The Housing Market Meltdown and the Credit Crisis: Basic Risk Management Ignored

By Lee Kjelleren, President/CEO

Since my column in the last issue of *Financial History* (#90, Spring 2008), Museum visitors and interviewers have continued to ask me about the economy's decline. With nearly half a million job losses since January, and a half-trillion dollar record U.S. budget deficit announced for 2009 as the housing led economic slowdown cuts into government revenues, people want a closer understanding of what caused the collapse of the housing market, with foreclosures rising and the worst decline in home prices since the Depression. In Phoenix, Miami, greater Los Angeles and Las Vegas, home prices declined by over 25% this year, and the national average declined 17%, with around 10 million families having negative equity in their homes.

Visitors ask about the subprime mortgage crisis and the rapidly growing credit crisis, and why a U.S. mortgage meltdown has global implications. They wonder about the implied taxpayer liability for what the IMF has characterized as likely losses of $1 trillion from banks and other financial institutions. What brought on the credit squeeze and the real likelihood of still more financial losses? Why did financial institutions make such systemic mistakes in home mortgage lending?

My views, derivative in nature and not original scholarly research, are personal and not a function of Museum positions. But they do reflect my training in risk management as a former officer at the Morgan Bank, just up the street at 23 Wall.

When the U.S. housing bubble fully burst by July–August 2007, home prices had increased by an average of 124% from 1997 to 2006. The housing market had become a veritable casino based on the assumption that prices would appreciate indefinitely. When prices of overvalued homes began *declining* in late 2006, the $1.3 trillion subprime mortgage component (of the $6 trillion home mortgage bond market, which is even bigger than the Treasury bond market) triggered an ongoing crisis. Subprime borrowers were unable to service their mortgages or refinance, leading to defaults (see sidebar) which eroded the value of mortgage-backed securities, that had been sold globally.

> *"Wall Street got drunk and now it's got a hangover,"*
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> **President George W. Bush, July 18, 2008***

The valuing down of these mortgage bonds has led to catastrophic losses at financial institutions worldwide on the order of $500 billion. Bankers and policy makers are struggling to contain what has become a housing and credit crisis, with availability of credit shrinking as lenders continue to retrench. In this short piece I contend that brokers, lenders and rating agencies played an egregious role in credit processes, and lenders in particular were irresponsibly negligent in consistently extending credit to unquestionably unqualified subprime mortgage borrowers. The driving force behind the current problems has been *flawed risk management,* with the most elemental considerations of debt repayment consciously ignored in the aggressive pursuit of higher yields. The overriding focus was on fees, commissions and ever-larger bonus pools rather than risk assessment implications. That there is a direct relationship between returns and risks seems to have been ignored. If professionalism can be measured by the ability to resist temptation, great numbers of mortgage originators, underwriters and lenders were unprofessional, unable to resist the lure of what (predictably) turned out to be unwarranted cash rewards.

Major financial institutions have been materially weakened by the near collapse in the housing market, which has wiped out $3.5 trillion in home price gains from the boom years. Millions of Americans have been forced out of their homes, with defaults costing Wall Street hundreds of billions of dollars and been the primary cause in depressing the broader economy. Indicative of the situation, by the middle of summer 2008 Switzerland's biggest bank wrote off $44 billion following a scathing Board report on management's risk failures. Wachovia wrote off $8.6 billion, Merrill Lynch

* "The question is," he said, "How long until we sober up and not try to do all these fancy financial instruments."

Snapshot of the Subprime Crisis

When the U.S. housing bubble fully burst in 2007 and home prices dropped, 1.25 million subprime mortgages foreclosed, up 80% from 2006. Projections of 2.5 million foreclosures for 2008 seem likely. Over $1 trillion in subprime mortgages will likely be revalued at 60%–80% of their original value before the home mortgage crisis and subsequent, but related, credit crisis is worked through. Also, an inventory glut of 4.5 million unsold homes is an overhang to be addressed, as well as the ongoing need for financial institutions to mark to market remaining mortgage backed securities in their portfolios. The other shoe hasn't yet dropped, and the possibility of a protracted recession cannot be readily dismissed unless investor confidence can be restored, an unlikely near-term

$41 billion, and Citigroup $55 billion, as a result of mortgage backed securities' losses. All forced the resignation of their Chairmen/CEOs and entered a serious period of damage control.

In September, the largest U.S. bank, Citi, is to write off another $8 billion while to date this year its shares have dropped over 40% and its book value dropped 50%. It will in addition be forced to reimburse around $7 billion to investors for overtly misleading sales tactics regarding securities sales. Citi was seeking to get distressing assets off its books as the market was collapsing, and will pay a $100 million fine. UBS has agreed to return $19 billion to buy back bonds because of claims of deceptive sales practices, and pay a $150 million fine.

Merrill will shortly write off another $6 billion and are selling $31 billion of their mortgage securities in a fire sale for only $7 billion to Lone Star, while actually financing some $5 billion of the sale. That Merrill was selling at around 22 cents on the dollar stunned Wall Street, but this sale could well be an applicable precedent for banks' portfolios, many of which have not yet been fully marked to market (as value accounting requires). As one justification, Merrill said its 60,000 employees were terribly concerned about the implications of the write down in mortgage related assets. They are also seeking $9.8 billion in new capital, the second largest sale of stock ever despite it being an extraordinary dilution of Merrill's shares.

The Mortgage Market

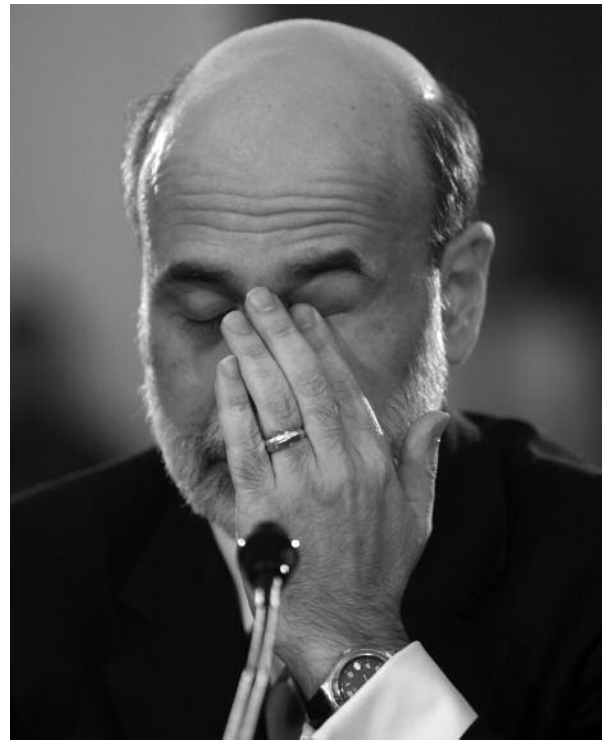
The meltdown in the U.S. mortgage market has seen home prices in free fall in many markets, with new home sales down over 40% since June 2007. Even TV investment commentator Jim Cramer advised on *The Today Show* in June, "Don't you dare buy a home." But Fed Chairman Alan Greenspan in April 2005 had praised the virtues of lending to poor credit borrowers, saying the subprime mortgage industry was very capable of assessing credit worthiness. He was later widely criticized for his role in the rise of the housing bubble and subsequent subprime problems.

Overbuilding from 2002 on did not limit demand until 2006 as borrowers sought mortgages, often interest-only for some years, in the belief they could flip them or readily refinance them to keep mortgage payments current or withdraw equity from their increased home value for consumer spending, as well as credit card and auto loan repayments.

Mortgage originators and lenders aggressively pursued higher-yield mortgage loans by targeting subprime borrowers. Often receiving 2% more in yield in addition to fees and commissions, these subprime borrowers were profitable but failed to qualify for regular housing loans. Fees as high as $15,000 on a $300,000 adjustable rate loan were not atypical, against a $2,000 fee for a fixed-rate loan to a qualified borrower.

Possessing poor or no credit history, uncertain income and questionable debt servicing capability, credit to such borrowers was often referred to as "Ninja loans"—no income, no job, no assets. Frequently, no down payments were required and fixed rate one- or two-year loans were offered at low "teaser" rates—which would later reset at higher floating rates. As long as home prices went up the foolishness of such loans was masked, with lenders receiving attractive bonuses despite marginal concern for mortgage affordability.

It should be noted that many borrowers also engaged in widespread fraud in their loan applications and net worth statements. But it seems clear that lenders turned a blind eye to these practices for years. Widely-used computerized applications compounded the credit problem as many brokers and other originators were apparently able to manipulate unacceptable numbers to conform to



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Ben Bernanke, Chairman of the Federal Reserve Bank, testifies in January, 2008, before a House Budget Committee hearing on losses in the U.S. subprime market.

ostensible industry standards. And there have been widespread complaints about appraisers falsifying home information. Overall, marketing and sales people tended to dominate the lending process, not the compliance officers and risk managers. FDIC Chairman Sheila Blair (June, *New York Times*) said lenders should be faulted for "lax lending standards" and "making poorly underwritten loans," placing borrowers in "products that created financial hardship rather than build wealth."

Countrywide Financial, the country's biggest subprime lender (saved from bankruptcy by Bank of America), is being prosecuted by the Illinois Attorney General for unethical business practices, which include: "Deceitful conduct…misleading marketing…hidden fees and risky terms…egregiously unfair and deceptive lending to steer borrowers to loans that were destined to fail." The CEO of Countrywide, Angelo Mazilo, was paid $132 million in 2007, and gave Senator Dodd (Senate Banking Committee Chairman) a $75,000 special break on his Connecticut mortgage, perhaps indicative of the housing industry's influence.

Securitization of subprime mortgages is how banks, governments, pension funds and other investors all over the world ended up with defaulting U.S. mortgages. The individual mortgages were packaged in a variety of ways into pools which received monthly payments of principal and interest, which were then sold to third party investors—*who also took over the credit risk for default*. It was a wonderful deal for the lenders, who got the mortgages and their risks off their balance sheets and obtained new liquidity, plus an additional upfront fee for providing a relatively higher yielding bond.

Investors tended to rely on Triple-A ratings for the bonds by rating agencies rather than their own due diligence. Rating agencies astonished the world when they abruptly began in 2007 to downgrade the subprime securities they had previously blessed. Over a trillion dollars in mortgage-backed securities have been downgraded through August, putting pressure on banks to repair their balance sheets by fixing their capital ratios and/or paring down their lending. Banks have therefore been seeking huge amounts of capital to cover mark to market losses, with investors having to cope with serious dilution. Rating agencies may well be involved in another story that doesn't reflect well on the ability of executives to resist temptation.

Overextended and undercapitalized banks have become very cautious and are limiting their loans, thereby deepening the economic slowdown and causing credit risk to spread to most major debt categories, including auto loans and credit cards and areas formerly immune from the snowballing mortgage meltdown. New bank loans in many areas, especially housing, are like truffles—hard to find and very expensive. Said Richard Shelby, the ranking Republican on the House Banking Committee in July with regard to credit, "We are sitting on a powder keg."

Regulators also failed to give expressions of concern over subprime lending. Nobel Prize-winning economist Joseph Stiglitz said, "regulators looked the other way when investment banks packaged their bad loans in non-transparent ways." And Dr. Richard Sylla at New York University has observed about our often ineffective regulatory patchwork of state and federal agencies, the U.S. has a 21st century economy with a fragmented, early 20th century regulatory system. Dr. Sylla also noted that one must look back to the bank failures and fallen stock prices in the Great Depression to find a time when financial industry losses have been so severe. Said renowned billionaire Ted Forstman (July, *New York Times*), who runs one of the world's biggest private equity firms, "We are in a credit crisis the likes of which I've never seen in my lifetime. The credit problem is considerably worse than people have said or know. I didn't even know subprime mortgages existed."

The stories of Bear Stearns, Indy Mac and Freddie Mae and Mac are well-known, and space precludes a review of their implications and the privatization of profits but socialization of losses. However it should be noted the government has been seeking to recoup $115 million from the top executives of Fannie Mae for manipulating earnings to maximize bonuses over five years. And the risk management executive at Freddie Mac recently charged his CEO with disregarding his mortgage warnings. The CEO, whose bonus was $38 million from 2003 to 2007, vigorously denies the allegation.

Institutions clearly had financial incentives for selling mortgages to higher-risk subprime borrowers, since fees and bonuses were significantly higher. But the risks were not unknown. Hedge fund owner John Paulson personally earned $3.7 billion in 2007 by establishing a fund specifically for the purpose of betting against the subprime market, shorting firms with large positions in subprime mortgage backed assets. George Soros made $2.9 billion in 2007 reportedly betting appropriately also on the mortgage market (among other areas).

It would also be hard to believe subprime mortgage lenders didn't simply look the other way when toxic mortgage backed bonds were created and sold from 2003 to 2006. They had to know, as they flouted the basic rules of credit, that the loans were questionable, and that one day the overvalued housing market bubble would burst. As J.P. Morgan famously said when asked what would happen to the market: "They will go up, and they will go down." Except for housing?

In July 2008 James Grant, editor of *Grant's Interest Rate Observer*, wrote in the *Wall Street Journal* that he is of the view the prime lending situation and subsequent securitization—sold globally—was not an error, and that Wall Street bankers are superbly talented if sometimes too self-aware of that. He noted how by and large they have a keen eye and superb judgment and live by their wits. They are, however, also in business "to maximize employee compensation in the short run," and to enhance the bonus pool, even if it "runs itself and the rest of the American financial system over a cliff." Mr. Grant seems to have captured the essence of our situation.

Indicative of the many ways the government is looking to shore up the financial system, through the exercise of extraordinary regulatory powers, Fed Chairman Ben Bernanke is in the process of introducing legislation targeting lax lending standards and borrower protections from predatory and deceptive lending practices. He also is clearly concerned about the real possibility of a protracted recession. And the former president of the New York Fed and Goldman CEO, Gerald Corrigan, is heading a very high-level banking group to make a broad set of proposals for banks to institute tougher standards for managing their own risk and liquidity in the face of the current turmoil.

Warren Buffett said some years ago that you only find out who is swimming naked when the tide goes out. The implications of the lack of proper risk analysis and irresistible incentives based only on short-term performance are no longer covered over—and it's not a pretty sight. In the end a turn in the market regretfully punished not just those seduced by financial temptation, but has severe repercussions for millions of Americans and non-Americans as well. FH

Foreclosure sign in front of one of the millions of homes affected by the subprime mortgage crisis.

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