

## Subprime Bust Expands

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To the students of history, the vicious cycle around the bust is all too familiar.

The subprime mortgage market continues to head rapidly downhill, picking up speed. Its negative effects are reinforcing the parallel downhill slide of the housing market and cutting the appetite of financial markets for credit risk in general.

Major homebuilding companies are reporting large losses and pessimistic outlooks, as new home sales have dropped steeply and for-sale inventory has grown, putting downward pressure on home prices.

Subprime mortgage default rates, already very high, continue to increase, and intermediate credit quality "Alt A" loan delinquencies are rising rapidly too. Countrywide Financial, the nation's largest mortgage lender, shocked the stock market by announcing large credit losses related to home equity loans made to originally prime-rated borrowers. The company announced its actions in response to what it described as "tightening of credit guidelines, particularly related to subprime and prime home equity loans, further curtailment of subprime product offerings... [and] risk-based pricing adjustments."

About 80 subprime mortgage lenders have gone out of business since December, according to the count of National Mortgage News, and other major lenders are also cutting back on subprime lending (all a little late), withdrawing subprime mortgage products and generally raising credit standards. All of this reduces the availability of mortgage credit, especially for the marginal borrower, and thus reduces the demand for homes.

The excess supply of homes, and declining demand for them, means falling home prices. Falling home prices, in turn, tend to increase mortgage defaults, because pressured borrowers can no longer sell the home for enough to pay off the mortgage debt. Higher default rates lead to continued tightening credit and less demand for homes, with more downward pressure on prices, and the self-reinforcing downward cycle will continue, not forever, but for some time. Angelo Mozilo, Chairman and CEO of Countrywide, recently expressed the view that the housing sector will not begin recovering until 2009.

American Home Investment Corporation, a major mortgage funder and investor, recently announced large write-downs in its portfolio and severe pressure from its creditors. Trading in its stock was suspended by the New York Stock exchange, and when it resumed, the stock fell more than 90 percent. The company subsequently filed for bankruptcy. Radian Group, a principal mortgage insurance company, announced provisions for credit losses leading to an 86 percent drop in second-quarter profits. Then Radian and MGIC, the largest mortgage insurer, announced they might turn their joint investment in a subprime mortgage affiliate, C-BASS, into a \$1 billion write-off. And there is another risk factor few have thought about, according to the Institutional Risk Analyst: "missing original notes...the documentation has been horrendously sloppy."

It is now apparent that the problems of the subprime bust run far beyond the failure of specialist subprime lending companies. A key link to investment and credit markets more generally is that the subprime boom, and an important portion of the housing boom, were financed with tranching, senior-subordinated structured bonds made out of subprime loans. These bonds were structured based on the models of the credit rating agencies. Their resulting junior tranches, sold to yield-hungry investors, are highly leveraged to credit losses being worse than the models expected.

A sobering element of this issue is that the models for loan repayment include home price appreciation (“HPA” in the trade lingo) as a factor. According to one report of an investment manager, his firm asked a rating agency, “What if HPA were to [be a negative] 1% to 2% for an extended period of time? They responded that their models would break down completely.”

If the junior tranches of subprime securitizations are in addition bought by investors on a leveraged basis, using money borrowed under repurchase agreements or “repos,” they become hyper-leveraged to the risk of the credit losses being worse than the models expected. And the losses are indeed worse than the models expected—with results that were expected by us pessimists as we surveyed the housing bubble a year ago.

At that point we were saying, we know these risky securities are being sold and moved around the financial market, but where did they go? Who’s got them? Now some of the answers have been revealed.

The most notable case so far has been the two large hedge funds specializing in subprime investments, operated by Bear Stearns, which have ceased trading and entered bankruptcy with virtually total losses to their investors. Other hedge funds in the United States, England and Australia have announced large losses tied to subprime mortgage investments. Such investment losses have also required the bailout of the German bank IKB, which cost the president of the bank his job, and the bailout of a French mutual fund. Now everybody is asking, who else took these risks?

The credit market reaction has been to reduce credit and tighten liquidity generally, upping the collateral requirements for repo borrowing, reducing credit availability and raising the price of credit risk bearing. This has widely affected corporate bonds and loans, with numerous corporate financings canceled, as well as reducing mortgage credit availability. The August 3 Wall Street Journal featured the headline, “Lenders Broaden Clampdown on Risky Mortgages—Tightening Standards Could Worsen Slump in the Housing Market.” Indeed they will, as happens in every bust.

Given these developments, it is instructive to look back to some of the more optimistic forecasts of the past, all of which proved wrong.

A year ago, it was common to say that while home prices could fall on a regional basis, they could not on a national basis, because that had not happened since the 1930s. Well, now home prices are falling on national basis, as measured by the S&P/Case-Shiller U.S. National Home Price Index.

Six months ago, people were saying that it looked like the housing market was bottoming and stabilizing. Nope.

Three months ago, as the subprime bust grew worse, people assured the market that the problems would be confined to the “relatively small” subprime mortgage sector and would not spread further. Not a good call, either.

The pessimists all along were those of us who study history, because all the elements of the subprime mortgage and housing bust display the classic patterns of recurring asset bubbles based on credit overexpansions. Such credit celebrations are based on optimism and a euphoric belief that the price of some asset class—in this case, houses and condominiums—must always rise.

These booms are inevitably followed by a hangover of defaults, failures, discovery of excessive speculations by “sophisticated” investors, dispossession of unwise or unlucky borrowers, revelations of fraud and scandals, late cycle political and regulatory reactions or overreactions, and a credit contraction as the former optimistic beliefs turn into their opposites.

When will they ever learn? My guess is never.

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