The Subprime Mortgage Crisis:
The Downward Spiral Effect

Matt Semmelrock
Seton Hall University '09
Finance, International Business, and Spanish
400 South Orange Ave. Suite #1714
South Orange, NJ 07079
860-841-1493

Everyone dreams of owning their own home someday. For many it is just a dream, but many also manage to turn it into a reality. Today, that dream is becoming harder and harder to achieve. Houses and property cost money, and there is no way around it. There is no such thing as a free lunch, and there is certainly no such thing a free house. How people finance their home makes a world of difference, to many people beyond themselves.

In order to finance a house, a mortgage must typically be given by a bank or lending institution. In an economy so much is based on credit, how do people with bad or no credit secure mortgages? What about those who might qualify for a mortgage, but only marginally, or those who have enough income but not enough cash for a traditional down payment? The answer is with difficulty and high interest payments. People in these circumstances have historically had a much harder time finding financing for a home, because their risk of default is high. Risk analysis by banks and lending institutions is a major part of the job today, because businesses certainly do not run on trust and IOU's. The ironic thing is; if a person with poor credit is approved for a loan, then they usually have to pay higher interest rates or premiums. How is a person with poor credit to afford paying higher interest rates when they have already shown they are not credit worthy in the past? That question suggests one reason for the recent credit market trouble. Due to subprime mortgage lending, a credit crisis has erupted as more and more people default or appear to be about to default on their payments. Mortgage companies and lending institutions are forced to write down these sub-standard loans, recognizing losses, which affects their own creditworthiness and liquidity. As the Federal Reserve Bank (Fed) battles this growing problem, the downward spiral effect that has begun may accelerate, possibly even leading to an economic recession, all originating from lender's aggressive tactics, and borrower's bad or ill-informed decisions.

One cause of the crisis is the naive individual who gets into a mortgage agreement without knowing or appreciating all the risks. In order to get a mortgage for their first home, many people stretch financially. The recent popularity of no-interest and below-market ARM's with low initial rates has allowed many first time and other marginally qualified purchasers to get mortgages where they would not have qualified under historically more stringent underwriting standards. These below-market rates that are hyped up to be attractive allow a borrower to pay a set low interest payment for the first couple of years, then the rate rises after that to whatever the going rate is. So when interest goes up in the economy, suddenly individuals paying a 3% interest payment on their mortgage are suddenly stuck paying a 6%-8% payment and they find themselves unable to make the new increased payment, resulting in defaults, and ultimately, foreclosures and bankruptcies. The question here is who would let themselves enter into these kinds of agreements? The answer is the lending institutions are in large part responsible for this crisis by relaxing their underwriting standards. More risk analysis and better credit analysis clearly is needed before some of these individuals should be approved for a mortgage. But new problems arise when lending companies become stricter in their underwriting. When it is harder to get a mortgage, it is mainly because of adverse selection. Not knowing enough about the other party in the financial markets today leads to asymmetric information and is a major cause for concern. But how is it possible to avoid adverse selection and at the same time avoid individuals who are likely to default? The answer is anything but simple, and finding that happy medium between being too giving and being overly selective is incredibly difficult to come by. It is clear right now that many lending institutions lately have been leaning more towards being overly relaxed in their standards in order to turnaround a short-term profit.

Lending institutions protect their investment when they lend money, in order to preserve their assets and make money for their owners. One of the most important ways for lenders to protect their investment is by requiring collateral. Usually in real estate, the property being financed is designated as security for the loan. The collateral usually takes place in the form of a lien against the property being purchased, which is in effect until the loan is fully paid. A lien basically attaches the property to the loan, so that if a default occurs, the lender has the full right to obtain and/or sell the property to satisfy the note. Another popular way for lenders to protect their investment is through requiring down payments. A portion of the purchase price is immediately put down so that the risk of default is much lower. Down payments also reduce moral hazard on top of reducing the total amount of interest that will amortize over time. Private mortgage insurance (PMI) can also be put in place to protect lenders so if a default occurs, at least some of the money will return to the lender. The first criterion that a borrower must pass in order to qualify for a mortgage is the lender qualification. “If the lender gives a mortgage loan to a borrower who does not fit the guidelines set by the federal agencies, the lender may not be able to resell the loan” (Stanley, Eakins, 300). That is one of the reasons for the trouble in today’s credit markets. All these problems piling upon one another have resulted in this downward economic spiral that has severely damaged the credit markets.

There are many types of mortgages. Borrowers are constantly looking for the best repayment rate, lowest interest rate, and decent loan terms in order to secure an affordable mortgage. Many conventional mortgages are typically insured by the FHA, but these loans are only for certain individuals: veterans or individuals with an income below a certain level. Conventional mortgages can also be insured through private mortgage insurance companies. All mortgages carry either a fixed or adjustable rate. Fixed rate loans are self-explanatory where as adjustable rate loans are often confusing to many borrowers. With an adjustable rate mortgage (ARM) the interest on the mortgage is directly tied to a market interest rate. As mentioned earlier, these people that enter these agreements simply do not understand that sooner or later, their interest rate is tied to the market, so they are exposed to rises in rates, as well as the inevitable adjustment that will take their initial below-market rate to a current market rate. So why do people get into these ARM mortgages? The reason is directly associated to the lender. Lenders prefer ARMS to fixed rate mortgages. "…lenders must entice borrowers by offering lower initial interest rates on ARMS than on fixed-rate loans" (Stanley, Eakins, 304)**.** Then when interest rises, the lender makes a much higher profit.[1] The credit crisis is directly associated to this. It once again comes back to the borrower's incompetencies and the lender's desire to make a higher profit. Together the formula derived when combined is that of trouble and potential economic disaster as seen in the news. As in the *Wall Street Journal*, it is obvious that the credit crisis is such a cause of concern right now. It is possible for a reader to pick up the newspaper and find a new article about the subprime woes almost everyday.

Several articles of note in the *Wall Street Journal* prove the crisis is likely to become more and more of a problem, perhaps causing our economy to spiral downward. Although stocks are currently doing well, it is only a matter of time before the whole

[1] Mishkin and Eakins, *Financial Markets + Institutions* (New York: Addison Wesley, 2006), p. 299

economic system spirals into a market nightmare. It is comparable to a epidemic. It has a source, and rapidly, it begins to spread. The subprime problems are like an epidemic in the sense that it has started off small and has the potential to spread into something huge and dangerous if not quickly countered. In a very macroeconomic sense, when rates went up, these new no-interest mortgages sprout up in order for lenders to get bigger fee income due to aggressive hunting for these marginal loans (revolving credit agreements, hybrid mortgages, buying with zero money down) borrowers are too optimistic that the value of their house would rise. In reality, their values did not rise, but began to fall incredibly sharp and fast. These people having to now pay a higher monthly payment can’t make the payment, and have to sell their houses into a market full of other sellers for the same reasons. Then the spiral effect takes place. This hurts the lender, the supply and demand for loans goes down, and fewer people are buying because everyone is selling, in turn bringing the supply up and demand down for houses. With fewer people buying houses, construction companies are slowing and even going out of business. Similarly, the companies that are closely tied to construction and construction products are also slowing their production lines to meet the reduced demand, and they, too, may indeed go out of business. Now the finances of these companies and others are in crisis, and that in turn brings down the equity markets, and eventually there has to be some kind of bottom. That bottom may or may not be a recession, but a recession spawned from this problem seems likely. In the end housing prices are falling and borrowers, lenders, and the everyday consumers are left high and dry.

These cases have been seen before. Several years ago getting a mortgage with zero money down was unheard of. In order to even qualify for a mortgage, the borrower would have to save up sufficient funds in order to make the down payment. Lenders then looking for larger profits took on larger risks as they began offering reduced down payment loans in order to make larger profits. These types of mortgages suddenly not only became popular, but also flourished, especially in certain markets. This is yet another one of the direct reasons for the crisis today. Suddenly these loans are being sought out by ordinary people who see these mortgages on the television, or hear about them from a friend; buy in with high hopes, and leave both lender and borrower in trouble in the end. When so called "opportunities" like these are publicized beyond those sophisticated enough to understand what the risks really are, trouble is evident. Another example is when futures first became popular. People made a lot of money off the futures market, and suddenly when it became public knowledge, many ordinary people, with no investment knowledge of these sophisticated vehicles buy in with high hopes, only to be left with significant losses more often than not. Another example is the dot com hype back in the late nineties. When information and investment opportunities become public topics like this, it is time to run without looking back. A popular notion of this is "when you hear you should sell a stock on the golf course or in the supermarket, you know you're already in trouble if you haven't already bailed" (anonymous). These same concepts come into play with the mortgage crisis. People must realize that with every boom cycle comes a bust cycle. The housing boom has now become the housing bust. What was once selling big, has now depreciated in value. Everyone hops on this bandwagon, and as it picks up more speed, it suddenly speeds more and more out of control until eventually it is going to crash and people are going to get hurt, not physically, but financially in this case.

With all the hype in the media, and the billions of dollars lost everyday resulting from this financial nightmare, the Fed has once again stepped up to the plate in attempts to help level out the crisis. In the middle of September, the Fed shocked the nation by dropping the Fed Funds rate half of a basis point. As of October 24th, 2007, the current federal funds rate was 4.73%.[2] This drop was more than anticipated, and it was solely done to help fix the credit problem. The fact of the matter is, it did not help as much as people hoped it would. Data released on the Fed's website shows an upward steady growth of mortgage debt outstanding in almost all sectors. Examining the chart issued by the Fed from 2004-August of 2007 on this page and continued to the next page (August 2007: when the mortgage crisis was at its peak) everything is directly proportional: The fees and charges almost doubled for the percent of the loan amount, the purchase price went up, and the contract rate and effective rate have also been steadily climbing.

	Item	2004	2005	2006	2007						
					Feb	Mar	Apr	May	June	July	Aug
		Terms and yields in primary and secondary markets									
	PRIMARY MARKETS										
	Terms[1]										
1	Purchase price (thousands of dollars)	292.0	326.8	345.7	361.9	369.0	368.4	355.0	357.9	356.1	368.9
2	Amount of loan (thousands of dollars)	215.0	238.5	253.4	270.3	270.5	268.8	265.8	267.2	270.1	282.9
3	Loan-to-price ratio (percent)	76.0	75.3	75.4	76.3	75.3	76.3	77.0	76.7	77.6	78.6
4	Maturity (years)	28.8	29.2	29.5	29.5	29.3	29.5	29.4	29.5	29.4	29.6
5	Fees and charges (percent of loan amount)	.51	.54	.66	.74	.79	.82	.76	.88	.85	.88

[2] Anonymous, *Description of the Federal Funds Effective Rate*, https://www.federalreserve.gov/datadownload/Preview.aspx?pi=400&rel=H15&preview=H15/H15/RIFSPFF_N.WW, (October, 2007)

	Yield (percent per year)										
6	Contract rate	5.68	5.86	6.50	6.20	6.10	6.09	6.11	6.41	6.58	6.60
7	Effective rate	5.75	5.93	6.60	6.31	6.22	6.21	6.22	6.54	6.70	6.73
8	Contract rate (HUD series)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	SECONDARY MARKETS										
	Yield (percent per year)										
9	FHA mortgages (section 203)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
10	GNMA securities	5.19	5.13	5.70	5.64	5.52	5.64	5.73	6.15	6.10	5.90

[3]

Although the equity market was able to pick up momentum from the Fed's decision and hit record highs, this temporary success was only to be met with more hardship as stocks began to fall again, the credit crisis worsens and companies began to pay for their mistakes. That is also why in the October 31st meeting Bernanke and the Fed lowered the Fed Funds rate once again a quarter of a basis point to 4.5%. Although this current rate will help level out the economy, inflation is rising to high levels of concern, meaning another decrease by the Fed will not occur for some time. Out of this new cut, investors and consumers, especially those that are caught up in the crisis for the worse can only hope that it will be the altering swing in the battle for stability.[4] Although the previous rate change helped the stock and bond markets stabilize, the credit market has become significantly worse since then. The Fed's beige book goes to show a drastic reduction in new home construction, proving that the spiral effect of the mortgage crisis is reaching new lows. The construction of residential homes has fallen at a fast rate since the housing market began to decline back in March. In May-July, construction fell the most since

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[3] Anonymous, *Statistical Supplement to the Federal Reserve Bulletin*, *1.53 Mortgage Markets*, *Mortgages on New Homes*, http://www.federalreserve.gov/pubs/supplement/2007/09/table1_53.htm, (September, 2007)
[4] "Fed's Rate Cut Could Be Last For a While," *Wall Street Journal*, 1 November 2007, p. A1

2004, meaning that companies will not be expanding and overall economic growth is significantly slowed. The last time there has been a consecutive drop in the percentage of homebuilding was back in February-March 2003.[5] Construction in America is a significant industry, that has ripple effect across our entire economy.

With the consumer price index at 2.8% and foods and energy costs being higher than normal also are causes of higher inflation. Because of the rising inflation over the last six months, lowering interest rates may only increase inflation, so battling the effects of the mortgage crisis is no easy task for the Fed. The beige book also shows the effect of the housing on other sectors. For example some sectors feeling the impact of the housing crisis include internet sales, car sales, and even advertising. The job shortage that was reported was also a cause for concern.[6] Every aspect of the economy has to be examined when the FOMC (Federal Open Market Committee) comes together to decide on the next rate to be established. Once again, finding that happy medium to satisfy as many areas of the economy as possible proves to be incredibly difficult. In another act to educate the masses, the Fed has also updated its website to include such information tools as: a consumer handbook on adjustable rate mortgages, foreclosure resources for consumers, Federal Reserve consumer help, and choosing a credit card, all of which are in response to the credit crisis.[7]

The result of the crisis to people who have defaulted on these mortgages over the last nine months has been devastating. With more than a 23% increase in bankruptcy filings over last year according to the American Bankrupt Institute, it appears that bankruptcies are only going to increase. Even with a law passed in 2005 making it much

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[5] "Construction Spending in the U.S. Unexpectedly Fell" *Bloomberg*, 3 July 2006
[6] "Fed Survey Yields Few Rate Hints," *Wall Street Journal*, 18 October 2007, p. A4
[7] Unknown, *Consumer Information*, http://www.federalreserve.gov/consumerinfo/default.htm

more difficult to declare bankruptcy, the number of occurrences has increased significantly from that date. The unfortunate thing is, even under chapter 7 (liquidation and forced sale of assets) of the federal bankruptcy code, many individuals will still continue to lose their homes through foreclosure. Now people are filing under chapter 13 (a debt reorganization), which with help of the law passed in 2005, forgives less debt than the chapter 7 filing option. According to William McLeod, a Boston bankruptcy attorney, "It's a mess, that is fed right now by real estate, and what's been this mortgage frenzy in the last several years" (Merrick). An interesting alteration is that instead of advertising these zero rate, zero money down mortgage opportunities, now, a new cottage industry has sprung up advertising and promoting chapter 13 bankruptcy aid out of the need for assistance. The only people who have hopes of turning around their foreclosure through chapter 13 are those had had merely a minor financial setback and can make a financial turnaround in the near future. A real time example comes from Donna Randles of Chicago who filed chapter 13 last year. The problem that stemmed from the mortgage crises for her now becomes, "As things progress, I'm learning that my income doesn't increase, but my mortgage does"[8] (Merrick). With this foreclosure problem that has been sneaking up since the start of this mortgage crisis, the government has had talks about altering the code once again. Now, bills are being introduced in Congress that would allow the courts to adjust the repayment period for a mortgage, making it so the borrower has more time, and more ease for the process. It is once again ironic that just two years ago Congress was cracking down on borrowers, making it harder for them if they did default. Also other proposals that are being debated right now include the possibility of tax write offs for people who have had their debt forgiven. For example if someone had a

[8] "More Debtors Use Bankruptcy To Keep Homes," *Wall Street Journal*, 23 October 2007, p. A1

$300,000 mortgage, and their property was worth only $200,000, if the property were sold, and the balance forgiven, then the $100,000 forgiveness would then be taxable income, subject to income tax. The proposals going around would allow for that difference to be at least partially exempt from taxes. How is it equitable, because for all other borrowers who are not falling into these mortgage black holes, how is it fair that some get a free handout by the government?

According to another *Wall Street Journal* Article, (Quoted by Ivy Zelman, CEO of a real-estate research firm) the mortgage crisis is “A case study on the way that greed convinced everyone there wasn’t risk” (Mollenkamp). Going back to economic indicators, red flags should have gone up when the number of bankruptcies surged. Also, Thomas Zimmerman, head of mortgage credit research at UBS believed that up to 16% of sub-prime backed securities were wiped out last year due to the occurring defaulting problem. He also believes that the unemployment level has a key role here in that if the unemployment level increases, even slightly, losses could exceed 20% or higher. One broker only told customers to use ARMs only if they were planning to purchase property for a short term period. It is disappointing others did not follow this broker’s actions.[9] Clearly before, when the housing market was booming, taking advantage of ARM mortgages, having the property’s value appreciate, then selling, and making a significant profit, was a popular way to make some fast money. These investment companies would outbid each other to be able to sell these loans and privately backed securities. When they started to default, these companies would take considerable losses, and in return, have had to layoff employees, and in severe cases, even liquidate assets to cover the losses. Merrill Lynch is a perfect example of one of the major companies that allowed the credit

[9] “Behind Subprime Woes, A Cascade of Bad Bets,” *Wall Street Journal*, 17 October 2007, p. A1

spiral to get started. Now the company is paying for their actions as the CEO Stan O'Neil takes heat from the press and from other investors for the company's poor lending decisions. They knew what they were doing, but what they were not planning on was for their short term profit to lead to long term disaster. The company had $8.4 billion in write-offs in their third quarter, solely from the mortgage sector of the company. Because of the accusations and the poor performance, O'Neil announced on 10/22/2007 that he would be stepping down as the CEO of Merrill Lynch.[10] The significant severance pay package when he leaves will be massive, so are his actions really getting punished? The answer is absolutely not. Will O'Neil be bothered by the negative press or feel the least bit immoral when he walks away with the $161.5 million package he was offered in stock options and retirement benefits?[11] Only he is capable of answering that question.

The epidemic of the credit woes do not end on American soil. They have managed to spread overseas as well. The credit crisis is not just an American issue, but a major global concern. An example of this is back in August, when the French bank BNP Paribas had to freeze several accounts resulting in a loss of over $2.4 billion.[12] Since then, major banks around the world felt the effects as well. To try and combat the spread of the crisis, institutions are injecting money back into the economy in order to try to keep the rates low. This global scale proves the seriousness of the matter at hand. Since early summer more and more institutions have folded as they too were responsible for hopping on the new hybrid ARM bandwagon that stemmed out of the American mortgage market.

Many times, Bernanke's capability at handling the situation has come into question as far as his effects implied through the FOMC. Alan Greenspan's superior

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[10] "O'Neil Out as Merrill Reels From Loss," *Wall Street Journal*, 29 October 2007, p. A1
[11] "Merrill's Job: Cleaning Up and Moving On," *Wall Street Journal*, 31 October 2007, p. C1
[12] "Impact of Mortgage Crisis Spreads," *Wall Street Journal*, 10 August 2007, p. A1

knowledge and experience have economists and politicians asking him to help stop the crisis. One must hope that there is a solution to this nightmare. Several attempts have been made, but it’s going to take more than another rate cut to see short term economic stability. Another major concern that results from the mortgage crisis is that of identity theft. In this time of financial chaos, documents and filings are being moved around carelessly, being dumped and tossed out, and exchanging hands. Dartmouth College’s management professor, Eric Johnson said, “In times of organizational change or chaos, we're much more likely to see those kinds of leaks -- what I call inadvertent disclosures”[13] (Hudson).This just goes to show how more and more problems are occurring as the spiral effect keeps spinning faster. The chances of hitting bottom that is without a doubt approaching grow closer on the global economic radar. As consumers, individuals must help in this difficult time by making the best financial decisions and not adding to the problem. One thing is for sure, that by the time this is over and stability has been reached, buying that dream house might not be so difficult. Some investors even look at this crisis as an investment opportunity. Could mortgage company stock and stocks out of the lending sector be a good buy due to extremely low book values? Only time will tell, but the smart investor will sit this one out. The economy can only hope for recent stimulation from the current rate cut, but there is certainly plenty more to prepare for down this long bumpy road ahead.

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[13] “Dumped Mortgage Files Invite Identity Theft,” Wall Street Journal, 23 October 2007, p. B1

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