Crisis on Wall Street

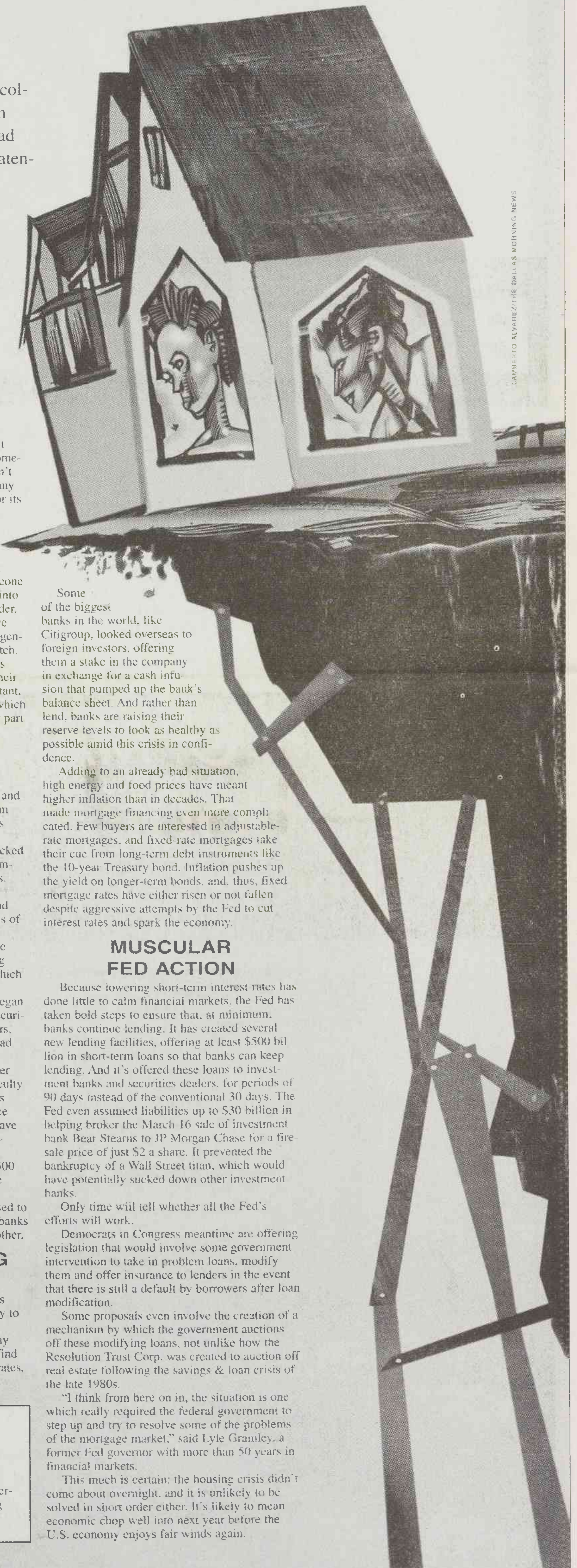
Every day there seems to be more bad economic news — dropping stock prices, collapsed investment banks, increasing foreclosures. But how did we get here? This primer takes a look.

By Kevin G. Hall, McClatchy Newspapers

One of Wall Street's most venerable investment banks has collapsed, the Federal Reserve has made available more than half a trillion in credit and dropped interest rates like a bad habit. And still, financial markets remain in turmoil, threatening the broader U.S. economy.

Confused? So are government regulators and economic analysts. Former Fed Chairman Alan Greenspan wrote recently that in the rearview mirror, the current crisis will be seen as the biggest global financial challenge since the end of World War II. He blames the problems on a breakdown in the evaluation of risk.

Here's a summary of some of the components that together have combined to cause the current crisis now gripping Wall Street and sucking wealth out of the retirement plans of millions of ordinary Americans.



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HOUSING

The housing sector is the principal cause of turbulence in financial markets. In the aftermath of the Sept. 11 terror attacks and a nine-month recession in 2001, Greenspan's Federal Reserve brought the benchmark federal funds rate down to 1 percent and this influenced lending rates across the economy.

Money was cheap, and that allowed Americans to buy new homes, or refinance their homes in order to tap the equity they'd built up in their home to add a sun room, purchase a car or add new furniture.

The cheap money fueled both a boom in home building and a run up in home prices, most notably in four states that make up the brunt of problem loans today — California, Florida, Arizona and Nevada.

Along the way, lending standards deteriorated significantly, particularly for the loans given to the weakest borrowers, sub-prime loans, which carried a higher interest rate because they implied a higher risk to lenders.

Many of these sub-prime loans involved adjustable rates, with a low starter rate that gradually ticked up and then, after two or three years, reset to monthly mortgage rates as high as 14 percent. Both loan originators and lenders often did little to verify income and, in some cases, didn't even require proof of income.

Although everyone involved knew those rates were too high, the working assumption was that the home prices would continue rising and borrowers could simply refinance to avoid a reset to higher monthly mortgage rates.

Most of these sub-prime loans were originated by mortgage brokers who are regulated on the state level with spotty enforcement. The loans were underwritten by non-bank lenders like New Century Financial Corp. and Ameriquest Mortgage Co. — both of which fell through the cracks of federal regulation and were weakly regulated on the state level. These mega lenders have since gone bust, as have more than another dozen important non-bank lenders.

MORTGAGE FINANCE

The housing boom ended and the housing crisis started in late 2006. The Federal Reserve had steadily raised interest rates from its low of 1 percent in June 2004 to 5.25 percent in June 2006. That meant that the sub-prime adjustable-rate loans, which exploded in number between 2004 and 2006, would adjust to much higher rates. And home prices stopped rising. A perfect storm was about to be unleashed on Wall Street.

In the past, banks underwrote mortgages and kept those loans on their books. But innovations in mortgage finance meant that once a bank issued a loan, that loan was quickly sold into what's called the secondary mortgage market.

There, many home loans were bundled together into a bond called a mortgage-backed security. Some were added together with other kinds of loans and sold as collateralized debt obligations, or CDOs. Investors were offered bonds with different risk classifications — the riskiest bonds, containing sub-prime loans, carried the biggest yield to investors.

This process is called securitization, and it happened largely behind the scenes. Most homeowners were completely unaware that it wasn't the bank who owned their home but a company — often an investment bank on Wall Street or its subsidiary — that sliced and diced loans and sold them to investors.

Many investors were largely unaware that the underlying collateral of the loan — the home on which a loan had been issued — was often owned by someone who misstated their income or had been put into an unaffordable loan by an unscrupulous lender. Investors felt comfortable because bonds have received favorable ratings from Wall Street agencies like Standard & Poor's, Moody's and Fitch.

What they didn't know was these agencies had a huge conflict of interest. One part of their operations was actually involved as a consultant, helping package together loans into bonds, which were then given favorable ratings by another part of their operation.

COMPLEXITY CONFOUNDS

Eventually, inflated national home prices and Wall Street's willful look past what now seem like obvious risks combined to create today's downward spiral.

As home prices fell, the collateral that backed the mortgage-backed securities and other complex financial instruments became worth less. Most of these complex bonds were illiquid, meaning they weren't meant to be bought and sold quickly but instead held for long periods of time to generate consistent returns.

But the homes on which these bonds were built increasingly became worth less, and big institutional investors like hedge funds — which pool capital from the very rich and college endowments to make huge investments — began trying to get rid of their mortgage-backed securities. Increasingly there weren't willing buyers, and many of the issuers of these securities had clauses in their contracts to take them back.

As they did so, investment banks and other issuers of these complex securities had difficulty even putting a price tag on these liabilities as they tried to bring them back on their balance sheets. To date, these financial institutions have written off more than $100 billion in tied-to-mortgage bonds and related financial instruments, but that figure could go as high as $500 billion if bond insurers and other players are forced to take steep losses in months ahead.

But no one's quite sure who is still exposed to these toxic bonds, or how much. That's led banks and other financial players to distrust each other.

ORDINARY LENDING FREEZES UP

As a crisis in confidence deepened, banks became very reluctant to lend and do so only to the best customers and at a premium.

Corporations who finance their day-to-day operations through short-term bonds could find few buyers and had to offer higher interest rates, eating into their operational costs.

Some of the biggest banks in the world, like Citigroup, looked overseas to foreign investors, offering them a stake in the company in exchange for a cash infusion that pumped up the bank's balance sheet. And rather than lend, banks are raising their reserve levels to look as healthy as possible amid this crisis in confidence.

Adding to an already bad situation, high energy and food prices have meant higher inflation than in decades. That made mortgage financing even more complicated. Few buyers are interested in adjustable-rate mortgages, and fixed-rate mortgages take their cue from long-term debt instruments like the 10-year Treasury bond. Inflation pushes up the yield on longer-term bonds, and, thus, fixed mortgage rates have either risen or not fallen despite aggressive attempts by the Fed to cut interest rates and spark the economy.

MUSCULAR FED ACTION

Because lowering short-term interest rates has done little to calm financial markets, the Fed has taken bold steps to ensure that, at minimum, banks continue lending. It has created several new lending facilities, offering at least $500 billion in short-term loans so that banks can keep lending. And it's offered these loans to investment banks and securities dealers, for periods of 90 days instead of the conventional 30 days. The Fed even assumed liabilities up to $30 billion in helping broker the March 16 sale of investment bank Bear Stearns to JP Morgan Chase for a fire-sale price of just $2 a share. It prevented the bankruptcy of a Wall Street titan, which would have potentially sucked down other investment banks.

Only time will tell whether all the Fed's efforts will work.

Democrats in Congress meantime are offering legislation that would involve some government intervention to take in problem loans, modify them and offer insurance to lenders in the event that there is still a default by borrowers after loan modification.

Some proposals even involve the creation of a mechanism by which the government auctions off these modifying loans, not unlike how the Resolution Trust Corp. was created to auction off real estate following the savings & loan crisis of the late 1980s.

"I think from here on in, the situation is one which really required the federal government to step up and try to resolve some of the problems of the mortgage market," said Lyle Gramley, a former Fed governor with more than 50 years in financial markets.

This much is certain: the housing crisis didn't come about overnight, and it is unlikely to be solved in short order either. It's likely to mean economic chop well into next year before the U.S. economy enjoys fair winds again.

ONLINE Q&A

McClatchy correspondents Kevin G. Hall and Tony Pugh are available to answer your questions about the shaky economy at home and abroad, and what's in store for ordinary Americans in the face of gathering economic storm clouds. Check out their Q&A, as well as breaking economic news, at **http://www.mcclatchydc.com/economics/**.

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