

The Deflating Mortgage and Housing Bubble, Part II

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Valuation Issues

- The holders of securitized subprime mortgages and other loans have seen a 20-30% discount to face value in the secondary market for paper originated in 2004-2006 period. Implies \$200-250 billion mark-to-market loss for CDO holders.
- Spreads on cash and derivative transactions involving subprime loans have widened considerably. Entire class of complex structured assets is discredited, perhaps for years, though secondary market for collateral is recovering.

Liquidity Issues

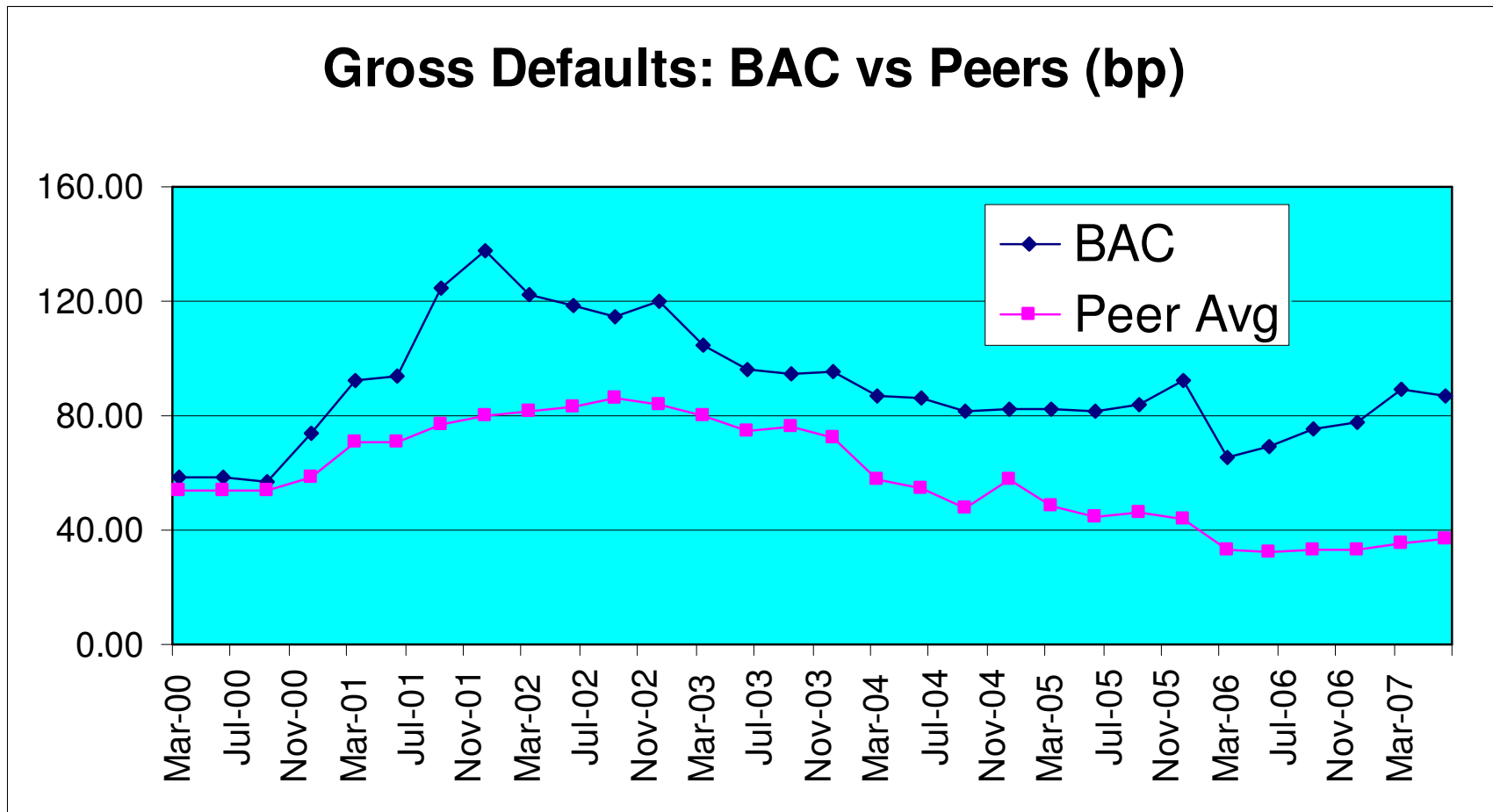
- Liquidity in the secondary market for corporate debt and whole loans is slowly returning, but “normal” market liquidity levels may remain far below “manic” 2002-2006 levels, further constricting credit available to mortgage industry and the economy.
- With players such as CFC retreating “in the bank,” the golden age of non-conforming loan securitization may be set back a decade or more as credit risk tail is unwound. US economy is going “cold turkey” after years of supra-normal credit access.

Behind the Subprime Bust

- Affordable Housing: A public/private partnership starting in the early 1990s to increase the ability of marginal home buyers to purchase a house using "innovative" financing techniques like collateralized debt obligations or CDOs. ⁽¹⁾
- Derivative Finance: A private sector push by largest banks and abetted by regulators to employ derivative vehicles like CDOs to meet demand for housing finance that came as a result of the affordable housing initiative.
- Monetary Policy: Irresponsible monetary policy followed by the FOMC in the early part of the decade, which poured gasoline on a real estate market that was already overheating and would run five more years in manic mode.

Bank of America

Source: FDIC/IRA Bank Monitor

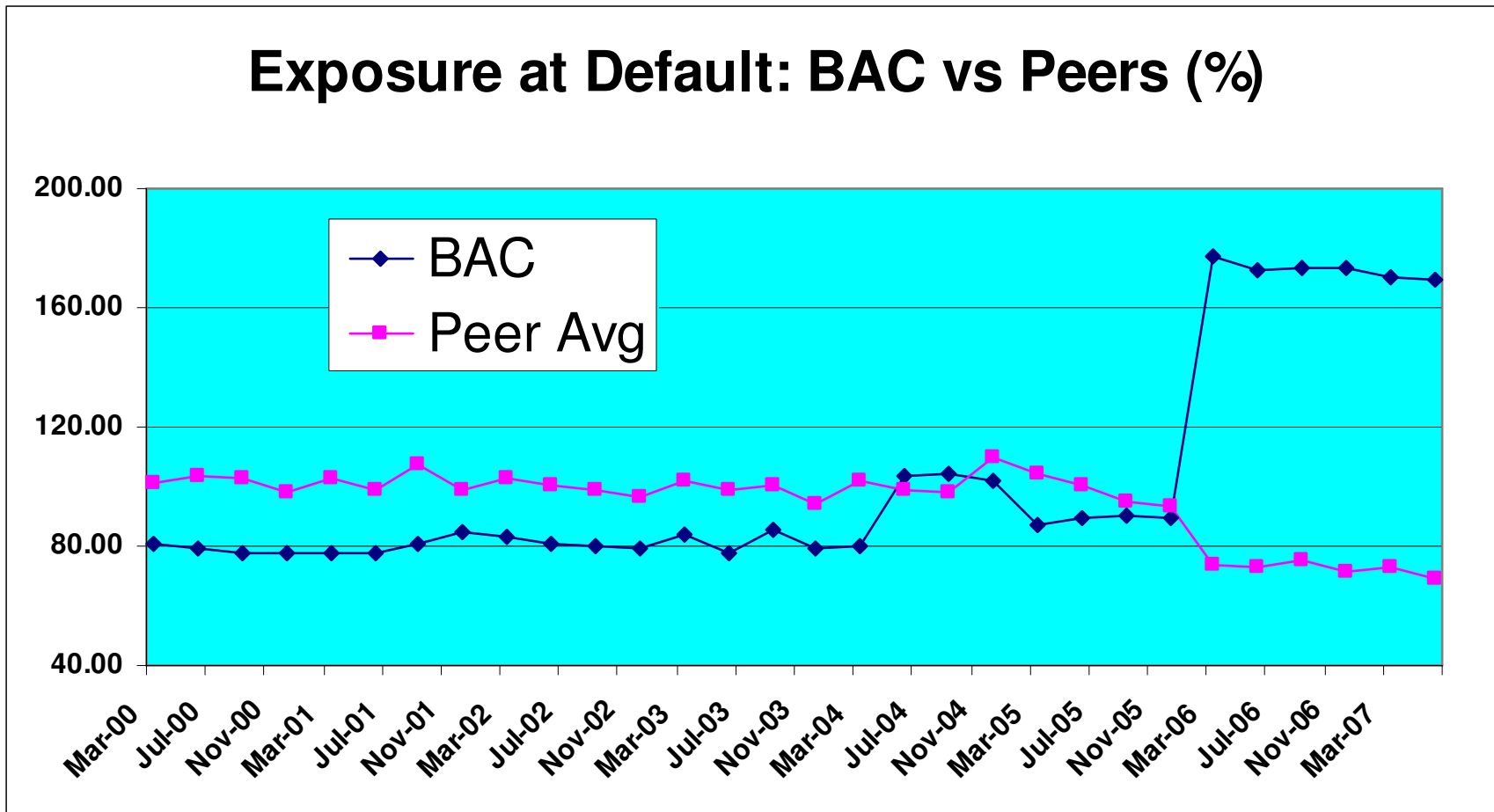


Observations

- Despite headline grabbing losses reported on the trading book of derivative dealer banks, overall loan credit default rates for all large banks remain quite low.
- Rising trend in BAC default rate in 2005 shows effect of \$150 billion MBNA credit card portfolio. BAC lead bank unit reported 24bp of default in Q2 2007 vs. 525bp for MBNA.

Bank of America

Source: FDIC/IRA Bank Monitor

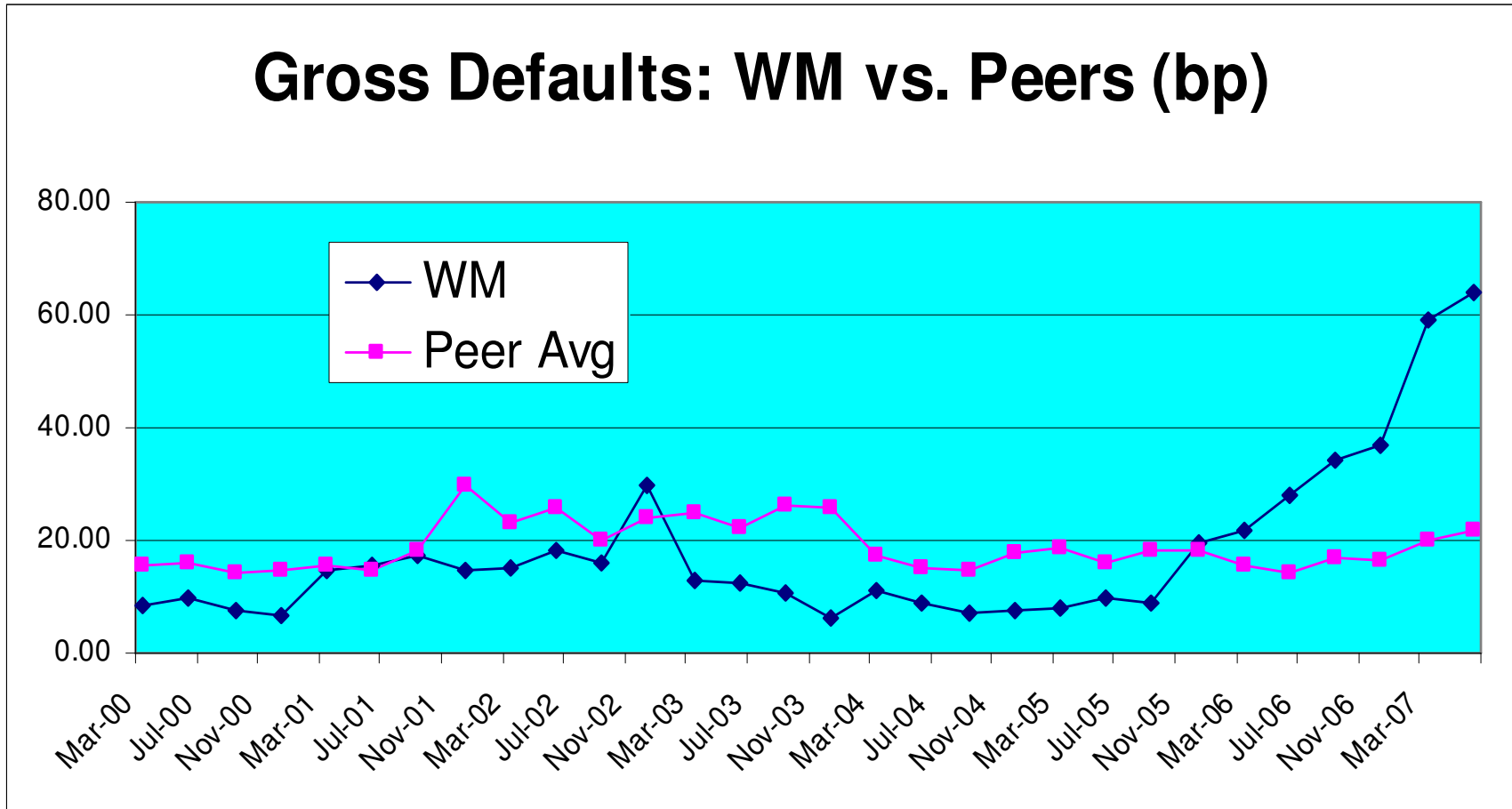


Observations

- Exposure at Default or “EAD” represents unused credit lines and represents a key bank business trend indicator.
- Large bank EAD has been trending lower since start of 2005, signaling tightening of credit availability by most US banks.
- Note surge in BAC’s EAD following close of the MBNA acquisition at close of 2005.

Washington Mutual

Source: FDIC/IRA Bank Monitor

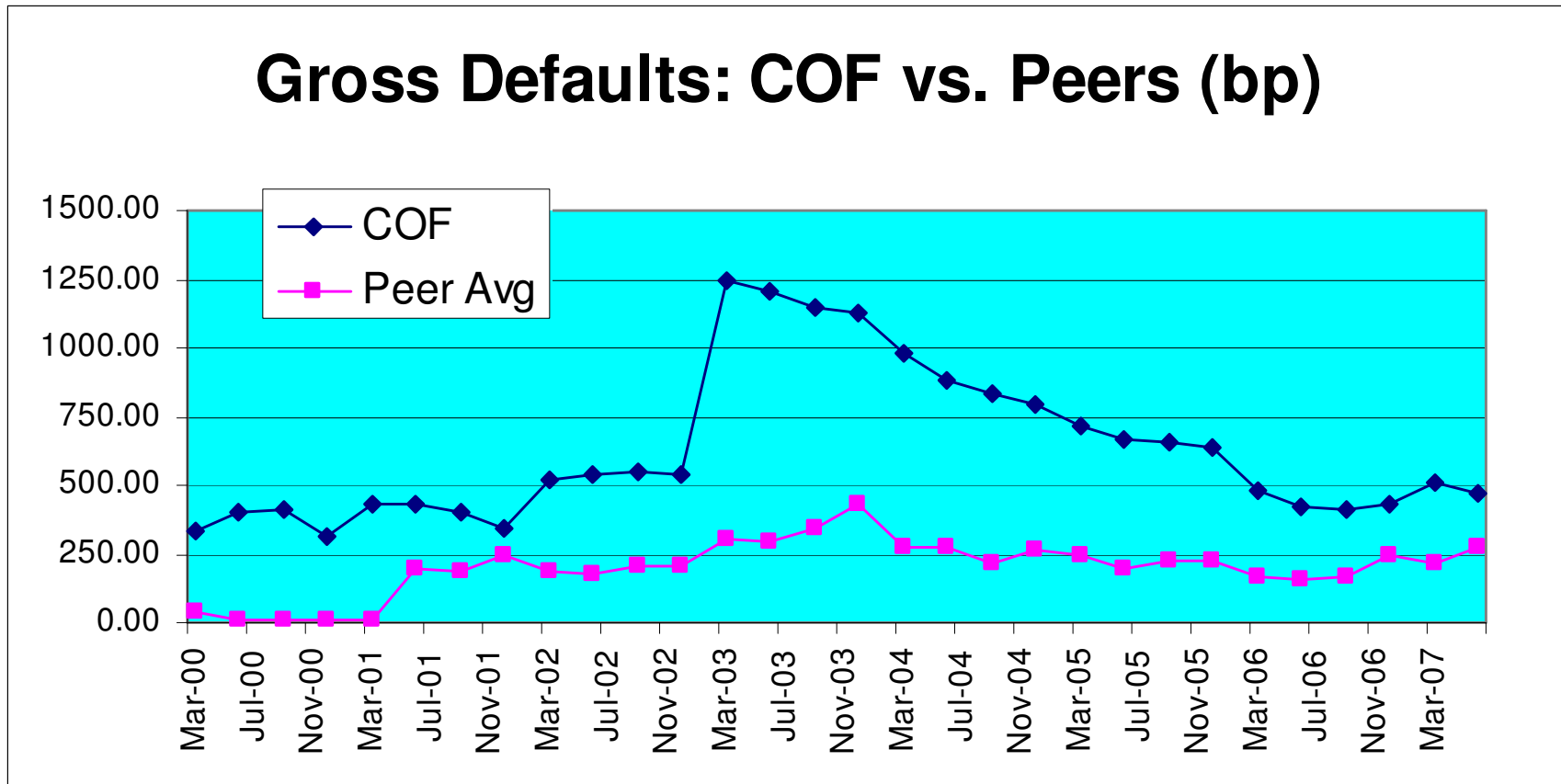


Observations

- Surge in defaults by WM partly reflects June 2005 acquisition of subprime lender Provident.
- Loan default rates for WM and other mortgage specialization peers have risen steadily since end of 2005, but still below 2001 “mini” peak.
- Rapidly rising foreclosure rates and other indicators suggest that 2001 peak loan defaults may be exceeded by end of 2007.

Capital One Financial

Source: FDIC/IRA Bank Monitor



Observations

- Many subprime consumer lenders in the US experienced serious, double-digit loan losses in 2002-2003 period, albeit for both economic and idiosyncratic reasons. ⁽²⁾
- Though loan losses at US banks currently remain low by comparison, 2008 and beyond could see overall defaults by subprime and prime consumer lenders exceed recent peak rates. Indeed, rising losses in unsecured consumer debt may be the next shoe to drop.

Conclusions

- The subprime mortgage bust stems primarily from a deliberate public policy decision in Washington to expand access to “affordable housing.” Consumers responded, taking \$9 trillion out of real estate over past decade. ⁽³⁾
- Efforts by the Congress to reduce the rate of mortgage defaults and foreclosures, or encourage private loan modification, are futile at best and may actually worsen the adverse effects on borrowers, bank safety and soundness, and the US economy.

Notes on Sources

- (1) For an excellent discussion of the roots of the public/private “affordable housing partnership” which laid the foundation for the subprime debacle, see the comments by Josh Rosner at the September 20, 2007 PRMIA meeting held at the Harvard Club in New York. See *The Institutional Risk Analyst*, 'The Subprime Crisis & Ratings: PRMIA Meeting Notes', September 24, 2007. Rosner notes that the average rate of home ownership in the US ranged between 62 and 64% in the post WWII period, but the effort to boost affordable housing after the real estate debacle in the late 1980s pushed that figure over 70% and in the process created the conditions which, combined with derivatives and easy money policies by the Fed, caused the subprime bubble. (<http://us1.institutionalriskanalytics.com/pub/IRAstory.asp?tag=240>)
- (2) While default rates among mortgage lenders and banks generally tend to track the economy and changes in GDP, subprime lenders tend to exhibit far greater losses from internal, portfolio-specific or “idiosyncratic” factors, making losses by such institutions far more difficult to predict. In general, because of the speculative nature of subprime lending, tracking the default experience of a consumer lender is difficult at best.
- (3) A sobering analysis of the US economic outlook resulting from the subprime crisis and related factors was carried on October 10, 2007, in an interview on *Bloomberg* radio with Harvard University economist Martin Feldstein. Dr. Feldstein notes that US consumption was boosted via the extraction of \$9 trillion in value via home refinancing transactions over the past decade, leading him to conclude that the dollar must sink and the US economy will slow substantially. (<http://www.bloomberg.com/>)

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