

# BHARAT SCHOOL OF BANKING

## Recession and Subprime Lending

### Recession

For a **healthy** economy, a country needs to have smooth **economic activities** of **production**, **distribution** and **consumption** of **goods and services** at all levels. But what if all these **activities** drastically reduced (due to some reason) to a very low-state and continues to be in that state for a long time?

This kind of **slowdown** or a **massive contraction** in economic activities, is known as **Recession**. It may **last** for some **quarters**, which have a great adverse effect on the **growth** of an **economy** (making **negative GDP growth**, may be). Other **adverse effects**, like -

- **Unemployment**
- Drop in **Stock Market**
- Decline in **Housing Market**
- **Business losses**
- **Social effects**, like low living standards, low wages, etc.

The technical **indicator** of a **recession** may be **two consecutive quarters** of **negative GDP growth**. **Recessions** can occur for excessive **subprime lending**, as described below.

### Subprime Loans

A bank generally follows a **credit scoring** system to determine **borrowers** eligibility for a **loan**. If a **borrower** doesn't have a good **credit history**, then the **bank** can deny him/her a **loan**. But if the bank decides to allow him/her a **loan** (even with that **limited credit** history), then the loan is known as **subprime loan**.

This type of **loan** carries more **credit risk**, and therefore carries **higher interest rate**. Think what will happen, if he/she eventually cannot pay back the loan (with extra interest rate on it!)

### US Subprime Crisis of 2007-09

US banks started to lend **subprime loans** to the low credit **borrowers**, with **houses**, or **properties** as **mortgage**. They thought that if the **borrowers** become unable to pay back, then they could **seize** the **properties** and sell in **high** prices to **recover** the loans.

But what happened is the **prices** of houses/properties **declined** drastically, leading to **mortgage** delinquencies and devaluation of **housing**-related securities. This led the banks to become **bankrupt** (e.g., **Lehman Brothers**), because they couldn't **recover** the amount of their huge **subprime lending** against **mortgage** securities.

### Current Recession in Venezuela

Due to **political instability** and falling **oil prices**, **Venezuelan** economy (highly dependent on **oil exports**) shrank by **2.8 %** in **2014**, while **inflation** topped **64 %**. It led **Venezuela** to fall in **recession**.

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