

# The sub prime mortgage crisis in the united states of america essay sample

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It is a popular belief that the sub-prime lending crisis started at the end of 2006 due to high foreclosure rates, excess inventory of houses, high housing price index which eventually fell drastically due to excess supply and no demand as home owners were not willing to sell at a lower price. Sub-prime loans and other loans started to default and foreclosure rates started to rise as more and more borrowers defaulted due to unstable high interest rates. It is also assumed that the rest of the world, especially Australia would be immune to this crisis. However, on the basis of academic journals, journal articles and newspaper articles there is evidence to prove that the mortgage crisis in the US was foreseen and anticipated due to the manipulation of the financial institutions and their innovation of new financial instruments that were misleading. Also, it will surface that the financial markets around the world dropped by large points, the financial institutions in developed and developing countries wrote - off large number of bad debts and finally, nearly every financial system in the world, including Australia, was adversely affected.

This report will encompass the causes of the sub-prime crisis and its global impacts in terms of the four aspects or elements of a financial system, which are the financial institutions, the financial markets, the financial instruments and the participants.

## 1. 0 Introduction

The biggest financial crisis after the great depression is in the reckoning, according to Nouriel Roubini, Prof., Stern Business School, NYU[1]. The sub-prime lending crisis in the US has triggered a series of losses and write-offs

for large corporate banks and has even closed a few of them or about to close the other financial institutions that are weak and vulnerable. The financial institutions in the US have also affected the financial institutions across the world with the likes of Deutsche Bank, BNP Paribas in France and many more[2]. There was a disturbance caused in the financial market due to which the stock value of the financial institutions and of the participants in the financial system (like the housing firms, real estate developers and other investors from various fields) went down considerably.

The financial instruments like commercial paper like bonds, securities, sub-prime loans, and Adjustable Rate Mortgages (ARM) loans started to lose their significance and confidence amongst the participants who constitute the financial system. All this was caused due to the bursting of the housing bubble[3]. Also, it is a popular belief among American CEO's shared by the Federal Reserve Chairman, Ben S. Bernanke that the impact of this crisis will be contained within the US and will not affect the financial systems of other countries in the world[4]. However, this report will prove and explain that there are many reasons that led to the US sub-prime crisis and that it has significantly affected the financial system in other countries, including Australia. The causes and the impacts will be discussed in terms with the four aspects of a financial system, that is, financial institutions, financial market, financial instruments and the participants in a financial system.

## 2. 0 Causes

### 2. 1 Housing Bubble - Boom to Bust

Financial market in every country prospers during a boom phase of an economy. The same happened with the US from 2001 to 2005. After the burst of the dot-com bubble, to revive the financial market in the US, the government decided to promote consumerism and real estate was a safe bet as property devaluation was considered rare[5]. However, this housing boom was short lived and burst in end-2005 as the valuation of the properties were growing by double digit rates every year and became unsustainable in comparison to the general income level[6]. Due to this, borrowers started to take loans as they thought they could refinance new property, get more by selling them at higher prices later. As a result of over building of houses, the housing prices fell down by 10.5 % in 2007 and there were nearly 4 million homes unsold at the end of 2007[7]. Therefore, the whole strategy to refinance was a setback and the borrowers started to default because they were unwilling to sell at a lower rate. The foreclosure rate increased by 75% and nearly 1.3 million homes were subject to default[8]. This excess led to losses for borrowers, investors and lenders. However, this event is an outcome of misleading incentives offered by financial institutions through financial instruments.

## 2. The Financial Instruments

According to Alan Greenspan, former Federal Reserve Chairman, it is not the loans but the securitization of the loans for people with high credit risk which is responsible for this mess[9]. Securitization is the process of selling assets to investors in the form of mortgage-backed securities (MBS) which reduces a bank's credit risk exposure. This isn't wrong as it satisfies the major

functions of a financial system, which are risk - transfer function and pooling of funds[10]. However, securitization of sub-prime loans wasn't the only problem. These were further pooled with random sub-prime mortgages of unknown risk to make collateralized debt obligations (CDOs) which used to blind the investor as they were given the highest ratings to fool the investor into thinking that they had bought a low risk asset whereas they were actually incurring capital loss. Furthermore, innovations like Adjustable Rate Mortgages (ARM) and payment option loan were even more dangerous as they had no down payment and didn't have a stable interest rate. So the initial interest rate would start with as low as 2.5% and then rise, on the discretion of the issuer, to 8% or 9% which ultimately led the borrowers to pay three time more of what they had initially borrowed[11]. Therefore the new instruments were designed for information asymmetry where the middle men had the most knowledge and the investors had the least, while the banks were least concerned.

## 2.3 The Financial Institutions and the Participants

All the participants involved in the process were just interested in making their commission in their own respective ways - mortgage broker by maximizing the volume of approved mortgage; mortgage appraiser by inflating the value of homes; credit rating agencies by giving high ratings that are actually false. Financial institutions had already contributed to this mess long ago by giving these independent third parties the authority to mislead the investor with the help of the new dodgy instruments[12].

## 3.0 The Global Impacts

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### 3. 1 The Financial Institutions

“ The balance sheets of financial institutions across the world are weakening”[13]. This was the opening statement of Jamie Caruana, head of the IMF’s Monetary and Capital Markets Department at the Global Financial stability Report press conference. It is a disappointing fact, but the truth is that the outcome of this crisis for all the banks in the US and the major banks in Europe and Japan has been the most devastating in the history of global financial system[14]. The losses incurred by all the banks in the US and the major banks across the world ranges between \$700 - 900 billion, where American banks alone experience a loss between \$200 - 300 billion. European Central Bank, on the other hand, has lent \$500 billion already to major banks across Europe[15].

In the US, the major banks that had significant losses are the Citigroup who posted a loss of \$21. 1 billion; Meryll Lynch was the highest with \$22 billion write off; Morgan Stanley wrote off \$9. 4 billion, Bank of America lost \$5. 3 billion so on and so forth[16].

The biggest bank of Switzerland, UBS, had the biggest write off in the whole world, so far, with a staggering \$37 billion write off and it is estimated it may go beyond this amount[17].

German banks were equally hit with Deutsche Bank AG posting 800 million euros loss and Commerzbank posting 248 million euros loss[18].

The worst hits were Bear Stearn and Northern Rock bank. Bear Stearn declared bankruptcy and was later bought by JP Morgan Chase with Federal

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Reserve backing the deal with \$30 billion. Northern Rock bank declared bankruptcy and then requested for emergency funding from the Bank of England and 5 months later it was nationalised[19].

However, the only winner out of the whole crisis was Goldman Sachs who bet against the mortgage market by confirming that the securities backed by risky home loans would devalue. When it did, Goldman Sachs reported a \$4 billion dollar profit in the year 2007[20].

### 3. 2 The Financial Market

Yukata Shiraki, senior strategist at Mitsubishi Securities, Japan quoted “ The sub-prime loan issue is a problem for the global financial market as a whole”[21]. The financial market around the world faced a setback with stock market in most of the countries falling to their record lows. The bond market in the US for all types of bonds that is, AAA, AA, BBB and so on became volatile and all the bond values declined by January, 2007[22].

The share prices of four major mortgage lenders, that are HSBC in Europe and Countrywide Financial, Farmont and Wells Fargo in the US, declined at a high rate with HSBC having the biggest fall[23].

In the foreign exchange market, the US dollar started losing its value by small margin at the end of 2007 against Sterling and Euro. However, it remained strong against Australian dollar[24].

On the stock market front, the effects of the crisis were minimal but visible.

The Hong Kong Hang Seng index fell 5. 37%; Japan’s Nikkei index fell 3. 35%;

Shanghai's stock index fell 2.8%; Seoul's index fell 2.4%; India's stock index fell 2%[25].

Therefore it can be seen that nearly every aspect of financial markets was affected by the sub-prime crisis.

### 3.3 Financial Participants and Financial Instruments

Pension funds are an indirect financial instrument, yet they are an integral part in the origination of funds which are later pooled by mutual funds. A significant ratio of the sub-prime mortgage industry is funded by hedge funds and mutual funds that pool together the pension funds and superannuation funds of individuals. Unfortunately, these pension funds and superannuation funds of the elderly have been adversely affected by the sub-prime mortgage crisis. Around \$2.5 billion was invested and lost by California Public Employees' Retirement System alone in the sub-prime mortgage crisis. As a result, pensioners who are a passive participant have lost their confidence in financial instruments like sub-prime loans, securities and bonds[26].

Investors and lenders in Japan, Europe and the US started to lose business confidence by good measures and became more and more risk averse, whereas borrowers in these regions lost consumer confidence considerably and became extremely risk averse by the end of March, 2007 due to heavy losses incurred in the past[27].

Similarly, participants in Japan, Europe and the US also lost confidence in loans, the financial instrument which is the backbone of the financial system.

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Demand for commercial and industrial loans and consumer loans fell by a moderate margin, whereas demand for real estate loans fell by a huge margin indicating that the housing industry in all these regions was hit hard[28].

As a result of constant fluctuation in the financial markets, the average oil prices, in pursuit of adjusting to other commodities, have risen from \$70. 95 a barrel (2007) to \$95. 50 a barrel (2008)[29].

Also, participants in the US lost confidence in the mortgage bonds market, especially in highly risky loans like BBB, -BBB, as mentioned earlier[30].

### 3. 4 Impact on Australia

“ Australia is managing just fine” is what National Australia Bank (NAB) Ltd group chief executive John Stewart has to say about the impact of sub-prime crisis on Australia. However, Australian homeowners are worried about rising interest rates[31].

The Australian investors were hit hard by the sub-prime crisis. Basis Capital, which has two hedge funds financing US mortgages, is renowned for balancing high risk with high return. However, due to the current sub-prime crisis it is estimating a loss of \$2 billion, leaving its investors with fifty cents for every dollar[32]. Macquarie, the biggest investment bank in Australia, experienced a \$300 million (or 25% of total) loss because of its retail division, Macquarie Fortress Investments (MFI), which deals with high-risk small investors and has a majority of its portfolio investment in the US mortgage market. Similarly, Absolute Capital also incurred a loss[33].

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Four major banks in Australia have raised their interest rates in response to the mortgage crisis in the US to recover the losses incurred or to balance the increase in wholesale price. ANZ has raised it from 0. 2% to 8. 77%; Commonwealth Bank 0. 1% - 8. 67%; NAB 0. 12% - 8. 69%; Westpac 0. 15% - 8. 72%[34].

Non-bank lender RAMS, a renowned Australian home loan provider, experienced a major downfall of 26% in its stock prices as it relies on the US short-term debt market to raise money for its loans. Similarly, even Bluestone, another non-bank lender, experienced a downfall in its stock prices[35].

Hence, it is evident that Australia wasn't immune or isolated from this crisis and it was adversely affected by the crisis in all the aspects of a financial system.

#### 4. 0 Conclusion

It can be implied after reading the report that the sub-prime crisis was not an accident of an economic cyclical phase of boom or bust. Yes there was a boom and there was also a bust, but all this was a result of the culmination of a need to boost the financial system in the US which had suffered a recession and the greed to make high initial earnings by innovating new financial instruments which, with all best intentions, ended up deteriorating the very purpose of these instruments and the financial institutions. Sub-prime lending and securitization in their genuine forms promote the major functions of a financial system.

However, when tweaked for personal gains by exploiting the financial condition, they can be contagious and may not necessarily contain within a geographic parameter. As it was observed that different individuals made different claims but the facts suggest that the crisis adversely affected the financial systems across the world along with the US. Also, it cracked into every element of a financial system, that are the financial institutions, the financial markets, the financial instruments and the participants who used the three elements. It ultimately deteriorated every element. It may also be observed that such an incidence is intentional, though passive and slow in process, it can occur again in any other financial system and therefore it is required that the genuineness of the different elements of a financial system must be maintained and that foresee ability and precautionary measures should be exercised before it is too late.

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