce problems of all foreclosure houses, where in a position to sell the owner is not a pleasant option value. In addition, the borrower becomes unable to refinance at lower interest rates, this will cause even more foreclosures. 3. 2 Impact on the Chinese economy The US credit crunch has played out in the Chinese housing market. The house price movements in China, the US and the UK have moved synchronically, with the Chinese market lagging a bit behind the two developed countries.

The market condition of China at the start of 2008 was similar to the US market during the first half of 2007, when the house prices began to drop. House prices in China increased sharply and even doubled during 2006-2008 in some fast developed cities. The Chinese National Development and Reform Commission showed that the House Price Index of 70 Large- and Medium-sized Cities in China rose 6. 5% in 2008, 1. 1% lower than the previous year. Meanwhile, the interest rate adjustment is widely used as a monetary instrument by most central banks to manage their national economies.

From January 2001 to 2003, the US Federal Reserve cut the interest rate from 6. 5% to 1% to boost the economy . Cheap credit overheated the US housing market quickly. Consequently, the Federal Reserve raised interest rates to cool the market. This U-turn in interest rate policy was the catalyst for the crash in the housing market that accelerated from 2006 onwards. 4.

Regulatory proposals and long-term solutions President Barack Obama and key advisers introduced a series of regulatory proposals in June 2009.

The proposals address consumer protection, executive pay, bank financial cushions or capital requirements, expanded regulation of the shadow banking system and derivatives, and enhanced authority for the Federal Reserve to safely wind-down systemically important institutions, among others. The Dodd–Frank Wall Street Reform and Consumer Protection Act was signed into law in July 2010 to address some of the causes of the crisis. 4. 1 State and Local Action Increasingly, state and local governments have taken action responding to the foreclosure crisis through a combination of municipal litigation and anti-predatory lending bills.

Baltimore and Cleveland initiated public nuisance suits against prominent lenders last year for targeting their communities through predatory lending. These cases may have an important role in providing meaningful, timely relief for a large number of homeowners who are in default or on the verge of default. In addition, over 25 states have initiated anti-predatory lending legislation triggered by North Carolina’s successful legislation enacted in 1999 and 2000. However, state legislation is limited due to federal anti-predatory lending statutes preempting state action.

The Baltimore complaint, in particular, stresses the racialized impact of predatory lending. Two-thirds of the foreclosures associated with Wells Fargo lending were in census tracts with over 60% African American populations, while less than 16% were in tracts with less than 20% African American residents. 4. 2 Federal Legislative Actions Over the last year, Congress has introduced a variety of proposals designed to address the crisis, from increased funding for housing counseling and consumereducationto empowering bankruptcy judges to unilaterally change the terms of existing mortgages to bail-out distressed borrowers.

Federal and state regulators are following suit with guidance and restrictions on some prime lending. There has been an increase in litigation related to the subprime lending market based on discriminatory predatory lending, an increased call for “ suitability standards” in mortgage lending, and more non-consumer law suits, such as investors suing issuers, lenders suing brokers, and investors suing lenders. This comprehensive legislation includes the Federal HousingFinanceRegulatory Reform Act, The Hope for Homeowners Act, and the Foreclosure Prevention Act.

The Federal Housing Finance Regulatory Reform Act provides regulation for government sponsored entities such as Fannie Mae and Freddie Mac and the Federal Home Loan Banks. This regulator will have the authority to establish capital standards, prudential management standards; enforce its order through cease and desist authority, civil money penalties and the authority to remove officers and directors; restrict asset growth and capital distributions for undercapitalized institutions; put a regulated entity into receivership; and review and approve new product offerings of the enterprises.

Conclusion This subprime mortgage crisis demonstrated a lesson for the world. Every financial institution and company learned an expensive lessen from it. Every country learned what they should do and what they should avoid in the future. Moreover, each individual also learned the norm, the ethics, and the responsibilities that they need to follow and take in business practice. One important thing to remember is to not be too obsessed and greedy about anything.