From Wall Street to Main Street:

Understanding How the Credit Crisis Affects You


Prepared by The Joint Economic Committee Majority Staff
Senator Charles E. Schumer, Chair
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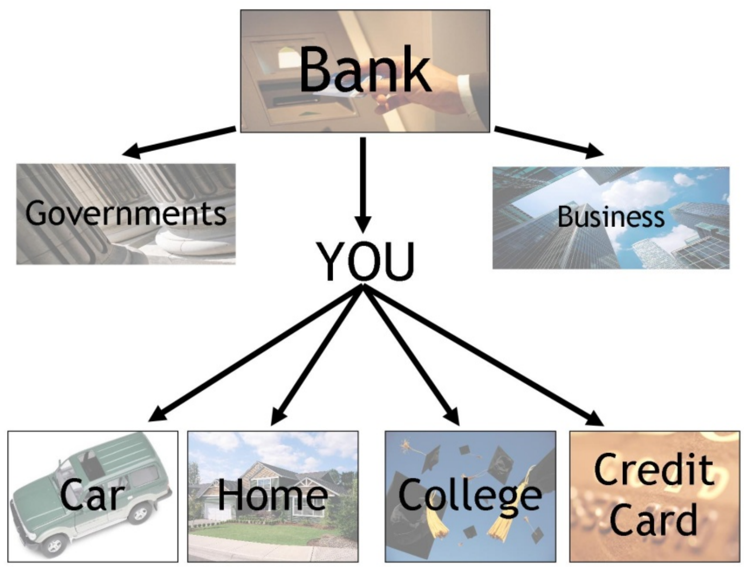
"The credit window is closed." Jim Press, President of Chrysler

OVERVIEW

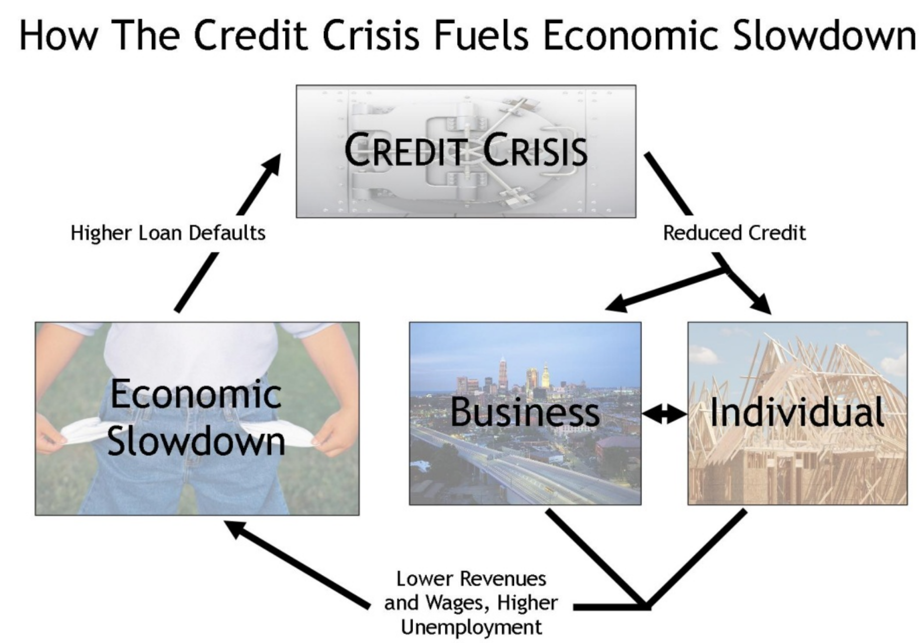
We are all familiar with the numerous ways in which we use credit. Credit finances the smaller purchases we make when we use our credit cards, and the larger purchases that are fundamental to our lives – the cars we drive, the homes we live in, the colleges where we send our children. Credit is also crucial for the needs of businesses, and for state and local governments.



At its most basic level, credit is what allows us to make purchases today based on the money we are going to earn in the future. When we purchase a car or a house, few of us have the full cash amount available, so we borrow money from a lender who has confidence in our ability to repay the loan (plus interest) over time. This enables us to turn our future earnings into current spending, and in turn, furthers economic growth by increasing demand for the goods we are purchasing. If people could only buy cars when they had saved up the full purchase price, there would be many fewer cars sold, and many fewer people employed in every facet of the auto industry.

In the same way, institutional actors also depend on credit. Businesses rely on credit to get off the ground (leasing space, buying start up equipment), to keep their operations running (stocking their shelves, buying new equipment, making payroll and paying the electric bill) and they use credit to expand (opening new stores and factories, and hiring new employees).Government also relies on credit to pay for many of their longer term projects—school improvements, highway repairs, new streetlights—which they finance by issuing bonds against future tax revenues.

In today's economy, all of these forms of credit are part of a much larger global financial web, in which financial institutions around the world are constantly borrowing and lending to one another, to manufacturers and retailers, and, ultimately, to consumers. In short, while we may not always see it, credit is the lifeblood of the economy.

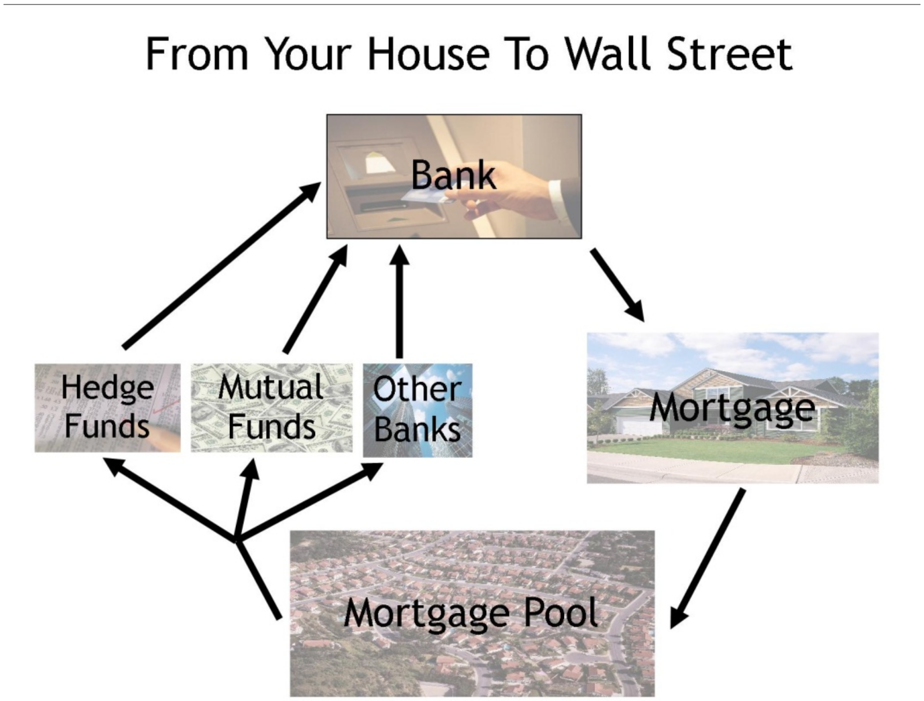


At its most extreme, the availability of credit can dry up, and a credit crisis, such as we are now experiencing, can occur. When a credit crisis does occur, the consequences for the economy can be devastating. The lack of available credit forces individuals and businesses alike to cut back on spending, reducing business revenues, which then causes wages to drop and unemployment to rise. The resulting economic slowdown causes more individuals and businesses to default on their loans, worsening the credit crisis. In short, this is a vicious circle, in which a credit freeze and economic contraction feed into each other.

THE ONSET OF THE CREDIT CRISIS

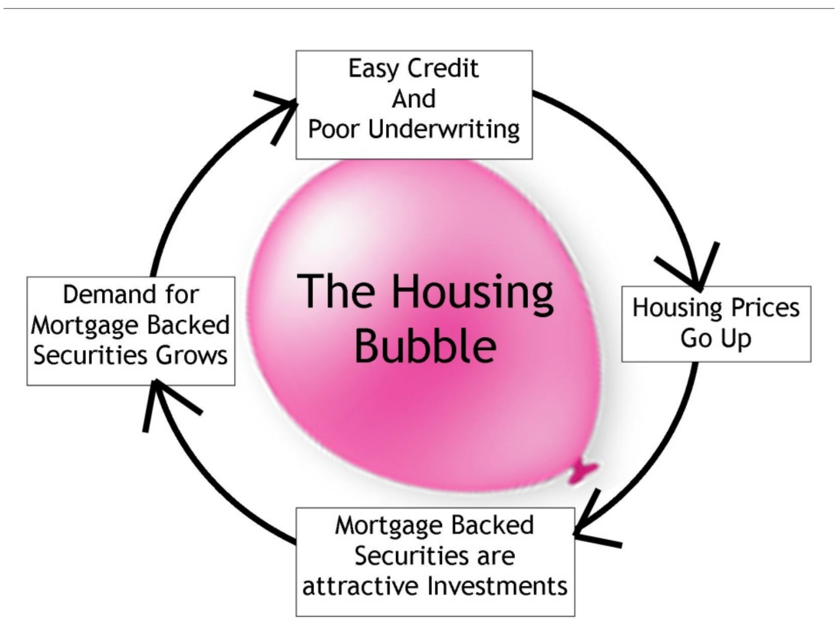
The Securitization of Loans

Over the past decade, credit was increasingly "securitized". Banks would pool together many different loans, and then sell securities, based on the rights to the payments from the loans in the pool, to outside investors. The sales of these securities provided banks with immediate cash, which they could then use to make more mortgages. And investors liked these securities, because they were considered safe investments (frequently, nearly as safe as U.S. Treasury bills, and they typically paid a higher return than equivalent investments).



The most common and well-known of these securitized loans is the “mortgage-backed security” (MBS), based on pools of residential mortgages. But many other types of loans have also increasingly become securitized over the past decade—car loans, student loans, even credit card debt. Over the past decade, this type of securitized credit saw explosive growth, because of the superior returns and perception of safety. By the first quarter of 2006, the total value of all outstanding U.S. MBS totaled approximately $6.1 trillion.

The Deflation of the Housing Bubble



As is now obvious, the US experienced an unprecedented housing bubble in the earlier part of this decade. The availability of easy, cheap credit with low underwriting standards inflated the demand for housing, which led to increased housing prices. The growing housing market made mortgage-backed securities increasingly attractive, creating more demand among investors for MBS, which then provided even more credit for US homebuyers. This housing bubble has now officially popped. But the repercussions for the US economy have not yet been fully felt.

The deflation of the housing bubble has brought increased mortgage defaults which, coupled with concerns about poor mortgage underwriting standards, and the widespread belief that US housing prices are still overvalued, have led to tremendous declines in the values of MBS. And because MBS—and other forms of securitized debt—were so widely held, some major financial institutions have been forced to take huge writedowns in recent months.

As these writedowns have become recognized, these financial institutions have been forced to raise capital to cover the losses incurred. Those which have been able to raise sufficient capital have so far been able to survive, while those which have been unable to raise sufficient capital have failed, sometimes suddenly and unexpectedly.

Large Financial Institutions Fail Overnight

Bear Stearns was one of the first major examples of a big failure of a financial firm, due to its inability to find sufficient capital to cover its mortgage related losses. In March 2008, the Federal Reserve negotiated a deal in which JP Morgan Chase acquired Bear Stearns at an extremely low price ($10/share), which only happened because of the inclusion of federal guarantees on some $30 billion in risky Bear Stearns assets. The collapse of Bear Stearns began a steady deterioration in credit conditions, during which time a number of banks failed, which came to a head in September.

The weekend of September 13-14, the eminent Wall Street firm Merrill Lynch, concerned about its ability to survive future MBS losses, agreed to sell itself to Bank of America for considerably less than where its stock price had stood a few months earlier. That same weekend, Lehman Brothers, another iconic Wall Street firm, was unable to obtain any relief, and so was forced to file for bankruptcy on September 15.

Both Merrill and Lehman came under heavy pressure because they possessed insufficient capital. As mortgage-related losses mounted, customers began pulling out of brokerage accounts with Merrill and Lehman, concerned about the safety of their assets. Merrill and Lehman thus came under increasing pressure to raise more capital to cover these losses and the outflows of brokerage deposits. When it became apparent that the capital available was insufficient to cover their expected losses, Merrill sold itself to Bank of America, and Lehman entered into bankruptcy.

Around this same time, AIG, the world's largest insurance company, also came under heavy pressure to raise capital. AIG's financial arm, AIG Financial Products, had accrued an enormous amount of exposure to mortgage-related assets, and as a result, it was carrying enormous unrecognized losses on its books. On September 15, the day Lehman announced bankruptcy, AIG's auditors forced AIG to recognize some of these losses. As a result, the next day, September 16, AIG was forced to effectively sell 80% of its equity to the Federal Reserve in exchange for an $85 billion line of credit.

These events were widely considered shocking. Many observers felt that Lehman could survive, and its inability to find any capital to save itself was an eye-opening event. The demises of Merrill and AIG were even more sobering, because they were widely considered to be in sterling shape up until a few days before their dispositions.

Confidence in the Health of Financial Institutions Drops, Causing Credit Freeze Among Banks

Finding credit was already difficult in this environment, but the sudden and unexpected failures of Lehman Brothers and AIG caused lending to freeze up even more. Lehman in particular caused problems, because many investors which had uninsured accounts with, or other exposure to, Lehman, suddenly lost the ability to access their cash, with no idea of how much, if anything, they would be able to eventually recover.

Confidence in the solvency of financial institutions has plummeted and as a result, banks virtually ceased lending to one another. The most widely-used measure of lending between banks (the London interbank overnight rate or "LIBOR"), reached an all-time high of 6.88% this past Tuesday (September 30), an indication that banks are extremely reluctant to lend to each other at any interest rate. This is an indication of the extreme lack of confidence banks have in the financial system right now.

Other Sources of Credit Also Freezing Up

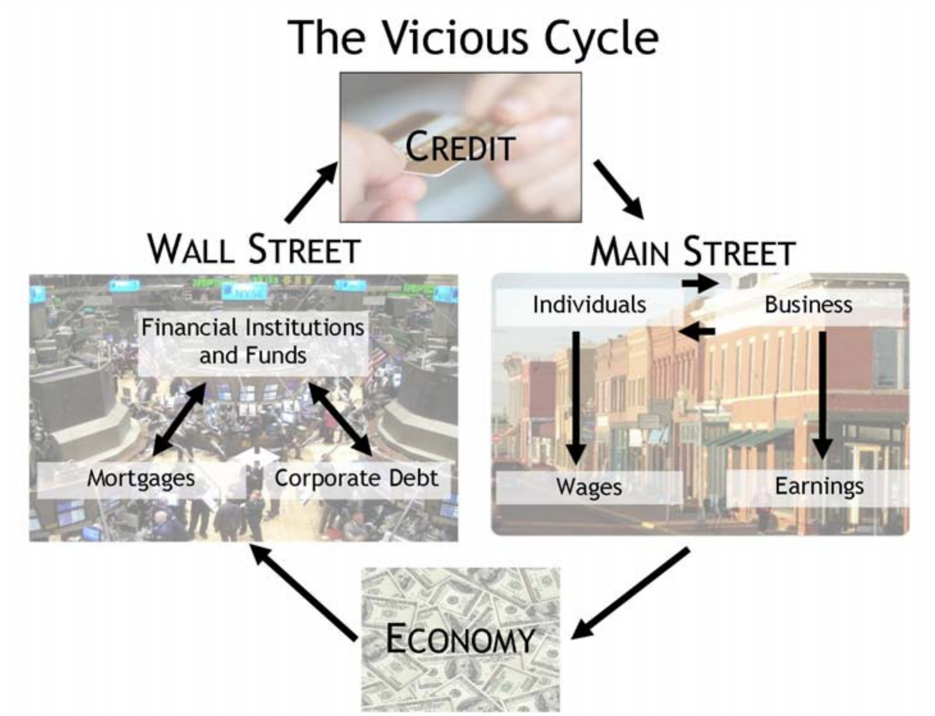
In addition to bank lending, other sources of credit have also dried up. Money market mutual funds, which are considered safe alternatives to depository accounts, have also come under serious pressure in recent weeks. Money market funds have historically been an important source of credit for businesses, as they are a major purchaser of short-term corporate debt (also called "commercial paper").

Following the failure of Lehman, two money market funds failed due to their exposure to Lehman debt. This is unprecedented. Money market funds, which are not federally insured, have historically been extremely safe and conservative, with their sole goal being to break even. From 1971 up to September 2008, there was only one money market fund which failed. These failures led to a run on money market funds, which has continued to this time, as investors have withdrawn their money. On Monday (September 29), money market funds saw a $10 billion outflow of funds.

The decline in money market funds has already caused corporate borrowing costs to skyrocket. Short-term corporate debt rates jumped from 2% on Monday to a range between 5.75% and 7.75% on Tuesday.

The problems in money market funds signal larger problems in the debt markets. Corporate and municipal bond issues are becoming costlier and harder to fulfill. Even such long-time institutions as GE, AT&T, and the State of Massachusetts are finding it difficult to find enough buyers of their bond issues.

HOW WILL THE CREDIT CRUNCH IMPACT ME?



So how will the credit crisis affect ordinary Americans, living outside the confines of Wall Street? It all goes back to the idea of the "vicious circle". As credit tightens up, Main Street businesses and consumers are forced to reduce spending. This in turn reduces the revenues of businesses, forcing them to cut costs, including lowering wages and cutting staff. As a result, businesses and individuals alike have more trouble paying their bills and are more likely to miss payments on their loans (like mortgages and corporate debt).

As these missed payments turn into loan defaults, the value of mortgage-backed securities and corporate debt is further reduced, which then forces Wall Street firms to cut back even further on their lending activities, causing a further tightening of credit.

In short, what we are seeing now, if uninterrupted is a feedback loop, where tighter credit leads to less economic activity, which leads to a decline in the value of financial assets, which then creates even tighter credit conditions. In an environment like the current one, only those borrowers with the safest credit ratings can find credit, and even this is costly. And without credit, businesses large and small wither and die. Whether it's the small business owner who cannot expand or the large conglomerate that cannot make payroll, the impact is the same – the economy shrinks and the pie gets smaller.

We are already seeing evidence that the vicious circle is well underway. Unemployment numbers are up again, with 159,000 newly unemployed workers in September. Auto sales have declined for 11 straight months, due to more restrictive credit and decreased consumer confidence, and as a result, 18% of US car dealerships may close in 2009. Private student lending has become severely restricted, as banks are increasingly unwilling to commit cash to long-term loans. And some colleges have already lost access to funds parked with failed institutions such as Wachovia and Lehman, which may ultimately raise the cost of tuition.

The impacts of the credit crisis are not limited to the private sector, either. Cities and states have become increasingly reliant on the issuance of bonds to finance various projects. Like other credit markets, the markets for "muni bonds" (which have historically been much safer than private bonds and offer significant tax benefits) have also frozen up. In recent weeks, a high number of municipalities, including Massachusetts, have been forced to back out of the muni bond market due to insufficient investor interest or overly high costs. One expert recently predicted that muni bond issuances would drop by 25-30% in 2009. Even those that are issued will almost certainly be at much higher cost, limiting the amount of new road construction, school maintenance, and other municipal and state projects that can be paid for.

Non-profit institutions have in recent years also made extensive use of short-term borrowing, and like their for-profit analogues, they are already experiencing problems because of the credit freeze. Blood banks, hospitals, homeless shelters are among the many types of non-profit institutions that rely on the credit markets to meet their short funding needs. If the availability of credit continues to deteriorate, many of these non-profit entities will have to cut back, or even shut down.

HOW WILL THE EMERGENCY ECONOMIC STABILIZATION ACT HELP THE CREDIT CRISIS?

The newly enacted Emergency Economic Stabilization Act (EESA) will help to alleviate the credit crisis by paying a fair price for the MBS that financial firms are currently holding. By adding a massive new buyer to the equation, EESA is expected to improve the market for MBS. Struggling financial firms can then sell some of their troubled assets, thus improving the condition of their balance sheets, and making it easier for them to attract new capital. More capital and less troubled assets will hopefully stimulate new lending.

However, the effects of EESA will not be known until the Treasury plan has been put into operation. While EESA may help to stabilize the credit markets, banks and other financial institutions may still require significant capital. Moreover, recent signs indicate that the real economy is beginning to slow significantly. Additional policy steps, including more stimulus, may be required in the near future.