THE MORTGAGE CRISIS; CAUSES, CONSEQUENCES AND SOLUTIONS.

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Abstract:

This research paper talks of the mortgage crisis and its effects on the global markets. It throws light on the reasons triggering this issue. The roots of this crisis are found to be the lack of transparency, bad regulation, quest of making more and more profit etc. The distressing effects on the economy were then considered where every household and firm was the ultimate sufferer. Various solutions were also put forward to tackle the situation and to avoid it in future.

Introduction:

Our research paper surrounds the current mortgage crisis that somehow affected the financial conditions of the globe. We tried to explain some of the factors contributing towards this crisis, the consequences it has had and some of the solutions that have been put forward.

The global credit crisis has its roots in the subprime mortgages and the boom in the mortgage backed securities. Mortgage is the housing or property loan. Subprime means credit extended to the people who have a poor credit history, borrow money without sufficient deposit or don’t have the ability to pay back the loan easily.

The crisis actually came into scene back in June 2007 with the collapse in the two hedge funds owned by the Bear Stean that had invested in the subprime market on a big scale. As the time passed, more banks faced losses with their mortgage securities. During the same period, rapid foreclosures led to the fall in housing prices and with that more defaults were observed in mortgage. Thus the situation got worse than ever before in the history of USA and the rest of the world.

Literature Review:

- Otto Van Hemert, Dec 5, 2008, analyzed the quality of subprime mortgage loans by varying borrowing and lending characteristics. He found out that the mortgage industry was heading towards the crisis for the last six years before the actual outburst. The mortgage market experienced a decline after a period of unsustainable growth.
- R Christopher Whalen, March 1 2008, explained that the causes leading to the crisis include the use of creative financial techniques which made housing affordable and easier. Secondly, federal regulators allowed all financial institutions to involve in securitization on a big scale. The third reason was the adoption of fair value accounting by SEC and FASB. Mr. Whalen also gave some possible solutions; first one was to build up the confidence of the people in market by adopting market transparency, standardizing contracts and account ting treatment. He advised to arrange simpler dealing procedure and to provide investors with the correct and necessary information.
- Stuart M Turnbull, Michel Crouhy and Robbert A Jarrow in July 08, wrote a paper which talked about different reasons contributing to the crisis e.g. profit maximization, poor risk management of financial institutions, lack of transparency, failure of regulators to anticipate the changing financial conditions.

- Luigi Zingales, Oct 2008, found out that the roots of the crisis are bad regulation, lack of transparency, and market complacency brought about by several years of returns. He further discussed the crisis with reference to the bankruptcy of Lehman's brothers.
- Stephen G Ryan in March 2008 discussed critically the practical application of fair value accounting. He threw light on the effects of the mortgage crisis on accounting in relation to the foreclosures and modifications of mortgages.
- Atif A Mian and Amir Sufi, Dec. 12, 08, found out that from 2002 to 2005, the incomes and the mortgage growth rates were inversely related by conducting an analysis. During the period the income growth was declining. This relation occurred due to the increase in securitization of the subprime mortgages.
- Joseph Ackerman, 25th Sept. 08, after describing the background of the crisis gives various solutions to the problem. In this regard he puts forward the advice to adopt improved transparency, better risk management, improved market infrastructure, enhanced liquidity management etc.
- Kristopher Gerardi and Andreas Lehnert, 5th Sept. 08, found out that the analysts had foreseen the catastrophic effects of the crisis on markets due to the fall in the prices, but assigned a lower probability to such an outcome. Thus, not warning the people about the possible misfortune.

Methodology:

Our research is a qualitative one. We consulted various term papers available online and based our research on their findings. These papers were written by people belonging to different regions, thus we got to see how people from different areas view this scenario. We then looked for relevant information about this crisis issue from different sites and it further helped us to reach our aim. The newspapers also added to our information. Guidance was also taken from teachers on points that were unclear. After the collection of data, we used our understanding on the topic and discussed our views in relation to those mentioned in the literature review.

Findings:

We provide our findings here relative to causes, consequences and possible solutions for the mortgage industry crisis.

Causes:

- The main reason for the decline of the mortgage industry is the creative financial techniques which made housing loans very common. Lower interest rates made mortgage payments very cheap. Because of these reasons the demand for the mortgage loans began to rise sending prices up. Millions of home owners took advantage of this opportunity. As the industry ramped up, the quality dwindled.

This point was discussed by Whalen in his article and we second him in his viewpoint.

- During the securitization process the risks were not made obvious to the transferees. Also the off-balance sheet treatment applied to the liabilities made the whole process opaque. This non-transparent behavior of the lenders made the situation worse and the confidence of the investors was also lost. This point is also raised in several other researches as mentioned in our literature view.
- The blame goes to the stock brokers as well who kept on creating more mortgages for maximizing their profits, not bringing the quality into consideration for the sole reason that they were not to bear the risk of loss. Thus the quality of the lending standards went worse.
- Negligence shown by the market participants also led to the crisis as it is described by Kristopher and Andrea. They did not play their correct role in anticipating and warning people about the situation deteriorating.
- Inflation was also one of the major factors. Prices rose, and the ability of the people to repay the loans was decreased and hence the banks had to bear the burden.

Consequences:

Consequences of this disaster are in front of us in the form of huge economic and financial instability. Banks went bankrupt, the values of their shares fell on the stock market and govt. then had to intervene and help them out. We have the example of how US govt. entered into the scenario and bailed out Freddie Mac and Fannie Mae.

Moreover, the confidence in the financial institutions and banks was lost and a large number of people became jobless.

Thus, this wasn’t a downfall of single firm or industry but had its impact on institutions and households at micro level.

Solutions:

The solutions proposed to come out of this troublesome situation and to avoid it in future include:

- Christopher Whales suggests, and we also go with him, that the lending process should b made as simpler as possible so that the participants trustworthily engage into the deals.
- Accounting principles regarding off-balance sheet treatment should be modified to bring the risks involved into clear vision thus making the process more transparent. Joseph Ackermann also emphasizes on the improvement of transparency in mortgage dealings and Whales talks about revising accounting treatments.
- Better risk managing policies should be adopted(as mentioned by Joseph).one of such policies should b that big financial institutions and regulators should arrange a meeting once or twice an year to discuss the risks to industry.
- The quality and quantity of lending loans should be checked.

Conclusion:

The mortgage crisis that appeared on the scene in 2007 was building up in the background for the last 6 or 7 years. Increased subprime mortgages were the major push for it which kept mounting through the years. Based on our perception and other researcher's work, we come to the conclusion that there is no single person or reason behind this critical situation but people from all departments share this blame- the banking sector, the analysts, regulatory agencies, and accountants to some extent. It had its effects on all the major banks in USA and when such big names of the banking world incurred huge losses, investments appeared riskier than ever. The governments stepped in bailed out the banks and tried to stabilize the conditions a bit. In order to avoid such incidents in future, every department must exercise caution, responsible attitude and honesty.

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