

# [Mortgage meltdown](https://assignbuster.com/mortgage-meltdown/)

The mortgage meltdown, otherwise known as subprime crisis, promises to have far reaching consequences on the socio-economic fabric of the entire world. The housing market in the United States witnessed a speculative bubble since 2006 and its collapse has adversely impacted not only credit markets of the United States, but has extended itself to the international markets leading to a economic conditions akin to theGreat Depression.

One of the leading causes of the crisis is the subprime lending practices, which involve loans offered at rates greater than prime rates to the individuals who have poor credit rating (Krinsman, 2007). Though subprime lending practices are viewed as ethical, the risks involved increased greatly when these practices turned predatory. Predatory lending practices are identified as subprime loans to which illegal and unethical practices are applied (Lander et al. , 2009). In addition to subprime and predatory lending, a growth was also seen in Alt-A loans and adjustable rate mortgages (ARM).

Alt-A loans are loans which are provided to borrowers with good credit history but with higher loan-to-value ratio and/or inadequate documentation provided by the borrower, also known as stated, reduced documentation or no documentation loans. The bursting of the housing bubble led to increased interest rates and decreased value of the properties, which caused reduced liquidity of the lenders, cascading to the mortgage meltdown. Many factors are attributed to the subprime crisis.

From a detailed discussion of these factors, it can be observed that precautionary measures could have been implemented that might have at least minimized the effect of the subprime crisis, if not prevent it completely. A major factor is seen as the rise of new lenders who were not regulated as traditional financial institutions were. The rise in subprime loans is primarily attributed to these unregulated lenders. Investments involving high risk in the form of asset-backed securities (ABS) and mortgage-backed securities (MBS), based largely on subprime loans, increased due to the promise of higher returns.

Repealing the Glass-Steagall Act (Heakal, n. d. ) led to deregulation of the financial institutions, posing a moral hazard due to relaxed standards. Also the Federal Reserve could have imposed restrictions on ARMs and Alt-A loans under the Home Ownership and Equity Protection Act (HOEPA) of 1994, which would have minimized the losses due to MBS and credit-defaults. External regulation of the lending organizations could have possibly influenced the financial organizations in controlling the kind of loans and investment options offered, thus reducing the risk posed by subprime loans and investments in ABS and MBS.

The lack of stringent regulatory standards for lending organizations led to an increased moral hazard. The lending agencies failed to undertakeresponsibilityfor the high-risk loans and investment options offered by them. The presence and enforcement of internal regulations within a lending organization could have reduced the risk due to moral hazards. Securitization of the subprime loans is seen as another factor that has led to the crisis (Krinsman, 2007). This originated a demand for MBS based investments which in turn led to loans with a high risk of default.

Securitization helped create a secondary market for mortgages by passing on the risks of credit, asset price and liquidity to investors, thus increasing the risk of moral hazard posed by the lenders. The demand for MBS based investments can also be attributed to the credit rating agencies which often parted with investment-grade rating for MBS, though there was very little historical data available to evaluate the securities backed by subprime loans. The investments were justified by the ratings given to the securities and the ratings in turn were justified using the increase in investments as proof.

In hindsight, the higher ratings offered to high-risk investments are observed to have arisen from conflicts of interest. The lack of regulation by the Securities and Exchange Commission (SEC) and a reduction of the disclosure requirements are observed to have abetted the credit rating agencies’ indiscriminate rating practices. The government policy of deregulation and the repeal of the Glass-Steagall Act in 1999, as discussed earlier, are seen as a factor contributing to the subprime crisis.

Resulting in a segregation of the commercial and investment banking industries and lack of adequate regulation in the securities industry, excessive undertaking of risks is observed to be a byproduct of deregulation. Also the increased investments in the high risk securities by the government sponsored enterprises (GSEs) acted as a trigger for further high risk investments. A discussion of the factors that have primarily lead to the subprime crisis indicates that precautionary measures could have prevented the crisis from occurring on such a large scale.

Prudent investigation by the investors into the securities they were investing in, instead of blindly relying on the credit rating agencies, could have possibly negated the burgeoning demand for MBS based on subprime loans. Adequate regulatory measures imposed on the financial institutions and credit rating agencies – internally within the organization and externally in the form of measures imposed by the government, Federal Reserve and central bank, would have largely minimized the effects of the burst in the housing bubble and the subprime crisis that followed it.

References Heakal, Reem. (n. d. ) What was the Glass-Steagall act? Retrieved March 09, 2009 from http://www. investopedia. com/articles/03/071603. asp Krinsman, Allen N. (2007). Subprime mortgage meltdown: How did it happen and how will it end? The Journal of StructuredFinance, 13(2), 13-19. Lander, Gerald H. , Barker, Katherine, Zabeline, Margarita and Williams, Tiffany A. (2009) Subprime mortgage tremors: An international issue. International Advances in Economic Research, 15(1), 1-16.