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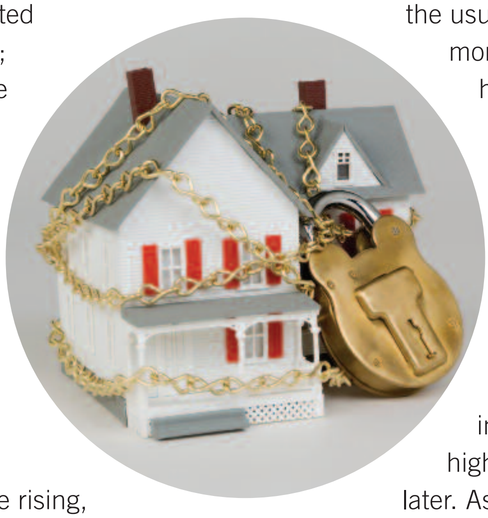
WHAT HAPPENED? THE SUBPRIME MORTGAGE PROBLEM AND ITS AFTERMATH

For several months, reports about problems in the housing and financial sectors have dominated the media—and for good reason. Virtually everyone has been affected, if only indirectly, by declining housing values and the seizing up of credit by financial institutions. And while the government has taken steps to fix the problems, repercussions may be felt for some time.

The story about the decline of the U.S. housing market has its roots in the ordinary act of purchasing a home. For years, housing prices in the United States have risen steadily; but in the early part of the current decade, housing prices went up so much that they formed a bubble—that is, they rose to unsustainable levels. Like all bubbles, the housing bubble eventually burst.



While housing prices were rising, interest rates and, therefore, mortgage rates were relatively low, putting home ownership within reach of millions of people. Traditionally, purchasing a home meant obtaining a mortgage loan from a financial institution and making a healthy down payment, usually up to 20% of the home's purchase price. Most people obtained *conventional mortgages*. These were usually 15-, 20-, or 30-year loans that carried fixed rates; the monthly payment on such loans was divided between the principal and interest of the loan.

In the low mortgage-rate environment of the current decade, some financial institutions relaxed their lending standards, and began offering mortgages to homeowners and speculators who may not have qualified for home ownership in the past. Most of these mortgages were *subprime*, which means the borrowers receiving them did not meet the usual criteria for obtaining a mortgage. They may have had little or no money for a down payment, poor credit histories or incomes that were too low to meet the monthly mortgage payments.

Many of these loans had interest rates that reset at higher levels months or years later. As a result, many homeowners saw their monthly payments rise—sometimes to levels they could no longer afford. Normally, homeowners in this situation would sell their homes and pay off their mortgages. But at that time, interest rates were rising and housing prices were declining. As a result, the housing bubble burst and subprime borrowers were unable to sell their homes

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at the prices they paid. Many homes went into foreclosure, which means the financial institutions that provided the mortgages took possession of the homes. The increased number of *foreclosures* created a surplus of homes on the market, and home prices declined further.

The Role of Fannie Mae and Freddie Mac

***Mortgage-backed securities* are bundles of mortgages that are sold to investors who are seeking income. As homeowners pay the principal and interest on their mortgages, investors holding mortgage-backed securities receive payments from the homeowners' principal and interest payments.**

To understand how defaults on subprime mortgages led to a credit crisis, it is important to know what happens when a home buyer obtains a mortgage. Most financial institutions do not keep mortgage loans on their books. Typically, they sell them to other financial institutions in order to receive cash to make loans to new home buyers. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are the biggest buyers of mortgage debt in the country. Together they are responsible for about half of the outstanding mortgages, or about $5 trillion of mortgage loans.

Fannie Mae and Freddie Mac are Government Sponsored Enterprises (GSEs) that were created by the U.S. Congress for the expressed purpose of making home buying more affordable. Even though Fannie Mae and Freddie Mac were charted by the government, they are private, shareholder-owned corporations. Fannie Mae and Freddie Mac do not make mortgage loans to individuals. They work with banks, brokers and other financial institutions to help insure that they have the funds to lend to home buyers at affordable rates.

When Fannie Mae and Freddie Mac purchase mortgages, they often create mortgage pools called mortgage-backed securities (MBS). These pools contain similar mortgages—for example, those with the same interest rates and loan durations—and are sold to investors. When homeowners make their monthly mortgage payments, investors holding these *mortgage-backed securities* receive their share in the principal and interest payments.

Over the past several years, financial institutions packaged *mortgage-backed securities* in a new way, coming up with investments called collateral debt obligations (CDOs) which were often sold to banks, mutual funds and other domestic and foreign investors. With a CDO, thousands of mortgages, both subprime and conventional, could be grouped together. The idea was that if 1000 homes were represented in a CDO, and 50 went into foreclosure, the other 950 would offset any losses an investor might suffer from the 50 bad loans.

Normally, the mortgage-backed securities market operates with few problems; but as homeowners began to default on their mortgages, subprime mortgage-backed securities lost value and investors lost money. There were no buyers for mortgage-backed securities, and the financial institutions that sell them and the investors who bought them became saddled with billions of dollars of devalued mortgages. Many institutions posted record losses on the value of securities backed by subprime mortgages. Their cash dried up. They could not make loans to individuals or businesses. Because of this *credit crunch*, short-term loans, on which all types of businesses rely, became unavailable. When businesses can't get financing, they cannot expand, pay salaries, or invest in new equipment and product development. Economic growth begins to slow and a recession often follows.

The Globalization Effect

Over the past 25 years, open trade policies, increased investment in foreign equity and fixed-income markets, and a rise in foreign direct investment—in which companies in one country run business operations in another country—have created a global economic environment. This *globalization* of the world's economies is often credited with having produced many positive results. But globalization has also been blamed for the sharp worldwide economic decline that resulted from the subprime mortgage problem that began in the United States. Mortgage-backed securities were marketed to international investors and banks around the world. As a result, many overseas financial institutions have substantial investments in U.S. mortgage-backed securities. These overseas investors have also seen their credit markets seize up and their economies contract.

Governments Around the World Step In

In the past several months, central banks and governments around the world have taken steps to support their financial institutions and shore up their economies. In the United States, the Federal Reserve lowered interest rates, as did the Bank of England, the European Central Bank, the Bank of Japan and the Bank of China, among others. Lower interest rates should reduce the rates on loans to individuals and businesses. In addition, governments have made large cash infusions into their financial institutions in an effort to thaw the credit markets and encourage lending.

In the United States, the Federal Housing Finance Agency (FHFA) established a conservatorship for Fannie Mae and Freddie Mac. As a conservator, the FHFA has taken over the assets and assumed all the powers of the shareholders, directors and officers. The FHFA may take any action necessary to restore Fannie Mae and Freddie Mac to sound financial condition. In addition, the U.S. Congress put together a $700 billion package, part of which has been used to purchase stock in some of the country's biggest financial institutions. By investing billions of dollars in several banks, the U.S. government has become part owner of these institutions and has provided a cushion of cash that can be used to write loans to creditworthy individuals and businesses. When banks return to normal working conditions and to the business of lending, an important step will have been taken toward getting the economy back on track for growth.

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