The Sub Prime Crisis In The United States

The sub-prime crisis was said to have sprung up when mortgage lenders in the United States began giving out creatively well-crafted loans to provide money to high-risk borrowers so as to purchase homes during the economic and housing boom of 2004. Sub-prime mortgage loans are loans which in essence are offered to people who comprise of possessing a greater level of risk than those borrowers who were eligible for traditional loans from banking institutions. Borrowers labeled as "high risk" are usually denied access to loans at standard rates and are thus are forced to look towards sub-prime lenders. In many cases, accepting a sub-prime loan is the borrower's only access to credit. These high-risk borrowers, it is usually seen have high debt to income ratio, little to no credit history and poor credit .

The expansion of the sub-prime market was due to a number of factors, such as the constant strengthening of the housing market; relatively low interest rates; and deregulation by the federal government which no sooner than later led to innovations in mortgage products making loans available with lesser down payments, and fewer documentation requirements. The increase of securitization of sub-prime mortgage products also turned out to be a contributing factor to this development of sub-prime loans as it transformed future income influxes into immediate liquid funds .

Also, the funds made available by securitization were utilized in such a fashion so to contribute as capital to fund more home finance. Thus, through securitization, increase in loans originated meant greater finance being accessible for future home finance. The existence of sub-prime loans as a percentage of all mortgages which were present in a given year saw an increase of nearly 8% in 2003 to 20% in 2006. And also, it is to be noted that most of this expansion was funded by securitization; approximately 75% of the $ 600 billion of all mortgages which emerge in a given year are now securitized .

What Is Sub-Prime Market?

Home mortgage lending in the United States is divided into two market segments - prime and sub-prime. The prime market can be availed of only by individuals with solid credit histories whereas the sub-prime market offers financial services to potential homeowners with sketchy credit histories. Borrowers in the sub-prime market in contrast to the prime market present an increased risk of default, which the sub-prime lenders in turn take advantage of by offering only higher interest rates and fees .

What Is Sub-Prime Mortgage?

In testimony before the Senate Committee on Banking, Housing and Urban Affairs, Roger T. Cole, Director of the Federal Reserve's Division of Banking Supervision and Regulation generalized the usage of the term ‘sub-prime borrower’ by stating that those "who do not qualify for prime interest rates because they exhibit one or more of the following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios. "

Apart from these above-mentioned properties of sub-prime borrowers, the loans usually considered as sub-prime have higher upfront costs, as far as fees associated with closing the loan (eg. Application fees and appraisal fees) and continuing costs, a resultant of higher interest rates. They are often identifiable by such other hybrid characteristics as an initial, low initial interest rate (sometimes called a teaser rate) that is in effect for one or two years (at times even for just a few months), that then changes to an adjustable rate which is much greater than the teaser rate for the remaining life of the loan. Sub-prime mortgages can usually be identified by just gauging the distinctiveness of the borrowers as well as by the terms of the loans that are made to them .

The Process of Securitization

After the mortgage agreement is concluded, the mortgage is usually sold on the secondary mortgage market, where financial institutions purchase the creditors interest in the loan i.e. the right to collect the payments and the right to terminate and foreclose should the borrower default on his/her payment requirements. When the creditor plans to securitize the mortgage the interest in the mortgage will be transferred to a Special Purpose Vehicle (SPV), generally a trust, which comprises multiple mortgages in its portfolio, creating a cluster of loans. The assets of the SPV (for the most part, the income that flows from the mortgagors' obligations under the mortgages held by the SPV)--be it is the right to discharge of payment of interest on the loans in the pool, or the payment of principal, or some other right--are classified into tranches, and such tranches are then bundled up as securities to be sold to investors .

Coordinating with an underwriter and rating agency, the various tranches are scrutinized for the risk related to the assets (the various income streams, as illustrated above) that back them. Usually, the bond rating agency depends on information given by the lender, especially the various representations and warranties made which in turn ensure that the loans in the pool were in compatibility with applicable law when they initially came into existence. It also considers information in the aggregate with pertinence to the loans in a particular pool, gauging information such as credit scores, the equity which the borrowers have in their homes, and documentation of income and assets. Simultaneously, an assessment is also made of the lender itself, assessing the underwriting standards along with lending and performance history .

Credit enhancements are also utilized by the creditors so as to make investment in the securities seem more viable by lowering the risk related with the investment. Such enhancements can consist of loan guarantees from a particular insurance company or similar guarantor, and the creation of a chain of tranches whereby particular tranches are more exposed to risk than others. Investors which comprise of hedge funds, mutual funds, pensions, brokerage houses, and individuals--then buy the securities created and backed by the assets in the SPV. An independent agent, the servicer, handles the daily management of the individual mortgages which back the securities. That servicer is duty- bound to collect the monthly payments of interest and principal, monitor loans in default and pursue foreclosures wherever they may be necessary .

Types of Sub-Prime Loans

Sub-prime borrowers usually do not choose to amortize the loan for fifteen or thirty years with a typical twenty percent down payment, as lenders of traditional mortgages would require. Sub-prime borrowers generally look for methods to afford a home which would be beyond their price range under typical lending guidelines. Lenders taking this fact into consideration are creative in constructing schemes that would seem attractive to consumers and profitable to the lenders, at times without any regard to the future effect. The two most popular products, which vary immensely in their terms, are the interest-only loan and the payment-option adjustable rate mortgage (ARM) loan which the researcher shall now discuss .

1. Interest Only Mortgage Loan

With the interest-only mortgage loan, the borrower pays only the interest on the loan for a certain period of time. The loan balance does not decrease as no payments are diverged to the principal during this period. After the interest-only time period expires, which may be as much as five to ten years, the borrower must pay both principal and interest. As a result of the interest accumulated during the interest-only period, the monthly payments on the loan gradually increase when the interest-only period ends .

2. Payment Option Adjustable Rate Mortgage

The second popular option of sub-prime lenders is a payment option known as the Adjustable Rate Mortgage (ARM). As the name implies, this loan has terms that allow flexibility to the borrower. In order to better manage the borrower's cash flow, there are several possible payments on the mortgage each month :

(A) The borrower may make a minimum payment based on a very low, introductory interest rate,

(B) The borrower may make an interest-only payment, or

(C) The borrower can make a fully amortizing payment as if it were a traditional loan

With the minimum payment option, using the low introductory rate the monthly payment for the first few months sets the interest due at the teaser rate. After this period, the interest rate increases, and is restructured according to a fixed time. With this option, if only the minimum monthly payment is made, it will not be enough to pay off all of the interest charged on that loan for that time period and the unpaid interest will be attached to the principal balance owed. This is again a case negative amortization, resulting in the borrower owing much more on the loan at the time the payment option period expires

Cause of the Sub-Prime Crisis

With the prospects in the home mortgage market becoming fragile, the drive to persist in issuing mortgage-backed securities resulted in many lenders loosening their underwriting criteria and give out riskier loans. The incentive structure in the market, combined with a deficiency of accountability in the system, has resulted in the present scenario of the sub prime mortgage market: a greater number of de-faults, bankrupt lenders, and devalued securities . Another reason for the growth in sub-prime was some of the federally enacted statutes which will be discussed in the next chapter.

II: The Role of Federal Law In Fuelling Sub-Prime Crisis

Sub-prime lending become much more widespread by statutory changes to banking legislation in the 1980s, and the introduction of creative implements in the method that mortgages were financed. State interest rate caps on mortgages were precluded by federal legislation in 1980 via the Depository Institutions Deregulation and Monetary Control Act (DIDMCA). In 1982, lenders were allowed to offer adjustable rate mortgages through the Alternative Mortgage Transaction Parity Act of 1982 (AMTPA). In the end, deregulation was crucial to the increase in sub-prime lending .

In the 1980s, the federal government passed several legislations that made sub-prime lending prevalent, even when such practices were made illegal in many states.

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) deregulated interest rates on loans. This act preempted state caps on interest rates for residential loans . The DIDMCA allows lenders to charge higher interest rates to borrowers with lower credit scores, i.e, the sub- prime borrower. By precluding state ceilings on mortgage loan rates, the law provided for interest rates on mortgage loans as high as usury laws tolerated. The DIDMCA gave lenders the option to charge increased interest rates to risky borrowers. Accordingly, lenders could validate taking risks on borrowers with a bad credit history as a higher interest rate guarantees a higher payoff .

The Alternative Mortgage Transaction Parity Act (AMTPA) was created to make mortgage loans available to a larger pool of individuals by offering alternative mortgage transactions . Such transactions were comprised of variable-rate transactions, consisting of variations usually construed as uncommon to traditional fixed-rate, fixed-term transactions. The Act allowed non-federally chartered housing lenders to provide for alternative mortgages in accordance with federal regulations. This ensured that such lenders were in conformity with federally chartered institutions. The consequence of this law was to provide for non-federally chartered lenders to grant a loan either under state law, which was highly regulated upto this point of time.

The AMTPA brought about variable-rate loans and balloon payments to the market of mortgages. This act seeked to do away with the discriminatory impact past regulations placed on non-federally chartered housing creditors and to place the creditors on equal footing with federally chartered institutions. It gives all housing creditors the authority to purchase, make, and enforce alter-native mortgage transactions and thus served to act as a legislation which proved to be a major contributor as far as the sub-prime crisis was concerned. .

The Tax Reform Act, 1986 encouraged homeowners to obtain mortgage loans by doing away with the interest deductions for consumer loans but at the same time permitting mortgage interest deductions. Because of the tax incentive, homeowners were provided incentive to acquire loans secured by their homes instead of acquiring consumer loans .

These three acts had opened the floodgates for sub-prime lending. The DIDMCA increases ceilings on state mortgage interest rates; the AMTPA gives non-federally chartered institutions the same alternative mortgage rights as federally chartered institutions; and the TRA provides borrowers incentive to borrow money on their home from bankers and other financial institutions.

III : Damage Control By the United States Federal Government

On December 18, 2007, legislation was enacted so as to assist sub-prime borrowers obtain tax relief. The Mortgage Forgiveness Debt Relief Act of 2007 created a three-year period for homeowners to refinance their mortgages and pay no taxes on any debt forgiveness that they received. This changed current law, where the tax code construed any monetary sum forgiven by lenders as taxable income. The rationale was that this would preclude potential foreclosures . In addition, the Department of Treasury and the Department of Housing and Urban Development encouraged the formation of a private-sector alliance to help sub-prime borrowers. The program, entitled the HOPE NOW alliance, comprised of efforts at encouraging lenders and mortgage servicers to provide workouts to borrowers, which may include lowering an interest rate on a loan, or spreading out the interest payments over a longer time period on the loan .

In August, 2007, the Bush administration came to the conclusion that the market alone would not be able to solve the problems created by the sub-prime lending industry, and introduced FHA Secure. Under this plan the Federal Housing Administration (FHA), which provided mortgage insurance to borrowers through private lenders, provided for sub-prime borrowers an option to refinance into loans it insured. The Federal Reserve Board also introduced a new rule under the Home Ownership and Equity Protection Act. The motive of this rule was to protect consumers from predatory lending and advertising practices. Specifically, as it was applicable to sub-prime loans, creditors would be prohibited from extending credit without considering the borrowers' ability to repay the loan, it would be a pre-requisite for creditors to corroborate income and assets, prepayment penalties would only be issued in certain instances, and escrow accounts would have to be established for taxes and insurance. With regard to advertising, certain deceptive advertising practices would be banned, including making representations that if a rate is fixed, it can change .

Iv: The Spill-Over Effect of the Sub-Prime Crisis in the Indian Market

The impact of the sub-prime crisis was felt in a number of growing economies as well. As far as India, which was riding on an economic boom at that point of time, the economic growth rate tumbled from 9% in 2007-2008 to around 6.5% in 2008-2009. However, the impact of the recession on India, was not as bad as other countries, since India did not posses great exposure to foreign markets.

However, due to the foreign institutional investors, selling off their assets in the Indian market, the stock exchange in India, suffered a blow, and its dreary situation reflected it. The stock market tumbled from nearly 20000 points to a situation of 8000 points. The tumble was attributed to three factors namely: the drying up of finance from abroad for Indian banks and corporates, the constraints of raising funds in the domestic capital market as a result of the situation world-wide and also because of the decrease in the accruals of the corporate in India.

As far as liquidity is concerned, there was a drying up because of the pulling out by the foreign institutional investors, and thus this led to a fall in reserves. The influx of investments in the IT Sector was a result of the multitude of investment in it, as Indian IT firms derived 75% of their revenue from the United States. The inability of Indian firms in raising funds abroad in light of the crisis led to the RBI, providing for an expanse in liquidity by reduction of the cash reserve ratio (CRR), the repo and the reverse rates.

As far as exports were concerned they suffered a sharp hit as well. This was because of the fall in purchasing power of consumers. This fact can be illustrated by the inflows in 2007-2008, which were nearly 100 billion dollars as compared to just 10 billion dollars in the following year.

As far as the banking system in concerned, the Committee for Financial Sector Assessment (CFAS) set up by the Government of India and the Reserve Bank of India has assured that the financial system is essentially sound and stable, and there is no cause for fear with regard to the vulnerabilities which other banking systems were facing. Despite the strength of the assets of the banks across the country, the call money rate escalated by nearly 20% after the collapse of Lehmann Brothers and the daily liquidity adjustment facility overshot nearly 50,000 crores, under the tight liquidity situation.

The Reserve bank of India in this scenario took various steps to ensure that there was credit flow to various productive sectors of the economy, despite the liquidity crunch. Liquidity was infused by controlling the interest rate management, risk management and the credit management.

For example,

The CRR was reduced by nearly 400 points from around 9% in August, 2008 to 5% in January, 2009

Reduction in the repor rate (the rate which RBI lends to banks) from 9% to 4.75% in order to improve the flow of credit.

The reverse repo rate was also reduced to around 3.25% by nearly 2775 points.

As far as fluctuation in the exchange rate was concerned, the rupee became stronger to the dollar, and this led to exporters pushing for government intervention and rate cuts. However, it is to be noted that the government took note of the reduction in the import bill and thereby narrow the wide trade deficit.

V: The sub-prime crisis in retrospect

The major cause for the sub-prime crisis in the United States could be attributed to the deregulation procedures followed by the government, and giving the private financial sector, more or less unlimited freedom. In stark contrast, is the Indian financial scenario, where due to the conservative practices of the banking sector and the Reserve Bank of India having a strong foot-hold in the functioning of banks throughout our country, the country was able to withstand a global melt-down of such a great scale. Apparent is the idea, in light of how adeptly the RBI handled the liquidity crunch by regulating the interest rate management, the risk management and the credit management systems, always ensuring that the productive sectors of our economy do not disintegrate. The argument in favor of deregulation has always been capitalism, however, this crisis teaches us that leaving the hands of the economy in the private sector, would only lead to short-term gains and long-term pains. In a way, it could be said that we should be thankful for the nationalization of banks in the 1970's or we might have been facing a situation, being a developing country at that , a crisis worse than the one which is plaguing the United States of America.