

Different causes of the 2008 financial crisis finance essay



Based on economist view , there are many reasons for economic crisis happened in 2008 . Most economists believe that it happened in the United States. From 1997 to 2006, people bought very pricey houses even though they did not have enough money. But because of the money upcoming in to the U. S. from other countries, it was easy to have good credit. People used this credit for pricey home loans so this formed a housing bubble, which made the price of houses increase more. Because they had a lot of money, the loaning companies made it easier to get a loan. So, it cause many people to get home loans that they cannot pay for and this is called as subprime loans.

in this time, many homeowners refinanced their home. This say that their mortgage? was changed so that they had lower interest.? After they refinanced, homeowners could take out another mortgage to use as expenses. The loaning companies changed their loans so that they had low interest at first, which would boost the interest later. This is called amendable rate mortgage. in addition, the companies did this to try to convince more people to take loans. Many people with subprime loans also took these amendable rate mortgages, eager that the good price of home can help them refinance soon. While the housing prices were still high, many America and European companies, as well as banks, inverted in subprime loans. These investments gave more money to the loaning companies, who used it to give out more subprime loans. These investments would make a lot of money as long as the price of housing was high.

housing require model taking into concern the price uncertainty, bequest motives, and resale of housing. . When this happened, many people were

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paying more money than their homes were worth, it is measured as negative equity. About 8.8 million homeowners in the U. S. had 0 or pessimistic equity by March 2008. This caused the number offer closures on homes to increase, significance that many people lost their homes. in 2007, almost 1.3 million U. S. homes can be foreclosed on. The amount of houses for sale continued to boost, which made the prices turn down. The homeowners with subprime loans left their houses with less value than they had when they were buy, which meant that the loans were worth more money than the house. This meant that the loaning companies were not able to make money from these houses.

2. 1 Growth of the housing bubble

People who had increased their wealth significantly with the unusual run-up of stock prices were spend based on this increased wealth. The stock-wealth induced expenditure thrive led people to buy bigger or better homes, since they found to splurge some of their new stock wealth on housing. in addition, the housing bubble was the supply-side effect of the dramatic increase in house prices, as housing starts rose significantly. The bubble start to burst in 2007, as the building thrive led to so much over-supply that prices could no longer be supported. Prices countrywide began to head downhill, with this process accelerating through late 2007 and into 2008. As prices turn down, more homeowners face? foreclosure. This increase in foreclosures is in part voluntary and in part involuntary. It can be involuntary, since there are cases where people who would like to keep their homes, who would borrow against equity if they could not pay their monthly mortgage costs. When falling

house prices destroy equity, they abolish this option. Besides, the voluntary
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foreclosures take place when people grasp that they owe more than the value of their home, and decide that paying off their mortgage is in result a bad deal. In cases where a home is valued far lower than the amount of the outstanding mortgage, homeowners may be able to simply walk away from their mortgage.

2. 2 Easy Credit Conditions

Some of the most sophisticated people doubt a link between consumer protection and any macroeconomic outcomes.? In the analysis of consumer protection is microeconomics and quite different from macroeconomic issue such as the speed and nature of our economic recovery. legitimately measured interest rates are down from their height? in the Great Panic of 2008-2009 and the financial markets, roughly defined, continue to steady.?

On credit cards, it's getting more pricey to borrow, mostly because new fees and charge are appearing. The lenders have the right to alter the terms on which they? offer credit.?? We could just note that this? tightening of credit does not help the recovery and flies in the face of everything the Fed is trying to do although it fits with Treasury's broader strategy of allowing banks to recapitalize themselves at the expense of customers.? additionally, The financial regulatory system is a disaster.? The Obama government should have called it by its proper name, planned to close it down completely, and argued to replace it with a more incorporated and completely updated approach.? That at least would have moved the bargaining position of the regulators, so they would now be too busy trying to save their jobs to oppose Treasury on substance.

In the past, the most powerful overseers of the system think that this kind of detail did not matter that any changes in what banks did were a form of “financial innovation” that must in nature gain everyone. But this is exactly the attitude that brought us to subprime, Alt-A, and other “exotic” mortgages, for example mislead rip-off. The manner among existing regulators that still predominates today. This implicit attitude towards consumers is in no way helpful, if we want an economic recovery, jobs, and a sensibly steady growth going forward.

2. 3 Sub-prime lending

Based on the statement that sub-prime lending precipitated the crisis, some have argued that the Clinton management may be partly to blame, while others have pointed to the way of the Gramm-Leach-Bliley Act by the 106th Congress, and over-leveraging by banks and investors keen to achieve high returns on capital.

Besides, others have pointed out that there were not enough of these loans made to cause a crisis of this scale. In an article in Portfolio Magazine, Michael Lewis spoke with one trader who noted that “There weren’t enough Americans with (bad) credit taking out loans to satisfy investors’ desire for the end product. (Investment banks and hedge funds) used (financial technology) to create more of them. They were creating them out of whole cloth. One hundred times over! That’s why the losses are so much greater than the loans.”

2. 4 Predatory Lending

Subprime lending is not synonymous with predatory lending. Many subprime lenders and servicers ran sustainable, profitable businesses addressing the needs of a previously underserved client base. In addition, predatory lending can and does occur outside of the subprime market. But with an ample supply of funding from the secondary market and with high demand for home ownership, many subprime lenders targeted an ever-larger share of the

home loan market. The industry grew rapidly and unsustainably, without the opportunity for adequate staff training or infrastructure development. Sophisticated technology increased the distance between lenders and their clients. In many instances, the result was a culture tolerating, perhaps even engendering, abusive policies toward borrowers.

Predatory lending became an industry buzzword, and a regulatory target. The example of useful guideline predatory lending is any of number fraudulent, deceptive or unfavourable lending practices. Many of these practices are illegal, while others are legal but not in the interest of the borrowers. Furthermore, predatory lending is frequently associated with the poor study of borrower's ability to repay, violent marketing of high-risk, high-interest loans, ? promotion of complicated loan products not easily understood by borrowers, collection of unrevealed charges and expensive fees and payment of unlawful kickbacks.

In 2006 and 2007 the market began to feel the pinch of predatory lending (especially in the financially vulnerable subprime market) and the trend toward relaxed underwriting standards. Investors noticed increasing loan

defaults, particularly in the vintage 2005 and 2006 loan pools. Many of the defaulting loans were underwritten with no income verification⁵ and had reached their first payment adjustment date with borrowers now unable to afford.

2. 5 Deregulation

The economic downturn of 2007 brought the subject of deregulation into fierce debate. Advocates of tighter rules claimed the theory that financial markets will regulate themselves was debunked. It was said that free-market principles had been subverted to a terrible degree, and that as a result some banks were now “too big to fail.” This meant there were certain institutions whose financial liabilities were so great that if they folded, the knock-on effects would be disastrous for the rest of the industry.

However, some sources say that the blame for the financial crisis does not lie with deregulation and the impact of the recreation of the rules is flashy. The Heritage Foundation, in an October 2008 essay, wrote that “on the contrary, some aspects of deregulation actually served to stabilize markets.” An example of this is after deregulation banks were allowed to operate in multiple states which, according to financial analysts, enables them to balance risks better since a dangerous trade or set of trades in one region can be offset by safer dealings in another.

besides, other analysts also debate whether tighter financial regulations would have averted the crash. In a study by the Cato Institute, it is argued that a grouping of pressure from political leaders and inability on the part of financial analysts to correctly predict market bubbles in real time means that <https://assignbuster.com/different-causes-of-the-2008-financial-crisis-finance-essay/>

deregulation of the system would not be an important contributory factor in any downturn.

2.6 Increased debt burden or over-leveraging

The financial crisis of 2007-2009, like many prior financial crises, was blamed in part on “excessive leverage.” However, the word is used in several different senses. Consumers in the United States and many other industrial countries borrowed large amounts of money, \$2.6 trillion in the United States alone. For most of this, “leverage” is a euphemism as the borrowing was used to support utilization rather than to lever anything. Only people who borrowed for assets, such as provisional house purchases or buying stocks, were using leverage in the financial sense.

Financial institutions were highly levered.? For example, Lehman Brothers in its last annual financial statements, showed accounting leverage of 30.7 times (\$691 billion in assets divided by \$22 billion in stockholders' equity)]. Bankruptcy examiner Anton Valukis resolute that the true accounting leverage was higher, so it had been understated due to doubtful accounting treatments including “repo 105”. Accounting leverage is the ratio usually cited in the press. Furthermore, Notional leverage is more than twice as high, due to off-balance sheet transactions. At the end of 2007, Lehman had \$738 billion of notional derivatives in addition to the assets above, plus momentous off-balance sheet exposures to special purpose entities, planned investment vehicles and conduits, plus various lending commitments, contractual payments and group obligations.

On the other hand, almost half of Lehman's balance sheet consisted of closely offsetting positions and very low risk assets such as regulatory deposits. The company emphasized " net leverage" which excluded these assets. On that basis, Lehman held \$373 billion of " net assets" and a " net leverage ratio" of 16. 1. This is not a harmonized calculation, but it probably corresponds more closely to what most people think of when they hear a power ratio.