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AHEAD OF THE TAPE

When Nerves Get Short, Credit Gets Tight

By JON HILSENRATH
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One aspect of this credit crisis has a familiar ring to it. All around, investors and lenders are getting squeezed because they depended on short-term borrowing to finance long-term holdings. When their lenders get nervous, once-cheap short-term borrowing becomes dangerously expensive or disappears altogether.

Think about the Americans with sketchy credit backgrounds who depended on adjustable-rate mortgages to finance home purchases. Many thought they would refinance into fixed-rate mortgages if their adjustable rates reset much higher. Instead, their rates shot up and their banks wouldn't refinance. For many it suddenly becomes impossible to finance the most essential of long-term investments -- a home. Nearly 16% of risky, subprime mortgages with adjustable rates were at least 90 days delinquent as of Sept. 30, compared with 6% for subprime mortgages with fixed rates.

Wall Street is getting trapped by short-term borrowing in different ways. Two prime examples from last year were investments known as asset-backed commercial paper and structured investment vehicles. In both cases, banks and their clients went to the short-term commercial-paper markets to raise money. They used the money to acquire long-term investments, such as mortgage debt, or to make long-term loans. When commercial-paper markets seized up, the short-term borrowing rates soured and the strategy imploded.

An old-fashioned bank run works the same way. Depositors put their money in a bank, understanding they can pull it out at a moment's notice. Banks use the money to make long-term loans to businesses or homeowners. When depositors get skittish and demand their money back, the bank has a problem: the funds are tied up for decades with customers. That is what happened to a British mortgage lender called Northern Rock last year. Now, the bank has been nationalized.

Something with similar contours is happening in the auction-rate-securities market. Municipalities, museums, student lenders and others issue these securities, which have interest rates that reset every week to 35 days. They use the money to finance projects or make student loans with long repayment periods. Investors have fled the market, and the municipalities that issue the notes have had to digest soaring interest costs.

There is nothing new about any of this. It was an ingredient in the financial crises that plagued emerging markets in the 1990s. Countries that depended on short-term debt got squeezed when investors became skittish about the miracle stories of emerging-market growth. The savings-and-loan crisis of the 1980s had its roots in a mismatch between the maturities of thrifts' long-term assets and their short-term liabilities.

The U.S. government does the same thing. Much of its debt rolls over within a few months or years, even though its obligations to retirees look out as far as the eye can see.

Borrowing short term works most of the time. In the past 26 years, yields on three-month Treasury bills have been higher than yields on 10-year Treasury notes in only 22 months out of 313, or about 7% of the time.

The trouble is even the most sophisticated bankers have very short-term memories. Because when the strategy doesn't work, the consequences can be dire.

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Corrections & Amplifications:

In the past 26 years, yields on three-month Treasury bills have been higher than yields on 10-year Treasury notes, on average, in only 22 months out of 313. In an earlier version, this column incorrectly said short-term bill yields were lower than long-term note yields in only 22 months.

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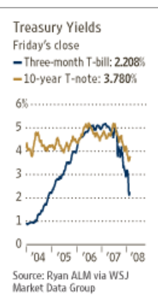

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