ILLINOIS FARM ECONOMICS UPDATE

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The Current Financial Crisis: How Did We Get Here?

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October 15, 2008

IFEU 08-01

The Dow Jones Industrial Average (DJIA) fell by more than 18% during the trading week of October 6th 2008, the largest one-week decline in the history of the index. News reports of the failures of large mortgage lending institutions in the U.S. have become commonplace. In short, we are in the midst of a massive financial crisis. So how exactly did we get here?

The simplest and most direct answer to how we got here is that, over the past few years, too many "bad" mortgage loans were made in the U.S. Historically, mortgage lending has been done through "local" savings and loan institutions who lend money directly to people within their communities. The traditional mortgage terms typically include a fixed interest rate over a fixed term, and require a significant down payment from the borrower to provide sufficient collateral even if real-estate values decline.

However, over the past 30-40 years the amount of debt owned by traditional savings and loan institutions has declined while total mortgage debt held by "non-local" parties, through the use of asset-backed securities, has increased significantly (Hamilton, 2008). These securities are created by pooling a large number of mortgages together for sale to investors who are then (theoretically) paid a return over time using the stream of mortgage payments from the borrowers.

Recently, the combination of relatively low interest rates and credit availability combined to create the boom in U.S. real-estate markets. Borrower demand for home mortgages increased significantly and mortgage brokers, driven by profits determined by commissions, came up with creative ways to make loans available to a larger pool of potential borrowers. From 1995 to 2007, total mortgage debt in the U.S. increased from $3.5 trillion to more than $11 trillion (Hamilton, 2008).

Additionally, the rapid increase in real-estate values provided justification for lending amounts in excess of market values without down payment requirements and/or documented proof of repayment ability. Originating lenders were more than willing to approve loans to even the riskiest borrowers because they never intended to personally finance and take on the risk of the mortgages. This was done by the buyers of the mortgage-backed securities.

Unfortunately, in 2006 the party literally started to end. Many of the existing non-traditional mortgage contracts became unaffordable to borrowers as variable interest rates adjusted upwards and balloon payments on no-interest loans became due. At the same time, housing values began to decline so that the collateral upon which the individual mortgages and pooled securities were based upon - the value of the homes themselves - were not sufficient to cover the outstanding loan balances (Barnes, 2008). It is estimated that at least 15.4 million U.S. homeowners (~30%) will have zero or negative equity in their homes by the end of 2008.

Since then, the value of mortgage-based securities has plummeted as default rates increase and investors shift their money out of increasingly risky debt-based instruments into safer investments. This has led to the failure of large investment institutions and the current credit crisis, which is ultimately driven by a lack of liquidity. Investors are wary of putting their money at risk in debt markets, which makes it exceedingly difficult for lenders to obtain the financing needed to originate new loans or lines of credit, even to creditworthy borrowers – the money is simply not there to do so. The $700 billion dollar bailout plan signed into law on Oct. 3rd 2008 is intended to help alleviate these liquidity problems.

References

Barnes, R. 2008. "The Fuel that Fed the Subprime Meltdown." [http://www.investopedia.com/articles/07/subprime-overview.asp?Page=1]

Hamilton, J.D. 2008 "How We Got Here." [http://www.econbrowser.com/archives/2008/10/Hamilton_Rady.ppt]