

How and why the financial crisis unfolded.

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The financial crisis that has transfixed the world over the past five months has its roots in the subprime crisis that began plaguing world markets in 2007.

This essentially involved lending to people with a bad credit history. These people are now known as NINJAs — no income, no jobs, no assets.

The NINJAs' mortgage debts were then packaged up into structured financial products (mortgage-backed securities) and sold to various banks, fund managers and others. When house prices began to fall in the US in 2006-07, homeowners started defaulting on their debts. This affected mortgage lenders first, but then started affecting institutions that had bought into mortgage-backed securities.

Why would anyone want to buy someone else's bad debt?

The packaged-up mortgage debts (also known as collateralised debt obligations, or CDOs) would pay whoever bought them a return based on the quality of the debt. The lower the debt quality, the higher the return. When house prices were rising, the risk of default, even on bad debt, was relatively low, making CDOs an attractive investment. But when house prices started falling and defaults began rising, CDOs started losing a lot of their value.

Okay, but what does that mean?

Due to the complexity of the mortgage-backed securities and uncertainty about their impact on financial institutions, banks stopped lending money to each other as freely as they had been. This caused the cost of money to rise, meaning that banks had to pay more to source the funding to service their existing debts, such as your mortgage.

As the subprime crisis got worse, and more and more US homeowners defaulted on their debts, banks around the world found themselves holding mortgage-backed securities whose value had plummeted. This caused a series of write-downs (money being wiped off the balance sheet) from banks around the world. Globally, some \$500 billion has been lost in this way so far.

So why did Lehman Brothers collapse?

Good question. Lehman Brothers has been in trouble for a while — invested heavily in mortgage-backed securities— and recently announced a quarterly loss of around \$5 billion . Last weekend, US government authorities and international banks tried to come up with a plan to save the bank through a sale, but the potential buyers — Barclays Bank and Bank of America — backed out of the deal.

That left the company with no option but to declare itself bankrupt. The US Government has previously bailed out mortgage finance companies Fannie Mae and Freddie Mac, and offered credit guarantees to the buyer of investment bank Bear Stearns, which collapsed in March. However, it was not willing to do the same for Lehman.

Bailout bonanza

Bailout, along with meltdown, crisis and prefixing of various days of the week with the word "black", has become a term ubiquitous with the second part of the year.

Governments globally have been throwing money around like drunken sailors recently in a bid to keep their economies from going under. Since the crisis began, the US Government has announced combined bailout funds of around \$1.5 trillion. In the UK, the government spent \$600 billion on bailing out its banks and nationalising parts of the banking industry, while Germany has announced a \$61 billion stimulus package.

China, meanwhile weighed in with a massive \$800 billion economic stimulus. The fact that the Australian Government's stimulus so far totals just \$10.4 billion says a great deal about our position compared to virtually all other industrialised countries.

Okay, so why did the markets keep crashing every time a new bailout was announced?

Well, the best way I can think of explaining that is by using an analogy. Think of the financial markets as a small child and the global authorities as a weary parent. As this crisis began the child began throwing a tantrum to end all tantrums. The toys were well and truly thrown out of the pram. Like any concerned parent, the authorities began attempting to calm the child with soothing words.

When that failed to work, bigger action was clearly required. So, out came the sweets. Each bailout and bank rescue was like a sugar rush for the markets. It provided an instant positive reaction, which was followed fairly shortly by another crash as the sugar wore off.