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How subprime killed Bear Stearns

A problem with risky mortgages has led to a global financial crisis. The bigger issue: Experts don't know when it will end.

By [Tami Luhby](#), CNNMoney.com senior writer
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NEW YORK (CNNMoney.com) -- It started last summer when borrowers with weak credit started defaulting on their mortgages. Last night, it brought down an 85-year-old pillar of Wall Street.

How did we get to this point? How did rising foreclosures among subprime borrowers lead to Bear Stearns being scooped up in a fire-sale for two bucks a share?

The answer starts with investment banks: They sold complex securities backed by debt that was a lot riskier than most realized. The realization that the banks had failed to manage this risk sparked widespread concern among investors and other financial firms. Suddenly, investors found they couldn't put a value on much of what the banks were selling. As a result, the lending markets that keep Wall Street humming seized up because people feared they wouldn't get paid back.

"We got to the point where the various parties in the financial system started not to trust each other," said Lawrence White, an economics professor at New York University.

What's worse is that no one knows when it will end.

Every week, it seems, another part of the U.S. financial system falters and the federal government has to come up with a new rescue plan. The Federal Reserve Bank's actions have helped soothe the markets in past crises, but the magnitude of the current meltdown may prove unprecedented, experts said. Today's troubles ensnare not only traditional banks, but investment firms, hedge funds, insurance companies and non-bank lenders.

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The roots of the current crisis lie in the euphoria of the real estate boom. With housing prices soaring and the economy solid, financial firms dove into the lucrative mortgage market. To meet the insatiable desire for mortgage-backed securities, firms loosened their lending standards and extended credit to people with weaker financial backgrounds.

But the lenders didn't put in place the necessary controls to handle the risk of a downturn in the housing market, said Amiyatosh Purnanandam, assistant professor of finance at the University of Michigan. The financial firms weren't ready to cope with a downturn in the value of the housing market or of these securities.

The signs were there: The rates paid on risky securities, such as junk bonds, moved closer to those of super-safe Treasuries, an indication that investors didn't feel the need to pay a premium to take on more risk.

"Every time we see a big crisis, someone messed up the risk management," Purnanandam said.

A slowdown in home values last year touched off the maelstrom. Subprime homeowners found they could no longer afford their monthly payments, leading to a spike in delinquencies and defaults. Investors panicked because they could no longer value the securities backed by these mortgages.

At first, some thought the problem would be contained within the mortgage industry. But within a few months, it spread like wildfire through the debt market as people lost faith in the investment banks' ability to manage risk in general. Investors are hesitating to put money in securities backed by municipal bonds, student loans, credit cards and even mortgages backed by Freddie Mac and Fannie Mae, which have an implicit government guarantee, for fear they won't be paid back.

"What happened was we figured out the whole scheme wasn't working the right way," said George Tsetsekos, dean of the LeBow College of Business at Drexel University. "It's an issue of confidence in the marketplace over the ability of institutions to receive back the funds that were lent."

Financial firms are also shying away from extending credit to one another, afraid that the collateral backing the loans will lose value.

The banks are saying "I don't want to be involved in any relationship where you owe me money because I don't know if you will be able to honor that obligation," White explained.

Faith in the currency wanes

The dollar is compounding the problem. The dollar's fall against other currencies has made it less attractive for foreign investors to put their money in dollar-denominated U.S. securities. And that is pulling much-needed funding out of the system, Tsetsekos said.

Without liquidity, the global financial markets started breaking down, forcing the Federal Reserve to repeatedly inject cash into the system and take the hard-to-trade mortgage securities as collateral in return.

The crisis reached new heights last Thursday when Bear Stearns suffered a classic run-on-the-bank after questions about the investment bank's finances surfaced. The bank, one of largest underwriters of mortgage-backed bonds, had suffered greatly in the meltdown and didn't have the diversity of revenues that cushioned its rivals.

Clients began withdrawing funds or demanding more collateral from Bear Stearns ([BSC](#), [Fortune 500](#)), leading it to turn to the federal government for help. On Friday, JPMorgan Chase ([JPM](#), [Fortune 500](#)), along with the Federal Reserve Bank of New York, announced they would step in with funding while the investment bank explored its alternatives.

Two days later, JPMorgan announced that it would buy the venerable Wall Street firm, once known for its high-quality risk management, for a shockingly low \$2 a share, a 93% discount from Bear Stearns' closing price

on Friday.


The move, however, has not calmed everyone's nerves. Instead, some investors are looking for the next institution to fail, with their sights set on Lehman Brothers ([LEH](#), [Fortune 500](#)), whose shares were down 32% in late-afternoon trading Monday.

"Once you see one bank subject to this kind of run, depositors starting worrying maybe the bank across the street may be equally as susceptible," White said. "Clearly that's what the Fed is worried about." ■

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