



# Why is the Country Facing a Financial Crisis?

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**The views expressed in this presentation are the views of Julie Stackhouse and are not necessarily those of the Federal Reserve Bank of St. Louis or the Federal Reserve System.**



## Today's challenges started with bad home loans called “subprime mortgages.”

- A “mortgage” is a loan to a borrower so that they can purchase a house or similar properties.
- A “subprime mortgage” is a loan to a borrower who has not established a good record of paying back debts (a poor “credit history”).
- Today, we can look back and see that people taking on subprime mortgages may not have been able to afford them, may not have understood them, may have been misled or simply may not have been honest.

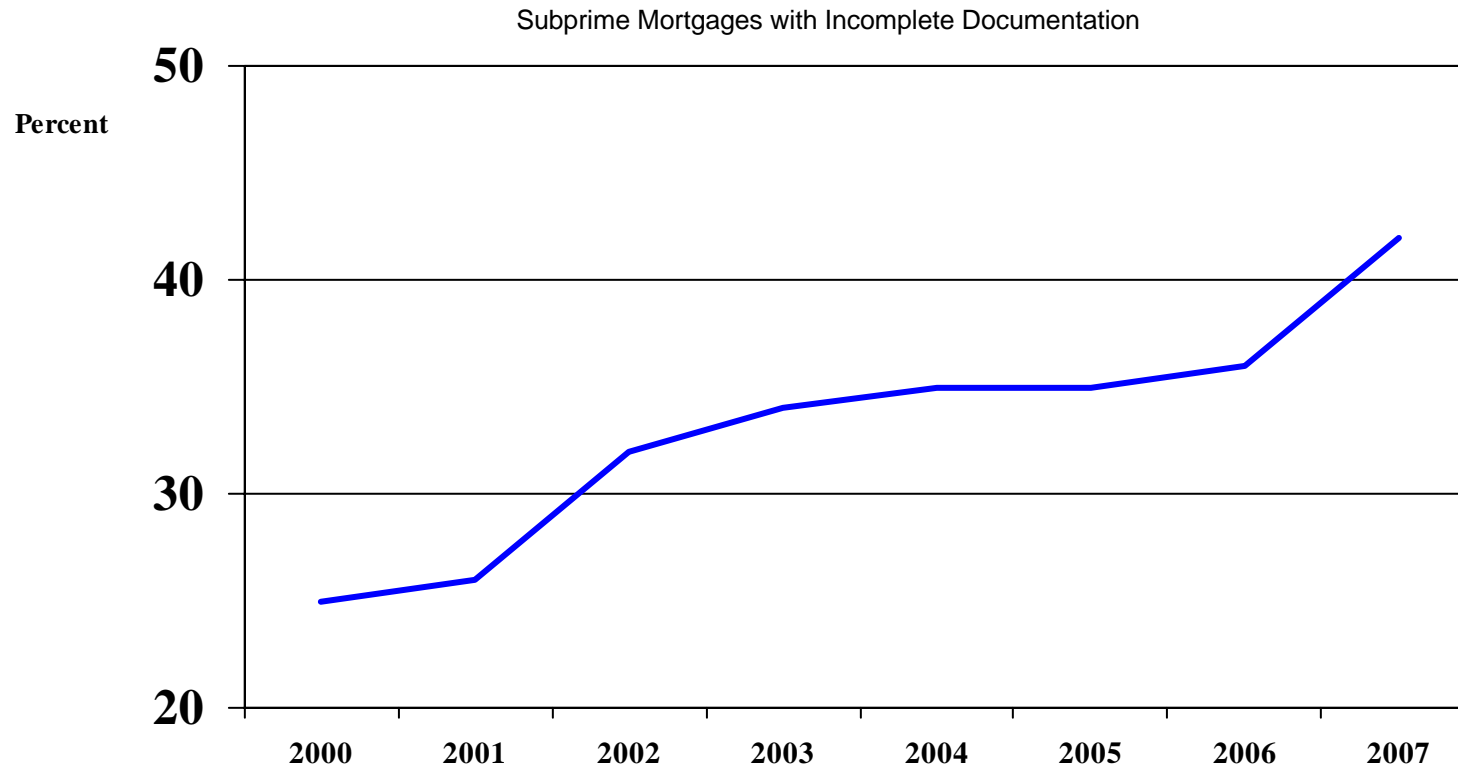


## What happened to make the subprime mortgage situation so bad?

- Weak borrowers:
  - Weak credit history (the “report card” of how you pay your bills)
  - History of problems with other debt
  - Uncertain ability to understand the terms of mortgages
  
- Loans that would be difficult to repay in the best of circumstances:
  - It was never clear that the borrower had the income to repay the mortgage.
  - The borrower took on a lot of debt as compared to the value of the home.
  - The interest rate on many of the loans could change and increase rapidly. Not everyone understood what this meant.
  - Many times, the borrower used the mortgage as a means of getting cash for other purposes.
  - Many salespeople pushed borrowers to take on the loans.



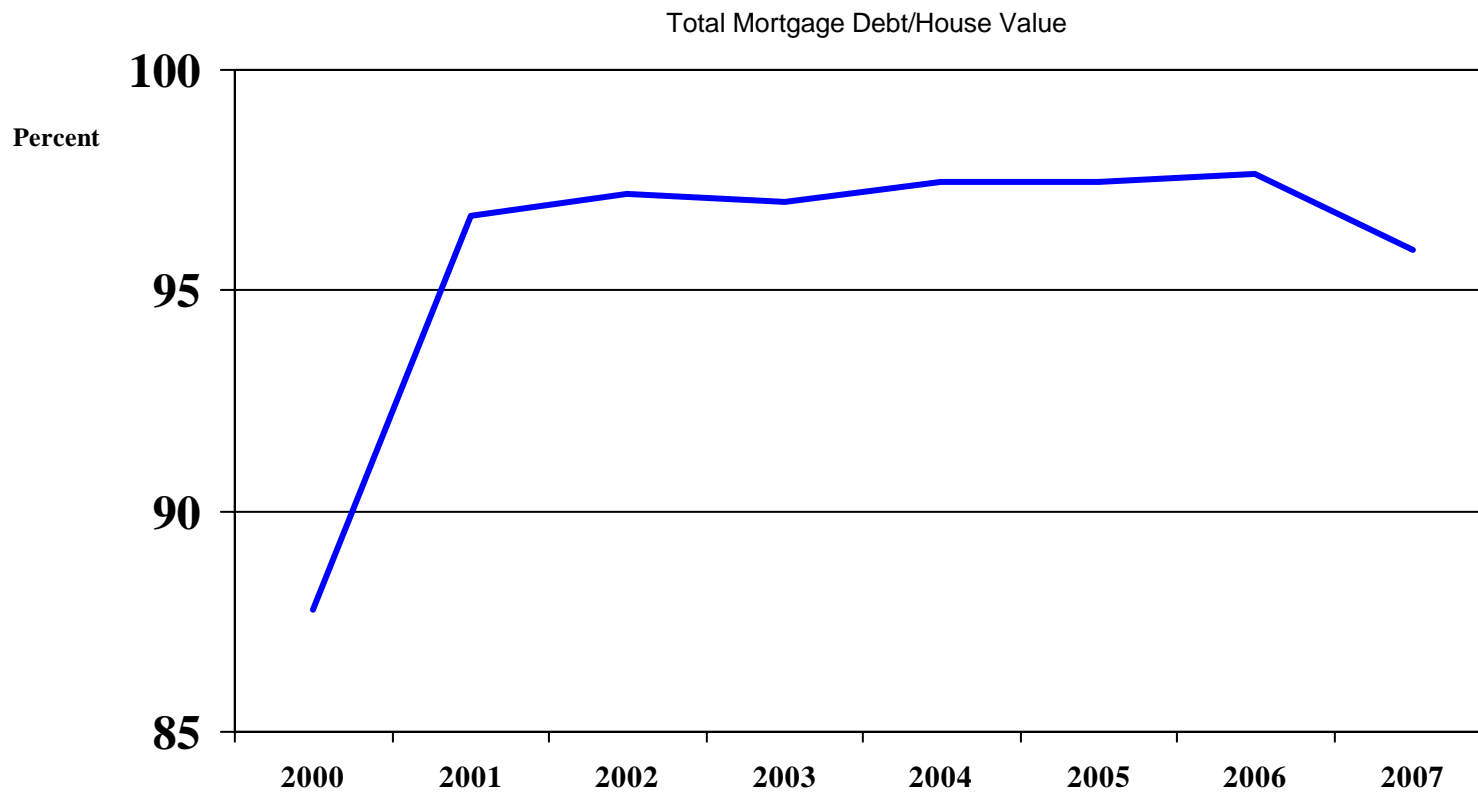
## The paperwork was often incomplete.



Source: Loan Performance Corp.



The borrower put little of his/her own money into the home purchase (a “down payment”).

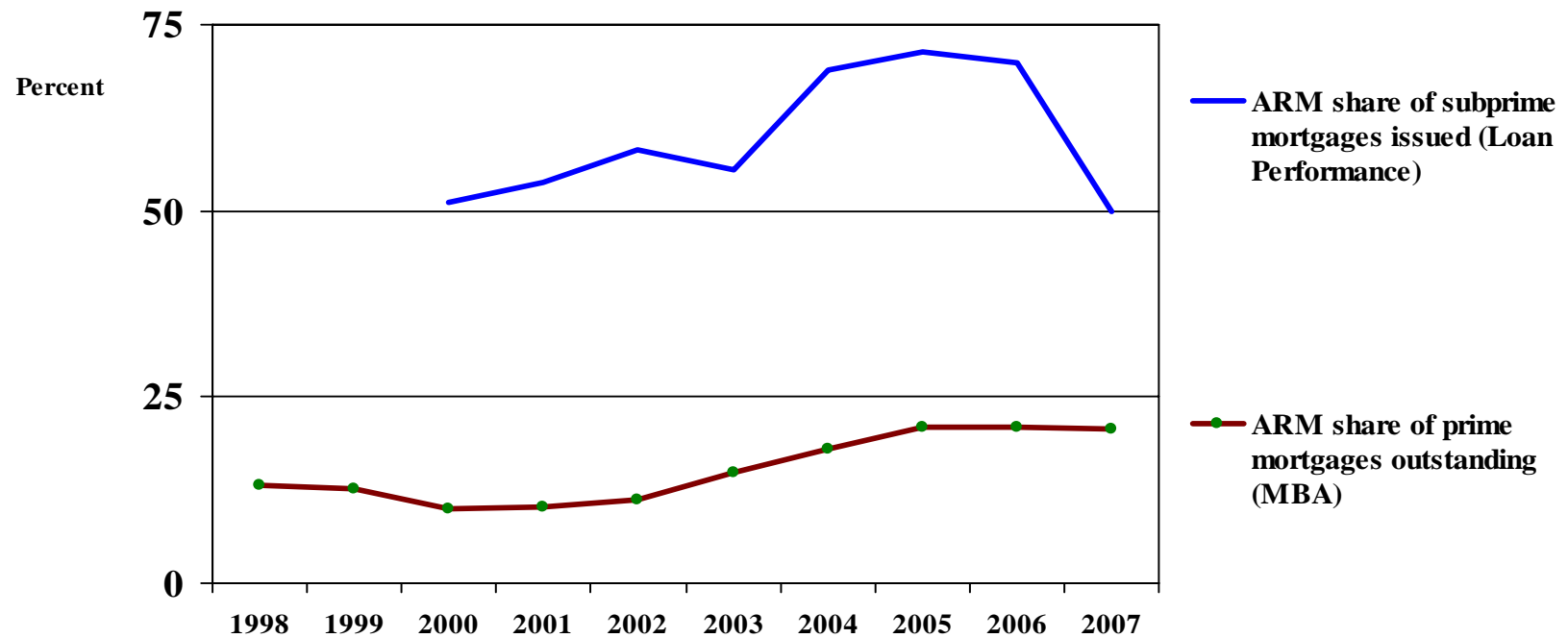


Source: Loan Performance Corp.



On many loans, the interest rate could change and go higher.

Share of Mortgages with Adjustable Rates

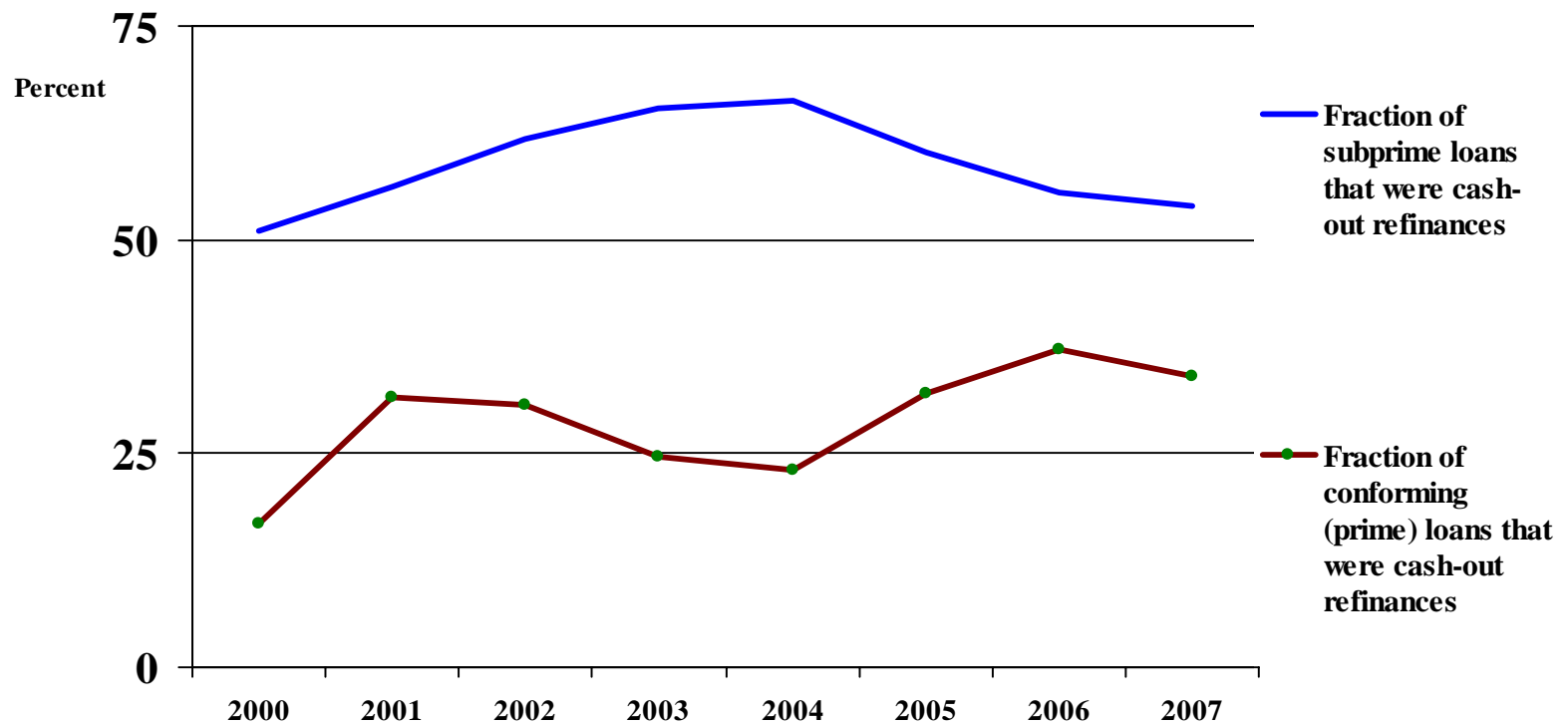


Sources: Mortgage Bankers Association, Loan Performance Corp.



Many borrowers used their mortgage for cash to spend immediately or to pay other bills.

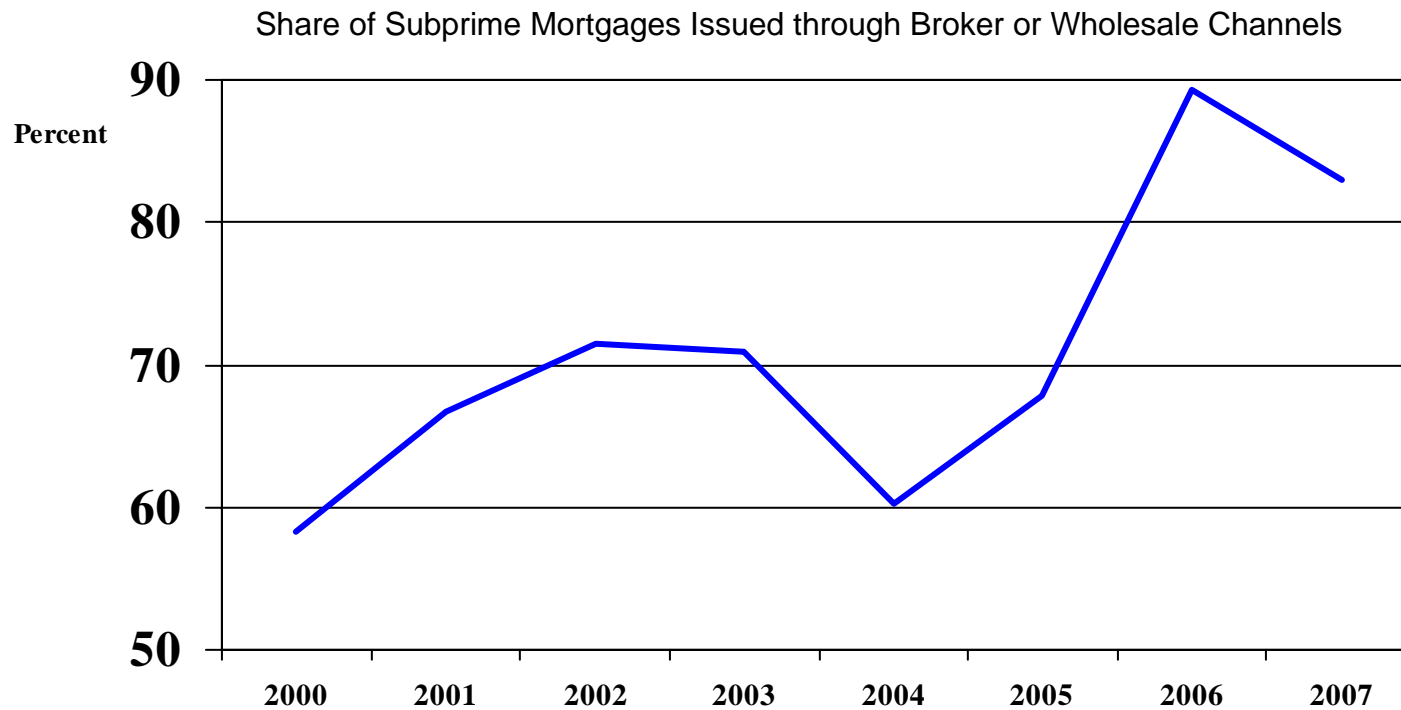
Share of Mortgages That Were Cash-Out Refinances



Source: Loan Performance Corp, Freddie Mac.



Mortgage “brokers” (lenders) wanted to make a commission and may not have cared if the loan could be repaid.

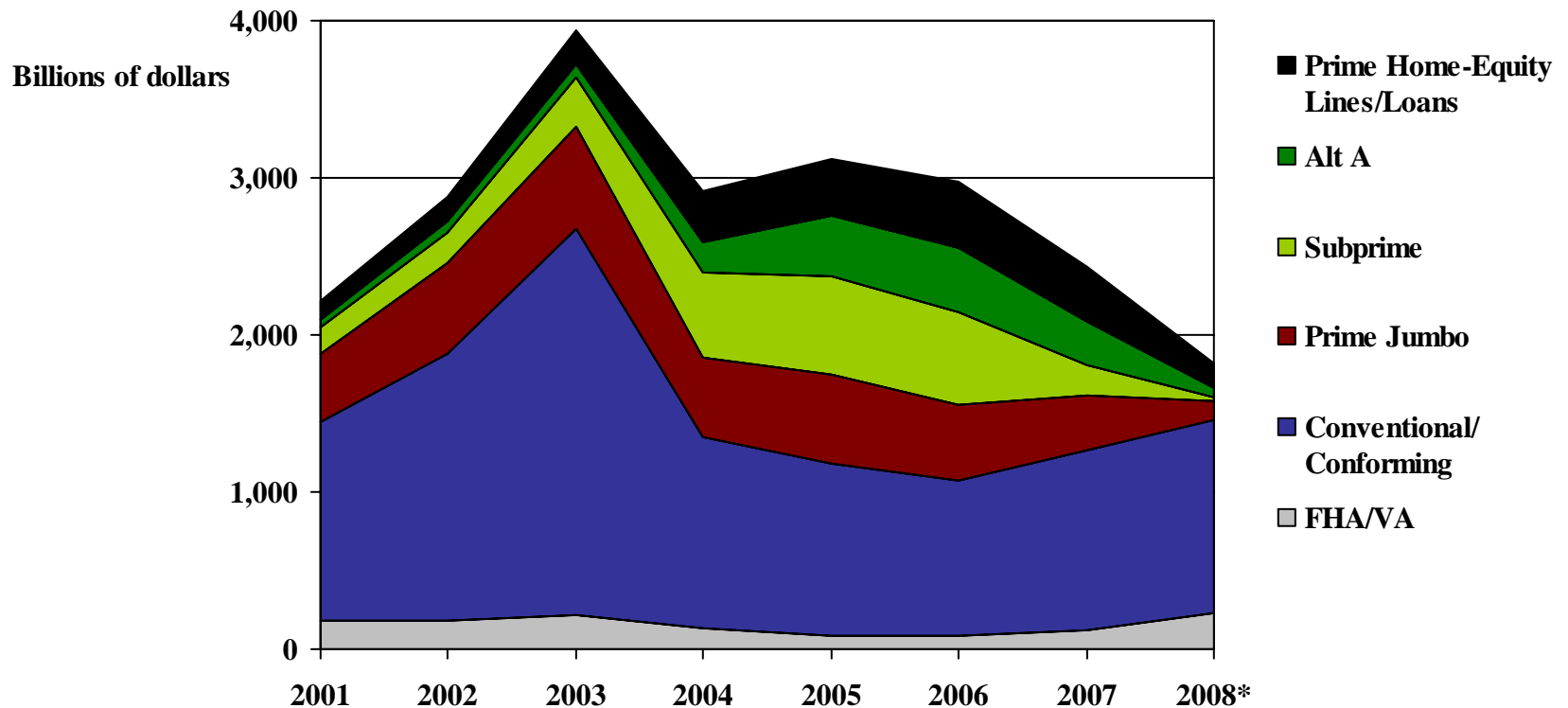


Source: Loan Performance Corp.



Easy money meant that more and more subprime mortgages were financed.

### Mortgage Originations by Product Type



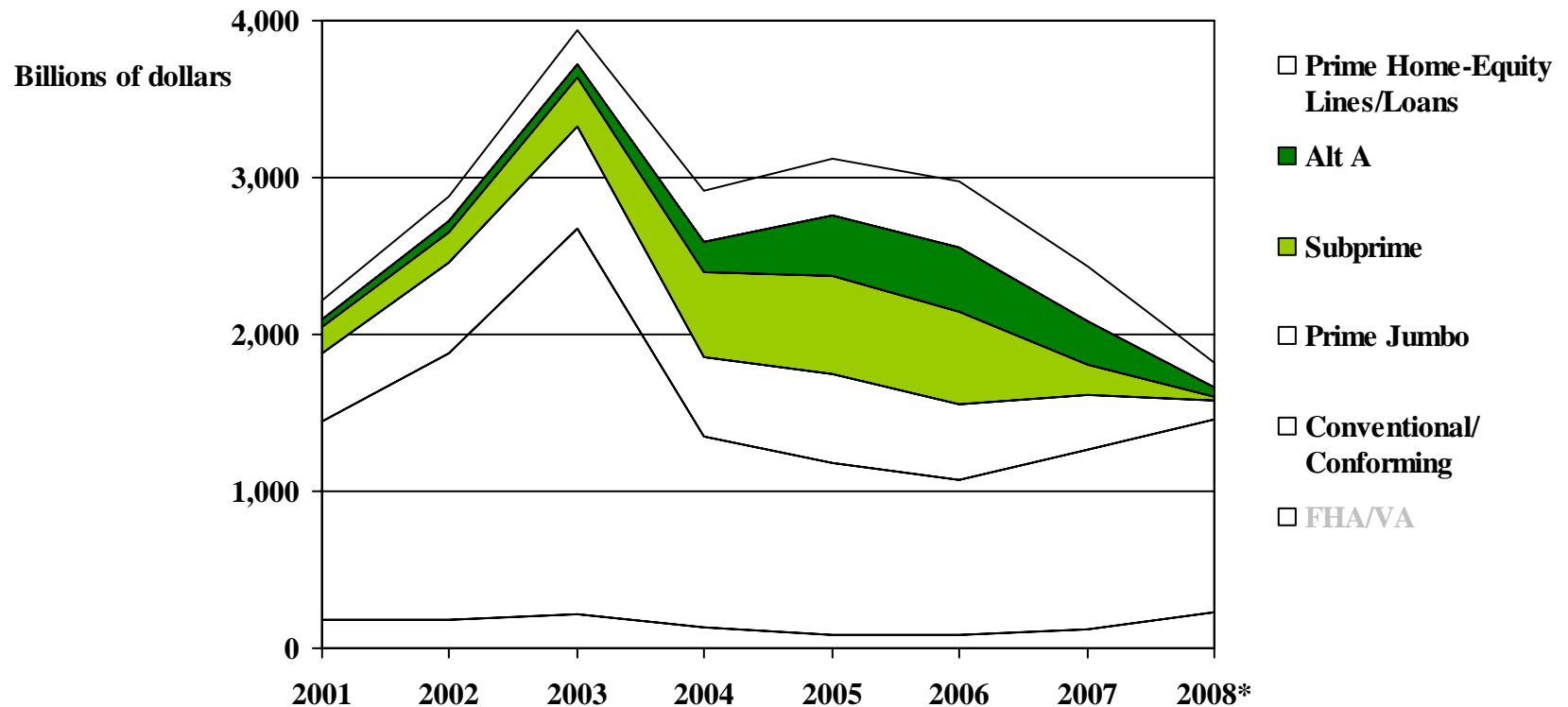
Source: *Inside Mortgage Finance*, Sept. 5, 2008.

\*Annual data through 2007; 2008 based on first six months at annual rate.



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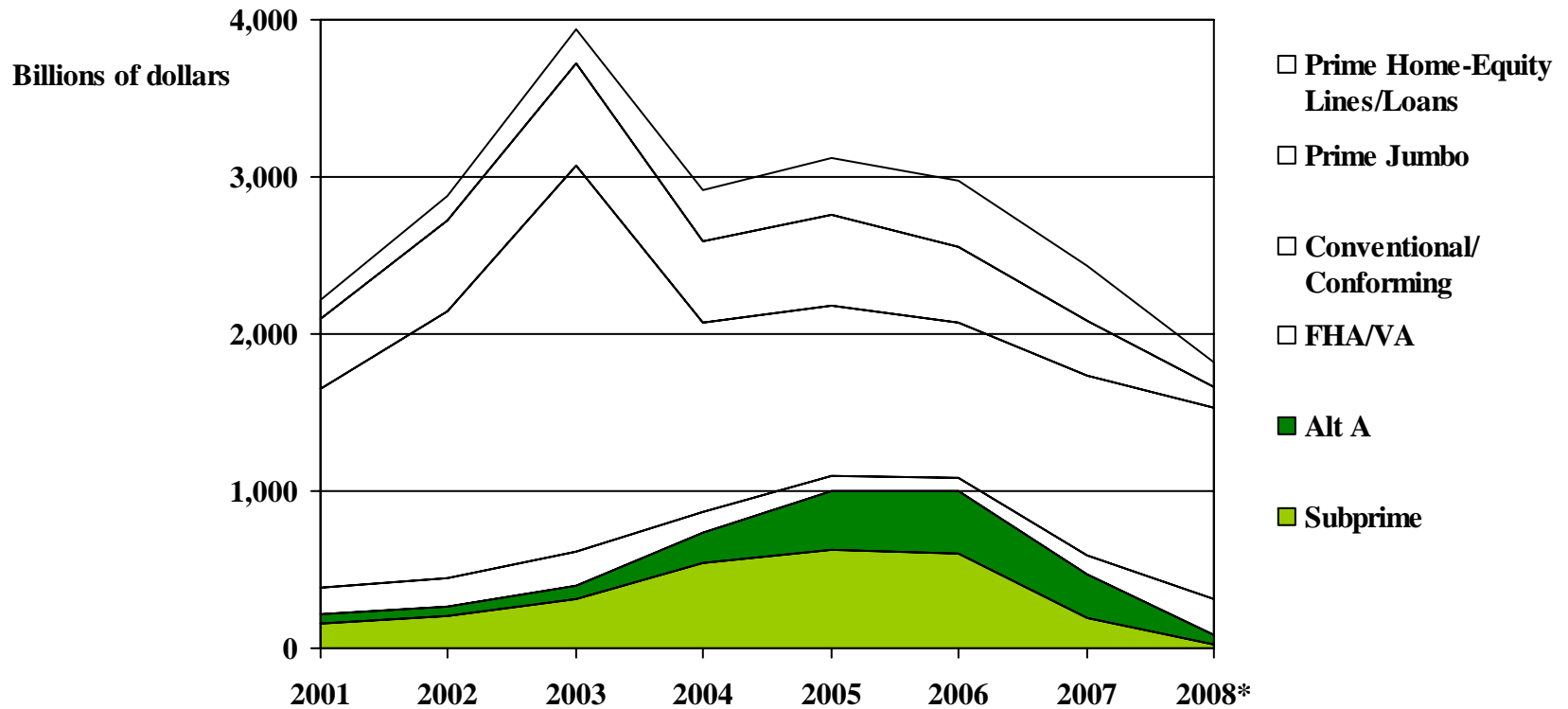
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### Mortgage Originations by Product Type



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Things got complicated when the mortgages were “packaged” as securities and sold to investors across the world.

- What is a security?
  - A security is created when many individual assets are pooled together and sold to investors in the financial markets.
  - The income from the assets making up the security produces cash for the investor.
  - Investors may sell the securities to other investors.
  
- Subprime mortgages were typically pooled into “mortgage-backed” securities.
  - Sometimes, the mortgages were broken into pieces and packaged with other similar mortgage pieces.
  - In 2006, about \$350 billion of subprime mortgages were transformed into securities.



Many of these securities (called “structured investment vehicles”) were very complicated.

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The SIVs were made up of many complex securities called “collateralized mortgage obligations.”





The CMOs contained similar parts of many mortgages, put together into a “mortgage-backed security.”





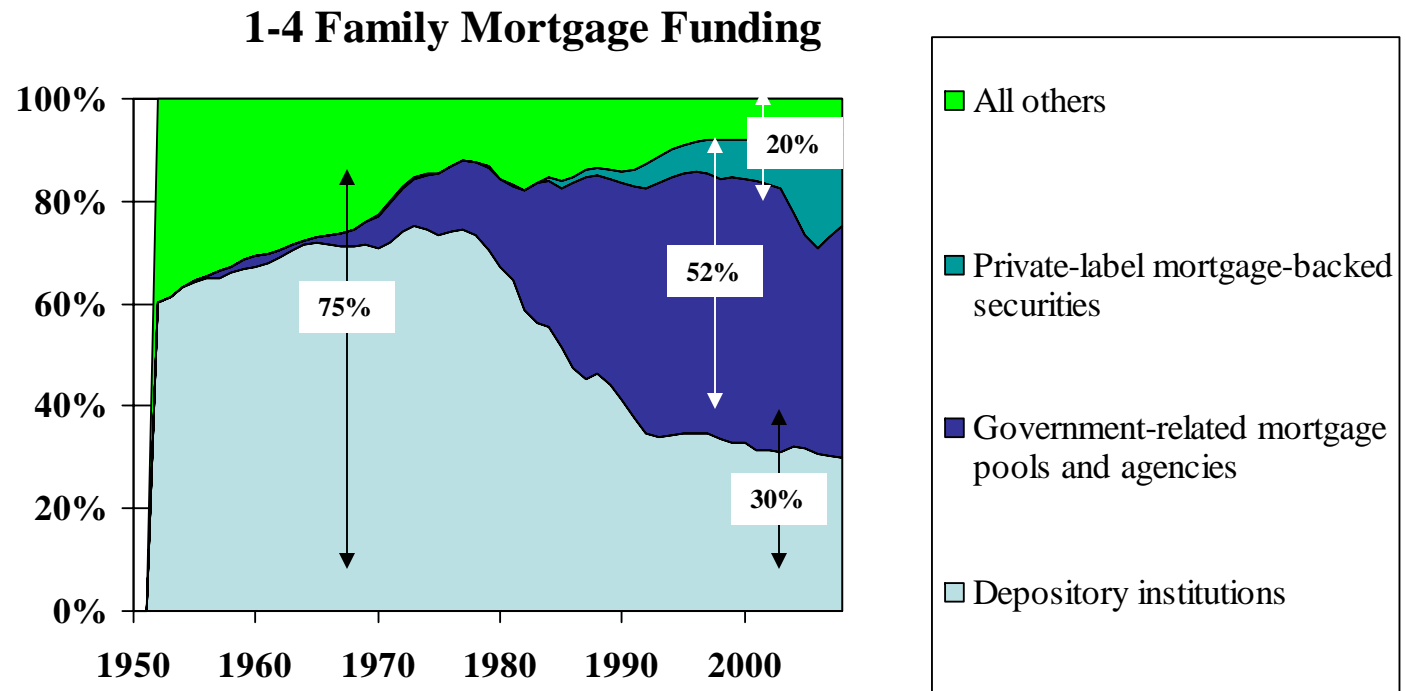
At the core were many high-risk mortgages.







## Subprime mortgage securities grew and grew.



Source: Federal Reserve *Flow of Funds Accounts*

Year-end data through 2007; June 30 data for 2008.



And then, many people became unable to pay the mortgages. (<http://www.newyorkfed.org/mortgagemaps/>)

The screenshot shows the website interface for "Dynamic Maps of Nonprime Mortgage Conditions in the United States" from the Federal Reserve Bank of New York. The header includes the bank's name and navigation links like "BANKING", "MARKETS", "RESEARCH", "EDUCATION", "REGIONAL OUTREACH", and "ABOUT THE FED". A search bar is also present. The main content area features a map of the United States with a color-coded overlay representing mortgage conditions. To the right of the map is a control panel with a "Print Map" button, a "Loan Type" selector (currently set to "Subprime"), and a list of 13 data series with radio buttons and corresponding color swatches. The series include: "Loans per 1000 housing units", "In foreclosure per 1000 housing units", "REOs per 1000 housing units", "Share ARMs", "Share current", "Share 90+ days delinquent", "Share in foreclosure", "Median combined LTV", "Share low FICO &amp; high LTV", "Share low or no documentation", "Share ARMs resetting in 12 mos.", and "Share late payment last 12 mos.". The "Report" dropdown is set to "August 2008". At the bottom of the page, there is a "Trusted sites" indicator with a green checkmark.

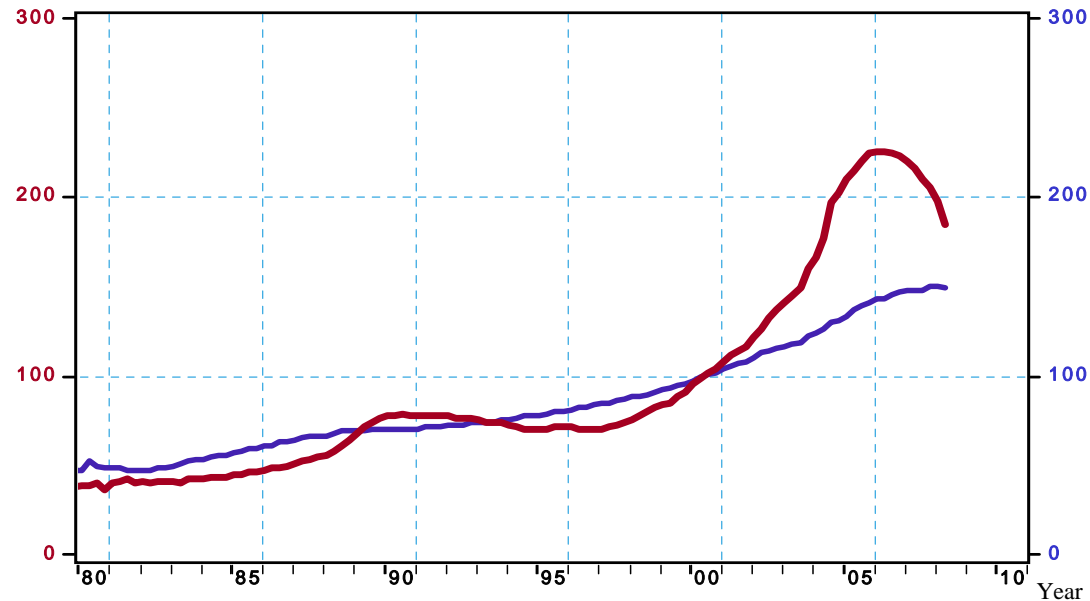
Interested in credit card delinquency maps? Visit:  
<http://data.newyorkfed.org/creditconditionsmap/>



This bad situation was made worse by falling home prices in most parts of the country – it was hard to sell the house to pay the mortgage.

**OFHEO House Price Index: San Diego-Carlsbad-San Marcos, CA**  
Average level in 2000 set equal to 100

**OFHEO House Price Index: St. Louis, MO-IL**  
Average level in 2000 set equal to 100



Source: Office of Federal Housing Enterprise Oversight /Haver Analytics

Quarterly data through Q2.2008.



And there are more homes for sale than buyers.

Total Vacant Housing Units, United States: Year-round For Sale Only

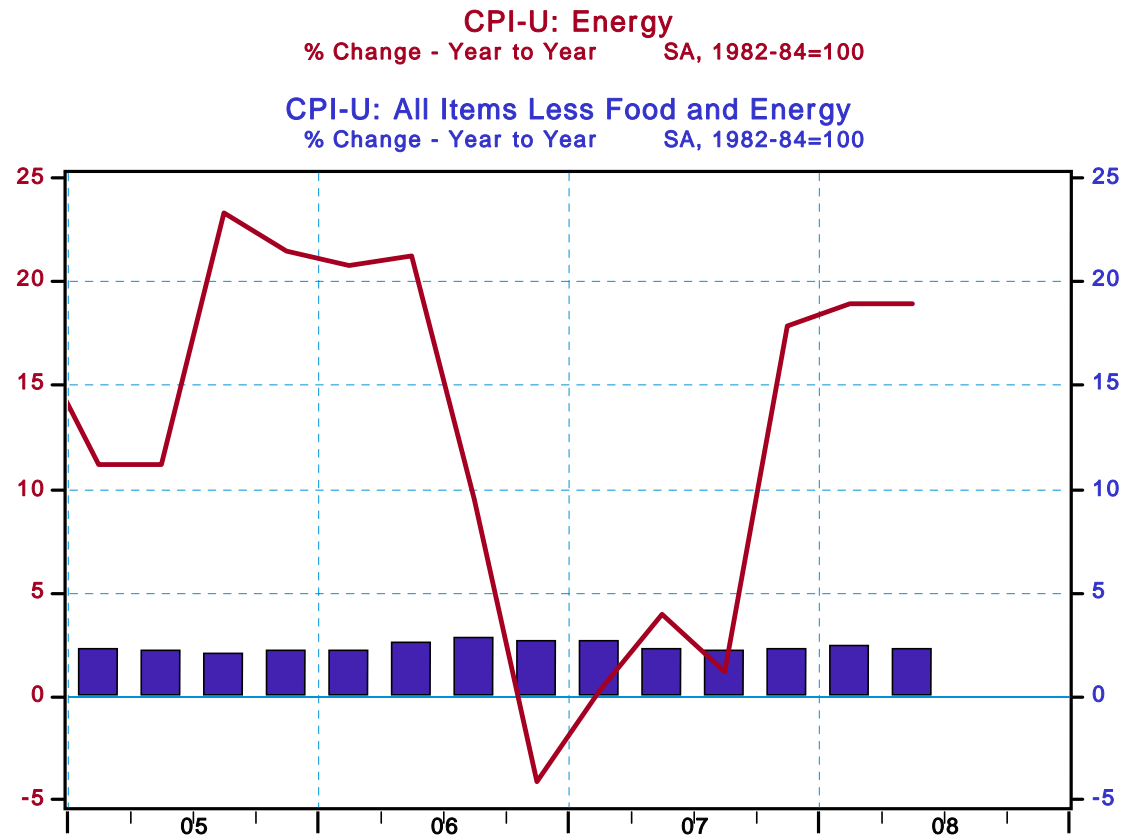
Thousands of units



Source: Bureau of the Census /Haver Analytics



Rising food and energy prices over much of the past year only added to the problem. Which bill gets paid first?



Source: Bureau of Labor Statistics /Haver Analytics



## So how might all of this affect the economy?

- Many large financial institutions owned these complex mortgage securities. They have lost a great deal of money.
- Others don't want to buy these securities from large financial institutions because they don't know what they are worth. It has become hard to free up money to lend for other good causes.
- Loans from financial institutions are important to all types of companies across the country. It allows them to keep making their products and other new investments that keep jobs.
- If people start to lose jobs, they can't pay their loans and the cycle starts again.
- And people don't feel good if they think the value of their home is declining. They may not make purchases that would otherwise help economic growth.



## Is the situation right now as bad as the Great Depression?

- No.
- Between 1929 and 1933, U.S. personal income declined 44 percent, real output fell by 30 percent, and the unemployment rate climbed to 25 percent of the labor force.
- The home foreclosure rate peaked at 13.3 per 1,000 mortgages in 1933. An average of about 1000 home mortgages were foreclosed every day.



## What has the Federal Reserve done so far?

- The Federal Open Market Committee has substantially reduced interest rates.
- As early as August 2007, the Fed began expanding the terms of its lending programs to banks and has introduced several new programs.
- The Fed has introduced several lending programs to certain nonbank organizations, using a provision in the Federal Reserve Act that has not been used since the 1930s.

The important point to understand: A key role of a central bank is to promote financial stability. These special lending programs serve this purpose.



## What has the federal government done?

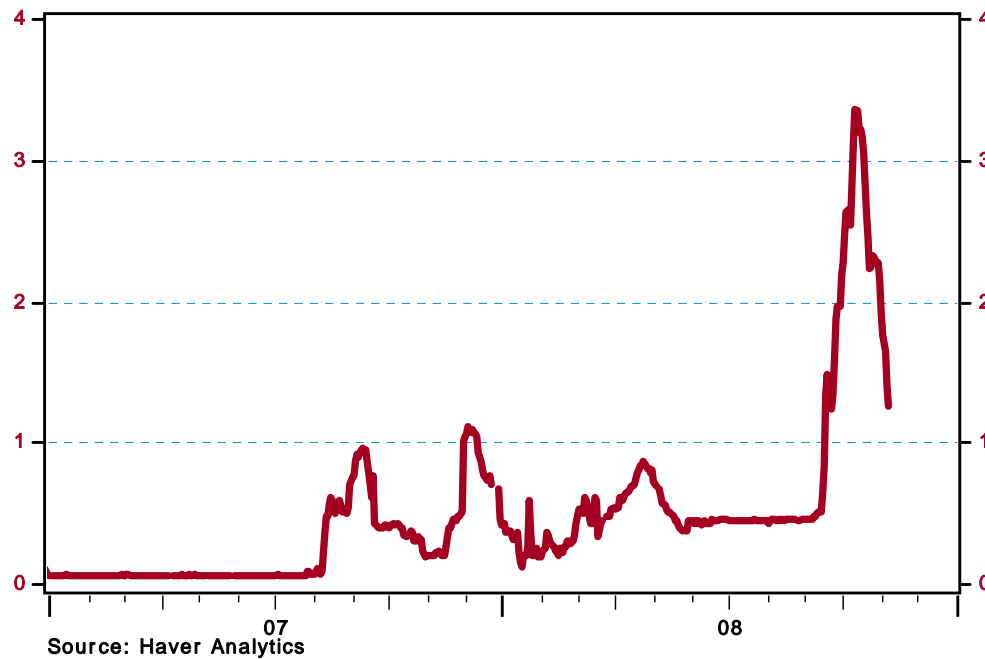
- Legislation has been Enacted – The Emergency Economic Stabilization Act of 2008. The legislation contains provisions for a “Troubled Asset Relief Program” or “TARP”.
- The basic idea is that the government would make equity investments in financial institutions, buy mortgage assets (for the most part) and hold them until stability returns, and/or insure mortgage assets.
- The Federal Deposit Insurance Corporation has also been authorized to temporarily increase the insurance level on certain bank deposits. This is important to consumers and small businesses.
- Overall, the goal is to protect the U.S. economy, strengthen public confidence in financial institutions, and foster functioning of credit markets.



## How will we know when things are starting to get better?

### 1-Month LIBOR-OIS Interest-Rate Spread

Percentage points



Before August 2007, the difference between these two rates was very small. Now, the difference is very large. The rates will move closer together again as things improve, although perhaps not back to historic levels.

Daily data through November 7, 2008



## What do students need to remember?

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- Use debt wisely/ Debt to pay for college is an investment; debt to buy a fun, new wardrobe is not.
- Never take on debt that you are not confident that you can pay even if something unexpected goes wrong for a while. Be especially sure that you can pay your credit card debt. It is expensive, and the failure to pay can cause you great problems later.
- Save, save, save. It is the best investment you can make in yourself.
- If something sounds too good to be true, it is. Look harder and ask for help in understanding why.



## In closing:

- Take a few moments now to discuss how the current financial markets have affected you or your family.
- Discuss what you think you should do over the upcoming months.