

U.S., European central banks step in to contain mortgage crisis

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Friday, August 10, 2007



The U.S. subprime mortgage mess escalated into a full-blown global financial crisis Thursday - making credit harder to get from Paris to San Francisco.

Early Thursday, France's largest bank stopped letting clients take money out of several of its funds exposed to U.S. subprime loans. The European Central Bank and the U.S. Federal Reserve then intervened, flooding their banking systems with cash to keep interest rates from spiking as lenders around the world slammed shut their loan windows.

"What you're seeing is a classic credit crunch," said Christopher Thornberg, a Los Angeles economist with the firm Beacon Economics.

Thursday's developments will make it even more difficult to borrow and could put a further crimp in home prices and the broader economy, experts said. The Bay Area, which has the highest home prices in the continental United States, could be particularly vulnerable, some economists warn.

Stock markets around the world nose-dived Thursday amid worries that the U.S. mortgage meltdown has not yet run its course and could take a big bite out of economic growth. The Dow Jones industrial average dropped 387.18 to 13,270.68, down 2.83 percent, while the Standard & Poor's 500 Index fell 44.40 to 1,453.09, off 2.96 percent.

"If the market is ultimately driven by fear and greed, then we had fear in spades," said Liz Ann Sonders, chief investment strategist with brokerage giant Charles Schwab & Co.

So far, the mortgage crisis remains contained because bonds created from U.S. subprime mortgages have been distributed widely around the world and few, if any, major financial institutions hold a

lethal dose. The biggest hits so far have mainly been at funds with small numbers of investors and niche mortgage companies that specialized in subprime loans - those made to high-risk borrowers.

Still, tight credit conditions, if they last, could slow the economy or even cause a recession by reining in consumer spending, market experts say. Much of the oomph in the U.S. economy in recent years came from a booming housing market and the ease with which ordinary Americans were able to convert the rising value of their properties into instant cash through home equity loans.

"We have an economy driven very much by access to credit," Sonders said. "If it gets worse from here, it's hard to believe it wouldn't have a real impact on the economy."

The mortgage mess is already boosting rates for borrowers in the United States - if they can get home loans at all. Jumbo loans - those greater than \$417,000 - are carrying interest rates of 7.5 to 8 percent, 1 to 1.5 points higher than a month ago, according to the Mortgage Bankers Association.

Consumers could be affected in several other ways. Tight credit puts downward pressure on home prices. Thornberg, a housing market bear, predicts California home prices could keep falling for as long as two years, with prices dropping as much as 20 percent from their peaks.

Households also could take hits on their investment and retirement portfolios. Some pension funds have invested in subprime securities and could suffer losses. But even investments that have nothing to do with mortgages could get whacked if loan problems prompt a prolonged sell-off in the broad market.

Everyone, of course, would feel the effects of an economic downturn, which would put further downward pressure on home prices and make jobs scarcer. That could take the wind out of the sails of the Bay Area economy, which has had several years of traction after the prolonged dot-com bust.

Experts are divided on just how much damage mortgage woes might inflict on the overall economy.

Those who see a big hit stress the role of easy credit in the economy.

"Consumers have been running on fumes, using their homes to finance extravagant lifestyles," Thornberg said.

Others say strong corporate profits, low unemployment and robust global business conditions will shield the economy from a housing downturn.

"We may have a few more volatile months and a lot more hand-wringing, but ultimately the fundamentals look pretty good for growth," said James Paulsen, chief investment officer for Wells Capital Management.

The makings of the current crisis reflect the revolutionary changes in the home loan market in recent decades.

In the old days, when a bank, thrift or mortgage company lent to a home buyer, the financial institution kept the loan on its books. If the homeowner couldn't pay the mortgage, the lender took the loss.

Beginning about a generation ago, lenders started selling home loans, using investment banks to package individual loans into securities that could be peddled to investors. During the current decade, as U.S. home prices rocketed, worldwide appetite for these securities soared. The market grew to trillions of dollars.

"A mortgage made in Minneapolis could be held in an institutional hedge fund in Europe," Paulsen said.

Amid the housing-boom euphoria, investors gladly bought securities based on loans made to even the highest-risk borrowers - people with tarnished credit histories or inadequate incomes to pay the monthly cost. As the housing market slowed, large numbers of those borrowers defaulted, leaving buyers of mortgage securities holding the bag.

That market collapse crippled subprime mortgage companies, which could no longer easily sell the loans they made. And it destroyed investment vehicles, such as hedge funds managed by investment banking giant Bear Stearns that found their capital eaten up by bad loans.

But the broadest effect has been to cause large swaths of the mortgage market to all but shut down. Investment funds that have tried to unload a wide array of mortgage securities have found no buyers

at virtually any price.

"Liquidity is drying up for all mortgage-backed bonds," said Arthur Micheletti, chief investment strategist for Bailard, a Foster City investment firm

That's the point at which the central banks stepped in.

Early Thursday, BNP Paribas, France's largest bank, said it was no longer allowing investors to withdraw money from three investment funds exposed to the U.S. subprime market. The announcement touched off a panic in which European banks desperately tried to borrow money in the overnight lending market. One motive, presumably, was to have cash on hand to pay their own clients who might want to withdraw money from investment funds.

Short-term interest costs shot up, prompting the European Central Bank to pump the equivalent of more than \$130 billion into the banking system to keep rates in check. It was the first time the bank intervened this way since the day after the Sept. 11, 2001, terrorist attacks.

The Federal Reserve acted similarly but on a smaller scale, injecting \$24 billion into the U.S. banking system after its benchmark overnight bank lending rate suddenly jumped.

The central bank moves stabilized short-term interest rates. But they did not halt the sense that mortgage problems are spreading, fueling the stock market's sour mood.

"The market is in a wait-and-see mode to see what is the next shoe to drop," Sonders said.

Indeed, reports surfaced of several more European banks taking losses on U.S. subprime loans. And American International Group, a major U.S. mortgage lender, warned Thursday that late payments are increasing among borrowers above the subprime level.

How the mortgage meltdown could affect you

-- Credit, especially home loans, could become more expensive and harder to get.

-- Home prices could fall.

-- Investments could lose value if directly exposed to subprime mortgages or indirectly, if broad stock and bond sell-off persists.

-- Jobs could become harder to get if the economy slows or falls into recession.

Source: Chronicle research

Subprime meltdown: Readers comment

Some feared the sky might be falling; others said it was a long time coming. Few were in favor of a bailout for those nailed by the mortgage collapse or for those who lent the money in the first place. But something needs fixing, readers said, and it's going to hurt. Here is a sample of the 186 comments registered Thursday on SFGate.com:

How did the industry NOT see this coming?! The recent housing boom was built on a proverbial house of cards. Who is to blame? I blame the idiots that came up with the creative mortgage solutions and the borrowers that actually thought they could find a way to afford the ludicrous terms. It all boils down to greed, pure, good ol' all-American greed.

- Bruce Smith, 54, Mill Valley

Expect the following: a more rapid devaluation of real estate (fewer products means fewer eligible buyers), rate softening by the Fed, and more people quickly getting out of the real estate and mortgage businesses. Once it hits bottom in 12 to 24 months, it'll be time to buy some cheap Bay Area property.

- Alberto Aldana, 39, Brentwood

The government should NOT bail out homeowners, but they need to get real on the cap for conventional loans. The S.F. Bay Area needs to have what Hawaii and a couple of other places have, a higher cap on standard home loans so the average person who has a great credit score (earned on their own, not purchased) and good stated income can get a standard home loan without having to get creative just to live where they work.

- Molly Ziman, 35, San Bruno

A lot of people are going to go down. The more that do, the more downward pressure it's going to apply on the rest of the housing market. It may be unavoidable, but if we want to try to keep it from happening, we need to help people who want to stay in their houses refinance with a reasonable loan. It's going to cost the economy (that's us) a lot more if people walk away from their houses than it will to help them keep their house with a reasonable loan. Lax regulation and greed has created this mess. It's not going to get better without an effort on our part to help some of these people out (and help ourselves in the long run).

- *Carl Schwab, 53, Sea Ranch*

Real estate is a cyclical beast and is prone to excess. This isn't the first time this sort of thing has happened and won't be the last. It'll take a couple of years to resolve the current situation, but it's not the end of the world (except for a few overextended people). My question for you all is, with the real estate market and the stock market both tanking, where is the smart money going? Pork belly futures, anyone?

- *Malcolm R. Carden, 60, Piedmont*

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<http://sfgate.com/cgi-bin/article.cgi?f=/c/a/2007/08/10/MNU2RG11T.DTL>

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