Extra Feature Story

'Fed Tries to Ease Impact of Housing Mortgage Crisis Impact on U.S. Economy

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The government is working on ways to help Americans pay their mortgages and stay in their homes so that a growing housing crisis does not weaken other areas of the economy.

Economists worry that if more Americans lose their homes and home prices continue to drop, people will lose confidence and spend less money --, creating a slow period for American companies, which could, in turn, lead to layoffs and further economic uncertainty.

Subprime mortgages

More than two million Americans are expected to lose their homes in the next few years.

Many of them have "subprime" mortgages -- loans made to people who often do not qualify for traditional ("prime" interest-rate) loans, usually because they have poor credit history. These loans are considered high-risk because there is a greater chance that borrowers won't pay them back.

The practice of subprime lending didn't really exist a decade ago, but became a $625 billion market by 2006, when it comprised 20 percent of the total mortgage industry.

The growth coincided with an unprecedented expansion in the housing market-- home prices increased by 80 percent between 2000 and 2006. With home values increasing, lenders were more willing to offer risky mortgages.

And as more lenders got into the business, they tried all kinds of incentives, including low "teaser" interest rates, to attract customers. The initial low rates of these adjustable rate mortgages (ARMs) would later reset to a higher level, making it much harder to meet the monthly payments.

When the housing bubble collapsed in late 2005, and home prices started leveling off or dropping, more that 16 percent of subprime borrowers defaulted on their loans.

Wall Street in trouble

The fallout of the subprime mortgage market has had an impact on the global economy. The reason is "securitization" – a popular new investment tool that generates large returns quickly.

Through securitization, mortgages are not owed to a single lender like they were in the past. Instead, lenders resell their mortgages to larger banks, who bundle the smaller loans into more complex investments, called mortgage-backed securities.

The appetite for mortgage-backed securities grew on Wall Street, and a lot of buying and selling went on without government supervision. More than half of the original subprime loans were made by organizations that are outside the government's regulatory system.

"Securitization is a marvelous thing. It has lubricated the market and made mortgages more affordable," Princeton Economics professor Alan Blinder wrote in the New York Times. "But securitization sharply reduces the originators incentive to scrutinize the creditworthiness of borrowers."

When the subprime mortgage market began to unravel in late 2006, several of the world's largest banks were left with bundles of mortgages quickly losing value. The stock market plunged and major banks, including Merrill Lynch and Citigroup, announced billions of dollars in losses.

A special election year

As the consequences of the subprime mortgage meltdown began to mount, the Bush Administration came under increasing pressure to intervene.

In October, Treasury Secretary Henry Paulson announced a cooperative deal with banks and lenders that would allow some low teaser rates to stay fixed for up to five years. This would give up to two million borrowers more time to pay off their loans.

Meanwhile, the U.S. Central Bank, called the Federal Reserve, is trying to clean up the mortgage industry.

"Unfair and deceptive acts and practices hurt not just borrowers and their families, but entire communities, and, indeed , the economy as a whole," Federal Reserve Chairman Ben Bernanke said in a statement. "They have no place in our mortgage system."

Critics say the government's response does not do enough because it only helps people who won't be able to pay when their interest rates go up while doing nothing for people who already cannot pay back their loans.

Michael Shea, director of the Chicago-based housing advocacy group Acorn Housing says the proposal is bowing to big investment banks.

"This crisis is likely to be the worst we've seen since the Depression, but [the plan] is only dealing with the easiest slice of borrowers," Shea told BusinessWeek.

"What they are proposing won't help a single soul who is currently delinquent on their mortgage or facing foreclosure. We need bold proposals like the ones set by FDR during the Depression."

What's next

The Bush Administration is currently considering other measures to respond to a slowing economy, but the president says he remains optimistic.

"My view of the economy is that the fundamentals are strong, that we've had strong growth for a reason: that we're competitive, we got flexible workplace, that we kept taxes low, exports are up," President Bush said in a December news conference.

Advisers say the president may announce an economic stimulus plan when he gives his State of the Union Address on Jan. 28.

-- Compiled by Christina Satkowski for NewsHour Extra