

THE ESSENTIALS OF RISK MANAGEMENT

Third Edition (EoRM3)

ONLINE CONTENT FOR CHAPTER 9

Box 9-4 of EoRM2

From pp. 311–312 of *The Essentials of Risk Management, Second Edition* (EoRM2)

BOX 9-4

SLIPPING STANDARDS IN SUBPRIME LENDING

In the period between 2002 and the onset of the 2007 subprime crisis, consumers and the industry allowed themselves to believe that real estate prices would continue to escalate.

Combined with low interest rates, poorly structured incentives for brokers, and an increasingly competitive environment, this led to a lowering of underwriting standards. Banks and brokers began to offer products to borrowers who often could not afford the loans or could not bear the associated risks.

Many of the subprime mortgage loans underwritten during this time had multiple weaknesses: less creditworthy borrowers, high cumulative loan-to-value ratios, and limited or no verification of the borrower's income.

Some loans took the hybrid form of 2/28 or 3/27 adjustable-rate mortgages (ARMs). That is, they offered a fixed low “teaser” rate for the first two or three years and adjustable rates thereafter. The jump in rates this implied meant the mortgages were designed to be refinanced—feasible only under the assumption of an increase in the collateral value (i.e., a rise in house prices)—or risked falling into default. Because many of these mortgages were set around the same time, lenders had inadvertently created an environment that would lead to a systemic wave of either refinancing or default.

In addition, consumer behavior with respect to default on mortgage debt changed in ways that were not anticipated by banks (or rating agencies).

When the subprime crisis broke in 2007, many commentators called it a “perfect storm” in that everything possible seemed to go wrong. But it was a perfect storm that had, to a large degree, been created by the banking industry itself.