Miraculous Financial Engineering or Toxic Finance? The Genesis of the U.S. Subprime Mortgage Loans Crisis and its Consequences on the Global Financial Markets and Real Economy

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Abstract

In the fall of 2008, the U.S. subprime mortgage loans defaults have turned into Wall Street's biggest crisis since the Great Depression. As hundreds of billions in mortgage-related investments went bad, banks became suspicious of one another's potential undisclosed credit losses and preferred to reduce their exposure in the interbank markets, thus causing interbank interest rates and credit default swaps increases, a liquidity shortage problem and a worsened credit crunch condition to consumers and businesses. Massive cash injections into money markets and interest rates reductions have been assured by central banks in an attempt to shore up banks and to restore confidence within the financial system. Even Governments have promoted bail-out deal agreements, protections from bankruptcies, recapitalizations and bank nationalizations in order to rescue banks from disastrous bankruptcies.The credit crisis originated in the previous years when the Federal Reserve sharply lowered interest rates (Fed Funds at 1%) to limit the economic damage of the stock market decline due to the 2000 dot.com companies' crisis. Lower interest rates made mortgage payments cheaper, and the demand for homes began to rise, sending prices up. In addition, millions of homeowners took advantage of the rate drop to refinance their existing mortgages. As the industry ramped up, the quality of the mortgages went down due to poor credit origination and credit risk assessment. Delinquency and default rates began to rise in 2006 as interest rates rose (Fed Funds at 5,25%) and poor households across the US struggled to pay off their mortgages. Many of them went bankrupt and lost their homes but the pace of lending did not slow. Banks have transformed much of the high-risk mortgage debt (securitizations) into mortgage-backed securities (MBS) and collateralised debt obligations (CDO), and have sold these assets on the financial markets to investment firms and insurance companies around the world, transferring to these investors the rights to the mortgage payments and the related credit risk. With the collapse of the first banks and hedge funds in 2007 the rising number of foreclosures helped speed the fall of housing prices, and the number of prime mortgages in default began to increase. As many CDO products were held on a "mark to market" basis, the paralysis in the credit markets and the collapse of liquidity in these products let to the dramatic write-downs in 2007. When stock markets in the United States, Europe and Asia continued to plunge, leading central banks took the drastic step of a coordinated cut in interest rates and Governments coordinated actions that included taking equity stakes in major banks.This paper written by the Author (on October 7th, 2008) at the rise of these dramatic events, aims to demonstrate, through solid and fact-based assumptions, that this dramatic global financial crisis could have been addressed and managed earlier and better by many of the stakeholders involved in the subprime mortgage lending process such as, banks' and investment funds management, rating agencies, banking and financial markets supervisory authorities. It also unfortunately demonstrates the corporate social responsibility failure and the moral hazard of many key players involved in this crisis, since a lot of them probably knew quite well what was happening but have preferred not to do anything or to do little and late in order to change the dramatic course of the events.

Keywords: U.S. Subprime Mortgage Loans Crisis, Toxic Finance, Financial Engineering

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