Credit Crunch Explained (again)

The credit crunch refers to a sudden shortage of funds for lending, leading to a resulting decline in loans available.

A Credit Crunch can occur for various reasons:

- Sudden increase in interest rates (e.g. in 1992, UK government increased rates to 15)
- Direct money controls by the government (rarely used by Western Government’s these days)
- A Drying up of funds in the capital markets

The recent credit crunch was driven by a sharp rise in defaults on subprime mortgages. These mortgages were mainly in America but the resulting shortage of funds spread throughout the rest of the world.

Steps to Credit Crunch

1. US mortgage lenders sell many inappropriate mortgages to customers with low income and poor credit. It is hoped with a booming housing market, the mortgages will remain affordable.

2. Often there were lax controls in the sale of mortgage products. Mortgage brokers got paid for selling a mortgage, so there was an incentive to sell mortgages even if they were too expensive.

3. To sell more profitable subprime mortgages, mortgage companies bundled the debt into consolidation packages and sold the debt on to other finance companies. In other words, mortgage companies borrowed to be able to lend mortgages. The lending was not financed out of saving accounts, for example.

4. Many of these mortgages had an introductory period of 1-2 years of very low interest rates. At the end of this period, interest rates increased.

5. In 2007, the US had to increase interest rates because of inflation. This made mortgage payments more expensive. Furthermore, many homeowners who had taken out mortgages 2 years earlier now faced ballooning mortgage payments as their introductory period ended.

6. This caused a rise in mortgage defaults, as many new homeowners could not afford mortgage payments. These defaults also signalled the end of the US housing boom. US house prices started to fall and this caused more mortgage problems. For example, people with 100% mortgages now faced negative equity. It also meant that the loans were no longer secured. If people did default, the bank couldn’t guarantee to recoup the initial loan.

7. The number of defaults caused many medium sized US mortgage companies to go bankrupt. However, the losses weren’t confined to mortgage lenders, many banks also lost billions of pounds in bad mortgage debt. Banks had to write off large losses and this made them reluctant to make any further lending, especially in the now dangerous subprime sector.
8. The result was that all around the world, it became very difficult to raise funds and borrow money. The cost of interbank lending has increased significantly. Often it was very difficult to borrow any money at all. The markets dried up.

9. This affected many firms who had been exposed to the subprime lending. It also affected a wide variety of firms who now have difficulty borrowing money. For example, biotech companies rely on ‘high risk’ investment and are now struggling to get enough funds.

10. The slow down in borrowing has contributed to a slowing economy with the possibility of recession in the US a real problem.

Credit Crunch in the UK(104,781),(796,799)

1. UK mortgage lenders did not lend so many bad mortgages. Although mortgage lending became more relaxed in the past few years, it still had more controls in place than the US.

2. However, it caused very serious problems for Northern Rock. Northern rock had a high % of risky loans, but, also had the highest % of loans financed through reselling in the capital markets. When the subprime crisis hit, Northern Rock could no longer raise enough funds in the usual capital market. It was left with a shortfall and eventually had to make the humiliating step to asking the Bank of England for emergency funds. Because the Bank asked for emergency funds, this caused its customers to worry and start to withdraw savings (even though savings weren’t directly affected)

3. As a result of the credit crunch, the UK has seen a change in the mortgage market. Mortgages have become more expensive. Risky mortgage products like 125% mortgages have been removed from the market. (mortgage squeeze)

How Long will the Credit Crunch Last?

The credit crunch could last a long time. This is because:

1. House prices are still falling in the US, reducing the value of mortgage loans

2. Many homeowners still face rising interest rates, when their introductory periods come to an end

3. It can be difficult to regain confidence in the financial markets

4. A recession in the US and global downturn could cause a further rise in bad loans

Source: http://www.mortgageguideuk.co.uk/blog/debt/credit-crunch-explained/