

Subprime crisis essay sample



**ASSIGN
BUSTER**

The terminology subprime is used in the financial sector to mean the loans that are awarded to individuals or organisations who have not qualified as per to the set standards for the prime loans. The financial institutions provide loan to individuals who do not qualify for the optimal market interest just on the reason that the financial institutions want to beat their credit score and more especially in the case where the prime loans are insufficient to meet their credit score. The subprime loans are perceived as being risk than the prime loans in the sense that individuals who are awarded subprime loans do not have a well establish economic history that will promise adequate serving of their loans. The financial institutions normally provides subprime loans at a higher interest late compared to the prime loans interest rate because of the risks that are contained in the subprime loans. Therefore the high interest rate can be seen as a way of discouraging subprime loan in comparison to the prime loans.

The term subprime crisis is used to describe a situation in which the subprime borrowers default to service their loans on the reason that their financial state can not allow them to. This situation was evident in the United States starting from the late 2006, which all together affected whole world in the 2007 and 2008. This subprime crisis in the United states of America it arose as a result of subprime borrowers defaulting to repay their loans and more especially the housing mortgages, which resulted to an increased number of foreclosure activities. The subprime crisis in the United States mostly involved the housing mortgages in which the subprime borrowers had made an inaccurate focus, believing that the prices of houses were to arise.

They believed in the rise of the prices of houses just from the previous longterm trend which had reflected a continuous rise in the houses price, which later turned to be the reverse. Their expectations in the rise of prices made them to take loans on either constructing or purchasing houses, believing that they will be able to service their loans from the property acquired which turned tragic. This situation was at its optimum state in 2006. It is reported to have caused banks and other financial institution a loss of almost US \$ 379 as at May 21st 2008 (Soros 2008). The other group that suffered from the losses caused by the subprime crisis include individuals and co-operate institutions that has held mortgage backed securities because the value of the securities declined in that even if they were to sell them, they are likely to sell them at a loss. This individuals and co-operate organisations normally hold this mortgage backed securities in the process of securitization as a risk management strategy adapted by financial institutions.

The subprime crisis had a great effect on the banking sector as it affected the lending and the borrowing trend within the banking operations, by providing a disincentive for more borrowing. The lending activities declined, and it was caused by the increase in the borrowing interest rates which discouraged borrowers from borrowing as it was perceived to quite expense thus uneconomical. The crisis also came to the concern of the various governments central banks in them advising their member commercial banks to offer credit selectively, that is credit was to be offered only to individuals and organisations with good economic soundness. The crisis had

an adverse impact on the economic growths of various economies and this impact arose from the causal effects from the increased interest rates.

The increased interest rates normally affect the level of investments negatively, because high interest rates are likely to discourage borrowing thus less funds available for investing. Economic growth heavily depends on the level of investment, and when investments decline, the economic growth is certain to decrease. Investments also affect the level of employment in a given economy, and in this the lowered investment rate leads to an increased level of unemployment in the economy due to the impact of subprime crisis on investments. The high unemployment level affects the average personal income levels in an economy and as such the purchasing power of the consumers will be lowered hence low economic welfare among the citizenry and also low demands for the produced goods which affects the firms' profitability negatively. Therefore the effects of subprime crisis are cyclical in nature thus harmful to the economy.

Various factors played varied roles in the subprime crisis, and they include securitization, credit quality, Due diligence, financial regulations, monetary policy and non-bank institutions, Their roles are as discussed below;

Securitization is a risk management strategy in which financial organisations then to reduce the risks involved in the loans that they offer. It's a financial process that involves pooling together financial assets that can have cash flow, and then repackaging these securities which are later sold to the ultimate user of the security. The reason behind securitization is to avoid the financial institutions from going bankrupt, thus lessening the risks

involved in mortgages. Another reason for securitization is uplifting of the credit quality of the portfolio, and in that the borrower's financial soundness is compromised in enabling him or her to attain the credit regardless the inability to beat the prime guidelines. In the process of securitization, the mortgage lenders normally securitize their mortgage loans in them issuing the mortgage backed securities to capital market investors.

The mortgage backed security holder is the ultimate owner of the loan, with a undivided interest in the mortgage pool. The borrower normally makes his or her down payments and the interest and then the funds are transferred to the capital investor. The capital investor is entitled to a consisted payment schedule which is normally agreed on the seal of the transaction and the mortgage backed security holder is entitled to receive the future cash payments from the borrower, he or she acts as a mediator between the borrower and the capital asset investor. The pattern in which the mortgage backed security holder receives cash from the borrower does not need to be the same as the one in which he or she pays the capital investor and agreements that exists between the mortgage security holder and the capital investor is different from the agreement laid between the borrower and mortgage backed security holder.

Securitization played a great role in causing subprime crisis because it enhanced the subprime borrowers to access credit easily in them acquiring assets. This was made possible, because the the mortgage backed security holders repackaged the loans in some way in which the subprime borrowers can qualify, thus it can be seen as a loop hole that encouraged subprime crisis. The borrowers were certain to default repaying their loans or at times

proceeding to foreclosure activities, because their financial history was not worth such loans as they never had the abilities to service the loans borrowed. This defaults and foreclosures accounts for losses and harm that was caused by subprime crisis which emanated from the process of securitization. The mortgage backed security holders stood a chance of getting losses when the value of the security assets went down, while they meant to adhere to the agreements which were set on sealing the transaction, thus likely to sell the assets at a loss.

Credit quality is also another factor that had an impact in causing the subprime crisis. The procedure that is used to analyse the credit worthiness is important in an attempt to identify the possible defaulters and individuals who are likely to encourage foreclosure activities if guaranteed loan. The best method to evaluate the credit quality of a given is to look at the borrower's financial soundness and also his or her financial history. These two factors are likely to justify the ability of a borrower to repay the loan extended to him or her. In the evaluation of the credit quality, the lender tries to consider the risks that are inherent in the loan that is to be awarded to the borrower. The poor assessment of the credit quality accelerated the number of defaulted loans and also the foreclosure activities, therefore if it were not that there existed bogus credit quality evaluation procedures, subprime crisis was a situation that was avoidable because loan was granted even to those customers whose financial position were unsatisfactory to be granted a loan.

Due Diligence is the process in which one engages himself or herself in analysing the benefits and losses that are in an investment before entering

<https://assignbuster.com/subprime-crisis-essay-sample/>

in an agreement of purchasing an asset. It provides an opportunity of evaluating the viability of the investment before entering into an agreement. Subprime crisis can be associated to inadequate due diligence by both the lenders and the borrowers. The lenders did not analyse properly on the kind of investment in which they were putting their funds in, because the funds in which they lent fall on the hands of incapable borrowers who were unable to service their loans, thus a bad investment.

The lenders could have invested the funds in other viable investments other than lending, on them lacking sufficient prime borrowers in the process of hitting their credit scores, other this would not have happened if they had evaluated the investment properly before making an agreements with the borrowers. The borrowers also failed to apply their due diligence properly as they did not consider the risks that were involved in them investing the loan acquired in low paying assets. They rather made their decisions relying only on the previous trend hoping that the trend was to hold, without considering other factors like the overcrowding of house ownerships, as all persons were focused in investing in houses. Therefore subprime crisis could have been prevented if more rational decisions were made by both the borrowers and the lenders.

Financial regulations is also another factor that had the powers to either prevent or accelerate defaults and foreclosure activities. The Financial regulations are meant to subject banks and other financial institutions to adhere to certain set rule and regulation in enhancing smooth running of the banking sector. The main role of the financial regulation in hold the public confidence over the banking system, in ensuring a fair play in the banking

industry. The financial regulations within their context, can be designed in some way in an attempt to control the credit extension among the banks, and in this case by setting some standards for a borrower to qualify for loan and also limiting the amount of loan which can be extended a given borrower given his or her financial history. It is due to the inadequacies that are contained in the financial regulations that provided an uncoordinated award of credit to borrowers and also the issue of a lot of liberty given to the financial institutions which results to conflicting goals among the financial institutions. This situation gave the financial institutions an incentive of them extending subprime loans without considering its effects because of their competing goals which as they were never limited by the financial regulations in engaging in such unreasonable operations. Thus the financial regulations also to some degree contributed to the emergence of the subprime crisis.

The monetary policy of any economy through its specialized interventions , it has the role of controlling demand for money, supply for money and also fixing of interest rates. The excess supply of money will reduce the interest rates thus encouraging borrowing from commercial banks. The Central bank through its role in determining the money supply and money demand, it failed in controlling the emergence of the subprime crisis which is was a problem within its scope. The excess money supply enhanced surplus funds in financial institutions which gave them an incentive of giving out more cash in the form of loans. The excess cash made them to misappropriate their reserves. A low cash reserve ratio imposed by the central bank also enables banks to have unnecessary surpluses in their reserves thus a loop hole for

extending more loans. Therefore the central bank contributed to the emergence of the subprime crisis.

The non bank institutions also in some way accelerated the emergence of subprime crisis and more especially the the non bank financial institutions. This non bank institutions acted as a link between banks and the subprime borrowers, because they borrowed money form banks at a prime loan interest rates and then extended the same funds acquired to the subprime borrowers but at a higher interest rate on which they can be able to make profits. Their profit motive was given first priority other than considering the risks that are inherent in the loans that they extended, and this gave an opportunity for the happening of defaults an foreclosure activities thus accelerating the subprime crisis. These defaults are also transferred to the non bank institutions also defaulting to pay the loans that were extended to them from the commercial bank thus the arise of the subprime crisis.

Given the above discussed factors there are some which were very important in causing the subprime crisis and they include; the monetary policy, Financial regulations and also due diligence. The factors with least effect include the non bank institution, credit quality and securitization. The subprime crisis in a monetary problem and such monetary solutions are required which makes monetary policy the main factor to blame. Through excess supply of money, motivated high demand for money and also a lowered cash reserve ratio promoted the happening of the subprime crisis. The bogus financial regulations also promoted the emergence of the subprime crisis in the sense that banks were given a lot of liberty with their conflicting interests that lead to extension of loans to unqualified persons.

The poor due diligence of both the borrowers and the lenders also promoted the happening of the subprime crisis, in the sense that they focused incorrectly on the basis of an inappropriate analysis.

Modern banking is exposed to regular failure and crisis in the because the banking sector is not independent as there are factors out of their control which affects the banking sector of which some are within its reach but unable to act upon them. The banking sector is always controlled by the government of the day and always the government utilizes the banking sector in achieving their objectives with less interest on the effects of their act on the banking sector by such unnecessary and unreasonable interventions. Governments are likely guarantee loan to some projects which does not qualify for prime loans.

The default of this projects not repaying the loan is also backed by government because the loan was awarded at the interest of the government on it trying to achieve its objective, and it also happens to be unrealistic when on taking serious legal actions on such projects because they were initiated by the very government that has also the powers to make the judgement. This situation affects the banking sector because the funds which could have otherwise been invested in viable investments are redirected to non viable investments. The Banking sector is also affected by political interferences depending on the political stability of one given country, and this involves appointments and varied interests of political groups, thus political groupings is likely to interfere with the operations of the banking sector. Lack of banking sector autonomy that is certain to arise from the above factors will disable the banking sector from adapting the <https://assignbuster.com/subprime-crisis-essay-sample/>

appropriate risk management strategies and also the making of sound investment decisions. This situation is inevitable because of the societal structure where the government has a sole power over the monetary system and it can only be solved if there happens to be constitutional amendments that are to make the banking sector autonomous.

The subprime crisis can be seen to be equivalent to the Great depression of 1929 to 1933, which resulted from the collapse of the United States stock market. The great depression was characterized by a decline in international trade, high unemployment levels, low personal incomes, low tax revenues to governments, low prices of goods, low profits in firms, decline in construction and fall in agricultural products prices among other features. The emergence of the great depressions is attributed to failure of the federal reserve to take the necessary precaution in avoiding its emergence. The equivalence of the subprime crisis can be explained as given below; The subprime crisis can be equated to the Great depression because of its effect on investments, where investments are believed to be the major determinant of economic growth.

Subprime crisis will lead to increase in interest rates on financial institutions trying to reduce the risk of lending, where this will affect the overall borrowing hence reducing the amount of money available for investments. Low investments arising from the increased interest rates will adversely affect the employment level negatively. The low employment levels resulting from low investments will lead to low personal income and hence low income tax to service the government activities. Low prices for goods are expected because the purchasing power of consumers in the economy have been

crippled by low personal incomes and even if income was high for some consumers in the economy, there will be high dependency level. Firms are expected to be recording low profits because of the reduced purchasing powers that emanates from reduced personal incomes through the reduced demand for goods and services. There will be less construction due to inadequate credit accessibility in buying the construction materials and also there is no incentive for constructing as the prices of housing are likely to decline. Therefore it is a kind of causal effects that starts with the increase of interest rates and then other effects follow.

Conclusion. The subprime crisis is a monetary crisis that arose from the default of borrowers serving their loans. It occurred due to the fall of prices of houses. The blame for the emergence of this phenomena can be associated to some factors which gave an incentive to banks and other financial institutions to extend subprime loans to borrowers with unsound financial history which increased the possibilities of their being either defaults or foreclosure activities. The factors include the bogus financial institutions, inappropriate monetary policy, poor assessment of the credit qualities, securitization, inappropriate due diligence and also the non bank institutions. The subprime crisis can be equated to the great depression because its effects which are similar to the effects of the great depression. The modern banking sector is prone to constant crisis and failures because it is not autonomous in its operations.

Reference;

Soros G., 2008, The Paradigm for Financial Markets; The Credit Crisis of
2008, Perseus Books Group, pp 23