

Subprime Crisis and Regulatory Responses

Mohan Qin *

Columbia International College, Hamilton, Canada

*Corresponding author: chen76302@gmail.com

Abstract. The 2008 financial crisis brought about the worst economic depression since World War II. This paper covers the three main components of the economic meltdown, along with its cause, consequences, and countermeasures. The crisis emerged against a backdrop of rapidly expanding credit, high risk-taking, and heightened financial leverage. In particular, factors related to the real estate bubble are discussed, among which the subprime mortgage crisis has received widespread attention. The various impacts caused by the crisis are irreversible and affect the financial market to this day. Therefore, discussing various measures after the crisis is helpful to the development of the financial field. Whether it is analyzing monetary policy or fiscal policy, or the ever-renewing Basel Accords, they all help to improve global imbalances. Although the financial crisis emerges in the American market first, its widespread impact is beyond the scope. In this paper, the whole development of the 2008 financial crisis will be deeply discussed.

Keywords: Subprime mortgage; mispricing; failure of investment banks; financial bailouts.

1. Introduction

A perfect storm of economic instability resulted in the 2008 financial crisis as a result of a number of causes. The US market for subprime mortgages collapsing was the main contributor to the crisis. In the subprime mortgage industry, high-risk loans were frequently made to applicants with weak credit histories with little or no supporting documentation. As housing prices began to fall, many of these borrowers found themselves unable to make their mortgage payments, and a wave of foreclosures began. As a result, financial institutions with investments in the subprime mortgage market saw a tsunami of losses, and the crisis swiftly expanded to other areas of the financial system [1]. Banks were obliged to reduce the value of their assets, which resulted in a credit crunch that made it more challenging for people and companies to get loans. The crisis was exacerbated by several other factors, including the energy crisis, which led to high oil prices, the food crisis, which was caused by rising food prices, and high inflation rates. These factors put additional strain on households and businesses, making it even more difficult for them to weather the financial crisis.

The crisis was not limited to the United States. It quickly spread to other countries, including the United Kingdom, where several major banks failed. The crisis also had significant impacts on the world economy, causing a severe decline in economic activity and the widespread bankruptcy of financial institutions. According to estimates from the International Monetary Fund (IMF), the world economy shrank by 0.5% in 2009, and overall production was 6.7% lower than it would have been without the crisis. The 2008 financial crisis had far-reaching consequences for the global economy, and its impact is still being felt today. The crisis led to a massive transfer of wealth from taxpayers to banks, and a dramatic increase in government debt. It also resulted in a sharp decline in consumer spending, which in turn led to higher unemployment rates and a decline in economic activity. The financial crisis of 2008 serves as a reminder of the possible repercussions of financial instability and emphasizes the significance of efficient financial system regulation and oversight. In order to assist avoid similar crises from occurring in the future, numerous nations established new legislation and supervision measures in the wake of the crisis. The COVID-19 pandemic has brought many of the lessons of the 2008 financial crisis into sharp focus. The pandemic has caused widespread economic disruption, leading to a rise in unemployment and decreased consumer spending. It has also created significant challenges for the financial system, with many businesses and households struggling to obtain credit.

In conclusion, the 2008 financial crisis was a pivotal event in the history of the global economy, and its impact is still being felt today. Understanding the origins of the crisis and how it affected the world economy can help people better prepare for any economic difficulties and strive to build a more robust financial system. It is important to study the lessons of the financial crisis to understand the challenges facing the global economy today, and to ensure that the mistakes of the past are not repeated in the future.

2. Cause

2.1 Loose Monetary Policy

The government's effort to stimulate the economy by lowering interest rates and relaxing lending requirements, with the goal of making it simpler for individuals to buy houses, contributed to the emergence of the housing bubble that eventually caused the 2008 financial crisis [2]. Due to these measures, there was a boost in housing demand, which in turn raised property prices. However, as the bubble grew, the value of homes began to exceed their actual worth, creating an unsustainable market. Many people were able to take out mortgages with little or no money down, leading to a large number of risky loans.

As the bubble burst, many homeowners found themselves owing more on their mortgages than their homes were worth, and many of these risky loans began to default. As a result, property values fell precipitously and there was a surge in foreclosures. Banking institutions that had made significant investments in the housing market started to struggle as well, and many of them collapsed or required government bailouts. It didn't take long for the housing market issue to extend to other areas of the economy and trigger a worldwide financial catastrophe. It's critical to remember that, while not the primary source of the crisis, government policies had a role in its development. Additional reasons that led to the crisis were a lack of regulations, incorrect grading of assets by credit rating agencies, excessive risk-taking by banks, and a failure by financial institutions to control the risk they were taking.

2.2 Subprime Mortgage

Subprime mortgages were a significant contributor to the 2008 financial crisis. These mortgages are designed for borrowers with poor credit, who may not qualify for traditional mortgages. They typically come with higher interest rates and more relaxed lending standards, making them more risky for both the borrower and the lender. During the housing boom leading up to the crisis, many lenders began to relax their standards even further and make subprime mortgages available to borrowers who would not have qualified for them in the past. They also started to provide adjustable-rate mortgages (ARMs), whose starting interest rates are lower but which may increase over time, making it challenging for borrowers to make payments. Subprime mortgages became more widely available, which increased demand for houses and raised prices [3]. Nonetheless, a lot of borrowers struggled to make their payments, particularly as the property market started to decline. This led to a wave of foreclosures, which further decreased housing prices and caused many financial institutions to suffer large losses. The fact that many of these subprime mortgages were combined and marketed as securities to investors throughout the world further aggravated the issue. Several of these securities had value losses as the housing market started to tank, leaving many investors with worthless holdings. As a result, there was a credit crisis and a decline in faith in the world financial system.

In conclusion, subprime mortgages and loose lending criteria contributed to the housing bubble that caused the financial crisis of 2008. As the bubble burst, many borrowers were unable to keep up with their payments and foreclosures surged, further depressing housing prices and causing large losses for financial institutions. The securities containing the subprime mortgages also lost value and many investors were left holding worthless assets.

2.3 Credit Default Swaps

Credit default swaps (CDS) were also a contributing factor to the 2008 financial crisis. A CDS is a financial instrument that allows investors to insure against the default of a particular bond or loan. They were originally designed to transfer the risk of default from the bond issuer to another party. However, during the housing boom leading up to the crisis, CDS became a popular way for investors to speculate on the housing market. As the housing market began to collapse, the magnitude and volume of CDS increased dramatically. The notional value of CDS outstanding, which is the total amount of debt that the swaps were insuring, reached over \$60 trillion in 2008, with a large portion of that tied to subprime mortgages. This meant that a large number of investors were exposed to the risk of default in the housing market, which further amplified the crisis.

One of the main issues with CDS was the lack of regulation at the time. Unlike traditional insurance, CDS were not subject to the same types of regulations. This led to a lack of transparency and oversight in the market, which made it difficult to understand the extent of the risk that investors were taking on [4]. Additionally, there were no capital requirements for CDS, which meant that some market participants were able to take on large amounts of risk without having the financial resources to cover potential losses. The lack of regulation also meant that there was no central clearinghouse for CDS, which made it difficult to track the amount of risk in the market. This made it difficult to assess the impact of a potential default and made it more difficult to manage the crisis when it occurred.

In summary, CDS were financial instruments that allowed investors to insure against the default of a particular bond or loan. The magnitude and volume of CDS increased dramatically as the housing market began to collapse, with the notional value of CDS outstanding reaching over \$60 trillion in 2008. The lack of regulation at the time led to a lack of transparency and oversight in the market, making it difficult to understand the extent of the risk that investors were taking on, and there was no central clearinghouse for CDS, which made it difficult to track the amount of risk in the market.

3. Consequence

The consequences of the 2008 financial crisis were widespread and far-reaching, with many lasting impacts on the global economy. One of the most significant consequences was the failure of several large banks, including Lehman Brothers. This was a major turning point in the crisis and contributed to the spread of financial instability. The collapse of Lehman Brothers led to a wave of panic in financial markets, as investors and banks scrambled to assess the exposure of other financial institutions to the subprime mortgage market [5]. This, in turn, led to a contraction of credit, making it more difficult for individuals and businesses to obtain loans, and putting further strain on the economy.

The breakdown of the banking system was a major contributor to the sharp decline in economic activity that followed the financial crisis. Together with a steep fall in company investment, the economy's activity fell. This was the result of lower consumer expenditure. Consumer spending fell as households became more cautious about spending, as they faced rising unemployment rates and declining household wealth. Meanwhile, businesses were reluctant to invest in new projects and expansions, given the uncertainty created by the financial crisis. The decline in economic activity led to a rise in unemployment, as businesses faced declining sales and reduced profits. Unemployment rates in many countries rose sharply, and many workers found themselves without jobs for extended periods of time. This was particularly true in the construction and manufacturing industries, which were heavily impacted by the decline in consumer spending and business investment. The rise in unemployment had a negative impact on consumer confidence, which further slowed the pace of economic recovery.

Government finances were significantly impacted by the financial crisis as several nations were compelled to bail out their failing banking institutions. The cost of these bailouts was substantial, and it resulted in a significant increase in government debt levels [6]. This, in turn, led to concerns about

the sustainability of government finances, which put additional pressure on the global economy. Another consequence of the financial crisis was the erosion of trust in the financial system. Serious doubts about the soundness of the financial system and the capacity of financial regulators to avert future crises were raised by the failure of so many significant financial firms and the requirement for government bailouts. This eroded trust in the financial system and led to a decline in consumer confidence, which further slowed the pace of economic recovery.

In conclusion, the 2008 financial crisis had far-reaching consequences for the global economy, and its impact is still being felt today. The failure of many large banks, the rise in unemployment, and the increase in government debt levels are just a few of the lasting consequences of the crisis. People can try to build a more robust financial system and be better prepared for next economic problems by studying the origins and effects of the financial crisis. To prevent previous mistakes from being repeated in the future, it is crucial to keep learning from the financial catastrophe.

4. Response

4.1 Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act is a comprehensive piece of legislation that was enacted in response to the 2008 financial crisis. The act was signed into law by President Barack Obama on July 21, 2010 [7]. The Dodd-Frank Act's primary goals are to enhance consumer protections, better regulate the financial industry, and lower the likelihood of future financial disasters.

One of the key provisions of the Dodd-Frank Act is the creation of the Consumer Financial Protection Bureau (CFPB). Mortgages, credit cards, and payday loans are among the consumer financial goods and services that the Consumer Financial Protection Bureau (CFPB) is tasked with regulating. Moreover, the CFPB is able to develop rules and regulations to make sure that consumer financial goods and services are honest, open, and in the best interests of customers, investigate consumer complaints, and take enforcement action against businesses that break consumer protection laws [8]. Another important provision of the Dodd-Frank Act is the regulation of derivatives market. This act requires that most standardized derivatives be traded on regulated exchanges and cleared through central counterparties. This helps to reduce the risk of financial market instability and increase transparency in the derivatives market. Additionally, the act requires certain types of derivatives reported to regulators and subject to margin requirements.

The Dodd-Frank Act also strengthens the authority of financial regulators and enhances their ability to respond to financial crises. The legislation, for instance, empowers the Financial Stability Oversight Council to identify and oversee systemically significant non-bank financial enterprises and the Federal Reserve to dismantle sizable financial entities that pose a risk to the financial system. These provisions aim to reduce the risk of future financial crises by improving the ability of regulators to respond to financial emergencies and ensuring that large, complex financial institutions are subject to enhanced oversight and regulation. The Dodd-Frank Act has been criticized by some for its complexity and for imposing burdensome regulations on the financial sector. The act's proponents contend that improved consumer protection from dishonest business practices and better financial sector regulation are both required. They also argue that the act is necessary to reduce the risk of future financial crises, which can have devastating impacts on the economy and the financial system.

In conclusion, the Dodd-Frank Act was passed in reaction to the 2008 financial crisis with the goals of strengthening financial sector regulation, enhancing consumer safeguards, and lowering the likelihood of future financial disasters. The act has been the subject of ongoing debate, with some arguing that it is necessary to prevent another financial crisis, while others argue that it imposes burdensome regulations on the financial sector. Despite these debates, the Dodd-Frank Act remains an important piece of legislation that has had a lasting impact on the regulation of the financial sector and the protection of consumers.

4.2 Basel III

A significant economic slump that had wide-ranging effects on the global economy was the financial crisis of 2008. It was brought on by the collapse of the subprime mortgage market and the US housing market, which in turn sparked a wave of foreclosures and defaults on mortgages. Due to a domino effect that extended across the financial industry, numerous significant financial institutions failed, and the global financial system came dangerously close to collapsing.

In response to the crisis, bank regulators around the world re-examined their rules and regulations regarding asset and capital adequacy ratios. One of the key responses was the introduction of Basel III, a new set of international banking standards aimed at strengthening the regulation and supervision of banks. The 2013-implemented Basel III regulations are meant to strengthen the banking industry's resilience and lessen the chance of next financial crises. An rise in the minimum capital adequacy ratio demanded of banks was one of the significant improvements brought about by Basel III. The new criteria call for banks to keep larger amounts of capital to offset future losses. This ratio assesses a bank's capacity to absorb losses and preserve stability. This helps to ensure that banks have the necessary resources to weather financial shocks and maintain stability during difficult economic times.

Another important change introduced by Basel III was a strengthening of the rules on liquidity. Banks are now required to hold larger amounts of high-quality liquid assets, such as government bonds, to ensure that they can quickly and easily meet their obligations in the event of a crisis. This helps to prevent the kind of liquidity shortages that were a major factor in the 2008 crisis. Basel III also introduced new regulations aimed at reducing the risk of systemic events. For huge, complicated financial products that may represent a serious danger to the whole financial system, for instance, banks are now required to retain more capital. This helps to reduce the risk of future financial crises, by ensuring that banks are better prepared to absorb losses and avoid the need for taxpayers to bail out the financial sector.

In conclusion, the 2008 financial crisis was a major catalyst for change in the banking sector, leading to the introduction of Basel III, a new set of international banking standards aimed at strengthening the regulation and supervision of banks. Basel III's modifications have improved the banking industry's resilience and lessened the chance of subsequent financial crises.

5. Conclusion

In conclusion, the 2008 financial crisis was a seminal moment in the global financial system that had widespread impacts. The expansion of the subprime mortgage sector, which finally caused a broad decline in property values and the spread of toxic mortgage-backed securities across the financial system, was the primary cause of the crisis. Lehman Brothers was among the major financial firms that failed as a result of the crisis, which necessitated extensive government involvement to stabilize the financial system and avert the catastrophic collapse of the global economy. The consequences of the 2008 financial crisis were far-reaching and included increased regulation of the financial sector, higher levels of unemployment, and lower levels of economic growth. The Dodd-Frank Act was enacted in response to the crisis and aimed to improve the regulation of the financial sector, increase consumer protections, and reduce the risk of future financial crises. The 2008 financial crisis serves as a reminder of the importance of rigorous research and analysis of financial crises. The 2022 Nobel Prize in Economics, which was awarded for the study of financial crises, highlights the ongoing significance of understanding the causes and consequences of financial crises. By continuing to study and analyze financial crises, we can better understand the underlying factors that lead to these events and take steps to prevent future crises and protect the global economy.

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