

THE CRISIS of CREDIT

PART 1: FROM HOMEOWNER TO INVESTOR

VISUALIZED

1 BUYING A HOUSE
 A family like us wants a house, so we contact a **MORTGAGE LENDER**, who lends us a **MORTGAGE** loan.
 We buy a house and become **HOMEOWNERS!** This is great for us because housing prices have been rising practically forever.
 The lender profits from fees and interest payments.

2 SELLING THE MORTGAGE
 The lender gets a call from an **INVESTMENT BANKER** to buy his mortgage — a nice payday for the lender. Along with the mortgage, the lender has also sold his risk. Were the homeowner to default, it is now the banker's problem.

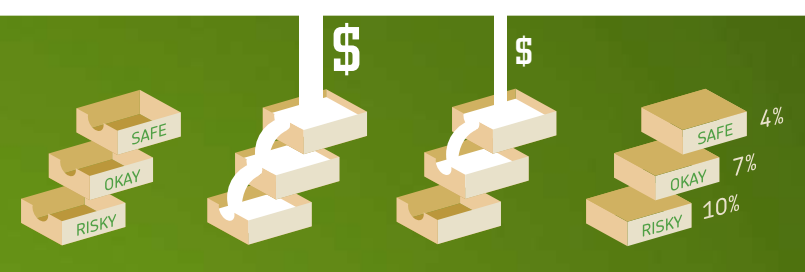
3 TRANSFORMING THE MORTGAGE
 The banker borrows millions of dollars and buys thousands more mortgages and puts them into a nice big box.
 This means that every month, the banker gets the monthly payment from all of the mortgage holders in the box, like me.
 This box is called a **COLLATERALIZED DEBT OBLIGATION**, or CDO.

4 INSIDE A CDO
 The banker then slices the box into three slices, or **TRANCHES**. The tranches work like 3 cascading trays.
 As money from mortgage payments comes in, the top tray fills up first, then spills over into the middle, then finally into the bottom.
 If some homeowners default on their mortgages, less money comes in, and the bottom tray may not get filled.

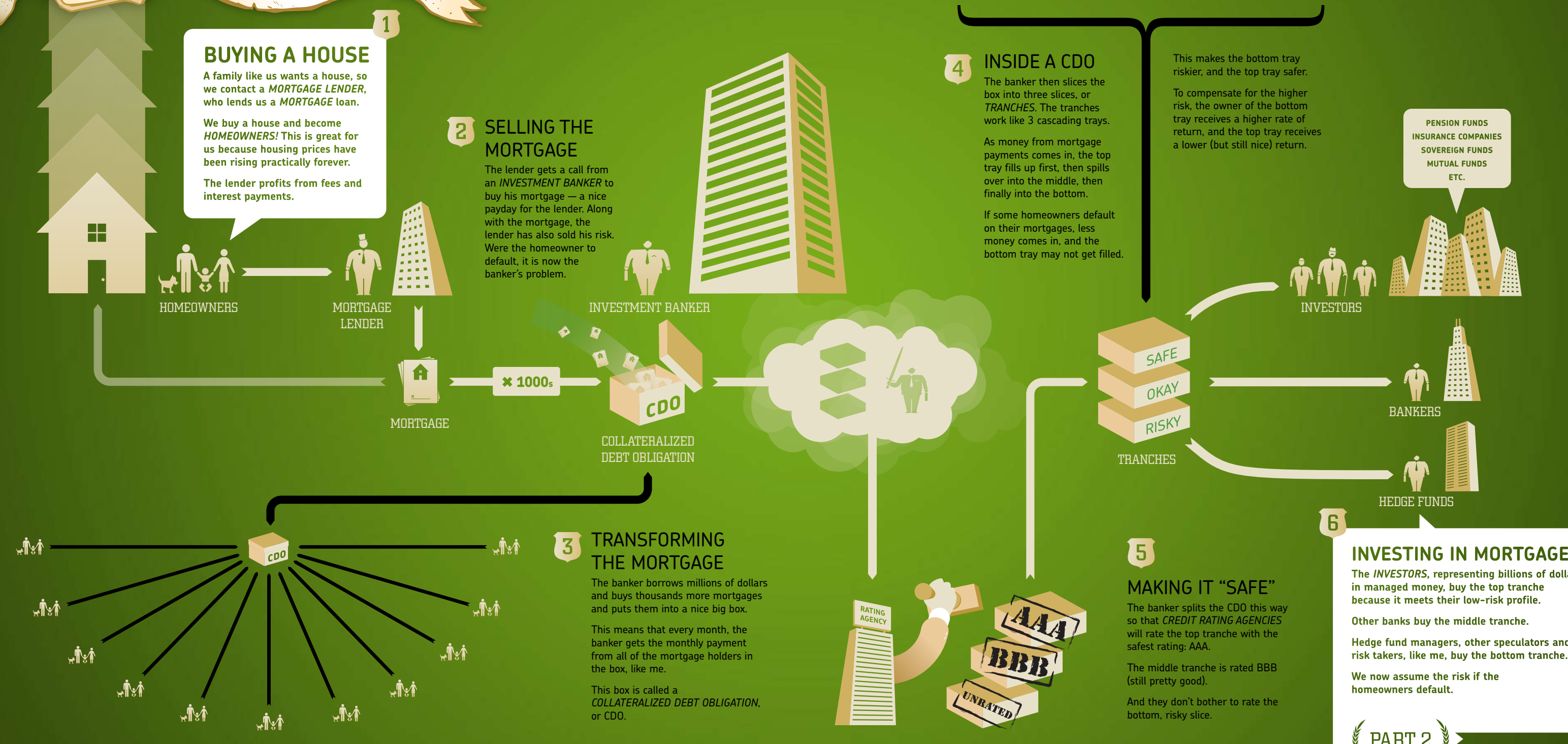
5 MAKING IT "SAFE"
 The banker splits the CDO this way so that **CREDIT RATING AGENCIES** will rate the top tranche with the safest rating: AAA.
 The middle tranche is rated BBB (still pretty good).
 And they don't bother to rate the bottom, risky slice.

This makes the bottom tray riskier, and the top tray safer.
 To compensate for the higher risk, the owner of the bottom tray receives a higher rate of return, and the top tray receives a lower (but still nice) return.

6 INVESTING IN MORTGAGES
 The **INVESTORS**, representing billions of dollars in managed money, buy the top tranche because it meets their low-risk profile.
 Other banks buy the middle tranche.
 Hedge fund managers, other speculators and risk takers, like me, buy the bottom tranche.
 We now assume the risk if the homeowners default.



PENSION FUNDS
 INSURANCE COMPANIES
 SOVEREIGN FUNDS
 MUTUAL FUNDS
 ETC.



by Jonathan Jarvis