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It's Not 1929, but It's the Biggest Mess Since

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It was Charles Mackay, the 19th-century Scottish journalist, who observed that men go mad in herds but only come to their senses one by one.

We are only at the beginning of the financial world coming to its senses after the bursting of the biggest credit bubble the world has seen. Everyone seems to acknowledge now that there will be lots of mortgage foreclosures and that house prices will fall nationally for the first time since the Great Depression. Some lenders and hedge funds have failed, while some banks have taken painful write-offs and fired executives. There's even a growing recognition that a recession is over the horizon.

But let me assure you, you ain't seen nothing, yet.

What's important to understand is that, contrary to what you heard from President Bush yesterday, this isn't just a mortgage or housing crisis. The financial giants that originated, packaged, rated and insured all those subprime mortgages were the same ones, run by the same executives, with the same fee incentives, using the same financial technologies and risk-management systems, who originated, packaged, rated and insured home-equity loans, commercial real estate loans, credit card loans and loans to finance corporate buyouts.

It is highly unlikely that these organizations did a significantly better job with those other lines of business than they did with mortgages. But the extent of those misjudgments will be revealed only once the economy has slowed, as it surely will.

At the center of this still-unfolding disaster is the Collateralized Debt Obligation, or CDO. CDOs are not new -- they were at the center of a boom and bust in manufacturing housing loans in the early 2000s. But in the past several years, the CDO market has exploded, fueling not only a mortgage boom but expansion of all manner of credit. By one estimate, the face value of outstanding CDOs is nearly $2 trillion.

But let's begin with the mortgage-backed CDO.

By now, almost everyone knows that most mortgages are no longer held by banks until they are paid off: They are packaged with other mortgages and sold to investors much like a bond.

In the simple version, each investor owned a small percentage of the entire package and got the same yield as all the other investors. Then someone figured out that you could do a bigger business by selling them off in tranches corresponding to different levels of credit risk. Under this arrangement, if any of the mortgages in the pool defaulted, the riskiest tranche would absorb all the losses until its entire investment was wiped out, followed by the next riskiest and the next.

With these tranches, mortgage debt could be divided among classes of investors. The riskiest tranches -- those with the lowest credit ratings -- were sold to hedge funds and junk bond funds whose investors wanted the higher yields that went with the higher risk. The safest ones, offering lower yields and Treasury-like AAA ratings, were snapped up by risk-averse pension funds and money market funds. The least sought-after tranches were those in the middle, the "mezzanine" tranches, which offered middling yields for supposedly moderate risks.

Stick with me now, because this is where it gets interesting. For it is at this point that the banks got the bright idea of buying up a bunch of mezzanine tranches from various pools. Then, using fancy computer models, they convinced themselves and the rating agencies that by repeating the same "tranching" process, they could use these mezzanine-rated assets to create a new set of securities -- some of them junk, some mezzanine, but the bulk of them with the AAA ratings more investors desired.

It was a marvelous piece of financial alchemy, one that made Wall Street banks and the ratings agencies billions of dollars in fees. And because so much borrowed money was used -- in buying the original mortgages, buying the tranches for the CDOs and then in buying the tranches of the CDOs -- the whole thing was so highly leveraged that the returns, at least on paper, were very attractive. No wonder they were snatched up by British hedge funds, German savings banks, oil-rich Norwegian villages and Florida pension funds.

What we know now, of course, is that the investment banks and ratings agencies underestimated the risk that mortgage defaults would rise so dramatically that even AAA investments could lose their value.

One analysis, by Eidesis Capital, a fund specializing in CDOs, estimates that, of the CDOs issued during the peak years of 2006 and 2007, investors in all but the AAA tranches will lose all their money, and even those will suffer losses of 6 to 31 percent.

And looking across the sector, J.P. Morgan's CDO analysts estimate that there will be at least $300 billion in eventual credit losses, the bulk of which is still hidden from public view. That includes at least $30 billion in additional write-downs at major banks and investment houses, and much more at hedge funds that, for the most part, remain in a state of denial.

As part of the unwinding process, the rating agencies are in the midst of a massive and embarrassing downgrading process that will force many banks, pension funds and money market funds to sell their CDO holdings into a market so bereft of buyers that, in one recent transaction, a desperate E-Trade was able to get only 27 cents on the dollar for its highly rated portfolio.

Meanwhile, banks that are forced to hold on to their CDO assets will be required to set aside much more of their own capital as a financial cushion. That will sharply reduce the money they have available for making new loans.

And it doesn't stop there. CDO losses now threaten the AAA ratings of a number of insurance companies that bought CDO paper or insured against CDO losses. And because some of those insurers also have provided insurance to investors in tax-exempt bonds, states and municipalities have decided to pull back on new bond offerings because investors have become skittish.

If all this sounds like a financial house of cards, that's because it is. And it is about to come crashing down, with serious consequences not only for banks and investors but for the economy as a whole.

That's not just my opinion. It's why banks are husbanding their cash and why the outstanding stock of bank loans and commercial paper is shrinking dramatically.

It is why Treasury officials are working overtime on schemes to stem the tide of mortgage foreclosures and provide a new vehicle to buy up CDO assets.

It's why state and federal budget officials are anticipating sharp decreases in tax revenue next year.

And it is why the Federal Reserve is now willing to toss aside concerns about inflation, the dollar and bailing out Wall Street, and move aggressively to cut interest rates and pump additional funds directly into the banking system.

This may not be 1929. But it's a good bet that it's way more serious than the junk bond crisis of 1987, the S&L crisis of 1990 or the bursting of the tech bubble in 2001.