The Crisis of The Risky American Mortgage Credits (Subprime Crisis) – The International Financial Crisis Initiating Factor

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Abstract: *Financial crises have begun to be a part of our daily life. The financial crisis that the whole world is dealing with presently, initiated by the USA mortgage crisis, is merely a link from a long chain of crises: the Latin American debtors' crisis (1982), the USA savings houses crisis (1986), the Japanese banks crisis (1992), the Mexican pesos crisis (1994), the Asian crisis (1997), the Argentinean crisis (2000), the technological field crisis (2000). All these crises appeared as a result of speculations without happy ending, following a lower supervising degree of the banks and a diminuation of the control regarding the capital being under circulation since the '70s.*

The US Subprime Crisis began in 2007 as a result of important disruptions in the international credit and capital markets. Had market participants anticipated the increase in defaults on subprime mortgages originated in 2005 and 2006, the extent of these market disruptions would be different. If investors in mortgage-backed securities would have demanded higher returns, borrowers would not have found credit cheap and easy to get as it happened during the subprime boom of 2005-2006.

Keywords: subprime crisis, house prices, credit default swaps, domino effect

The beginning of the Subprime Crisis

The factor initiating the international financial crisis that the whole world is dealing with since 2008 was the USA mortgage crisis in 2007 (Subprime Crisis). This crisis has produced serious effects in the entire Europe. Famous banks from Germany such as Düsseldorfer IKB, WestLB and SachsenLB, but also the greatest bank in the world, Citigroup of America, have registered losses of billions Euros.

At the same time with the bankruptcy of the investment bank Lehman Brothers of September 15, 2008, the crisis was generated at world level, leading to the situation of Ireland being threatened by national bankruptcy. The stock exchange rates have decreased to a minimum level, casting into the shade the "black Thursday" of October 24, 1929, the beginning of the world economical crisis at that time.

In October 2008, the whole world held their breath and waited for the consequences, meaning the increase of the unemployment rate, recession, falling of other banks, the auto industry blockage and the expansion of the crisis expected in the third trimester of 2009 due to the credit cards crisis.

In USA the credits benefited of variable interests, being oriented according to the American reference interest, determined by FED (Federal Reserve System). As a result of the explosion of the Dotcom Bubble ("the New Economy") at the beginning of this millennium (2000), but also as a consequence of the September 11, 2001 assaults, the American reference interest was diminished many times by the Head of the Federal Reserves, Alan Greenspan, who was aiming to attract investors and to encourage the private consume by granting advantageous credits.

After the repeated decrease of the interest by FED, its level reached a historical minimum, in this way facilitating the contraction of very low interest mortgage credits. Such reductions of the interest affected the entire situation in USA, having as consequences the decrease of the unemployment rate, as well as regular and firm incomes for the budgets of the American families, followed by an increase of the investments in real estates. All these led to the increase of the prices on the real estate market which however did not seem to prevent the Americans from investing in expensive real estates.

The American people do not approve saving (the Americans' savings rate is of almost 3 percents, while in 2008 in Germany this rate reached 11.2 percents), so they are willing to buy anything that they can be acquired by means of credits; thus most of the real estates bought by Americans were financed in percentage of 100%. The credits granted to the buyers with low incomes benefited of higher interests, as the banks considered that the granting of so-called "subprime" credits was advantageous. The respective real estates were handed over as "subprime" mortgages, respectively 2nd degree mortgages. The second degree classification represents the fact that the debtors did not have a good business and credit worthiness, so that the creditors should be covered in case of insolvency or forced execution. The respective real estates were accepted as a protection mean. On the background of the continuous increase of their value, there were granted more and more credits. The price of the real estates increased, generating higher risks.

The State contributed to a great extent

The fact that more and more average class families could mortgage the real estates they were going to acquire fitted perfectly to the American ideal of owning a property. The middle class was encouraged to buy real estates by the effective reduction of the taxes, but the interventions of the State only intensified the crisis and led to the collapse of the real estate market. "Fannie Mae" and "Freddie Mac", the two mortgage refinancing giants were responsible for this encouragement; they were taken over by the American State starting from September 7, 2008, since then being under the control of the FHFA (Federal Housing Finance Agency), in order to avoid their bankruptcy.

Solely the mortgage loans granted by Fannie Mae turned this institution into the greatest debtor in the world, with almost 2.400 billion dollars debt. In order to prevent the risk of the 2nd degree claims being borne exclusively by them, the claims were grouped and distributed as bonds which were transactioned especially by Hedge funds, by banks and insurance companies. This type of bonds was very advantageous, especially because it had as purpose a much higher increase of the value than in case of the State titles. This increase of the value attracted investors who performed transactions with such titles or took them over in their own portfolio.

Therefore, the real estates financed through 2nd degree mortgages benefited of a continuous increase of the value, at the same time constituting guarantees in case of insolvency. The creditors were granting more and more credits, thereafter grouping the claims and reselling them as bonds.

The collapse of the house prices

Together with the collapse of the real estate market prices a real catastrophe was generated on the world level. The continuous increase of the real estates value formed a balloon ready to explode any time. In order to fight against the danger of inflation increase, FED successively increased the reference interest starting from 2004. The credits granted in USA were based on the American reference interest, so automatically the mortgage credits interests also increased and several debtors found themselves in the impossibility of payment.

As the situation became worse in USA, the incomes were in a deadlock and the unemployment rate began to grow. As a consequence, the Americans began to lose their mortgaged houses. At first this aspect was not very disturbing due to the fact that the number of those who remained homeless was still quite low and the high interests practiced by the banks partially covered the losses. However, these were the signs indicating the debut of the real estate crisis.

Everything developed normally until the real estate market prices began to decrease. As a result of the reference interest increase, the losses resulted from not reimbursing the contracted credits increased much more and the real estate market was invaded by offers of houses. The prices of the real estates financed by subprime credits decreases so significantly, that the respective real estates did not present any kind of attractiveness whatsoever.

The first banks had to liquidate an important part of the granted credits, registering significant losses. In this way was created a domino effect, which began to move faster and faster.

Because the mortgages were not covered entirely by the respective real estates any longer, the subprime mortgage bonds lost their value. The first Hedge funds, banks and insurance companies stopped the transactions with mortgage titles, the big banks and investors being forced to liquidate billions of Euros. The Hedge funds which had to sell the titles couldn't place them on the market and registered losses. This domino effect expanded to the entire financial system on world level, even threatening the Island Republic with the national bankruptcy.

"Credit Default Swaps" Innovation – CDS (insurance premiums against the phenomenon of not reimbursing the credits) was the next decisive part of the domino effect. The product was created by Blythe Masters, a young mathematician, graduate of the Cambridge University in 1970 and employed by JF Morgan Chase of New York. She invented a product which cast into the shade the killing effect of the December 2004 tsunami compared to what was going to happen on the financial market, meaning the appearance of the product **"Credit Default Swaps"** CDS. The newly graduate convinced her superiors to promote this revolutionary product, which presently constitutes a great danger for the global economy.

By means of these CDS, the banks provided themselves mutual support in case of not reimbursing the subprime credits, the technique being similar to the insurance technique. By distributing the credit risk among more participants, there was intended the creation of a financial system which should easily absorb the shocks. However such system has a negative side: there can be created systemic crises such as, the USA subprime crisis.

Through the separate transaction system of these risks of not reimbursing the credit, the insurant (the buyer) was ensured against certain risks found in a credit report, by paying an insurance premium on the behalf of the party who offered the insurance. Institutions such as Lehman Brothers transactioned this kind of products, therefore the CDS sellers were forced to pay the agreed sums to the buyer.

However, the situation is much more complex, the end of the crisis being still far away, especially if we take into consideration that in 2009 a new phase is expected, meaning the credit cards crisis.

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