The Subprime Mortgage Crisis and its effects on the Banking Sector

Name

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In April 2007, the Federal Reserve Chairperson, Ben Benanke, warned that the subprime market would incur losses of up to $100 billion. This marked the start of a whirlwind in the United States and global markets, which ended in massive bank bailouts, bankruptcies, high unemployment rates, and a slowed global economic prospect that still lingers on. The consensus has been that mortgage-backed securities were a watershed in the subprime mortgage crisis that culminated in the 2008 global financial crisis (Davies, 2010, p. 80).

Davies (2010) asserts that the repeal of the Glass-Steagall legislation, also known as the Banking Act of 1933, which was replaced by the Financial Services Modernization Act of 1999, marked the start of a deregulated financial sector as commercial and investment banks merged roles (p. 20). The blurred roles and conflicting interests encouraged risk-taking among financial institutions. When the Federal Reserve lowered treasury and municipal interest rates to a historically low rate of 1%, between 2002 and 2004, in an attempt to squeeze out inflation from the 2001 recession, it further precipitated the subprime lending crisis.

Low-interest rates contributed to the mounting housing bubble that was further triggered by adjustable mortgage rates. The adjustable mortgage rates allowed borrowers to pay a significantly low monthly payment on the loan principal and interest. Consequently, low monthly payments led to an increase in home prices, but when the interest rates were reset to a higher figure, most subprime owners could not afford to make their monthly payments.

Lower interest rates on federal funds also facilitated the creation of high-yield

investment tools, primarily mortgage-backed securities. Investment banks were able to borrow funds at low-interest rates and create mortgage-backed securities as investment products through a process known as leveraging or investing in debt. Leveraging meant that there was adequate liquidity to fund mortgages while ensuring that the price of housing increased (Benanke, 2010, p. 25).

When the housing bubble burst and foreclosures due to mortgage defaults increased, the result was a lower value for mortgage-backed securities. Investors trading in mortgage-backed securities increasingly faced losses on them, and insolvency was inevitable as they were unable to borrow even short-term loans.

Reckless securitization of mortgage debt in which lending and investment banks participated created a false investment bubble. Debt originators were not worried about taking financial blame in the event of massive defaults, because they sold the mortgages to investors as soon as they were processed. In addition, investment banks were not concerned about the quality of the mortgages they bought out and issued to investors in tranches. Davies (2010) argues that the fact that top-rating agencies gave an AAA rating on Wall Street-issued securities backed by subprime mortgages was enough incentive to propel the irresponsible leveraging of mortgage debt (p. 18).

Government laxity over lending standards and oversight also played a crucial contributing role in the financial crisis. At the start of the 21st century, lending standards were stringent and based on factors indicating financial stability, such as income, employment, and credit ratings. At the start of the 1990s, the government's push to increase the number of low-income homeowners saw the introduction of legislation, such as the Community Reinvestment Act. Such legislation compelled lenders to issue

mortgages to subprime zip codes. Fannie Mae and Freddie Mac, chief financiers of the housing market also relaxed their requirements for buying mortgage loans, and increasingly bought out a large cohort of high-risk subprime mortgages.

At the height of the subprime crisis, homebuyers suffered losses in home equity due to lower housing prices and higher monthly payments. The rates of subprime foreclosure soared to 80% (Ciro, 2013, p. 27). Financial institutions bore the greatest brunt causing many to file for bankruptcy and bailouts; others were hastily incorporated into commercial banks, which faced greater FDIC regulations. Widespread panic across the financial sector triggered by falling housing prices, higher default rates, and subsequently massive losses in mortgage-backed securities saw many institutions write down their losses.

In 2007, Bear Stearns was among the first investment banks to declare losses and file for bankruptcy. The domino effect spread to other institutions including Lehman Brothers and Merrill Lynch, which filed for bankruptcy and were acquired by Bank of America. Global financial investors who bought bonds and financial instruments, such as mortgage-backed securities and their derivatives also felt the jabs of the American subprime crisis. From the year 2008, the United States and other governments embarked on costly liquidity programs to inject more funds into the private financial markets in an attempt to avoid a complete collapse. However, as Benanke (2010) explains, some banks were hesitant about the idea of bailing out their competitors (p. 31). A hike in the Libor rate, which rose to 6.7%, significantly higher than the base rate of 5.7% further precipitated the liquidation crisis. Through the Asset Relief Program, the federal government injected up to $7.7 trillion in federal funds to bail out banks that

were embroiled in toxic debt.

Greater regulation and oversight over the largest financial institutions is necessary to alleviate the presumption that an institution is too big to fail (Ciro, 2013, p. 19). The Dodd-Frank Wall Street Reform and Consumer Protection Act offer a plausible stepping-stone. Title I of the Act gives the Federal Deposit Insurance Corp. the mandate to force financial institutions to change their approach if they have proof that certain activities can jeopardize the financial system. Ciro (2013) further contends that obligating financial institutions to maintain larger capital portfolios will lower the risks incurred by taxpayers (p. 29). This may serve to mitigate disruptions in the financial markets when a large financial institution is in distress.

While massive bailouts offered a temporary solution to the devastating global financial crisis, there are still fears of recurrence. Stricter government oversight and ethical forbearance by the financial institutions can serve to allay another financial crisis.

References

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