BBC NEWS

The US sub-prime crisis in graphics

The US sub-prime mortgage crisis has lead to plunging property prices, a slowdown in the US economy, and billions in losses by banks. It stems from a fundamental change in the way mortgages are funded.

Traditionally, banks have financed their mortgage lending through the deposits they receive from their customers. This has limited the amount of mortgage lending they could do.

In recent years, banks have moved to a new model where they sell on the mortgages to the bond markets. This has made it much easier to fund additional borrowing,

But it has also led to abuses as banks no longer have the incentive to check carefully the mortgages they issue.

THE RISE OF THE MORTGAGE BOND MARKET

In the past five years, the private sector has dramatically expanded its role in the mortgage bond market, which had previously been dominated by government-sponsored agencies like Freddie Mac.

They specialised in new types of mortgages, such as sub-prime lending to borrowers with poor credit histories and weak documentation of income, who were shunned by the "prime" lenders like Freddie Mac.

They also included "jumbo" mortgages for properties over Freddie Mac's $417,000 (£202,000) mortgage limit.

The business proved extremely profitable for the banks, which earned a fee for each mortgage they sold on. They urged mortgage brokers to sell more and more of these mortgages.

Now the mortgage bond market is worth $6 trillion, and is the largest single part of the whole $27 trillion US bond market, bigger even than Treasury bonds.

HOW SUB-PRIME LENDING AFFECTED ONE CITY

For many years, Cleveland was the sub-prime capital of America.

It was a poor, working class city, hit hard by the decline of manufacturing and sharply divided along racial lines.

Mortgage brokers focused their efforts by selling sub-prime mortgages in working class black areas where many people had achieved home ownership.

They told them that they could get cash by refinancing their homes, but often neglected to properly explain that the new sub-prime mortgages would "reset" after 2 years at double the interest rate.

The result was a wave of repossessions that blighted neighbourhoods across the city and the inner suburbs.

By late 2007, one in ten homes in Cleveland had been repossessed and Deutsche Bank Trust, acting on behalf of bondholders, was the largest property owner in the city.

THE CRISIS GOES NATIONWIDE

Sub-prime lending had spread from inner-city areas right across America by 2005.

By then, one in five mortgages were sub-prime, and they were particularly popular among recent immigrants trying to buy a home for the first time in the "hot" housing markets of Southern California, Arizona, Nevada, and the suburbs of Washington, DC and New York City.

House prices were high, and it was difficult to become an owner-occupier without moving to the very edge of the metropolitan area.

But these mortgages had a much higher rate of repossession than conventional mortgages because they were adjustable rate mortgages (ARMs).

The payments were fixed for two years, and then became both higher and dependent on the level of Fed intereset rates, which also rose substantially.

Consequently, a wave of repossessions is sweeping America as many of these mortgages reset to higher rates in the next two years.

And it is likely that as many as two million families will be evicted from their homes as their cases make their way through the courts.

The Bush administration is pushing the industry to renegotiate rather than repossess where possible, but mortgage companies are being overwhelmed by a tidal wave of cases.

THE HOUSING PRICE CRASH

The wave of repossessions is having a dramatic effect on house prices, reversing the housing boom of the last few years and causing the first national decline in house prices since the 1930s.

There is a glut of four million unsold homes that is depressing prices, as builders have also been forced to lower prices to get rid of unsold properties.

And house prices, which are currently declining at an annual rate of 4.5%, are expected to fall by at least 10% by next year - and more in areas like California and Florida which had the biggest boom.

HOUSING AND THE ECONOMY

The property crash is also affecting the broader economy, with the building industry expected to cut its output by half, with the loss of between one and two million jobs.

Many smaller builders will go out of business, and the larger firms are all suffering huge losses.

The building industry makes up 15% of the US economy, but a slowdown in the property market also hits many other industries, for instance makers of durable goods, such as washing machines, and DIY stores, such as Home Depot.

Economists expect the US economy to slow in the last three months of 2007 to an annual rate of 1% to 1.5%, compared with growth of 3.9% now.

But no one is sure how long the slowdown will last. Many US consumers have spent beyond their current income by borrowing on credit, and the fall in the value of their homes may make them reluctant to continue this pattern in the future.

CREDIT CRUNCH

One reason the economic slowdown could get worse is that banks and other lenders are cutting back on how much credit they will make available.

They are rejecting more people who apply for credit cards, insisting on bigger deposits for house purchase, and looking more closely at applications for personal loans.

The mortgage market has been particularly badly affected, with individuals finding it very difficult to get non-traditional mortgages, both sub-prime and "jumbo" (over the limit guaranteed by government-sponsored agencies).

The banks have been forced to do this by the drying up of the wholesale bond markets and by the effect of the crisis on their own balance sheets.

BANK LOSSES

The banking industry is facing huge losses as a result of the sub-prime crisis.

Already banks have announced $60bn worth of losses as many of the mortgage bonds backed by sub-prime mortgages have fallen in value.

The losses could be much greater, as many banks have concealed their holdings of sub-prime mortgages in exotic, off-balance sheet instruments such as "structured investment vehicles" or SIVs.

Although the banks say they do not own these SIVs, and therefore are not liable for their losses, they may be forced to cover any bad debts that they accrue.

BOND MARKET COLLAPSE

Also suffering huge losses are the bondholders, such as pension funds, who bought sub-prime mortgage bonds.

These have fallen sharply in value in the last few months, and are now worth between 20% and 40% of their original value for most asset classes, even those considered safe by the ratings agencies.

If the banks are forced to reveal their losses based on current prices, they will be even bigger.

It is estimated that ultimately losses suffered by financial institutions could be between $220bn and $450bn, as the $1 trillion in sub-prime mortgage bonds is revalued.

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