THE CREDIT CRISIS has its roots in a world awash in cash. In the aftermath of the 2000 stock market crash, Federal Reserve chairman Alan Greenspan cut short-term interest rates to historic lows to stoke consumer spending and prevent a recession. Greenspan's gambit worked, if anything, too well. The U.S. economy kept moving smartly, filling corporate coffers with record profits, even as the stock market continued to slump.

Greenspan's moves triggered an explosion in global liquidity. Central banks from Britain to Japan followed his lead and pumped money into their banking systems. Insurance companies, mutual funds, and pension plans all over the world used their cheap money to buy assets in the world's most stable economy, the U.S. At the same time China's roaring export boom brought in a flood of dollars that China sent right back to the U.S., mainly by buying Treasury securities.

The result was a remarkably benign economic environment. Inflation was low. Corporate profits soared. Economic growth around the globe followed a smooth, ascending curve. "We've never seen a world economy like it, where volatility practically doesn't exist," says renowned economist Peter Bernstein.

Sounds great, doesn't it? But there was a catch. The strong, stable global economy began to lull investors into a false sense of security. They began to behave as if the chance of losing money had all but disappeared. You can see it clearly in the narrowing of risk premiums—the extra yield that investors typically demand for holding mortgage bonds and low-rated corporate debt. In early 2001, for example, the average junk bond yielded 9.3 points more than the ten-year Treasury bond. By 2005 that gap had narrowed to four points—and it kept shrinking. "Risk premiums hit a record low back in February," says Grantham. "They were probably at the lowest point in history and across a very broad base of assets."

That indifference to risk would have severe consequences. "People showed a new fearlessness about borrowing cheap money," says Bernstein. Indeed, cheap money made the leveraged-buyout boom possible. With stock prices lagging, private equity firms made lush profits by borrowing money to buy companies like Hertz, cleaning up their operations, and

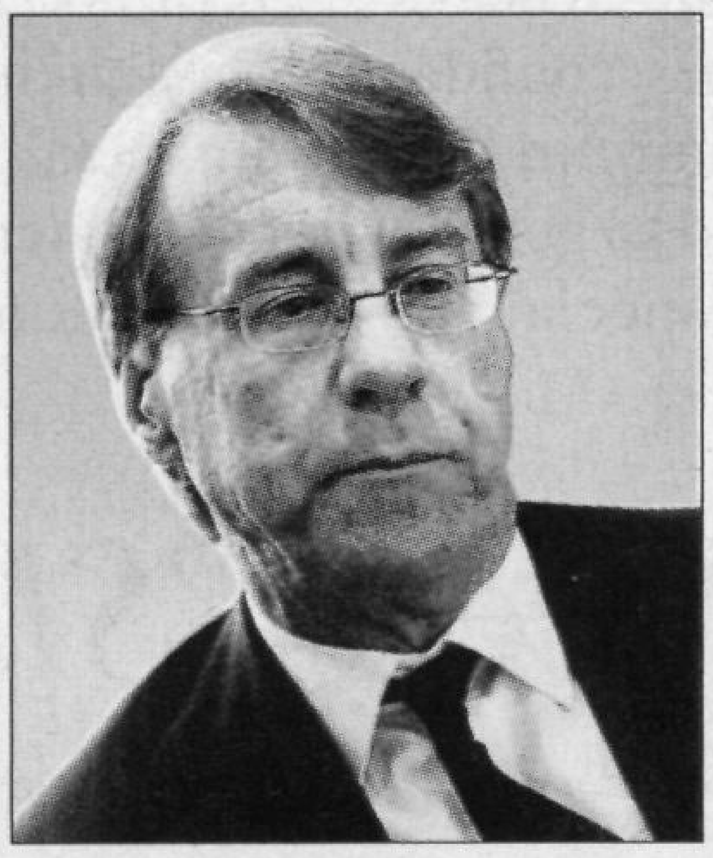
Where Were the Cops?

Shouldn't someone have seen the subprime blowup coming? Yes—and that's why the ratings agencies are coming under fire.

On a recent conference call with ratings agency Standard & Poor's, Steven Eisman, a managing director at hedge fund Frontpoint Partners, had a question. Referring to the agency's move to downgrade billions of dollars of mortgage-backed securities, he said, "I'd like to understand why you're making this move today and why you didn't do this many, many months ago." "It's a good question," responded the S&P analyst. "You need to have a better answer," said Eisman.

Hedge fund managers aren't the only ones demanding answers as estimates of global losses due to U.S. subprime mortgages mushroom to as much as $150 billion. While out-of-date banking regulations and lax federal oversight didn't help matters, it was the complicity of the rating agencies—Standard & Poor's, Moody's, and Fitch Ratings—that enabled the boom. Now European regulators are probing whether they underestimated risk, and many expect U.S. investigations and investor lawsuits to follow.

DISGUISED RISK Here's how it worked. After buyers with less than stellar credit were approved for a mortgage, lenders would bundle a bunch of iffy loans and sell them to investment banks, which would repackage these into Franken-loans and sell them to investors. By working hand-in-glove with the rating agencies—which were paid large fees for their involvement—institutions managed to get masses of these mortgage-backed securities rated investment grade. All of a sudden risky consumer loans were reconstituted into—presto!—something seemingly no more risky than a government Treasury bond. The whole concept, says hedge fund manager Bill Laggner, is "lunacy." Michael Burry, who runs hedge fund Scion Capital and was one of the first to aggressively bet against supposedly investment-grade securities based on subprime mortgages, says his thesis was that "the rating agencies were horribly wrong." In a letter to investors he compared them to investment banks during the dot-com bubble. "They were money-grubbing and sorely in need of an ethical compass," he wrote.



Chanos bet that Moody's was heading for a fall—and so shorted the stock.

Until recently the rating agencies insisted that everything was fine. The problem is that their models relied on historical data, and for newly popular things like "liar loans" and "piggyback" mortgages, there *were* no real historical data. Suddenly, in July, both Moody's and S&P downgraded billions of dollars of securities, and S&P said it was "adjusting" its rating process.

Even today the rating agencies have downgraded only a sliver of the securities based on subprime mortgages. All three defend their ratings, and they point out that they told investors not to rely solely on them. For its part, S&P says that it takes time for loan pools to show the sustained loss patterns that it needs to see before it can come to the opinion that a downgrade is appropriate. It's hard to find anyone in the know who thinks that the rating agencies have acknowledged the extent of the problem. "You might have three months where you don't hear a word about subprime, but it's not over," says one trader.

MORE LOSSES? So what will that mean for our markets—or for the agencies themselves? Josh Rosner, a managing director at research firm Graham Fisher, co-authored a paper in February in which he predicted "significant losses" in even investment-grade securities because the agencies' models were so far off. He also expects that rating agencies will face litigation as a result of the role they played in creating these instruments. The bigger question may be an existential one. Asks Jim Chanos, the head of Kynikos Associates, which has a short position in Moody's stock: "If the rating agencies will downgrade only when we can all see the losses, then why do we need the rating agencies?"—*Bethany McLean*

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