

# Sub prime crisis



**ASSIGN  
BUSTER**

imeContent Page Sub prime crisis <http://banking.about.com/od/mortgages/a/mortgagecrisis.htm> <http://www.lewrockwell.com/rozeff/rozeff203.html> <http://www.slideshare.net/satanic/subprime-crisis-presentation-785636> [http://en.wikipedia.org/wiki/Causes\\_of\\_the\\_2007%E2%80%932012\\_global\\_financial\\_crisis](http://en.wikipedia.org/wiki/Causes_of_the_2007%E2%80%932012_global_financial_crisis) <http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp> <http://ezinearticles.com/?Merrill-Lynch-and-the-Subprime-Mortgage-Market&id=1600761> <http://www.youtube.com/watch?v=kb6g3S4scy4> <http://moneymorning.com/2008/09/22/credit-default-swaps-2/> [http://money.cnn.com/2008/09/16/news/companies/aig\\_questions/index.htm](http://money.cnn.com/2008/09/16/news/companies/aig_questions/index.htm) [http://en.wikipedia.org/wiki/Credit\\_rating\\_agencies\\_and\\_the\\_subprime\\_crisis](http://en.wikipedia.org/wiki/Credit_rating_agencies_and_the_subprime_crisis)

Discuss the cause of the Sub-Prime crisis and the parties responsible for causing such a crisis. There were different complex factors that may have contributed to the Sub-prime crisis during 2008-2009. They were easily associated with the investment banks and government sponsored enterprise, such as Fannie Mae, on how to have dealt with their liquidity issues and Subprime mortgage loans that got them back-fired.

One of the largest contributors to the expansion of the high-risk-loans was Fannie Mae and Freddie Mac. When majority of the banks first started off with low credit interest and easy conditions loans, property was seen as an appreciating asset. Banks offered adjustable-rate-mortgage (ARMs) and Subprime loans to all kind of people with good or bad credits scores as they wanted higher revenue when they resell the bundled subprime mortgages called the Collateralized debt obligations (CDOs) and Mortgages-backed securities (MBS) to the other Investors around the world.

<https://assignbuster.com/sub-prime-crisis/>

The subprime crisis had shaken Northern Rock bank so badly that they had a hard time seeking help to keep the business going. The British banks Lloyds TSB group Plc had bought over HBOS Plc whom is the largest mortgage loans lenders. Bradford & Bingley took control over by UK Government while their branches were taken over by Spain's Santander. Germany struggled to save Hypo Real Estate while Nomura Holdings Inc was being bought over by Lehman's franchise in many countries such as Europe, Asia Pac, Japan and Australia.

The Crisis caused shockwaves and sent panic to the other neighbouring countries causing shares to drop sharply over a short period of time. Commercial Banks, investment banks, investors and people suffered great losses resulting in certain foreclosure or even bankruptcy. Large amount of loan was also taken from hedge funds to assist banks that are falling apart. When banks fell from its former glory, tons of people lost their jobs and banks became more cautious when dealing with any loans to business, properties or even to other banks.

Traditionally, banks would go deep into analysing every single loan applicant, from their credit scores, to their employment details, net disposable income and even to check their ability to pay off their mortgage loans before financing the applicant with sufficient funds to purchase their desirable property. Thorough checks had to be done before granting them with the loans as some of the applicants that came forward may have high probabilities of defaulting their loan or would leave for other competitions for loan which would eventually cause a property downturn in the market.

These methods were often the safest choice but banks were restricted to their growth. The traditional methods were soon discarded by the newer generations. Hence, the newer generation were willing to take higher risk loans for higher revenues. Assuming that prices for property continue to appreciate, they would be enjoying higher profits thus willingly offered larger amount of loans at low interest rates to the borrowers. Before subprime mortgage was implemented, prime mortgages were sold to banks investors which they would bundle them up as CDOs and sell it to outside investors after securitising it.

Securitization became a demand as it provides the opportunity for rating agencies to rate, or in another words to repackage or beautify those poor credit score investment assets from the collateral pool into AAA grade credit score investment assets. Investors whom are not well versed with these bundled subprime mortgages called the CDO were exposed to high risk investment unknowingly as they assumed that what they were handling was a group of people who have good credit scores.

As banks at wallstreets began to greed, mortgage underwriting standards de-proved during this period where the banks failed in these 3 sectors; Failure to examine if the borrowers is able to repay the amount, implemented automated loan approval (which allows users to get through even without proper documentations) and fabricating information or fraud by both banks and applicants. This simply showed how devious and irresponsible the banks were when they try to gain huge profits through the loopholes of the poor standard mortgage underwritings over a short period of time.

Studies showed that the difference between normal prime mortgage interests declined greatly comparing to subprime mortgages as Subprime mortgages offer better returns than the normal prime mortgages. The rise of the property increase greatly until the subprime mortgages began to default; after repaying of the first two years, Federal interest rate rose and adjusted. Subprime loaners soon encounter difficulties in refinancing their houses due to ARMs, which eventually led to foreclosure after a few warning letters.

As the bank investors included Subprime mortgages, which are defaulted, in the CDOs they are dealing to the outside investors. The outside investors soon suffer losses as the CDOs became worthless over a short period of time and U. S property's prices dipped as more foreclosure occurred. Economy was affected as few of these U. S. banks such as e. g. Peter Lehman which was refused by the Federal government to be bail out; Bear Stearns, an investment bank, which was acquired by J. P. Morgan Chase lost US\$1. billion; Washington Mutual was closed by the US Government their assets was bought over by J. P Morgan Chase. With reference to President Obama speech on his take on banks " Too big to fail", " The American people who are already struggling in their own right were forced to rescue financial firms facing crisis largely of their own creation". The actual meaning of such is that the tax payers have become the safety net of the financial institutions which went into crisis and the tax payers are paying off their debt on behalf of them.

President Obama also states that banks should not use tax payer's money to trade for profit or abuse the funds coming from the tax payers as subsidy for investment. It is unfair to those tax payers as it will cause conflict of interest

between the bank's and the customers. President Obama also said that the Americans have to cut down on their luxuries to help in this crisis. The parties that are responsible for the crisis are, Bear Stearns, Lehman Brothers Investment Bank, Merrill Lynch & Co and AIG. Bear Stearns used to be a conservative firm and see conservation as a defensive move.

Eventually, they are discovered of risking the hedge funds for higher turnover which they miscalculated investing huge amount (without setting aside a sum for event risk) in CDOs and insuring Credit default swaps (CDS) bonds in a short period of time and the cash back was too slow for them to have a turnover in time of crisis which brought them to their failure. To put it in a simpler way, they purchase CDOs that are deemed to be rated "AAA" by rating firms, sells them to investing banks (usually in bundles and at the cheaper rates) and then again sells them to investors.

This allows the bank to free itself from the principles and interests they are getting for the borrowers gaining lump sum from the investors, called Mortgage backed securities. The CDS bonds works with 3 parties which are the CDS buyer, the bond issuer and the CDS seller. Assuming that if bond defaults when the CDS issuer is unable to pay back the principle and the interests at the maturity date, the CDS buyer may pay a certain amount of interest to the CDS seller (for instances, Bear Stearns) to purchase a CDS as an insurance for the invested amount.

Therefore, if the bond issuer is unable to pay up, the CDS buyer that made his purchase of CDS with the CDS seller will be compensated by the CDS Seller. This strategy is known as the absolute return strategy, if everything flows smoothly and economic continues to boom, which was not the case.

Problem began to arise when the subprime mortgages didn't work out and property value dipped tremendously. When the property price dipped, Bear Stearns managers realised that they do not have sufficient funds to protect the losses.

It's a domino effect when public was enlightened of Bear Stearns crisis. They started selling the bonds at lower price to fund their losses and more bonds are sold when they realise that the losses increase exponentially causing the price of the subprime bonds to drop tremendously and eventually led to the down fall of Bear Stearns. Soon after the downfall of Bear Stearns, Lehman Brothers filed the largest amount of debt throughout the history, debt of \$619 Billion dollars. As the U.

S government refuses to bail them out, Lehman Brother, one of the few largest banks in U. S. faces their downfall and sent 25, 000 Americans jobless. This tremor caused by Bear Stearns directly result in the decreasing value of CDOs prices day by day. CDS bond causes banks to fail as more and more defaults are happening. Subsequently, it led to the bank liquidity issues and went into a credit crunch while being unable to sell their CDOs to sufficiently assist the losses they face.

Lehman's stocks plunged as investors pull out on them and their liquidity pool depletes. Lehman then tries to sell their firm to prevent further losses but potential partners turned them down as such, led to their bankruptcy. Right after the downfall of Bear Stearns and Lehman Brothers Investment Bank, Merrill Lynch & Co followed up, facing the crisis as they are into generating commissions, subprime loans, CDOs and such which are similar with what Bear Stearns and Lehman brother dealt with.

On top with what they are dealing with, they took an extra path by providing loans to investors for the purchase of their bundle of CDOs right after they have been securitized. Some of the CDOs are even brought over from nonbank institutions and sent for a much risky asset backed securitization (ABS), before providing more loans to the investors for the purchase of the bond. This was also the reason why Merrill Lynch was able to survive as they are the most aggressive when dealing with subprime market.

Merrill was the investment banks that make the highest amount of loans to any nonbanks as long as they sell the mortgages to Merrill eventually. Before Merrill falls, they actually tried to get Bear Stearns to pay them back the \$850 million from the hedge funds which Bear loans hoping to make a turn over. However, the hedge funds collapsed and started the economic crisis. It was when Lehman brothers was still struggling, the government refuses to bail them out but instead requested The Bank of America to buy over Merrill Lynch as they see them both a potential assistance to the subprime crisis.

Merging Merrill Lynch and Bank of American, it made them the ninth largest corporation in the world and presently called the Bank of American Merrill Lynch. American International Group Inc (AIG) was the largest insurance company that grew aggressively in U. S. The problems arise when AIG started to lose money in the investment they dealt with like CDOs, CDS, Pool of subprime mortgages and pool of Alt-A mortgages. Without a doubt they were earning a huge amount of premium incomes from their invested products, they came crashing when the prices of the properties falls.

Increasing rate of foreclosure and amount of the loan pools it had insured cannot be leveraged and realized that their company do not have enough



money for pay-outs. The Securities and Exchange Commission also found out that AIG had got low integrity as they shifted from the main balance sheet to the off balance sheet to cover up the problem. There weren't transparency as the company tries to move or shift the amount that was supposed to be shown on the main balance sheet to the written off balance sheet, abusing the loopholes of the off balance sheet to beautify the main ones.

They suffered the largest amount of losses when the rating firm's such as Standard & Poor's, Moody's Investors Service and Fitch Ratings Inc lower the company's rating. AIG was already on the edge of bankruptcy when all the counterparties started to demand for their cash which they do not have. AIG was greedy and irresponsible and failed to assure that there was enough fund to pay-out all the insured parties. The U. S Government cannot let AIG fall as they are one of the largest insurance company, if they were to declare bankrupt, U.

S will fall into a financial crisis and the insurance regulator will have to take over the firm and compensate the insured and it would create a tighter credit market for consumers and businesses trying to get loans. Thus, the U. S government cannot allow the economy to go down any further, they will have to use the tax payer's money as a safety net to bail AIG out. Credit rating agencies such as Standard & Poor's (S&P) have been reprimanded as they are also one of the crucial groups of people that contributed to the subprime crisis.

They handled complex securities such as the MBS and CDO which are from the loaners with bad credit scores and rated them highly so it could be sold to the investors. The underrated MBS and CDOs that the investors purchase

caused them to suffer great losses. It comes hand in hand, as without the rating agencies doing, the bank would not be able to resell the CDOs and MBS. It was ridiculous as a subprime loaner with a bad credit score can be securitized and rated as AAA ratings. It was also said that part of the revenue that the banks got from selling the CDOs and MBS are shared to the agencies.

Competitions happened between different rating agencies as all of them wanted to enjoy the high influx of revenue which eventually caused the rating standard to drop tremendously due to the conflict of interests. A source from ??? (from where) also states that due to the low standardization in the ratings from the agencies, the AAA CDOs and MBS that went through securitizations doubled the amount as it used to be. As rating the CDOs and MBS is the rating agencies job, they are not held responsible for the compensations to the investors as ratings, was only a piece of advice from them to make references to.

TO sum it up, investment banks were unable to rectify the illusion of how property value would climb continuously thus causing a domino effect that ultimately caused their downfall. When there is a rise, there will always be a fall. As the bank did not foresee such circumstances affecting the prices of property, hence continued with the high-risk-loans to everyone and anyone that applies for a grant to purchase a property. It all falls into place when rating agencies started lowering their rating standard to compete with their competitors due to favouritism of their own interests.