Good essay on subprime lending

Business, Marketing

Introduction

Financial crises are generally protracted affairs. In most cases, the periods after a severe financial crisis have three similar characteristics. The first characteristic is that there is a deep and prolonged collapse of asset market. This means that the real prices of housing declines at an average of 35 percent. This decline is stretched over a period of more than six years. The price of equity also collapses at an average of 55 percent for over a period of three years. Secondly, there is a decline in the country's output and employment. In this case, unemployment rate rises at a rate of 7 percent and lasts for a period of fours and above while output decreases at an average of 9 percent lasting for a period of two years. The third common characteristic is explosion of the government debt sometimes rising to an average of 86 percent (Reinhart & Rogoff, 2009).

The diagram below shows how U. S. households and financial businesses increased borrowing in the years that were leading up to the crisis

Source: Financial Crisis Inquiry Commission Report

The subprime mortgage crisis or the mortgage meltdown became a reality to many when home foreclosures rose at an alarming rate and went out of control in the year 2007. The foreclosures triggered the national financial crisis. This financial crisis caused the consumer spending to go down while housing market plunged. The number of foreclosures continued to rise and stock market seriously shaken. Disagreement among the consumers, the lenders and legislators brought a debate over what caused the subprime mortgage crisis and the possible fixes, (Bianco, 2008). Many factors in which the major factor was subprime lending brought mortgage crisis.

Housing bubble is referred to as an economic bubble occurring in global or even global real estate markets. Housing bubble is characterized by sharp increases of real property valuations reaching to unsustainable levels in relation to the people’s income as well as other affordability indicators. After the rapid increase, there is a sharp decrease accompanied by mortgage debt that is usually higher than the actual values of these properties. During the bubble years, subprime borrowing was one of the major factors that caused the increase in the home ownership. The rate of ownership in U. S. increased from 64 percent recorded in 1994 to 69. 2 percent in 2004. This demand assisted to fuel the increase in home prices as well as consumer spending. This created the increase in home values to 124 percent in 1997 to 2006 (Murillo, Ghent & Owyang, 2012).

Homeowners increased the values of their properties in order to refinance their homes using the lower interest rates. Then they would take out the second mortgage against the value that they added to their properties to use it for consumer spending. Eventually, the household debt for the U. S. as a percentage of income went up to 130 percent in the year 2007. When the housing bubble collapsed, there were high default rates on subprime and other mortgage loans that were made to higher-risk borrowers who had lower income than the prime borrowers did. According to Forbes, compared to total originations, the share of subprime mortgages increase to 20 percent in the year 2006. Subprime mortgages stood at $600 billion in the year 2006. This accounted for one-fifth of the total U. S. home loan market. According to

2007 Federal Reserve study, the subprime and prime mortgage interest rates reduced from a percentage point of 2. 8 in 2001 to 1. 3 percentage points in the year 2007. Therefore, the risk premium that the lenders required in offering a subprime loan had reduced.

Source: Financial Crisis Inquiry Commission Report

This raises one major question. How did many weak and highly risky loans occur in this bubble? The origin of problems was the 1992 enactment of " affordable housing goals" by the Congress. These goals were meant to charter Fannie Mae and Freddie Mac to operate the secondary mortgages market. Ideally, the two companies were to buy mortgages from financial institutions as well as other originators of mortgages, they would then standardize these documents and then resell the mortgages to investors and other institutions. This was a way of creating the U. S. national market for mortgages (Financial Crisis Inquiry Commission Report, 2011).

In 1992, out of the total mortgages that Fannie and Freddie bought, 30 percent of those loans were from borrowers in the bracket of median income and below. The Department of Housing and Urban Development (HUD), kept adjusting this figure to 42 percent in 1995, in 2000 went up to 50 percent and 55 percent in 2007. Note that at 50 percent level, for every prime loan they acquired, Fannie and Freddie were required to acquire one goal eligible loan. Not all subprime loans were goal eligible. Therefore, they had to buy many subprime loans instead of prime loans in order to meet these goals. Because of this, the company held a credit risk amounting to 12 million subprime loans by the year 2008 (Wallison, 2011).

HUD put Fannie and Freddie Company into competition with Federal Housing

Administration (FHA) by tightening affordable housing goals. This is because; the explicit mission of FHA is to provide the low-income borrowers with credit. When these companies including FHA, insured banks as well as S&L are in competition of finding the loans to low income borrowers, deterioration in the underwriting standards was inevitable. For instance, in 1990, only one out of 200 mortgages that involved a 3 percent down payment. While by 2007, it was only one in less than three mortgages (Wachter, Pavlov & Pozsar, 2008).

The graph below indicates the growth in mortgage loan fraud based upon US Department of the Treasury Suspicious Activity Report Analysis.

Source: Financial Crisis Inquiry Commission Report

The graph below shows Number of residential properties set for foreclosure actions in U. S. by quarter (2007–2012).

Source: Financial Crisis Inquiry Commission Report

Subprime crisis was expected to cause reduction in earnings and investment banks experienced reduction in mortgage backed securities. Dow Jones Industrial Average closed above 14, 000 for the first time in July 19, 2007. By the end of August 2007, Dow was below 13, 000 while S&P went negative to date. This drop occurred in all markets in the world. There were large daily drops. For instance, Korea Composite Stock Price Index dropped 7 percent. Standard & Poor in United States had the largest daily drop of 500. All this was a direct cause of subprime. The real GDP contracted in U. S. in the year 2008, which did not come to growth until 2010. Unemployment rate rose to 10 percent from 5 percent. Banks, real estate investments trusts, mortgage lenders and other stakeholders all suffered big losses following the mortgage payment defaults as well as asset devaluation. By the end of 2007, financial institutions had recorded the losses exceeding $80 billion related to subprime.

The graph shows the real GDP for U. S. (components percentages contributions 2007-2009)

Source: Financial Crisis Inquiry Commission Report

According to international monetary fund, U. S. banks and European banks lost excess of $1 trillion due to bad loans and toxic assets from 2007-2009.

Conclusion

Analysts have understood the causes and effects of subprime mortgages. The results of the fallout of mortgage crisis is well documented and especially in the Financial Crisis Inquiry Commission Report. All stakeholders and the world over are now aware of the devastating effects of the subprime lending to the global economy. This paper examined the performance of subprime lending. How it was borne and brought to success by various players in the mortgage industry. The paper also determined that majority of mortgages that were packaged in form of subprime MBS were going to borrowers who had high income. The paper determined how Fannie and Freddie came to hold substantial number of subprime mortgages. This holding of many subprime mortgages lead to their demise. The paper went down show how the subprime mortgages caused high number of foreclosures and eventually leading to U. S. financial crisis and global financial crisis at large.

Work Cited

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