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The credit crisis that has consumed the U.S. for the past two years has offered many different lessons to many types of people. This paper discusses the start of the crisis, the lessons learned from it and behavioral changes that came about because of it, and the prevention of a subsequent crisis. The main three lessons learned discussed are: government intervention is a necessary evil, remembering the basics about lending, and what goes up, must come down, and vice versa. While there are many other issues that could be discussed, these three are key in the prevention of a subsequent crisis and are thoroughly examined.
Introduction

Two years ago in January of 2007, no one believed that we would be in the midst of a crisis as massive as the one in which we are currently. Many economists and scholars claimed that it was only a matter of time before we would dip into a downturn, as it is part of the economic cycle of a society. However, even they could not have predicted that it would be as bad or widespread as it is today. Many consumers at that time did not care about the future; they were only concerned about the present. Many of them did not realize that they might not have a job down the road, or that they might not be able to pay their mortgage. While this crisis seemed so unexpected, looking back, we can see clear signs of why it happened and what needs to be done in order to fix it, and prevent it from happening again.

However, not everything that resulted from this crisis was a bad thing. Many lessons were learned by many people, including consumers and financial institutions. Those that will be discussed include:

- Government entities are a necessary evil
- Remembering the basics about lending
- What goes up, must come down, and vice versa

While these are the major lessons learned from this crisis, there are many other that span across many different people. This crisis has taught us many things and showed us the vulnerabilities in our society, especially in regulatory oversight of financial institutions. While there are signs of emergence from this crisis, the effects will be felt for many years after it ends.

Start of the Crisis

Pinpointing the start of this financial crisis is difficult, mainly because there are many different factors that contributed to its genesis. I believe the element that contributed most to this crisis is the subprime mortgage market.
Many financial institutions are faced with an increased number of subprime mortgages, especially those in foreclosure. This increase in subprime mortgages is mainly due to the fact that many banks relaxed their lending standards. In an interview with Bryce Lang, assistant branch manager of the Oswego Chase Bank, Lang confirmed that he saw relaxed lending standards at his bank. For customers whose credit scores met a certain threshold, the bank did not ask for income verification and often did not require a down payment. Traditional lending standards require a 20 percent down payment, and both income and employment verification. Other banks are tightening their standards even more; Wells Fargo, for example, now requires a 25 percent down payment on all its mortgages. It is estimated that 30 to 40 percent of consumers who would have been approved for a mortgage during the “housing boom” will not be approved now (“Wary Banks Revert to Strict Lending Standards”).

The housing boom between 2001 and 2005 saw new-home sales grow at a rate of 9.4% and house values grow at 10%, while mortgage rates were at their lowest in years (“After the Housing Boom”). These factors combined to double home values within five years. Home values during this period were often overstated by appraisers who needed to meet the demands of the market. Appraisal companies justified these inflated figures, citing pressure from banks to meet the demand of the number of loans that were being processed. If a house is expected to appreciate in value, there is also a higher likelihood that the home will be overvalued to begin with (Mishkin). This explains why an appraiser might overvalue a house: he expects the price to increase in the future, such that even if the house is somewhat overvalued now, its value will eventually catch up to the appraisal. This increase in home prices, coupled with an increase in interest rates by the Federal Reserve, set in motion the downturn in the housing market.

During the housing boom, the relaxation of lending standards led to an increase in those marginal, riskier accounts. Banks took these accounts on in order to increase their profits by charging higher interest rates. Mr. Lang confirmed this practice in his own bank, and observed that it was
common practice in banks across the country. These marginal accounts are now largely the mortgages that are in foreclosure, and are known as "subprime."

The main difference between a prime and a subprime mortgage is that the costs are much higher for a subprime loan. Principle and interest payments, late fees, and fines for delinquent payments are all subject to a "subprime premium" (Chomsisengphet 32). And because many banks did not require down payments for mortgages, borrowers entered into contracts in which they had no stake. It became easier for these people to walk away from their homes because they had not invested a great deal of money (aside from monthly payments) into them. According to the Mortgage Bankers' Association, by the end of 2008, 48 percent of subprime adjustable-rate mortgages (ARMs) were at least one payment past due. In addition, from the third to fourth quarter of 2008, subprime loans in foreclosure increased 116 basis points to 13.71 percent. In order to reduce defaults, banks need to make it costly for the borrower to just walk away (Jaffee 5).

Some federal regulations may have contributed to an increase in these marginal accounts as well. With the passing of the Depository Institutions Deregulatory and Monetary Control Act of 1980 (DIDMCA), it became legal for lenders to make higher-priced mortgages. If a borrower's credit rating was not high enough, they could just charge a higher interest rate. The new homeowners that were created over the housing boom were largely first-time homeowners, and largely racial and ethnic minorities. This increase can be attributed to the Community Reinvestment Act (CRA). This act gave banks incentive to make loans to low-income borrowers. The subprime mortgages that were created out of this boom had exotic terms and conditions that many borrowers did not fully understand (Gramlich 106).

While marginal accounts and subprime lending were commonplace throughout the country, not all banks contributed to the credit crisis. David Conlin, branch manager of the DeKalb Castle Bank, stated that his bank did not use relaxed lending standards. He noted that Castle recently acquired another bank
that had employed those relaxed standards, and he saw the unfortunate results. Conlin also pointed out that Castle has since tightened standards in regards to the loan amount as a percentage of the collateral value. Conlin admitted that, though his bank maintained appropriate standards, it did loan a significant amount to the land development and construction industries. The decline in those industries in recent months has resulted in some bad loans.

Another factor that exacerbated the credit crisis is the practice of bundling and securitizing subprime mortgages into mortgage-backed securities. When owners defaulted on their mortgages, the interest payments on the securities were cut off. As a result, the liquidity risk as well as the default risk of the securities increased. Fannie Mae and Freddie Mac are two government agencies that bought many of these mortgage-backed securities in order to give banks money for more loans (Flowers 60). In September 2008, the government seized both of these companies because officials were concerned with increased losses in their mortgage portfolios. Because they were deemed “too big to fail,” these companies were placed under a conservatorship by the Federal Housing Finance Agency and the CEOs were ousted. This action is understandable, considering that the two firms had lost a combined $14 billion over the previous four quarters (Somerville). Furthermore, Fannie Mae and Freddie Mac bought these securities because they were given investment-grade ratings by credit rating agencies. These agencies gave investment-grade ratings to securities that were obviously based on loans of subpar quality (Verschoor 11). Because of the default of these so-called “investment-grade” securities, many believe that increased transparency of these investments would allow investors to better understand what they are buying (Jaffee 6).

Lessons Learned and Behavioral Changes

The current credit crisis offers many lessons to be learned. Consumers and lenders (financial institutions) are the two groups most directly affected by this crisis and have, therefore, the most to
learn. While it is difficult to numerically measure the far-reaching implications, certain observable behavior changes indicate what people have learned.

Most consumers have been affected in some respect by the credit crisis. Some have had their hours cut at work, resulting in decreased income. Others have lost their jobs entirely, leaving them in a state of emergency concerning their futures. Both Mr. Lang and Mr. Conlin confirmed that they saw changes in their customers' behaviors over the past six months. Mr. Lang noticed that many of his customers were withdrawing funds from time deposits before the expiration date and transferring money from savings accounts to checking accounts more frequently. Mr. Conlin also noticed an increase in the same type of transfer. Mr. Lang also stated that, while many of his customers did want to save money, they did not want to open savings accounts because the interest rates were so low.

Another factor that has contributed to consumer indebtedness is increased credit card usage. According to the U.S. Census Bureau, the number of credit cardholders has increased from 159 million in 2000 to 173 million in 2006, and is expected to grow to 181 million in 2010. In 2008, 55 percent of credit cardholders kept a balance on their card, which is up 2 percent from 2007. And finally, between 1989 and 2006, the total amount of credit card charges increased from $69 billion a year to $1.8 trillion a year (Schulz). These statistics clearly show an increased number of cardholders and an increased level of total credit card debt. Consumers were spending money that their income was secure and growing. In an interview with Bonnie Brandon, a retail sales associate, she confirmed that she used her credit cards more often than she should have. Her income is based largely on commissions and, in this economic downturn, has decreased dramatically; she can now pay only the minimum amount on her credit cards every month. Consequently, she has cut her spending dramatically and no longer buys items she cannot afford.

Millions of Americans are in situations similar to Mrs. Brandon’s. Javelin Strategy and Research found that 37 percent of consumers say they are using their credit cards less, and 28 percent say that
paying off their credit cards has become more difficult (Schulz). So, while many consumers are using their credit cards less, they are still having difficulty making payments; one in six households makes only the minimum payment on its credit cards every month (Schulz). Consumer spending decreased for the sixth month in a row in December 2008, mainly because of decreased incomes, which also fell in December ("Factory Decline Eases, Consumer Spending Drops"). This information reveals one clear trend among consumers: they are spending less, and are paying out of their own pockets. Because many consumers are earning less money, they have less money to spend on luxury items and are focusing on the necessities: groceries, electric, water, transportation, etc.

Lenders have also learned difficult lessons from this credit crisis. The Federal Reserve reported that two-thirds of its banks have tightened credit standards between May and July of 2008. Consumers have also noted more stringent standards, citing higher interest rates and low approval for loans. Credit card companies have decreased the number of applications sent to high-risk areas and are decreasing credit limits offered to high-risk customers (Shinkle). Mrs. Brandon also noticed this change, explaining that she used to receive approximately five to six credit card applications per week, while she now receives only one.

**Prevention of a Subsequent Crisis**

Along with a crisis of this magnitude comes a multitude of suggestions from scholars to consumers across the globe. Everyone believes that they have the new idea that will “fix” the banking industry and its problems. While there is room for improvement in the banking system, many other issues need to be addressed in order to prevent another crisis like this one.

Mr. Conlin and Mr. Lang both confirmed that their banks have tightened standards since the crisis, and will tighten them further in the future. Banks have also shifted their focus away from financially engineering their balance sheets in order to post increased profits. Instead, they are focusing on the retail-bank activities of customer acquisition, customer retention, customer service and creating
financial products and services that will satisfy customers' needs. This is proving to be quite difficult because many consumers mistrust their banks. Paul Worthington, a specialist in branding services, believes that banks need to radically change their strategies in three ways. The first is to instill consumer trust by focusing on actions, not messages. The second is to refocus on deposits, and the third is to move to a consumer-centric model. This model helps banks concentrate more on their customers and less on balance sheet manipulation (32).

Many people believe that a reform of the banking system is needed in order to improve it. Dr. David McIlroy, a lawyer who specializes in banking and insolvency laws, recommends three actions to be taken to reform the banking system. The first is to minimize the moral hazard associated with loan origination-the lack of incentive to be careful about who they lend to and how much. McIlroy suggests that banks be required to maintain a certain percentage of the dollar amount of the loan, therefore increasing the incentive to make sure customers can pay back their loans (287-288). The second action is to increase the transparency of risk in financial products, providing the buyers of mortgage-backed securities and collateralized debt obligations with sufficient information about their risk. McIlroy suggests that securitized objects be standardized or, if that cannot be done, banks should not be allowed to deal with objects for which they cannot obtain a risk profile (289). The final action is to reform Basel II, which gives investments weights based on their credit ratings. If an investment loses its AAA rating, banks are expected to adjust their capital accordingly. McIlroy suggests that regulators require banks to hold more capital than the minimum 8 percent so they are prepared in the case of a sudden market downturn (290-291).

Although there are unwritten traditional lending standards that most financial institutions abide by, there are no regulatory lending standards enforced. The Federal Reserve needs to create a standardized process for lending money that includes gathering proof of income, the customer’s credit report, and a substantial down payment of at least 20 percent, among other requirements. Regulations
intense regulation over derivative and exotic securities including credit default swaps, which were blamed for much of the meltdown of the market (Crutsinger). The plan also requires large hedge funds and private equity firms to register with the SEC if their assets exceed a certain size. Finally, firms whose collapse could “pose a risk to the entire financial system” would be required to have more capital than others (Drawbaugh). Geithner’s proposal is one that was needed a long time ago, and is a good start to the reform of the financial markets. By having this increased government regulation over especially risky securities and firms, it decreases the chances of another financial crisis tremendously. However, there are some criticisms to Geithner’s proposal. Some are afraid that there will be too much government involvement in the financial markets, and others are concerned that one regulator might become much more powerful than the others, which could be harmful. One suggestion to this objection would be to have a “college of regulators” oversee different parts of the plan (Crutsinger). Geithner’s proposal is a good base to build upon and will require extensive changes before it is actually put into action, something that many lawmakers hope will happen as soon as possible.

Conclusion

As President Barack Obama said in a recent speech, there is no quick fix for this economic crisis. While many consumers wish that this would all just go away overnight, there are things that need to be fixed in order to strengthen the economy and decrease the chances of another crisis of this magnitude occurring again. There will always be downturns in an economy, but the goal of the Federal Reserve and other governmental agencies is to dampen those downturns. While this downturn is big enough to be called a recession, we have to remember that there have been far worse times in our history, and we managed to move on from those, just as we will be able to move on from this one.
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