

## FROM WASHINGTON . . .

Politicians of all stripes, long preaching the virtues of home-ownership, resist efforts to tighten lending standards. The American economy depends heavily on free-spending consumers, and interest rate cuts beginning in 2001 were tinder for the housing boom.

## . . . TO WALL STREET

Banks and mortgage lenders opened the vault to anyone who had a pulse. Platoons of mortgage brokers canvassed the country, offering deals that seemed too good to pass up. Wall Street bundled packages of good, bad and ugly loans for eager investors.

## . . . TO MAIN STREET

American consumers go on a borrowing binge. They buy homes they can't afford, use their homes as an ATM and speculate in real estate. Some are victimized by largely unregulated mortgage brokers. When the bills come due, they're tapped out.

# How we got in this mess

Housing values never go down. That simple premise enticed American consumers and Wall Street to load up on mortgage debt. Plunging home values now threaten to drag down the global economy.

## 1 THE BOOM 2000-2006

Clinton and Bush administrations and Congress, as part of their domestic agenda, push to increase homeownership from about 63 percent of U.S. households to 68 percent. Underwriting regulations are eased to allow more low-income borrowers to obtain a mortgage.

**2000:** The dot-com bubble bursts in March, followed by the 9/11 terrorist attacks in 2001.

**Stock markets tumble.** The Federal Reserve, under Alan Greenspan, cuts interest rates 12 times beginning in January 2001. By June 2003, interest rates are at a 40-year low.

**New home construction,** existing home sales and median home values surge.

**Lenders** use the cheap money to create ever-more exotic mortgages, including adjustable-rate loans with "teaser" or introductory rates as low as 1 percent.

**Subprime loans,** those made to borrowers with poor or risky credit histories, soar from 7 percent of all home loans in

2001 to 20 percent in 2006.

**Lenders pool the mortgages** to sell on Wall Street, which embraces the real estate sector and its promise of high returns.

**Credit ratings agencies** bless these mortgage packages with their safest rating, AAA. A key assumption: home values will continue to rise.

**Banks, insurance companies,** hedge funds, pension funds and foreign governments gobble up these supposedly safe mortgage-backed securities.

**Some firms buy** insurance policies from American International Group and similar firms to protect them in the event of defaults.

## 2 THE SUBPRIME CRISIS LATE 2006 TO EARLY 2008

The Federal Reserve raises interest rates in June 2004, the first of 16 increases. The bubble begins to deflate a year later with the first wave of foreclosures, a slowdown in new-home construction and a slide in home values.

**January 2006:** Ameriquest Mortgage Co. settles 49-state probe into deceptive subprime practices for \$325 million.

**April 2006:** Fed Chairman Ben Bernanke acknowledges "signs of softening" in housing market.

**Median home sale prices** stall, then fall.

**Housing starts to fall.**

**February 2007:** New-home sales drop 20.1 percent from same month in 2006.

**Sales of existing homes fall.**

**The consumer economy** stalls as home sales — a key indicator of future consumer spending — fall.

**Teaser rates** give way to higher monthly payments.

**Owners,** unable to refinance or sell, start missing payments.

**Foreclosures mount.**

**The value** of those mortgage-backed securities sinks.

## 3 THE MELTDOWN 2008

Accounting rules require owners of the mortgage-backed securities to "write down" their value. As the housing market worsens, confidence in the value of any mortgage-backed security evaporates. Investors are forced to write off hundreds of billions of dollars.

**February:** AIG and other agencies that sold insurance against defaults have to pay up and take similar writedowns.

**March:** Bear Stearns, a major investment bank and underwriter of mortgage-backed securities, runs out of capital and is sold to J.P. Morgan Chase.

**April:** New Century Financial, the second largest subprime lender, files for bankruptcy.

**Sept. 7:** Mortgage giants Freddie Mac and Fannie Mae, with more than \$5 trillion in mortgage-back securities, are taken over by the federal government to avert a bankruptcy after their market values fell by more than half.

**Sept. 15:** Lehman Brothers investment bank goes bankrupt.

**Sept. 15:** Merrill Lynch

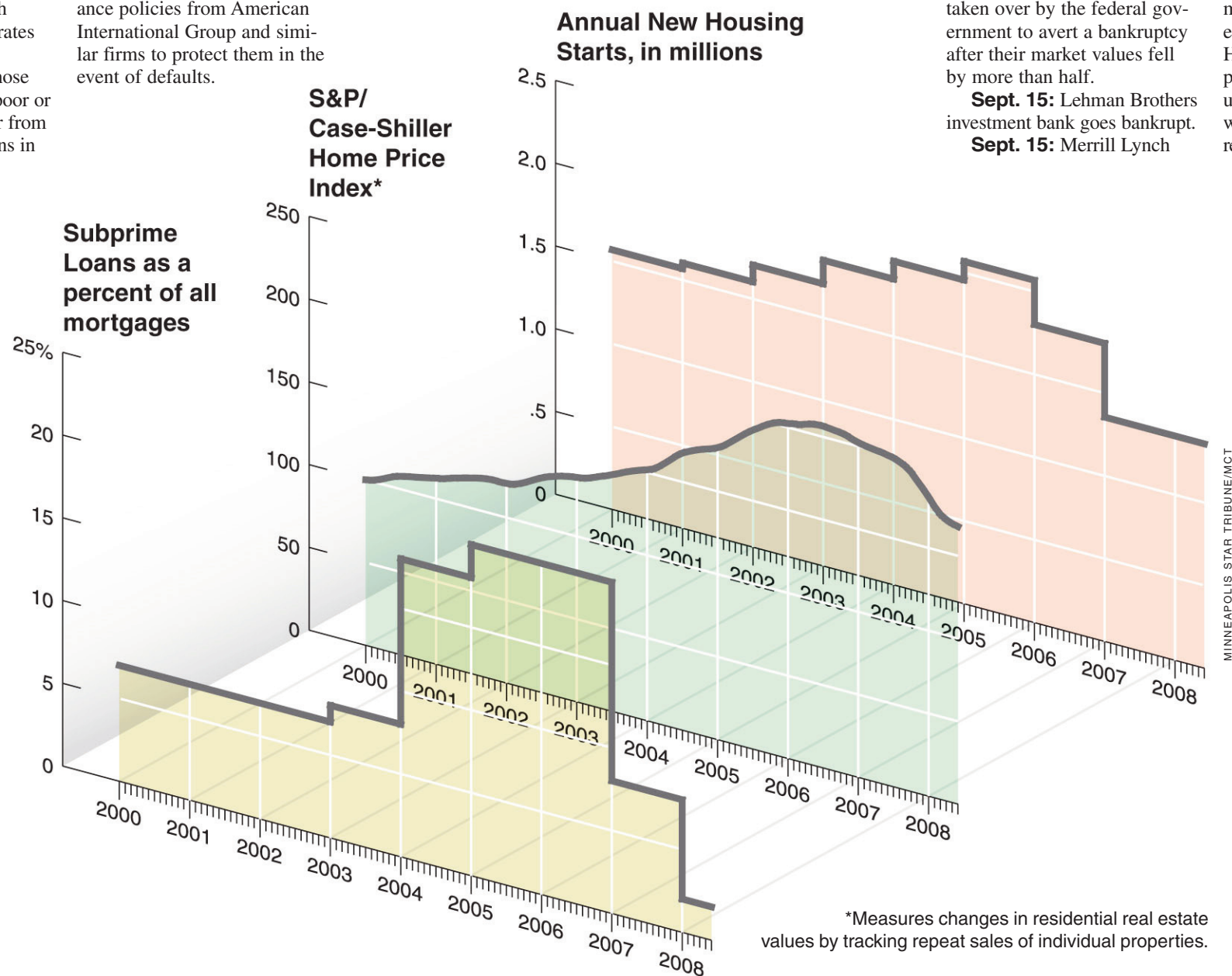
hastily accepts a purchase offer from Bank of America to avoid Lehman's fate.

**Sept. 16:** AIG is rescued by the Federal Reserve with an \$85 billion secured loan in exchange for a 79.9 percent government stake.

**September:** Bankers, unsure of their total exposure to bad mortgages, raise interest rates for their best customers and shy from lending money to others.

**September:** Fear of a deep global recession grows.

**September:** Saying piece-meal interventions are not enough, Treasury Secretary Henry Paulson and Bernanke propose a \$700 billion bailout under which the government would buy and then attempt to resell mortgage-backed securities.



## Wall Street's problems are quickly becoming Main Street's

By KEVIN G. HALL  
McClatchy Newspapers

Many Americans are nervously watching the wild swings on the New York Stock Exchange for signs of a Wall Street collapse, but it's the opaque credit markets that matter most right now to consumers and businesses alike.

These markets can be mind-numbing in their complexity, but they are vital to corporate America's ability to fund its daily cash flow, and to Main Street itself. And they're the reason why President Bush proposed the controversial \$700 billion rescue plan. Here are some answers to questions about the credit markets.

### Q: What's the credit market?

**A:** It's not one but several interconnected markets. Some of these markets involve banks lending to each other at overnight rates, while others involve issuance of a variety of debt instruments such as bonds that carry a short lifespan.

### Q: Why do banks need to provide each other overnight credit?

**A:** The Federal Reserve requires banks to keep a certain amount of cash in reserve on the premises or in one of the Fed's district banks. The amount is actually a ratio to the level of deposits the banks have. The required ratio of reserves-to-deposits goes up and down, so banks lend to each other to cover this ever-shifting target.

The Federal Reserve establishes a target for the rate that banks charge in overnight lending — called the Fed funds rate. This target is set through the Fed's rate-setting Federal Open Market Committee, which normally meets eight times a year. But the actual overnight lending rate is set by the banks themselves.

The Fed's target interest rate for overnight lending has been at

2 percent since April, but the market-set rate actually shot up to 7 percent Tuesday morning before tapering off to 3 percent. That's still a full point above the Fed's target, and it means banks are hoarding cash and only willing to part with it for a high price. The result: They borrow less, and thus lend less.

### Q: How does this translate to problems on Main Street?

**A:** Commercial banks take a cue from the Fed funds rate when they set the prime rate, which is the interest they charge on loans to customers with the best credit. The prime rate is usually 3 percentage points higher than the Fed funds rate, but banks do set this rate based on conditions on the ground. Changes in the Fed funds rate affect short-term interest rates, foreign exchange rates and indirectly the price of goods and services and even employment.

So overnight rates are a vivid, immediate expression of the confidence or lack thereof in credit markets. When nervous banks charge each other higher overnight rates, it ripples across all kinds of lending in the economy.

### Q: How is this credit crunch affecting corporate America?

**A:** Corporations don't have piles of cash sitting in bank accounts to pay their bills. They issue IOU-like short-term notes, sometimes called commercial paper, that often mature in 30 days. In some cases, the collateral on these notes is a company's inventory or other assets, so these bonds are also called asset-backed commercial paper.

When these largely unregulated short-term notes mature, investors can cash in or roll them over for another 30 days. If there is the perception of more risk, the yield — or the interest paid to investors — rises.

When there's confidence in the markets, the yields are low, which means that borrowing costs for corporations are low. When fear is rampant, as it is now, investors are reluctant to hold these bonds, fearing a default. They demand a higher interest rate, or yield. As the yield rises, it becomes more costly to borrow to fund day-to-day operations.

### Q: So what? These Wall Street fat cats deserve what's coming to them.

**A:** Maybe so, but remember that although the investors who buy these short-term debt instruments may be on Wall Street, the companies issuing this debt are corporations that employ millions of people in the U.S. and around the world. When their costs of borrowing go up substantially, they have to cut costs elsewhere, and that often translates into layoffs. That's how Wall Street problems quickly become Main Street problems.

### Q: Any other examples?

**A:** Automobile dealerships. Carmakers don't just give them cars. Dealerships borrow money to purchase the cars they will then sell to customers. When the cost of borrowing goes up for dealerships, they're forced to raise the price of the vehicles they sell at a time when there are already few buyers and when loan terms have tightened sharply for consumers.

The credit crunch also hits developers and civil-engineering firms that build shopping malls, office buildings and public works projects. When funding for their projects dries up, construction workers are laid off.

### Q: How are local communities hit by the credit crunch?

**A:** Many local governments rely on issuing debt, often in the form of municipal bonds, to fund road projects or other development in their region. They too are being squeezed as the cost of credit goes up. Local quality of life will suffer.

"I think it's going to limit (bond issuance) because it is going to be expensive to borrow. It's going to be tough on small communities," said Michael Long, the treasurer for Klamath County in Oregon, on California's northern border.

**MORE Q&A:** McClatchy correspondents Kevin G. Hall and Tony Pugh are available to answer your questions about the economic meltdown at <http://www.mcclatchydc.com/turmoil/>.