The Housing Pendulum Shifts: From Sublime to Subprime

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The author argues that a cut in interest rates may be the best way to solve the subprime lending crisis.

Preliminary Note: As this article is being written, concerns over the ultimate consequences of the subprime crisis are mounting and global financial markets are in a state of flux. Since once future events could easily become recent history, this commentary should not be viewed as a prediction of market effects.

Modern technology now lets traditional investors buy into ultra-analyzed, rated and handicapped tranches of securitized pools of variable cash flow streams funding everything from commercial and residential mortgages to auto loans, credit card, student loans, reverse mortgages to low or no-income borrowers, and viatical loans to terminal patients. Computers can now predict the odds of particular groups of cash-flow streams defaulting over finite periods of time, and their effect on coverage ratios and rating standards. While legions of freshly schooled analysts crunch complex spreadsheets, buy-side Analysts wowed by massive spreadsheets and glossy ratings easily forget that clichés usually contain a grain of truth—in this case, try: ''Garbage in, garbage out'' and ''The devil is in the details.'' ''AAA,'' ''AA'' and even ''BBB,'' ratings based on untested default assumptions gave investors and their advisers the excuse they needed to justify pouring billions into an alternative investment supported solely by newly designed mortgage loans.

The advent of the multi-trillion dollar mortgage securitization market made mortgage loans a highly desirable commodity. Cheap money was also easy money, as Wall Street firms progressively moved from underwriting billion dollar pools of highly rated mortgage pools, to making bridge loans to unregulated non-bank mortgage originators to buying and legitimizing unregulated mortgage lenders. Young couples with no credit history or low-paying jobs or unreportable cash income could now jump into a fancy new condo or subdivision house with little or no down payment, thanks to an Option ARM at one percent to two percent for the first year or two, and a no-doc loan. Older homeowners with limited incomes could escape their deteriorating first house and overpay for a larger, newer home because they too could get below-market interest rates without worrying about reset rates. Normal, good credit homeowners happy with their homes could refinance at lower rates and take out cash for vacations, cars or jewelry. Wall Street was hungry for product and fees, so mortgage bankers were able to offer lower rates with less documentation. The rating agencies were no stranger to the fee party, rating trillions of loan pools with newly relaxed standards for new products that had never been tested in a down market. This was the ''sublime'' scenario carefully crafted by the Fed in 2001 to pull the economy out of the recession.

Fueled by high origination fees, armies of brokers imposing layers of markups, greedy promoters used the Fed's easy credit policies to concoct new alternative types of mortgages. Armed with pre-printed applications, a calculator, a cellphone and homemade business cards, new mortgage missionaries scoured mid and lower-income neighborhoods to offer ''exploding mortgages'' with low teaser rates to limited-income homeowners seeking to renovate or move up to the next rung on the housing ladder. Known as ''2/28'' and ''3/27'' loans began with less than one percent or two percent interest for the first two or three years, but accrued the difference against borrower's minimal down-payments. This ''negative amortiza-

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tion'' would raise the principal amount of the loan, along with the usually exorbitant upfront fees of as much as five percent. Add to this batch a new group of 40 and 50-year and interest-only loans, all with low early payments that would double or triple upon reset. The plan was to induce these low income borrowers, fearful of being priced out of the move-up market, to refinance and pay a new set of fees when the rate jumped to nine percent or 10 percent (or more). Unfortunately, no one — including our watchdog Fed and rating agencies — worried very much about what would happen when the pendulum swung back and home prices declined, instead of appreciating at 15 percent annually, making refinancing difficult, and in many cases, impossible.

As defaults and troubled loans increase, all of the market participants are running for cover and hunting for scapegoats. The Fed is in for a major share of blame, first for stoking the markets with low interest rates, then declining to regulate or encourage realistic underwriting criteria. Recent comments from other economists point to the Fed's apparent sanctioning of adjustable rate loans in preference to conventional fixed-rate loans, without sufficient consideration to higher reset rates. However, this finger-pointing may be misplaced. Historically, short and medium-term rates for three to seven year terms have, on average, been lower than 30-year fixed rates—which obviously benefited borrowers. Thus, the real issue is not whether reset rates will be so much higher, or whether a properly underwritten loan can be refinanced at a higher rate, but whether borrowers had sufficient income capacity to pay normal short or long-term rates, or alternatively, sufficient equity to withstand the inevitable market value correction from an artificially inflated environment. The Fed can legitimately be called out for hosting a musical chairs game well beyond the needs of the tech bubble recession.

Banks and independent brokers created millions of securitized subprime (poor credit, no doc, and often, high LTV) and Alt. A (moderate credit, sometimes low-doc or high LTV) loans. These loans were then packaged into billion dollar pools with AAA ratings assigned to the first 65 percent to 80 percent, based primarily on the assumption that the subordination of lower-rated loans to less creditworthy borrowers would provide a sufficient cushion to avoid any default in the senior tranche. Using low and moderate default assumptions drawn from more conventional fixed and ARM mortgages on these new, untested mortgage products was a major mistake. If default rates remained true to previous form, their minimal losses and cash flow reductions would affect only the non-rated retained junior tranches, and absorb all losses, leaving just enough cash flow to service the rated tranches. But rosy assumptions and projections do not always come true and the glossiest spreadsheet cannot prevent the 151st default just because the pool was only supposed to have 150.

The Key to Rating Mortgage Pools: Default Rate Assumptions

Whatever happened to the early securitization default models in which all loans below a certain FICO or equivalent credit score or LTV, and all low-doc or no-doc loans, were presumed to default within three years? The major rating agencies are asking about that right about now. In early July, Moody's, Stand & Poor's and Fitch finally began to downgrade the subprime pools, which despite high concentrations of lesser credit borrowers, used historically low default assumptions. Instead of a five percent to eight percent projected default rate, we are starting to see 13 percent to 15 percent delinquencies—as early as the first year of loan history. These rates will doubtless move higher as teaser ARM reset rates are slated to double required payments well beyond borrowers' undemonstrated income capacities. The AAA-investor may not care all that much right now, but that could change literally overnight if the structured subordination cushion disappears and their tranche is downgraded from AAA to even AA. That would trigger a serious liquidity crunch as pension funds and other legally constrained institutional investors are forced to bail out. This scenario would devalue all levels of mortgage backed securities—residential pools of both mortgage loans and CDO bonds comprised of multiple layers of those pools—far beyond a realistic assessment of default rates.

In fact, higher delinquencies and defaults are beginning to appear on Alt. A and other high LTV loans to good credit borrowers as the direct result of reduced valuations, and tighter credit constraints on refinancings and homequity loans.

Subprime Borrowers: Winners or Losers?

It is hard to understand exactly who benefited the most from the witches' brew of historically low Fed-managed rates sprinkled into easy credit access and stirred without regulatory oversight. Certainly not the poor, elderly and first-time borrowers who were the supposed beneficiaries in the Mortgage Bankers Association's self-serving statements seeking to avoid regulation. Borrowers at all income and asset levels were led to believe that an ''Option ARM'' mean ''Angel Raising Money,'' and was specially designed just to enable them to pay well beyond their meager means. These lucky borrowers were told not to worry about income because the reset rate would never come. Their property would appreciate so much they could always refinance into a lower LTV ARM with yet another teaser rate. Sound familiar? Flash back to the late 1980s savings and loan crisis, and 110 percent commercial mortgage financing — also based on continuing property appreciation and aggressive appraisals. Newly self-proclaimed developers and investors took full advantage of a gold rush atmosphere in both commercial and residental markets, aided by unregulated loan underwriters expecting 15 percent or higher annual appreciation in property values. Most of those borrowers lost their distressed properties in auction sales and RTC-mortgage pool securitizations, but in those days, most borrowers had no or little equity, so they were able to move on.

By contrast, the first victims of our most recent subprime meltdown are likely to be lower-income and elderly individuals who lose their homes and savings poured into properties beyond their means, when many could have bought or remained in lower-priced homes with lower-rate conventional loans with more affordable constant payments. Perhaps, the Fed policy makers and mortgage bankers — whose oft-unlicensed ranks swelled with former used-car salesmen and landscapers — can point to the increase in first-time homeownership, but over time, the massive defaults, foreclosures, bankruptcies, and displacements will take a societal toll far beyond any temporary statistical gain. The Fed's use of low rates to stimulate a stagnant economy is laudable, but it could so easily have been done with moderating credit constraints to deter speculation and with regulatory oversight over mortgage lenders and brokers. (Candidly, as one who has taken the various tests needed for various securities licenses, I would seriously doubt if even half of the mortgage brokers unleashed on the unwary could pass any similar test geared to real estate and mortgage markets.)

It may sound cynical but the main beneficiaries of the evolution of the subprime market are the mortgage brokers, bankers and Wall Street bankers who multiplied their incomes with little to no knowledge or concern for the unsuitability of a high-fee loan to an under-qualified borrower on an overpriced property. After all, the depersonalization of mortgage lending through securitization was supposed to let lenders offload not only their loans but also their consciences. We've come a long way from the old Savings & Loan in James Stewart's ''It's A Wonderful Life.'' Wall Street bankers and seven- or eight-figure hedge fund managers may be forced to retire into owning a bar or restaurant, but dispossessed mortgage borrowers won't move on quite so easily.

These well-funded speculators are also in for a day of reckoning. At the same time as subprime lenders are closing after unmet margin calls, hedge funds and other leveraged investors in higher-risk CDOs are being pressed by the reduction in collateral values. Unable to meet margin calls on their highly leveraged positions, these funds may need to sell their liquid but declining equity positions into a chaotic market.

Too Little, Much Too Late

Let's look at some other effects of the subprime implosion. After ignoring early warnings of speculative fever accelerated by loosely underwritten mortgage financing, the Fed and State regulators have finally taken the hint, but only after delinquency and default rates have tripled or worse. Long after the thundering herd jumped the paper fence, regulated lenders and their affiliates — including many former subprime lenders — will now be forced to qualify borrowers based on real provable income and normal reset rates. Unregulated lenders will be unable to securitize new or refinance loans on the old assumptions, so they will be forced to follow form, or close.

The real victims are not the bankers or itinerant mortgage brokers who may need to move on, but the stretched borrowers who can't meet reset rates and can't get their credit or loan amount approved for a refinancing. They are now being asked to provide sufficient equity to absorb very real valuation declines upon refinancing of ARMs, as well as provable income. The result is that borrowers will be stuck with higher reset rates until they surrender their homes, or are offered workout packages that seize 50 percent or more of their living income. Many lenders will accept ''short sales'' (below the outstanding mortgage amount) to avoid costly foreclosures, but the impact on the real estate market will be the same, whether units are sold privately or at auction. The already bloated supply will expand even more when mortgage borrowers are distressed and displaced.

Value is a function of supply and demand — pure and simple. The high end of the housing market has survived — even prospered — because the demand from affluent boomers and highly paid professionals, particularly on both coasts, has remained while the supply of newly constructed urban condo palaces, McMansions, and Country Club golf-homes has slowed. The supply-demand imbalance evidenced by doubling of builder inventories and extended market time from listing to sale has brought property values down 10 percent to 15 percent — more in overheated areas like Florida, Las Vegas, and Arizona — over the past year alone, with no end in sight. Concessions such as free upgrades and builder-supplied financing an closing cost absorptions have limited cancellations to the 35 percent to 40 percent range, but unsold new units overhang each major market and make it that much harder for private sellers.

The Pendulum Hits Wall Street

Now, let us consider the impact of the subprime debacle on Wall Street firms and the investment capital held by hedge funds and other actively managed portfolios. Subprime mortgages might only aggregate about $480 billion of the multi-trillion dollar market for mortgage backed securities, but it is both the most sensitive bottom rung on the ladder and the ultimate domino in the chain.

Wall Street was undoubtedly one of the major beneficiaries of the Sublime market for cheap, easy mortgages. Mortgage securitization generated millions in fees annually from underwriting, warehousing, and investing in mortgage originator and securitizing billions of mortgages. It is nowhere near an equalizing loss, but if the lower tiers of mortgage pools experience enough defaults, and the mortgage originators are not sufficiently liquid or supported by Wall Street lenders to enable them to buy back defaulted loans, these subordinate tranches will lose their cushioning effect. Then, sooner or later, some portion of the senior AAA tranches will be downgraded, though with great resistance from Wall Street firms, who may be forced to provide additional reserves or capital support. Recently, Bear Stearns announced that its two hedge funds invested in mortgage pools (only one of which was highly leveraged) had lost 100 percent of their equity, due primarily to valuation declines in both subprime and Alt. A mortgage assets. The firm had extended a $1.6 billion loan to the less-leveraged fund to meet margin calls and forestall an auction of their most solid collateral but had actually allowed only $200 million to be drawn. Similarly, Lehman, Goldman, HSBC and other firms that bought or capitalized subprime originators may be forced to lend to sponsored mortgage lenders or buy back defaulted pools or tranches to maintain the integrity of senior tranches ands avoid bulk sales and revaluations of collateral. This chain of events will impact the value of all of the collateral in each pool, as well as the unsecuritized inventory in the hands of banks and investment firms. The fallout could be massive when rating agencies drop their AAA and AA on fully performing loan pools and CDO bonds because pension funds and other legally restricted investors would be forced to unload mortgage-backed securities CDOs and CLOs at the same time into a chaotic market.

Continued stress on the subprime and Alt. A markets will inevitably increase rates on new mortgages. When pension funds—who supposedly took relatively small positions in CDOs—insurance companies and governmental investors shun MBS for fear of losses due to downgrades in a potentially volatile market, other investors will also require higher rates on new deals. Thus, even without any further Fed rate increase or inflation-related Treasury bond rate increase, even a limited liquidity crunch due to volume sales of mortgage pools would raise secondary market yields on existing MBS and cause newly formed pools to pay much higher rates. This will invariably translate into higher new mortgage and reset rates for both new and existing mortgage borrowers. Hedge fund investors who have not yet been scarred beyond recognition in subprime or other MBS pools devalued by market imbalance may be the only non-bank source of mortgage funding.

The inevitable result of all of this is declining property values in all but the higher-end properties. Multimillion dollar river view condos and mini-estates are often purchased with Wall Street bonus cash or by celebrities who don't need mortgages. These buyers are also in a privileged position to pay up for what they want and not worry about whether they overpaid or will get their money back upon resale. However, all but the top five percent or so of housing units will be impacted by this supply factor. First Alt. A mortgage borrowers with good credit but higher LTV ratios will have more difficulty refinancing out of ARMs because their LTV ratio will have increased. Even move-up applicants with top credit scores will have difficulty with higher down-payments triggered by lower appraisals. Nobody who needs cash is going to be drawing very much out of a declining homequity line and a newly devalued home. Whether that homequity cash was going into a new business venture, renovation, or big-ticket purchase, its absence will be felt in a slowing economy — more than is presently anticipated by economists fearing inflation.

As for the Wall Street firms, tears can be withheld. Most firms had relatively little unhedged credit exposure to unsold pool and even those that retained junior tranches were able to cover some portion of the overall exposure through credit derivatives or default insurance. The likely first effects are writedowns in the equity of acquired subprime and other lenders and capital infusions or reserve injections to replace defaulting junior tranches, which will be immaterial in the midst of record earnings from trading, investment banking and underwriting. Still, the dollars and targets are large enough to attract the attention of class action predators, and if that occurs, Wall Street may end by giving back more of its windfall profits.

The Macro Effect of Illiquidity

As indicated, market pressures in CDOs can easily translate into other debt markets. As issues are downgraded or auctioned in fear of future downgrades, even highly-rated bonds are devalued, leading to margin calls and forced sales. The degree of leverage employed in CDO and MBS pool investment portfolios is not widely known, but its impact could be felt in all financial markets.

In fact, by mid-Summer 2007, the equity markets became infected by selling fever. Highly leveraged investors seeing losses after years of double-digit returns had the choice of unloading illiquid debt securities or widely traded equities. Suddenly, the stock markets are flooded with sell orders and suffer a 5-10% reversal. This sudden market drop is being triggered directly by illiquidity in the securitized mortgage market. However, an equal culprit is the excessive reliance of the equity markets on continuing LBOs and mergers and stock buyback programs, all of which are threatened by tighter credit and higher rates. Is this really a correction of an overheated stock market or a predictable, if indirect, effect of the Fed's rate and credit management?

The Commercial Real Estate Markets

Thus far, the commercial market has soared, perhaps even aided by distress in the housing market. As investment capital poured out of public homebuilder stocks and residential REITs, some real estate diversity investors sought the steady returns of commercial REITs. Banks, insurance and pension fund lenders to major developers increased their allocations from residential to commercial. At the same time, as inflated condo prices dropped, and new inventory mushroomed, conversions of rental properties slowed, and more rental projects were initiated. Despite the low rate environment of the early 2000s, commercial development was not as inflated as the housing market, so office and retail projects were absorbed in a relatively orderly manner. Major urban and money-center office markets became tighter, as Wall Street and technology centers prospered.

However, these gains may be short-lived. So long as the economic impact of housing values on consumer confidence and spendable income continues to be underestimated by policy-makers, the residential mortgage and housing markets will continue to suffer. Housing has been the economy's life support system, so if retail sales will slow, shopping center vacancies will rise, rents will drop and new development will be discouraged for years to come. Spending declines, even in a near-recession have a far-ranging impact that could stimulate consolidation and layoffs and raise office vacancy rates. Last, but not least in this progression of effects, the likely increase in interest rates in the MBS market for residential mortgage pools will invariably spill over into the CMBS market for commercial mortgages. Banks forced to fund their own residential loans to even good credit borrowers will make fewer commercial loans and underwrite them more carefully in a weak economy. Faced with higher interest expense and lower rents, many developers and investors will slow down or seek to dispose of properties. Ultimately, this sequence of events can only increase supply and reduce property values in all markets and at all levels.

Finally, this kind of liquidity crunch impacts all market participants. If banks can't generate humongous fees on LBO deals because ''covenant-lite'' deals can't be sold, they will selectively hold the loans themselves, using up valuable capital. At the same time, they'll be increasing reserves on loans to hedge funds and other leveraged investors. Its' a matter of time—probably not if but when—that they will require higher LIBOR spreads on construction mini-perm loans to developers and require more equity or pre-leasing to be sure they can securitize or syndicate those loans into a shell-shocked or apprehensive capital market.

Fed Policy: Active Management or Posturing

Regardless of the inflation-hawk comments emanating from FOMC meetings, Fed Chair Bernanke and his cohorts have continued to litter their speeches and notes with references to the lagging effects of Fed rate policy and its likely dampening effects on housing and the broader economy. Fed statements expressing unjustified concerns over lingering inflation have discouraged bond market bulls from projecting a rate cut before the end of 2007, but that may have been intended more to maintain a competitive dollar and investment rates in an increasingly global economy than to project higher inflation. Paradoxically, if the consumer — whose confidence has already been shaken by housing declines and limited real earnings growth after inflation — really believed the Fed's scary warnings of higher inflation, he would rush to buy big ticket products before those prices rose, but that is hardly what the Fed wants or truly expects. The Fed knows what we now know — that it was precisely this premise of higher housing costs that led speculators and second home buyers to rush to sign up for new developer units that are now glutting most real estate markets across the country.

Moreover, the Fed does not perceive its role to be a market soothsayer or prognosticator, unlike Wall Street pundits who monitor its commentaries like security cameras in retail stores. It considers its role to set monetary policy through controlling short-term interest rates for various, often-unstated economic reasons. Perhaps, a certain minimum rate level is needed to support the value of the U.S. dollar vs. the Euro or the Yen. Perhaps, it fears a withdrawal of Asian, Middle-Eastern or European investment capital from the U.S. treasury market if post-inflation rates are too low, with the undesired effect of causing long-term Treasury rates to rise more than desired. Then, too, the Fed seeks to maintain a stable market by avoiding or minimizing the effect of major surprises. For example, its cautions about lingering inflation are designed to project that it won't cut short-term rates any time soon—for its own reasons. But, it leaves us hope for a rate cut by noting that

According to their public pronouncements, Fed policy will be guided by future statistical results which we continue to hear may be impacted by the lagging effect of the housing decline and previous rate increases. If so, perhaps the underlying purpose behind the Fed's persistent emphasis on inflationary concerns — expressed at each meeting since it stopped raising the Fed Funds rate in June 2006 — is nothing more than a benign, but non-prophetic, urging to conserve energy or spend wisely, something like — ''Look out — we still have inflation, in spite of all of our painful rate increases!''. Maybe this rhetoric has nothing to do with the Fed's true expectations regarding inflation or its supposed two percent comfort zone. As a political and world-watched scion, maybe it's all designed to cover all possible economic bases within a wide range of possible future statistical reports and global economic events. Then, Bernanke can still claim constant credibility if it has to raise or lower rates, or keep up with the Euro or Mark, or wants to justify its refusal to lower rates when the housing market and its many participants are crying out for relief.

The shift of the pendulum from sublime to subprime seems to have caught the Fed, bank regulators and the U.S. economy by surprise, but sound credit policy, selective supportive action and, even simpler, short-term rate reductions, can prevent the mortgage meltdown from triggering a full-scale epidemic. Especially after tightened lending standards have been retroactively imposed on lenders and borrowers needing to refinance, rate relief is the very least the Fed can do to correct its earlier misjudgments and inaction. It will be much easier for the Fed to provide rate relief than orchestrate a borrower or lender bailout.

That relief needs to be across the board and in addition to any foreclosure deferrals, moratoriums or rate reset holidays granted to pressed homeowners. In this new market of tighter credit and higher lending spreads in commercial real estate and corporate loans, an equivalent reduction will be required in those markets as well.

For Further Reference

Author's Note: The views expressed in this commentary are personal but cannot be claimed to be entirely original. They are based both on observation and information obtained from the published reports of many professional market observers. While my opinions often reflect extensions — logical or otherwise — of the opinions of others, these market sources deserve attribution. Rather than attempt to attribute specific reports or observations, I have listed informative articles and source materials below, for further reference:

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