2007 Subprime mortgage financial crisis

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The **subprime mortgage financial crisis** refers to the sharp rise in foreclosures in the subprime mortgage market that began in the United States in 2006 and became a global financial crisis in July 2007. Rising interest rates increased newly-popular adjustable rate mortgages and property values suffered declines from the demise of the housing bubble, leaving home owners unable to meet financial commitments and lenders without a means to recoup their losses. Many observers believe this has resulted in a severe credit crunch, threatening the solvency of a number of marginal private banks and other financial institutions.

The sharp rise in foreclosures after the housing bubble caused several major subprime mortgage lenders, such as New Century Financial Corporation, to shut down or file for bankruptcy, with some accused of actively encouraging fraudulent income inflation on loan applications, leading to the collapse of stock prices for many in the subprime mortgage industry, and drops in stock prices of some large lenders like Countrywide Financial.[1]

This has been associated with declines in stock markets worldwide, several hedge funds becoming worthless, coordinated national bank interventions, contractions of retail profits, and bankruptcy of several mortgage lenders.

Observers of the meltdown have cast blame widely. Some, like Senate Banking, Housing, and Urban Affairs Committee chairman Chris Dodd of Connecticut, have highlighted the predatory lending practices of subprime lenders and the lack of effective government oversight.[2] Others have charged mortgage brokers with steering borrowers to unaffordable loans, appraisers with inflating housing values, and Wall Street investors with backing subprime mortgage securities without verifying the strength of the portfolios. Borrowers have also been criticized for over-stating their incomes on loan applications[3] and entering into loan agreements they could not meet. [4]

The effects of the meltdown spread beyond housing and disrupted global financial markets (see financial contagion and systemic risk) as investors, largely deregulated foreign and domestic hedge funds, were forced to re-evaluate the risks they were taking and consumers lost the ability to finance further consumer spending, causing increased volatility in the fixed income, equity, and derivative markets.

Credit crunch

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A "credit crunch" is a recessionary period in a debt-based monetary system where growth in debt has slowed and subsequently causes a drying up of liquidity in an economy. It is often caused as result of lax and innapropriate lending, which results in losses for lending institutions and investors in debt. These institutions may then reduce the availability and ease of obtaining credit, and increase the cost of accessing credit by raising interest rates for fear of further losses. In some cases lenders may be unable to lend further, even if they wish, as a result of earlier losses restraining their ability to lend.

A credit crunch is the opposite of cheap, easy and plentiful lending practices (sometimes referred to as "easy money" or "loose credit"), the likes of which have been seen around the world, particularly between 2002 and 2007. During this upward phase in the credit cycle in a debt-based monetary system, asset prices experience bouts of frenzied competitive, leveraged bidding, inducing hyperinflation in a particular asset market. This can then cause a speculative price "bubble" to develop.

When new borrowers cannot be found to purchase at inflated prices, a price collapse can occur in the market segment inflated by excess debt, along with a dramatic reduction in liquidity in that market. This can then cause insolvency, bankruptcy and foreclosure for those borrowers who came in late to that market. If widespread, this can then damage the solvency and profitability of the private banking system itself, resulting in a dramatic reduction in new lending as lenders attempt to protect their balance sheets from further losses. This in turn results in a contraction in the growth of the money supply, often referred to as a "drying up of liquidity."

A reduction in the growth of the money supply caused by a credit crunch can bankrupt marginal borrowers and threaten the solvency of marginal lenders, thereby triggering an economic recession or in severe cases, a depression, as the liquidity in the economy dries up due to a shortage of new debt money.

The 2007 subprime mortgage financial crisis may have brought about a credit crunch.