Causes and effects of the credit crunch

The words credit crunch have been all over the financial headlines in the UK, including the effects that has hit the financial markets both in the UK and in other parts of the world have been reflected in a number of ways, affecting both financial institutions(banks) and consumers. Several authors and regulators have showed their different views about the causes and effect of credit crunch. Many economists studying the credit crunch explain it as a cyclical fall in credit demand.

What is credit crunch?

Bernanke and Lown (1991) define a credit crunch as a decline in the supply of credit that is abnormally large for a given stage of the business cycle. Credit normally contracts during a recession, but an unusually large contraction could be seen as a credit crunch.

From Investopedia; credit crunches are usually considered to be an extension of recessions, also making it impossible for companies to borrow because lenders are scared of bankruptcies or defaults, which results in higher rates. The consequence is a prolonged recession (or slower recovery), which occurs as a result of the shrinking credit supply. The credit crunch is also known as the credit crisis and is represented by a reduction in the general availability of loans which leads to sudden tightening of the conditions required to obtain a loan/credit from banks.

Also, a broader definition of a credit crunch has been summarized by the Council of Economic Advisers (1992): A credit crunch occurs when the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects.

Amongst the things affected in the UK as a result of the credit crunch are:

Liquidity:

The atypical flow of money looking for a home went into the West's economies. Trade surpluses were recycled in the early part of the decade. This stimulated the " search for production of labor" and, in turn, the uncertainty in price of risk as investors imagined the high returns they were offered were safer than they proved. E. g. In September 2007, during the financial crisis of 2007-2010, the Bank had borrowed from the Bank of England a sum of about £13 billion, a liquidity support facility, this showed that the total amount was a loss of deposits. which followed problems in the credit markets caused by the US sub- prime mortgage financial crisis. And it was of great shock that could be avoided to the bringing down of Northern Rock was a risk. However, the result of two unsuccessful offers to take over the bank, not being able to achieve the repayment of taxpayers' money. This made the Government immediately take possession, away from its shareholders. Also reported cases showed some shareholders had their life savings in the shares, which were taken from them.

Sub-prime lending:

This covers different types of credit, including mortgages, auto loans, and credit cards.

Sub-prime loans allows the opportunity for borrowers with a less-than-ideal credit record (considered as people with bad credit history)to be home owner. Some of theses lenders may use the credit in purchasing homes, sometimes in financing other types of spendings e. g. paying for living expenses, remodelling a home, or even paying down on a high-interest credit card or purchasing a car. Sub-prime lending (mortgages to be precise)provides a method of “ credit repair”. Also with the interest rates low and liquidity in plentiful supply, financial institutions and businesses did not bother with adequate checks before, lending billions, who they realise could not afford repayments when some of this types of credits came with high interest rates, increased fees and costs which was a major cause for credit crunch.

Sub- prime lending became popular in the U. S. in the mid-1990s, with outstanding debt increasing from $33 billion in 1993 to $332 billion in 2003.

The cause for the crisis was an increase in sub- prime mortgage defaults, which was first noted in 2007. If general principle of lending : CAMPARI model, which could be used to determine whether a loan or overdraft proposal is a good idea or not and to satisfy it will require:

Character: The willingness to pay versus the ability to pay, which sometimes can be from the length of time the customer(s) has been with the bank.

Ability to repay: Adequate cash flow to meet repayment, which can be the age, the health

and dependence of the borrower.

Margin of finance: The lender borrowers must introduce a certain level of commitment, since the lender will not grants total financing.

Purpose: The borrowing purpose must be clearly defined and supported by relevant

documents; speculative reasons are considered risky.

Amount: The amount of commitment the bank is prepared to take a risk on the applicant

. e. g. Before the era of credit crunch, banks would lend 3 times the gross income of the customer.

Repayment terms: is considered as the most important, as this is the structure and terms of the repayment.

Insurance / Security: this could be seen as a second line of defence incase the main source of repayments fail(s), there is a pay-out source.

Securitisation

Black׳s Law Dictionary defines securitisation as a structured finance process in which

assets, receivables or financial instruments are acquired, classified into pools and offered

as collateral for third-party investment.

Due to securitisation, investor long for mortgage-backed securities (MBS) and the tendency of rating agencies to give investment-grade ratings to MBS, loans with a high risk of default could be provided, packaged and the risk readily transferred to others. Although, the problems arises when the customers defaults. This is a cause of credit crunch as banks lent to poor customers (sub-prime customers) who could default.

Increase in unemployment:

In a country like the United Kingdom, the effect of credit crunch cuts deeply into all societies especially with migrants in the country and who also work in the UK. The security for jobs are very slim as credit crunch holds a tolls, where people’s services are not needed any more as some businesses affected by the crunch are less effective or productive. Immigrants are more likely than the native born to be affected by the economic crisis. Most times, they are more likely to be fired first and they tend to have higher unemployment rates than their native counterparts.

Experience selective layoffs and discrimination in the labor market occurs, a trend that is likely to occur during an economic downturns.

Reduced standard of living / Lower income:

This threaten funding and raise difficult options e. g. customers and businesses confidence are low due to the uncertainty of the economy by spending their money.

Also, as the demand for council services increase, local authorities income drops, this is due to public deficit leading to constraints on all public spending; Loss of fees from planning receipts; Reduced income from section 106; Increased concessionary travel; Higher utilities costs; Pension increases; Reduction in prices for recyclable materials which leads to a sizeable reductions in income. E. g. Newcastle City Council expect reductions in capital receipt income of approximately £20m over the next three years.

Government bailout: This meant that the markets / businesses own stabilization mechanisms looks to be undermined by the implicit promise of government intervention if it were needed. Many businesses, in many cases, prefer to outsmart the regulatory authorities this is to secure bailouts or favourable terms instead of having losses.

Recessions: A period of general economic fall, this could be said to be a fall in gross development product(GDP) for two or more consecutive quarters. This is usually

either from the drop in stock market, and decline in housing market.

Increased Taxation: People in their various jobs in the current credit crunch era are suffering from the constant increase of tax on their income(s) by the Government.

Many UK businesses (53%), do not think the regulatory and taxation environment is business friendly, as they also face several barriers to business growth, and one key area highlighted by more than half is the UK regulatory and taxation environment as smaller businesses struggle the most with red tape.

Regulatory burden

Conclusion.

A key uncertainty facing the UK economy at present is how far the effects of the recent credit crunch will spill over from banks and other financial institutions to the rest of the economy.

The recessions come and go and the markets can and do recover if given enough time.