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Soup Du Jour

An ancient adage went this way: Invent a better mousetrap and the world will beat a path to your door. On Wall Street, "better mousetrap" translates as "hot new financial instrument." So it is that "sub-prime" has become the Problem of the Day for the markets, I offer a brief explanation.

When banks were finally allowed to charge different rates to borrowers based on their credit history (advent of the credit score), instead of just rejecting less than perfect borrowers, new jobs arose on Wall Street. The wizards figured out a way to bundle loans and sell them to institutions looking for income-producing investments. There is nothing inherently wrong (illegal, immoral) about this process, and everybody became a winner.

As loan packages were created, each was labeled with a credit rating indicating the risk of the loans in the package, the same rating process companies have for their bonds. Some are AAA credit like GE and some are not because the probability of something going wrong in the repayment process is higher. The credit rating for these loan packages is based upon the history of repayments for each class of loans. The repayment history of the people with poor credit scores is compared to the history of those with great credit scores. And the same is true with middle level credit.

Until very recently, there was little difference in the repayment history, or 'default rate' as it is called, between the high and low credit score classes. Since one's home is perhaps the most fiercely protected possession anybody has, when the mortgage packages were labeled for risk, they almost all had the same rating.

Armed with these investment ratings, Wall Street sold the bundles of mortgages to banks across the globe. Banks bought and sold them by the billions every day. They are a piece of the collateral banks use to create money and enhance their liquidity. Then, one day in August, everybody realized that something was wrong with the default rate calculation: the rates on some of the loan packages varied drastically from the historical trend and, since the packages all had the same rating, no one could tell one package from another. Absurd but true, and trading came to an abrupt halt. That's when central banks, here and abroad, stepped in to restore some measure of the lost liquidity.

The loan packages still have a value and the value is collateralized by a house, so that value isn't zero. Some of the packages are worth 100 percent of the original price because there are no defaults and some may be worth something like 75 percent because there are a lot of defaults in the portfolio, but it is not like banks worldwide are holding worthless paper. There is a liquidity crisis, which the central banks recognized and have acted appropriately to bridge. The problem will be resolved within the banking system. It may cost some banks a few bucks on their quarterly earnings statement, and it could damage consumer confidence a bit. By itself, however, this particular Problem of the Day will not cause a recession. It takes a bundle of problems to do that.

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