CASE STUDY ***"The Financial Crises of 2007-2008"***

is hereby Submitted to ***Pakistan Insurance Institute***

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## *INTRODUCTION :*

In the mid of 2007's the U.S. financial market started to face the worst financial crises. The effects of these crises first lead to the recession of country then later spread globally. The main causes and effects of 2008 financial crises will be discussed and analyzed later in this case. A complex of government policy, financial market structure and the real state were the main reasons for the critical outcome of the financial crises. The Financial institutions and investment firms were also the sources of severe outcomes.

## *STAKE HOLDERS :*

### THE GOVERNMENT :

The government wanted to boostup the housing economy. For this reason, America introduced a new lending system to finance the house called mortgage-a legal agreement between two parties where one party who lends money against the possesion given by the other party called borrower. The down payment will be paid by the borrower and in case of failure of repaying the money, the property will go into the possession of the lender. The National Bank of America – the Federal Reserve lowered interest rates to **1%** in **2001-2004** to make the dream of ownership of home come true and to boost economic growth. In **2006,** Federal Reserve increased interest rates to **5.25%** which caused the neglegency of more and more loaners, the result will be discussed later.

### REAL STATE MARKET :

There was a big change in the housing market. Having lowered interest rates, the demand of mortgage loans increased and more and more citizens were willing to own a house. At that time, house prices were rising as demand in the real estate market was increasing.

### BANKS :

Banks created too much money by making loans. Even after the increased demand of mortgage, the banks started to make loans without proof of income and employment.

### BORROWERS / BUYERS :

Having started the mortgage system, too many citizens cameout for their dream of ownership of home. When the banks offered low interest rates and reduced down payment, this pushed lower and middle class citizens to borrow money for bigger and bigger houses which normally they could not afford. This scenario created housing boom.

### INVESTORS :

Investors invested in housing market. There were smaller institutions and private investors both, who invested to get profit by earning interest.

### RATING AGENCIES :

Rating agencies gave 'AAA' ratings to mortgage-backed securities based on the assumption that home prices would not fall.

## ***BACK GROUND AND DETAILS OF THE CASE :***

After the second world war, a new lending system of mortgage was introduced to stimulate the housing system and to provide houses to the middle class citizens because home is the most essential need of every citizen. In this system of mortgage, the bank lends money to borrower in order to finance a house where the property of borrower which will be in the possession of bank till all the payment of loan will not be recovered. It includes down payment of **3-20%**. A verification of employment and income was the requirement for taking a mortgage loan.

Under President Bush, the National Bank of America – the Federal Reserve reduced interest rates to **1% from 2001-2004.** They reduced so that Americans can realize the dream of acquiring a home. As interest rates were low, the demand for mortgage loans increased and due to high demand, the prices in the real estate market increased. In the meanwhile, in some countries of California, the level of supply of houses was low because according to the level of increasing demand, it was not possible to produce new homes. So, due to shortage of supply, prices increased more and more. The belief that home prices would not decline leads to the sale of mortgage-backed securities. Rating agencies started to give ratings 'AAA' to mortgage-backed securities that home prices would not drop. Investors purchased those securities with believe that principal and interest would be repaid in a timely manner.

The banks started to issue subprime mortgage to the borrowers with no proof of income and employment. There were very low interest rates, downpayments were diminishing that pushed the middle class citizens to borrow more and more money to purchase bigger houses which they could not afford. It was just like "licking the candy and have a promise to pay for it later." In **2006**, the housing bubble bursts, the borrowers were buying not for fulfilling their need but to resell for profit. The subprime mortgages started to default as borrowers could not pay any more. On the otherside, the Federal Reserve led rates to **5.25%.** As a result, the monthly payments of borrowers increased and more and more loaners started to neglect. Especially this high interest rate effected mostly the subprime mortgage. The houses had become the property of banks and investors because of non-payment. As prices of houses were going up so banks and investors had an opportunity to have profit by selling the houses. As the house supply in the US market exceeded the demand, so the prices stopped to increase. After it, the housing bubble busted and prices dropped. As there was downward trend in house prices, so the householders, banks and investors decided to leave their property's as they were feared, if they would lose even more money. So, at the end, foreclosure rates increased by **43%** in **2006** and **75%** in **2007**. Paying the mortgage was more expensive than selling the house.

## ***CONSEQUENCES :***

When the US housing market started to go down or fall. As the people had started to buy the mortgages which they could not afford. So, finally at the end, they failed to repay the loan and started to leave their homes. Not only the people but the real estate sector was facing hard time because the demand cut down and the bubble busted. The companies providing funds to the thousands of banks and mortgage companies went bankrupt. Mistrust among banks created insecurity in the credit market and the banks stopped to make loans.

After the US Financial crises, the global recession started to spread globally. As the countries have link with each other and without being interlinked with eachother, they can't survive.

So, at that time also, many countries had interlinked with eachother. As a result of financial crises exports market faced huge loss. Especially, the China and Japan suppliers got effected and the export market got down as the demand in the US market started to fall. Due to this, the workers have come from other countries lost their jobs. The unemployment rates of **4.4%** in **March 2007** increased to **7.2%** in **December 2007**. It was expecting that the unemployment rate would be risen to **10%.**

## ***CONCLUSION :***

The government, investors, banks, rating agencies all were responsible for crises. Banks were issuing loans without having a look at risk. The confidence of banks had built by having ratings through rating agencies and the corrupted rating agencies inspite of knowing that their rating is a kind of bribery. They involved although they could have stopped but they continued.

On the otherside, the banks created too much money. Lots of people lost their homes, jobs and their savings. Even the wealth loss was so huge that it needed more than **700 billions** to save the banking system in the US. The other countries who had interlinked with US, some of them reached to some what insolvency.

It seems that the financial institutions could not solve the subprime crises on its own and especially when the crises spread beyond the US border. Governments around the world had started coming together to prevent the financial catastrophe. Because when a person or businessman faced the loss and got insolvent , a little part of society failed but when a country face loss then loss became a catastrophe.

## ***SOLUTIONS :***

As the government was interested to establish the housing economy but it choosed banks , the main financial sector of every country and left them free-handed , the main financial sector of every country. There could be another ways to foster housing economy i,e. where the people would have been provided loans , there would be low interest rates and a reasonable advance payment so that middle even lower class could afford. These kind of schemes are mainly introduced for the poor people because rich can fulfill their needs by their own but lower class people needs financial support and just governemnt can provide it. After introducing scheme, there would be check on every desired person either the person is capable or not. There should be proof of income and employment. Before the people have been provided homes. The schedule of payment would accordingly the worth of desired person. Supose, a person has worth of paying 5000 a month and he has been asked to pay 15000 a month, then might in starting, he will agree to pay but later he would get default and again there would be chances of insolvency and so on.

Lets take an example of a person who was having credit card with a certain limit. He started to consume it and spends a lot and the bill of that credit rose and rose. The time came when he was unable to pay his bill as it was the credit amount and he did not have the billed amount to pay instantly so the authorized officers started to tease him to take out money. The days were passing and he got into depression. Finally he lost his property and died. As the person did not have that credit worth and he spent out of his worth. Same is here, the people were being given loans out of their worth.

For betterment the government must take the control of market economy . In U.S. Everyone was seemed to be playing a game. They were doing what they wanted to do. Banks were creating too much money without looking at risk in future. For taking the most of that opportunity, real estate market was increasing the prices of houses. Rating agencies were giving ratings to attract more and more investors. No authorization was there to restrict them. Government should have imposed regulations and the involved sectors should have been controlled by government.

**Other suggestions are mentioned below ;**

- The Banks were investing more and more without any strategy on the basis of intangible money. It does not mean that they should not have invested but there was need of awareness that how fluctuations work & what is the best time to attract investors.

- Tracking of data at correct time will make the investment more fruitful.
- There should be focus on monitory policy. By having strong strategies, these kinds of major crises could not happen and when happened , they can be controlled easily at the initial stage. Because of flexilibility in policies , better decisions can be made. There is even a chance of growth for those who are flexible.
- As US is the most popular state. It's language is an international language, it's currency is an international currency. A developed state or a country would be at greater risk. There must be an authorized board which has an eagle eye on the market economy and it could give a sign when a favourable time would come
- The currencies of different countries effect each other. One country can remain vigilent by monitoring other countries' economy. They could even make the predictions about what is happening to other country. For Example, those countries having linked with US at that time, if they would have been aware about US conditions at earlier stage, they could have been saved from global crises.
- By issuing more and more loans, banks were keen to get more and more benefits. But no any sector was there to have a look at the long run catastrophe, that was going to come.