The credit monster

by the St. Louis Post-Dispatch

The subprime mortgage crisis started when bankers and investors who should have known better ignored one of the basic tenets of the lending business: Don't lend lots of money to people who might have a hard time paying it back.

It was the "greater fool" theory: As long as housing prices kept rising, shaky borrowers could refinance their loans with a greater fool, and the original investors would get their money. Eventually, housing prices got too high, and the dominoes started falling. The first to go were securities backed by subprime mortgages.

Once some dominoes fall, it's hard to stop the reaction from spreading from row to row to every corner of the table. We're seeing that now, as parts of the credit system that have nothing to do with mortgages are starting to waver.

Losses on subprime mortgages weakened big banks, which made them pull back from other kinds of risky lending. Suddenly, credit cards are getting harder to get, and rates on cards are rising for consumers with poor credit. Business loans are a bit harder to come by, and the student loan market is showing signs of strain. Worse, financial institutions late last year became reluctant to lend to each other, since no one knew which player might be sitting on a subprime bomb. Parts of the short-term money market started to clog up.

Some subprime loans were insured by bond insurance companies, such as MBIA and Ambac. Now those insurance companies find themselves on the hook, and their sterling credit ratings are in danger.

Those troubled insurers also insured lots of bonds that have nothing to do with mortgages. Now those bonds are in danger of losing value as their insurance falters. That could deepen losses for banks and other investors holding those bonds.

Thus a whole new row of dominoes is starting to wobble. Last week that caused trouble in the so-called "auction-rate" market, an obscure corner of the financial world where companies go to borrow short-term money cheap. As Post-Dispatch business columnist David Nicklaus reported, the Missouri Higher Education Loan Authority and Ameren Corp. got caught temporarily in the squeeze. Ameren found itself paying 12 to 18 percent interest on loans that had been at 2 to 4 percent.

Thus did a blooper in the mortgage business morph into a problem for an electricity company.

Meanwhile, the subprime fiasco is making investors wary of other asset-backed bonds. That's making it harder for student loan companies, like MoHELA, to raise money, causing some to worry about a possible student-lending crunch.

So far the credit crunch is not severe. It's being felt mainly by those with shaky finances. Good corporate borrowers still can issue bonds. Individuals with good credit still can obtain credit cards and mortgages.

But banks are losing billions, and no one is sure how tight the crunch will become. A slowing economy always causes lenders to tighten lending, and that adds to the worry level.

The Federal Reserve is busy trying to stop the falling dominoes, lending billions to the banks at low interest rates. It's also cutting short-term interest rates to encourage people to borrow and spend. Congress has authorized a $168 billion stimulus program to get economy rolling again.

We've been through credit crunches before. But the financial system is now much more complex, interconnected and globalized. No one is quite sure how failures in one part of the system will affect the others. No one knows when the last domino will fall.

Reprinted from the St. Louis Post-Dispatch. CNS

The credit monster by the St. Louis Post-Dispatch