Business Finance II – 40592 - Spring 2016
Book Review Template

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Book Title	House of debt
Author(s)	Atif Mian and Amir Sufi
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Author (s):

The book "House of debt" is jointly authored by Atif Mian and Amir Sufi.

Atif Mian is Professor of Economics and Public Affairs at Princeton University, and Director of the Julis-Rabinowitz Center for Public Policy and Finance at the Woodrow Wilson School. Prior to joining Princeton in 2012 he taught at the University of California, Berkeley and the University of Chicago Booth School of business.

Amir Sufi is the finance Professor at the University Of Chicago Booth School Of Business. He is also a Research Associate at the National Bureau of Economic Research.

Both author's research focuses on finance and macroeconomics.

Synopsis of the book:

"House of debt" is a brief account of how the great recession happened and what should be done to avoid such recession happening in future. The authors of the book strongly believe that house hold debts were the main culprit of the economic turndown of 2007-2008.

The book is divided into three parts: busted; boil and bubble and stopping the cycle. In the first part, the author details that what caused the severe recession and how the indebted households affected jobs across the global economy. In part 2, the authors describe that how banks fueled the housing bubble by giving the mortgages to those who could not afford it and in the third part, a new way to structure debt is proposed so that such recessions can be avoided in future.

It is usually thought by some economist and analysts that recession are provoked by natural or political crises while other think that these economic turndowns arise when irrational beliefs infect public consciousness.

Great recession was mainly caused by high household debts. US house hold debts doubled in size reaching to $14 trillion and debt owed to income earned ratio soared from 1.4 to 2.1.

The crisis fell on the poor borrowers through the creation of financial innovation which made the investor believed that they were buying safe product which was in fact toxic. This ultimately created the housing bubble which unreasonably affected the poorest borrowers. Any losses in house prices are to be absorbed by junior claim(borrower) and then to senior claim(bank). Majority of the equity of borrowers was tied into their homes so when the housing prices drops, their equity drops along with it. So those who borrowed the most , lost the most. Since poor people borrowed most than the rich, their losses were also big. Borrowers were hit by negative equity and foreclosures.

These increased household debts led to home owner's net worth collapse followed the severe cut down in consumer spending. Various studies evident a severe decline in spending after 2007 across Europe and Asia. This significantly affected the jobs across the globe. Reduced consumer demand from the indebted households led to nationwide job losses which impacted the entire economy.

The authors explicitly explained the way banks fueled the housing bubble. Mortgages were given to those households with low credit scores and low income growth. This expansion of credit created the bubble. Besides, complex financial instruments hid dangerous lending practices and fraudulent activity.

A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. The mortgages are sold to a group of individuals (a government agency or investment bank) that securitizes, or packages, the loans together into a security that investors can buy. The mortgages are given only to the borrowers who had high credit score. But in 2000's the mortgages that didn't satisfy the strict criteria of MBS, used the private label MBS - structure of trenching wherein each tranche offers varying degrees of risk to the investor. The mortgage pools had multiple layers, from a super-safe senior tranche to lower high-risk layers. This complex system of tranches deceived some investors who were overly optimistic about the level of risk associated with uncertain underlying mortgages.

Owner-occupied loans are considered less risky than investor-owned loans, so they are more likely to attract investors. 10% of the loans in private label MBS were misclassified as owner-occupier, even though they were investor-owned. This clearly explains that how investors were deceived.

The authors, in the last part of the book gave suggestions to avoid such economic collapse in the future. Federal reserve should lower interest rate so that borrowers who cannot afford to pay their mortgage can arrange new payment plans with lower interest and lower overall balancing, ultimately ensuring that they were no longer in negative equity. Moreover, debt forgiveness will improve the recession facing economy more effectively than government spending. Debt forgiveness makes a lot of sense when the economy experiences a large-scale negative shock that is beyond the control of any one individual. Besides, replacing interest based debt by equity based contracts in financial markets and shared risk mortgage structure can prevent the future such recession.

Key Learning:

- **Fundamentals of Economic might go wrong.**

  By reviewing the book we have found out that Economic Indicators might mislead which is exactly the case back in 2005 when Fundamentals of US Economy showed overwhelming growth, GDP Growth, Job Creation and Productivity Growth. These have shown the best augmentation in recent years which provide basis to believe that these fundamentals were the driving force behind the credit boom but that was a mistake because the credit boom was due to the excess accumulation of funds in Banking Sector which was behaving irrationally.

- **Animal Spirit and Debt View.**

  Animal Spirit view is the natural phenomenon in which by assessing the growth in the any sector of the economy, financial institution start investing or providing finance in that sector. Debt view is the phenomenon in which irrational lending of Financial Institutions cause the price speculation like in the case of Housing Price Boom in US.

- **Bank bailouts aren't the best solution for debt-driven crises.**

  During recession, government used to bail out banks so that they continue to lending money. Bailout supposed to improve the economy but that usually did not work because there were not many borrowers to borrow money from banks because of weak economic activities due to recession.

- **Debt forgiveness will boost a recession-addled economy more effectively than government spending and stimulating inflation.**

  Instead of fighting recessions by stimulating inflation or engaging in public spending, governments should restructure and forgive debt, which would benefit both debtors and creditors. Debt-driven recessions not only arise due to debt, but also lead to deflation and wage decreases – a vicious circle which makes it harder for consumers to pay back debt, thus extending the lifetime of a recession.

- **Shared responsibility mortgages (SRMs)**

  Proposal for avoiding debt-driven recessions is Shared Responsibility Mortgages (SRMs) which are more like equity than debt. Under this system, the lender protects the borrower if the home price drops, while the borrower agrees to share five percent of capital gains on the house. So if house prices rise, the interest payments remain constant, like standard mortgages. However, if the house prices drop, the total mortgage payments would fall in line with a local house price index, allowing the borrower to keep up with payments (thus avoiding default), while still maintaining equity in the house. Even then, if someone had trouble paying their mortgage, they could still sell their equity – allowing them to move somewhere cheaper and avoid a foreclosure.

Application in Pakistan:

- **Exploitation of Debt Forgiveness in Pakistan.**

Contrary to the practices adopt in West, in Pakistan we need to protect lenders against the finances they provide to purchase home because in current scenario there is no concrete legislation available to protect banks if the borrower defaulted. This is the reason why banks restrict to provide Loan in Retail Sector and they usually finance in T Bill and PIB's which is much safer options This restrict the fundamental economic growth of the country that is also described in the Book that lending in Retail sector is the key factor in building or similarly crashing the economy.

- **SRMs based financing structure in Pakistan.**

SRM based financing can be very successful in Pakistan because it strongly resembles to Islamic Financing System as it encourage the Profit and Loss Sharing Model rather than only Profit Sharing. It also enhances the borrowing as it provides confidence to borrower that they need to pay according to the current asset value.