

Subprime Mortgage Loans & Financial Crises

Posted on September 11, 2018

The subprime mortgage loan is a Loan provided to potential home-buyers at high interest rates and high credit risk. It also covers the clustering of loans, mortgage securities, and other monetary debts. Financial crises occurred from 2007-2010, and one major factor was the subprime mortgage crisis.

Subprime mortgage crises hit the United States [Financial market](#) and collapsed the housing bubble that triggered the financial crises. The major cause of the decline was the fast decrease in house pricing. A survey report by Standard & Poor's states that home prices declined by 20% from 2006 until the end of 2007. This decrease burst the notion of the housing bubble that Home prices do not fall. At the start of the 21st century, home prices were increasing at a high pace, which elevated the influx of potential consumers who wanted to purchase houses and secure their financial planning. To meet the demand for houses, financial institutions offered risky mortgages and enjoyed a high rate of return and profit margins in the mortgages. The mistake made by the financial market was that it assumed that housing prices could not fall. The report of the Department of Housing and Urban Development states that the majority of loans approximately 56% of the mortgage loans were provided to low-income consumers. At the start of 2007, housing prices started showing a declining trend against all the assumptions of consumers and financial institution's estimations. In response to the Subprime mortgage crisis, the government intervened and made the financial institutions rework the refund procedure and other terms and conditions on disturbed mortgages. Another step the Federal Reserve Bank took was lowering interest rates to approximately zero per cent by the end of the financial year 2009 (Bertella, 2015).

The decline in real estate Values & Financial Crises

Real estate is a major sector of an economy. Residential real estate offers housing services to domestic consumers, whereas commercial real estate covers business offices, manufacturing plants, commercial markets, and other retail spaces for consumers. Real estate makes a major contribution to the GDP of the economy. In the United States, real estate added \$1.2 Trillion to the GDP which approximately makes 6% of the total GDP in the financial year 2009. In the financial year 2006, real estate contributed 8.9% to the GDP of the United States. Real estate sectors and housing prices are highly dependent on each other. The reason is that real estate is labour-intensive and requires liquid cash. When the financial crisis hit the United States, and the housing bubble burst at the end of 2007, the crisis affected real estate factors. The reason is the house building decreased due to the lowering of prices, which ultimately decreased the revenues from the Real estate sector. Some economists suggest that a 12-16 per cent decrease in house prices eliminates capital, which has a snowball effect and hurts homeowners in the long run. This capital loss triggered the downfall of the economy which led to the financial crises.

Mortgage-backed Securities & Financial Crises

Potential investors conduct deep market analyses before making any investments in securities. Securities are investments that deal in the secondary market. This allows the investors to profit from mortgages without physical involvement in the sale transaction of Houses. Mortgages secure investment in Mortgage securities. Special purpose vehicles are designed to keep the mortgage-backed securities away from the banking services. Mortgage-backed securities added their fair share in the downfall of the financial market. Mortgage-backed securities allowed potential consumers to purchase the home for their families. The boom period of housing prices made the investors decide to allow loans without backing them with actual securities. It provided loans to low-income consumers who were not able to afford mortgage rates. Mortgage-backed securities had a lesser risk for the lenders, which made them blind to the long-term effect of creating the asset bubble through the influx of mortgage-backed securities. In the financial crises, all the stakeholders were at a loss due to the backing of pension funds and other huge financial institutions by mortgage security. When the home prices faced a downfall, it hit the investors, shifted the burden to the economy and added to the financial crises of 2008.

Relationship of Monetary policy and cyclical asymmetry

Cyclical asymmetry relates to the nonlinear economic functions and may have a dispersed impact on the major sections of an economy; it is the initiation of unequal distribution of factors of production arising due to the approaches followed to counter the change in the economy. Cyclical asymmetry causes disruption in economic conditions that may cover employment rates, financial debts, interest rates, financial securities and the stock market. The federal government intervened through the Federal Reserve Bank and utilised the tool of monetary policy to respond to market changes. Monetary policy is used to control employment rates, inflationary pressures, and shrinkage of the securities market. Economists suggest that strong monetary policy can contain unemployment and have a stronger effect on short-term market interest rates (Jermann, 2015).

Liquidity trap and its effect on cyclical asymmetry

The liquidity trap occurs when interest rates are at their low whereas the saving rates are high which shakes the monetary policy. Consumer focus on saving rather than investing in their funds in the market. That reduces the cash inflow in the market and raises the interest rates. Security bonds are inversely affected by the increase in interest rates. This creates a risky situation for the consumer and forbids him from investing and values have a high chance of decreasing in the short term. Poor fiscal policy added to the financial crises by taking the cyclical asymmetry to the severe tipping point that burst the asset bubble and triggered the downfall. Market investors avoided investing in rational

capital assets and focused on the housing boom period where prices were increasing, and the yield was high. This caused the cyclical asymmetry and made the consumers hold their repayments of loans due to the low influx of cash flows.

Liquidity trap and its Significance to policymakers

Liquidity traps inform policymakers about the risk areas of the financial market and enable them to forecast and respond accordingly to mitigate the impact of a severe liquidity trap. Inelastic demand on the consumer end for further investment withholds the cash from making its impact on the market. Policymakers can influence consumers through monetary policy to tempt them to invest in capital rational goods to keep the market balance in recession. Another aspect of a liquidity trap is the risk of deflation in the interest rates that lower the profit yield of an investment. It restricts the firms from investing due to the lower loan and investment yield. A liquidity trap provides an overview of the market, and as it is commonly said that crises are terrible things to waste, a liquidity trap is a crisis situation if not responded with adaptive policies, this allows policymakers to make strategic policies that have a threshold for contingencies and containing the severe impact of crises on the financial market (Epstein, 2014).

References

Bertella, M. A. (2015). The interaction between Fiscal and Monetary Policy in a Dynamic Nonlinear Model. *PLOS*, 6.

Epstein, G. A. (2014). *Banking, Monetary Policy and the Political Economy of Financial Regulation: Essays in the Tradition of Jane D'Arista.* Edward Elgar Publishing.

Jermann, U. J. (2015). Journal of Monetary Economics. *ELSEVIER*, 12.