THE ECONOMY: CRISIS & RESPONSE

Why did the mortgage meltdown threaten the financial system?

- **Mortgage-related losses skyrocketed**
  
  The rising number of delinquencies on subprime mortgages was a wake-up call to lenders and investors that many residential mortgages were not nearly as safe as once believed. As the mortgage meltdown intensified, the magnitude of expected losses rose dramatically. Because millions of U.S. mortgages were repackaged as securities, losses spread across the globe. In October 2007, shortly after the onset of the housing bust, the International Monetary Fund estimated that worldwide losses of financial institutions related to U.S. residential mortgages would total $240 billion. By April 2009, its estimate was nearly six times larger, exceeding $1.4 trillion.

  References:
  
  International Perspective on the Crisis and Response, speech by Donald L. Kohn, Vice Chairman, Federal Reserve Board of Governors, at the Federal Reserve Bank of Boston 54th Economic Conference, Chatham, MA, October 23, 2009.


- **Confidence eroded**

  As estimates of mortgage-related losses mounted, investors and financial institutions became increasingly nervous about their own risk as well as the financial health of firms with which they did business. This anxiety was compounded by how difficult it had become to determine the true value of many loans and mortgage-related securities. These securities included complex and exotic financial instruments that magnified the vulnerability of financial institutions to losses. Institutions became increasingly reluctant to lend to each other. The situation reached a crisis point in 2007 when these fears about the financial health of other firms led to massive disruptions in the bank lending market that institutions use to fund their day-to-day needs for cash. As a result, rates on short-term loans rose sharply relative to the overnight federal funds rate.

  References:
  


- **Financial markets panicked**

  In the fall of 2008, two large financial institutions failed: the investment bank Lehman Brothers and the savings and loan Washington Mutual. Several others threatened to go under, including the large insurance company, American Insurance Group (AIG). The extensive web of connections among major financial institutions meant that the failure of one could start a cascade of losses throughout the financial system, threatening many other institutions. Large losses at a big money market mutual fund extended the crisis to a part of the financial system previously regarded as safe, prompting investors to pull their money out. The market for short-term debt securities issued by corporations also froze. Confidence in the financial sector collapsed and stock prices of financial institutions around the world plummeted. The global financial system found itself on the brink of meltdown.

  References:
  
  Reflections on a Year of Crisis, speech by Ben S. Bernanke, Chairman, Federal Reserve Board of Governors, at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, WY, August 21, 2009.


http://www.frbsf.org/econanswers/crisis_q2more.htm