

# [The credit crunch](https://assignbuster.com/the-credit-crunch-2/)

The economy in the United States and around the world stopped in its tracks.

The lifeblood of the financial system, credit, began to boil. The story of the worst economic crisis begins the day after September 11, 2001. The economy was already hurt from the dot com bubble burst. After 9/11 Alan Greenspan, Chairman of the Federal Reserve, flew over the southern tip of New York City and said, ??? I was very much concerned we are in the throws of something we have never seen before.??? Alan Greenspan was right, something he has never seen before was about to happen. The people of America stopped spending, as there was news of more terrorist attacks on the way and investors continued to see billions of dollars disappear.

One tool the Federal Reserve used was to change the money supply by increasing or decreasing the discount rate. Greenspan lowered the interest rates the Reserve loaned to banks so banks could loan more. This strategy worked, because borrowing more money became more attractive and Americans started spending more again.

The lower interest rates made borrowing more appealing, but the demand for homes increased causing the prices of homes to increase a lot faster than incomes. If prices kept rising and people could not get enough money to buy these homes, the demand for houses will fall and the housing market will slow down. As a result, Veterans of the mortgage business were thinking up new ways to allow loans for everyone. Lenders didn??™t want to say no. According to Bill Dallas, obtaining a mortgage use to take 90 days when lenders would shake down potential borrowers to make sure they were going to get paid back. Freddie Mae and Freddie Mac were created by Congress to increase home ownership.

They would buy mortgage loans from loan companies and they dominated the mortgage back securities. Rules were strict and only bought mortgages from homeowners who could pay back their loans. Loaners in California wanted to change who they could lend to. They got their chance when Freddie and Fannie were caught in accounting scandals and loss their dominant role in the mortgage business. Essentially, there were in the penalty box. With Freddie and Fannie in the penalty box, loaner Bill Dallas needed someone to take the cash that will be more willing to bend the rules??” Wall Street.

Wall Street had cash and was willing to buy any loan, prime or subprime, from loan officers. According to Michael Francis, the mortgage market caught fire because the world was flush with cash. Wall Street liked this because it had securities back by American homes and American borrowers. Quick Loan Funding (QLF), created by Daniel Sadeck, emerged and targeted sub prime borrowers with credit below five hundred. QLF allowed people to state their income. Fundamentally, this means people who don??™t qualify for a loan will lie about their income because it is stated. If these people showed their tax records, they wouldn??™t qualify. This essentially removed the litmus test of verifying assets so lenders could start giving mortgages to anyone with a pulse.

Leading to the rise of the house of cards. In 2002, the Bush Administration pushed new opportunities for people to get loans. Alan Greenspan encouraged the mortgage industry to come up with new kinds of loans so more people can buy homes. Unfortunately an inappropriate popular program known as a ??? pay option negative amortization adjustable rate mortgage??? came to exist. This was designed to help first time homebuyers who could not actually afford the cost of the loan. They would have the option to pay part of the interest each month, and the unpaid interest was added to the principal. So people would be paying it up instead of paying in down.

This seemed acceptable as long as home prices went up. The rating agencies that deemed loans risky or safe began to get caught up in the house of cards. Rating agencies such as Moody??™s, Standard and Poor, and Fitch give investment grades, AAA being the safest and BBB being the riskiest. While making enormous profits, the rating agencies were concerned if they didn??™t give favorable ratings, they will not get business in the future. It became a repeated gain: I am going to take care of you for repeated business.

Revenues for rating agencies shot up and competed for the banks business. No one was paying attention to the ratings. With the Rating agencies on board, banks were happy to oblige.

So they packaged up a collaterized debt option (CDO). The way it works is individual mortgages are pooled to make a mortgage backed security and banks take different pieces of the mortgage backed security and create a CDO. By owning pieces of so many homes that prices were thought to never go down, what could go wrong With CDO??™s backed by AAA ratings, investors started to invest without knowledge of the particulars of the very complicated structured products known as CDOs. The CDO convinced investors around the world and worked like a charm. Because housing prices continued to grow, buying and selling homes for profit, or ??? flipping??? became a common profession. Housing kept the economy afloat, and between 2001 and 2005, the housing market created 800, 000 jobs and stimulated the economy. By that time, sub-prime mortgages accounted for 20 percent of all mortgages in the country.

Even fed chairman Alan Greenspan admitted that he did not realize the extent of the housing bubble. However, he said that even if he did know, there is not much that the fed could have done to prevent the bubble, unless it were to create a 10 percent unemployment rate, causing a weak economy. America was looking to be on top. The highest numbers of people had homes, unemployment was low, and housing prices were skyrocketing. The regulators of the mortgage business were not asking questions. Nevertheless, the boom was not looking as euphoric as it seemed.

When mortgage backed securities were deemed worthless and CDOs failed, the housing bubble burst, the so-called ??? House of Cards??? came down. The only person that saw it coming was an investor named Kyle Bass. He invested a billion dollars in Credit protection, a sort of insurance on mortgage-backed securities. If people were to stop paying their mortgages, the insurance would pay out, and Bass would make money. As the mortgage market collapsed, Bass??™ hedge fund grew 600%.

Sub-Prime loans began to default, and loan companies began to fail. Rising delinquencies also caused Wall Street firms to lose money on their mortgage-backed securities. Wall street firms then stopped buying mortgages from firms like Ownit. Without money from Wall Street, those firms shut down. Without those firms, mortgage credit began to dry up, and new buyers could not get home loans. Without new buyers, housing prices stopped rising, and families with adjustable rate mortgages had no way to afford higher payments.

Families then lost their homes to foreclosure, and their credit deteriorated. Eventually, the House of Cards collapsed causing one of the worst credit crisis known to date.