

# The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown

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## INTRODUCTION

The subprime mortgage crisis, popularly known as the “mortgage mess” or “mortgage meltdown,” came to the public’s attention when a steep rise in home foreclosures in 2006 spiraled seemingly out of control in 2007, triggering a national financial crisis that went global within the year. Consumer spending is down, the housing market has plummeted, foreclosure numbers continue to rise and the stock market has been shaken. The subprime crisis and resulting foreclosure fallout has caused dissension among consumers, lenders and legislators and spawned furious debate over the causes and possible fixes of the “mess.”

### **International Monetary Fund Report**

In its semiannual Global Financial Stability Report released on April 8, 2008, the International Monetary Fund (IMF) said that falling U.S. housing prices and rising delinquencies on the residential mortgage market could lead to losses of \$565 billion dollars. When combining these factors with losses from other categories of loans originated and securities issued in the United States related to commercial real estate, IMF puts potential losses at about \$945 billion.

This was the first time that IMF has made an official estimate of the global losses suffered by banks and other financial institutions in the U.S. credit crunch that began in 2007 amid the rising number of defaults on subprime home loans.

The incredible \$945 billion estimate of losses, made in March, represents approximately \$142 per person worldwide and 4 percent of the \$23.21-trillion credit market. IMF noted in its report that global banks likely will carry about half of these losses. The report cautioned that the loss estimates are just that, estimates, and the actual numbers may be even higher.

In March, Standard & Poor’s had predicted that global banking firms would write off approximately \$285 billion dollars in various securities linked to U.S. subprime real estate, with more than half the losses already recognized. Some analysts have put the figure higher for the subprime market and related losses.

The IMF, whose stated core mission is to promote global financial stability, said there was "a collective failure to appreciate the extent of leverage taken on by a wide range of institutions—banks, monoline insurers, government-sponsored entities, hedge funds—and the associated risks of a disorderly unwinding."

"It is now clear that the current turmoil is more than simply a liquidity event, reflecting deep-seated balance sheet fragilities and weak capital bases, which means its effects are likely to be broader, deeper, and more protracted," the report said.

## Unique Situation

As recently as mid-2007, many experts believed that the crisis would be contained within the arena of mortgage issuers who had overloaded on subprime loans. Few would have predicted that the subprime fallout would be so severe as to threaten the economy to the extent that it has thus far.

While downturns in the mortgage and housing markets have caused economic problems before, experts explain that the current situation is unique. In a 2007 interview, Susan M. Wachter, professor of real estate and finance at Wharton, University of Pennsylvania, said that in the past such events have created downturns in the overall economy through a credit crunch in the banking sector. This would be the first time downturns are driven by a credit crunch in the non-banking sector of finance.

## ROOTS OF THE SUBPRIME CRISIS

There are a number of theories as to what led to the mortgage crisis. Many experts and economists believe it came about though the combination of a number of factors in which subprime lending played a major part.

### Housing Bubble

The current mortgage meltdown actually began with the bursting of the U.S. housing “bubble” that began in 2001 and reached its peak in 2005. A housing bubble is an economic bubble that occurs in local or global real estate markets. It is defined by rapid increases in the valuations of real property until unsustainable levels are reached in relation to incomes and other indicators of affordability. Following the rapid increases are decreases in home prices and mortgage debt that is higher than the value of the property.

Housing bubbles generally are identified after a market correction, which occurred in the United States around 2006. Former Chairman of the Federal Reserve Board, Alan Greenspan, said in 2007 that “we had a bubble in housing,” and that he “really didn’t get it until very late in 2005 and 2006.”

Freddie Mac CEO Richard Syron agreed with Greenspan that the United States had a housing bubble and concurred with Yale economist Robert Shiller’s 2007 warning that home prices “appeared overvalued” and that the necessary correction could “last years with trillions of dollars of home value being lost.” Greenspan also warned of “large double digit declines” in home values, much larger than most would expect.

## Historically Low Interest Rates

Many economists believe that the U.S. housing bubble was caused in part by historically low interest rates. In response to the crash of the dot-com bubble in 2000 and the subsequent recession that began in 2001, the Federal Reserve Board cut short-term interest rates from about 6.5 percent to 1 percent. Greenspan admitted in 2007 that the housing bubble was “fundamentally engendered by the decline in real long-term interest rates.”

Mortgage rates typically are set in relation to 10-year Treasury bond yields, which, in turn, are affected by federal funds rates. The Fed has acknowledged the connection between lower interest rates, higher home values and the increased liquidity that the higher home values bring to the overall economy. In a 2005 report by the Fed, “International Finance Discussion Papers, Number 841, House Prices and Monetary Policy: A Cross-Country Study,” the agency said that house prices, like other asset prices, are influenced by interest rates, and in some countries the housing market is a key channel of monetary policy transmission.

## Criticism of Greenspan

Some have criticized then-Chairman Greenspan for “engineering” the housing bubble, saying it was the Fed’s decline in rates that inflated the bubble. In a December 2007 interview, Greenspan disputes that claim, stating that the housing bubble had far less to do with the Fed’s policy on interest rates than on a global surplus in savings that drove down interest rates and pushed up housing prices in countries around the world.

In March 2007, Greenspan led a Q&A session at the Futures Industry Association’s annual convention. In answer to a question about the causes of the subprime crisis, Greenspan said that it was more an issue of house prices than mortgage credit. The former Fed Chairman said that the increase in subprime lending was new. Subprime borrowers who “came late in the game,” borrowing after prices had already gone up, were not able to build enough equity before interest rates rose.

Despite Greenspan’s argument that low interest rates did not contribute to the housing bubble, Richard W. Fisher, President and CEO of the Federal Reserve Bank of Dallas, has stated that the Fed’s interest rate policy during the period of 2000–2003 was misguided by erroneously low inflation data, thus contributing to the housing bubble. Speaking before the New York Association for Business Economics in November 2006, Fisher said:

A good central banker knows how costly imperfect data can be for the economy. This is especially true of inflation data. In late 2002 and early 2003, for example, core PCE measurements were indicating inflation rates that were

crossing below the 1 percent “lower boundary.” At the time, the economy was expanding in fits and starts. Given the incidence of negative shocks during the prior two years, the Fed was worried about the economy's ability to withstand another one. Determined to get growth going in this potentially deflationary environment, the FOMC adopted an easy policy and promised to keep rates low. A couple of years later, however, after the inflation numbers had undergone a few revisions, we learned that inflation had actually been a half point higher than first thought.

In retrospect, the real fed funds rate turned out to be lower than what was deemed appropriate at the time and was held lower longer than it should have been. In this case, poor data led to a policy action that amplified speculative activity in the housing and other markets. Today, as anybody not from the former planet of Pluto knows, the housing market is undergoing a substantial correction and inflicting real costs to millions of homeowners across the country. It is complicating the task of achieving our monetary objective of creating the conditions for sustainable non-inflationary growth.

## The Bubble Bursts

Between 2004 and 2006, the Federal Reserve Board raised interest rates 17 times, increasing them from 1 percent to 5.25 percent. The Fed stopped raising rates because of fears that an accelerating downturn in the housing market could undermine the overall economy. Some economists, like New York University economist Nouriel Roubini, feel that the Fed should have tightened up on the rates earlier than it did “to avoid a festering of the housing bubble early on.”

Roubini also warned that because of slumping sales and prices in August 2006, the housing sector was in “free fall” and would derail the rest of the economy, causing a recession in 2007.

In August 2006, *Barron's* magazine warned that a housing crisis was approaching and noted that the median price of new homes had dropped about 3 percent since January 2006. At that time the magazine also predicted that the national median price of housing would fall about 30 percent in the next three years.

## Housing Market Correction

Adding to the growing crisis was the prediction by many economists and business writers in 2006 and 2007 that there would be a housing market correction because of the over-

valuation of homes during the bubble period. Estimates ranged from a correction of a few points to 50 percent or more from peak values.

Chief economist Mark Zandi of the economic research firm Moody's Economy.com, predicted a "crash" of double-digit depreciation by 2007-2009. In August 2007, in a paper presented at a Fed economic symposium, Yale University economist Robert Shiller warned that "past cycles indicate that major declines in real home prices—even 50 percent declines in some places—are entirely possible going forward from today or from the not too distant future."

## The Rise of Subprime Lending

Subprime borrowing was a major factor in the increase in home ownership rates and the demand for housing during the bubble years. The U.S. ownership rate increased from 64 percent in 1994 to an all-time high peak of 69.2 percent in 2004. The demand helped fuel the rise of housing prices and consumer spending, creating an unheard of increase in home values of 124 percent between 1997 and 2006. Some homeowners took advantage of the increased property values of their home to refinance their homes with lower interest rates and take out second mortgages against the added value to use for consumer spending. In turn, U.S. household debt as a percentage of income rose to 130 percent in 2007, 30 percent higher than the average amount earlier in the decade.

With the collapse of the housing bubble came high default rates on subprime, adjustable rate, "Alt-A" and other mortgage loans made to higher-risk borrowers with lower income or lesser credit history than "prime" borrowers. Alt-A is a classification of mortgages in which the risk profile falls between prime and subprime. The borrowers behind these mortgages typically will have clean credit histories, but the mortgage itself generally will have some issues that increase its risk profile. These issues include higher loan-to-value and debt-to-income ratios or inadequate documentation of the borrower's income.

The share of subprime mortgages to total originations increased from 9 percent in 1996 to 20 percent in 2006 according to Forbes. Subprime mortgages totaled \$600 billion in 2006, accounting for approximately one-fifth of the U.S. home loan market. An estimated \$1.3 trillion in subprime loans are outstanding.

The number of subprime loans rose as rising real estate values led to lenders taking more risks. Some experts believe that Wall Street encouraged this type of behavior by bundling the loans into securities that were sold to pension funds and other institutional investors seeking higher returns.

## Declining Risk Premiums

A Federal Reserve study in 2007 reported that the average difference in mortgage interest rates between subprime and prime mortgages declined from 2.8 percentage points in 2001 to 1.3 percentage points in 2007. This means that the risk premium required by

lenders to offer a subprime loan declined. This decline occurred even though subprime borrower and loan characteristics declined overall during the 2001-2006 period, which should have had the opposite effect. Instead, the decline of the risk premium led to lenders considering higher-risk borrowers for loans.

## New Kind of Lender Emerges

Some economists blame the emergence in the boom years of a new kind of specialized mortgage lender for fueling the mortgage crisis. These lenders were not regulated as are traditional banks. In the mid-1970s, traditional lenders carried approximately 60 percent of the mortgage market. Today, such lenders hold about 10 percent. During this time period, the share held by commercial banks had grown from virtually zero to approximately 40 percent of the market.

## Risky Mortgage Products and Lax Lending Standards

Along with the rise of unregulated lenders came a rise in the kinds of subprime loans that economists say have sounded an alarm. The large number of adjustable rate mortgages, interest-only mortgages and “stated income” loans are an example of this thinking.

“Stated income” loans, also called “no doc” loans and, sarcastically, “liar loans,” are a subset of Alt-A loans. The borrower does not have to provide documentation to substantiate the income stated on the application to finance home purchases. Such loans should have raised concerns about the quality of the loans if interest rates increased or the borrower became unable to pay the mortgage.

In many areas of the country, especially those areas with the highest appreciation during the bubble days, such non-standard loans went from being almost unheard of to prevalent. Eighty percent of all mortgages initiated in San Diego County in 2004 were adjustable-rate, and 47 percent were interest-only loans.

In addition to increasingly higher-risk loan options like ARMs and interest-only loans, lenders increasingly offered incentives for buyers. An estimated one-third of ARMs originated between 2004 and 2006 had “teaser” rates below 4 percent. A “teaser” rate, which is a very low but temporary introductory rate, would increase significantly after the initial period, sometimes doubling the monthly payment.

Programs such as seller-funded downpayment assistance programs (DPA) also came into being during the boom years. DPAs are programs in which a seller gives money to a charitable organization that then gives the money to buyers. From 2000 to 2006, more than 650,000 buyers got their downpayments via nonprofits. According to the Government Accountability Office (GAO), there are much higher default and foreclosure rates for these types of mortgages. A GAO study also determined that the sellers in DPA programs inflated home prices to recoup their contributions to the nonprofits.

In May 2006, the Internal Revenue Service ruled that DPA plans are no longer eligible for non-profit status because of “the circular nature of the cash flows, in which the seller pays the charity a ‘fee’ after closing.” On Oct. 31, 2007, the Department of Housing and Urban Development adopted regulations banning seller-funded downpayment programs.

## Moral Hazard Led to Lax Standards

Some experts believe that mortgage standards became lax because of a “moral hazard,” where each link in the mortgage chain collected profits while believing it was passing on risk. Mortgage denial rates for conventional home purchase loans reported under the Home Mortgage Disclosure Act, dropped from 29 percent in 1998 to 14 percent in 2002 and 2003.

## Mortgage Brokers and Underwriters

Because mortgage brokers do not lend their own money, there is no direct correlation between loan performance and compensation for them. Brokers also have financial incentive for selling complex ARMs because they earn higher commissions on them.

One study has found that in 2004, mortgage brokers originated 68 percent of all residential loans in the United States, with subprime and Alt-A loans accounting for over 42 percent of the volume. The Mortgage Bankers Association has claimed that brokers profited from the home loan boom but didn’t do enough to determine whether borrowers could repay the loans, leaving lenders and banks with resulting defaults.

Mortgage underwriters determine if the risk of lending to a borrower under certain parameters is acceptable. Most of the risks and terms considered by underwriters fall under three categories—credit, capacity and collateral.

In 2007, 40 percent of all subprime loans were generated by automated underwriting. Automated underwriting meant minimal documentation and much quicker decisions, sometimes as soon as within 30 seconds as opposed to the week it would take for an underwriter to generate a decision. An executive vice-president for Countrywide Home Loans also noted in 2004 that “previously, every mortgage required a standard set of full documentation.”

Many experts believe that lax controls and a willingness to rely on shortcuts led to the approval of buyers that under a less-automated system would not have been approved.

## Securitization

*Black’s Law Dictionary* defines securitization as a structured finance process in which assets, receivables or financial instruments are acquired, classified into pools and offered as collateral for third-party investment. Due to securitization, investor appetite for

mortgage-backed securities (MBS) and the tendency of rating agencies to assign investment-grade ratings to MBS, loans with a high risk of default could be originated, packaged and the risk readily transferred to others.

Asset securitization began with the structured financing of mortgage pools in the 1970s, according to the Office of the Comptroller of the Currency's *Asset Securitization Comptroller's Handbook*. The securitized share of subprime mortgages, those passed to third-party investors, increased from 54 percent in 2001, to 75 percent in 2006. In a speech given in London in October 2007, Alan Greenspan, while defending the U.S. subprime mortgage market, said that the securitization of home loans for people with poor credit—not the loans themselves—were to blame for the mortgage meltdown.

## Credit Rating Agencies

Credit rating agencies are now under scrutiny for giving investment-grade ratings to securitization transactions holding subprime mortgages. Higher ratings theoretically were due to the multiple, independent mortgages held in the mortgage-backed securities, according to the agencies. Critics claim that conflicts of interest were involved, as rating agencies are paid by those companies selling the MBS to investors, such as investment banks.

In a 2007 speech Greenspan made in London he implicitly criticized the role of ratings agencies in the crisis.

"The problem was that people took that as a triple-A because ratings agencies said so." Yet when they tried to sell the products they ran into difficulties, which shook confidence. "What we saw was a 180 degree swing from euphoria to fear and what we've learned over the generations is that fear is a very formidable challenge."

As of November 2007, credit rating agencies had downgraded over \$50 billion in highly-rated collateralized debt obligations and more such downgrades are possible. Since certain types of institutional investors are allowed to only carry higher-quality assets, there is an increased risk of forced asset sales, which could cause further devaluation.

Ratings agencies such as Standard & Poor's Corp., Moody's Investors Service Inc. and Fitch Ratings have come under fire for being slow to lower their ratings on securities based on mortgage loans to U.S. borrowers with poor credit records.

## Economists Say Borrowers Played a Role in Crisis

Easy credit and the assumption that housing prices would continue to appreciate encouraged many subprime borrowers to obtain ARMS that they could not afford after the initial incentive period had passed. Once housing prices started to decrease, due to the

housing market correction and the bursting of the housing bubble, refinancing, readily available during the boom, became much more difficult. Homeowners who could not refinance started to default on their loans as the loans reset to higher interest rates and payment amounts. Some homeowners chose to stop paying their mortgages and just walk away from their homes, allowing foreclosure of the property.

George Mason University economics professor Tyler Cowen said in January 2008, that “[t]here has been plenty of talk about predatory lending, but predatory borrowing may have been the bigger problem.”

As much as 70 percent of recent early payment defaults had fraudulent misrepresentations on their original loan applications, according to BasePoint Analytics, a company that assists lenders and banks to identify fraudulent transactions. A study done by the company analyzed over three million loans dating from 1997 to 2006, with a majority of the loans originating in 2005 and 2006. Applications with misrepresentations were determined to be five times as likely to go into default. The study found that many of the misrepresentations were quite simple. Some borrowers simply lied about their incomes, reporting up to five times their actual earnings. Other borrowers used false income documents created on their computers.

Suspicious Activity Reports of mortgage fraud increased by 1,411 percent between 1997 and 2005, according to the Financial Crimes Enforcement Network.

## **Legislators Blame Fed**

At a Senate Banking Committee hearing held in March 2007, “charges of blame were flying . . . for the meltdown of the high-risk mortgage market,” according to the Associated Press. Congress was feeling mounting pressure to fix the problem of rising foreclosures among homeowners unable to make their mortgage payments.

“What we’re looking at is a tsunami of foreclosures that is on the horizon,” Sen. Robert Menendez, D-N.J., said.

Members of the committee blamed federal regulators for much of the mortgage crisis. Sen. Christopher Dodd, D-Conn., Chairman of the Senate Banking Committee, laid out what he termed a “chronology of regulatory neglect” as banks and other lenders “loosened their standards for making riskier mortgage loans” during the housing boom.

“Our nation’s financial regulators were supposed to be the cops on the beat, protecting hardworking Americans from unscrupulous financial actors,” Dodd said. “Yet they were spectators for far too long.

Regulators said that they lacked full authority to prevent the crisis that began with the soaring housing boom. Many mortgage lenders had not been under the Fed’s supervision because their primary regulators were state banking authorities. Dodd and others argued,

however, that the central bank does have authority under federal law to exert jurisdiction over these lenders and to broaden lending regulations to cover them.

## Did Fed Fail?

In December 2007, the *New York Times*, in an article written by Edmund L. Andrews, accused the Fed of doing nothing as the subprime crises grew. According to the article, Edward M. Gramlich, a Fed governor who died in September 2007, had been warning of just such a crisis since 2000. Gramlich felt that a “fast-growing new breed of lenders was luring many people into risky mortgages they could not afford.”

Gramlich claimed that when he approached then Fed Chairman Alan Greenspan with his fears, he was “rebuffed.”

In 2004, leaders of a housing advocacy in California, a state hit early and hard by the subprime meltdown, met with Greenspan to warn him of the spread of unscrupulous practices by lenders. John C. Gamboa and Robert L. Gnaizda of the Greenlining Institute asked Greenspan to press lenders for a voluntary code of conduct. Gnaizda reported in December 2007 that Greenspan “never gave us a good reason, but he didn’t want to do it.”

“He just wasn’t interested,” Gnaizda added.

Greenspan defended his actions, saying that the Fed was not equipped to investigate deceptive lending and that it was not to blame for the housing bubble and its eventual bust. The former chairman noted that the Fed’s accountants and bank examiners were ill-suited to investigate fraud, which is “essentially an enforcement action, and the question is, who are the best enforcers?” he asked. “A large enough share of these cases are fraud, and those are areas that I don’t think accountants are best able to handle.”

In his memoir, *The Age of Turbulence: Adventures in a New World*, Greenspan wrote that “I was aware that the loosening of mortgage credit terms for subprime borrowers increased financial risk.” However, he “believed then, as now, that the benefits of broadened home ownership are worth the risk.”

## Government and Federal Regulatory Policies

Some economists have suggested that government policy encouraged the development of the subprime meltdown through legislation like the Community Reinvestment Act, which they claim forces banks to lend to uncreditworthy consumers. Economist Robert Kuttner criticized the repeal of the Glass-Steagall Act as contributing to the mortgage crisis. Others have noted that a taxpayer-funded government bailout related to mortgages during the Savings and Loan crisis may have created the above-mentioned moral hazard and acted as encouragement to lenders to make similar higher-risk loans.

Changes in the reserve requirements of U.S. banks and the creation in 1994 of special “sweep” accounts that link commercial checking and investment accounts allowed banks greater liquidity. This meant that they could offer more credit. From 2001 to 2002, in the wake of the dot-com crash, the Federal Reserve Funds Rate was reduced from 6 percent to 1.24 percent, leading to similar cuts in the London Interbank Offered Rate that banks use to set some ARM rates. Drastically lowered ARM rates meant that in the United States the monthly cost of a mortgage on a \$500,000 home fell to about the monthly cost of a mortgage on a \$250,000 home purchased two years earlier. Demand skyrocketed and the housing bubble was born.

## SUBPRIME FALLOUT

By 2005, the housing bubble had burst and federal interest rates had climbed. Foreclosures of homes purchased with subprime loans had risen drastically, and there was every indication that they would continue to climb. Despite these warning signs, subprime mortgages continued to gain in popularity. In Massachusetts, for example, subprime loans fueled by refinancings grew from 1.6 percent of mortgages in 2000 to 12.3 percent by August 2005.

With the subprime industry’s growth came problems for homeowners. Subprime lenders foreclose on properties much more frequently than do conventional lenders. The prevalence of subprime loans contributed to a 31-percent spike in foreclosure filings in the first half of 2006. Economists in Boston warned that if home prices fell, these subprime loans would accelerate a downturn as overleveraged homeowners throw their homes on the market or lenders sell foreclosed properties at bargain basement prices.

## Collapse of Subprime Mortgage Industry

Another bad omen for the housing market was the collapse of the subprime mortgage industry in early 2007.

By early January 2007, the United States’ subprime mortgage industry started to show signs of collapsing from higher-than-expected home foreclosure rates.

As homeowners fell behind in their mortgage payments in ever-growing numbers, foreclosures continued to rise and interest rates rose to their highest level in years. These conditions left subprime lenders unable to finance new loans.

Due to the collapsing subprime market, Ameriquest, formerly the country’s largest subprime lender, closed its doors and laid off 3,800 employees. In addition to the plunge in the housing market, Ameriquest made a \$325 million settlement with 30 states’ Attorneys General over deceptive marketing and lending practices.

Economists saw the failures of subprime lenders as bad omens for the housing market as a whole.

A Center for Responsible Lending (CRL) study in 2007 found that one in five subprime loans issued during 2005-2006 would fail, leaving two million homeowners at risk for foreclosure. The CRL study placed much of the responsibility on the marketing of risky “creative” mortgage products such as adjustable-rate mortgages to consumers with bad or no credit or bad financial histories.

## **Industry Analysts Warn Subprime Collapse Not Isolated Event**

By March 2007, the U.S., subprime mortgage industry had collapsed. More than 25 subprime lenders had declared bankruptcy, announced significant losses or put themselves up for sale. The stock of the nation’s largest subprime lender, New Century Financial, plunged 84 percent amid Justice Dept. investigations before filing for Chapter 11 bankruptcy on April 2, 2007, with liabilities exceeding \$100 million.

The manager of the world’s largest bond fund, PIMCO, stated in June 2007, that the subprime mortgage crisis was not an isolated event and would eventually take a toll on the economy. The meltdown’s greatest impact, he said, would be on the impaired prices of homes.

By mid-2007, financial analysts were predicting that the subprime mortgage market meltdown would result in earnings reductions for large Wall Street investment banks trading in mortgage-backed securities, especially Bear Stearns, Lehman Brothers, Goldman Sachs, Merrill Lynch and Morgan Stanley.

Lou Ranieri of Salomon Brothers, inventor of the mortgage-backed securities market in the 1970s, warned of the future impact of mortgage defaults, saying “This is the leading edge of the storm . . . If you think this is bad, imagine what it’s going to be like in the middle of the crisis.”

In Ranieri’s opinion, more than \$100 billion in home loans were likely to default once the problems in the subprime industry appeared in the prime mortgage markets.

## **Impact on Stock Markets, Other Industries**

On July 19, 2007, the Dow Jones Industrial Average hit a record high, closing above 14,000 for the first time. By Aug. 15, 2007, the Dow had dropped below 13,000, and the S&P had crossed into negative territory year-to-date. Similar drops occurred in virtually every market in the world. Large daily drops became common, with, for example, the Korea Composite Stock Price Index dropping about 7 percent in one day. 2007’s largest daily drop by the Standard & Poor’s 500 in the United States was in February 2007, and was a direct result of the subprime crisis.

Many banks, mortgage lenders, real estate investment trusts and hedge funds suffered significant losses as a result of mortgage payment defaults or mortgage asset devaluation. As of Dec. 21, 2007, financial institutions had recognized subprime-related losses or write downs exceeding \$80 billion, with an additional \$8-11 billion expected from Citibank.

Mortgage lenders and home builders were hard hit, and losses cut across sectors, with some of the worst-hit industries, such as metal and mining companies, having only the vaguest of ties with lending or mortgages.

## **Problems with Alt-A Mortgages Appear**

In April 2007, financial problems similar to the subprime mortgages began to appear with Alt-A loans made to homeowners who were considered to be less risky. Alt-A loans fall in between prime and subprime loans.

American Home Mortgage said that it would earn less and pay out a smaller dividend to its shareholders because it was being asked to buy back and write down the value of Alt-A loans made to borrowers with decent credit. This caused company stocks to tumble 15.2 percent. American Home Mortgage filed for bankruptcy in August 2007.

The delinquency rate for Alt-A mortgages had been rising in 2007. In June 2007, Standard & Poor's warned that U.S. homeowners with good credit increasingly were falling behind on mortgage payments, an indication that lenders had been offering higher-risk loans outside the subprime market. S&P said that rising late payments and defaults on Alt-A mortgages made in 2006 are "disconcerting," and delinquent borrowers appear to be "finding it increasingly difficult to refinance" or catch up on their payments.

## **Foreclosures on the Rise**

It was reported in August 2007 that the number of residential mortgage foreclosures jumped 9 percent from June to July 2007, surging a whopping 93 percent over July 2006. The monthly U.S. Foreclosure Market Report from RealtyTrac, an online marketplace for foreclosed properties, showed a total of 179,599 foreclosure filings in July 2007.

Foreclosure activity jumped a staggering amount in August 2007, soaring 115 percent over August 2006 and 36 percent over July 2007. RealtyTrac reported that August was the busiest month since it began issuing a monthly report in January 2005.

The report indicated that the national foreclosure rate had swelled to one foreclosure filing for every 520 households, representing the highest figure ever issued in the report.

"The jump in foreclosure filings this month might be the beginning of the next wave of increased foreclosure activity, as a large number of subprime adjustable rate loans are beginning to reset now," predicted Saccacio.

"Another significant factor in the increased level of foreclosure activity is that the number of REO filings (bank repossessions) is increasing dramatically, which means that a greater percentage of homes entering foreclosure are going back to the banks."

## MBA Report

RealtyTrac's numbers align with an August 2007 report from the Mortgage Bankers Association (MBA). The MBA found that incidents of foreclosure for the second quarter of 2007 were at their highest rates in the organization's 55-year history.

In discussing the August 2007 report, MBA Senior Vice-President and Chief Economist Doug Duncan pointed to the continuing collapse of formerly hot housing markets in California, Nevada, Florida and Arizona as responsible for extending the foreclosure epidemic.

"Were it not for the increases in foreclosure starts in those four states, we would have seen a nationwide drop in the rate of foreclosure filings," Duncan said.

Duncan noted that "The four states of California, Florida, Nevada and Arizona have more than one-third of the nation's subprime ARMs, more than one-third of the foreclosure starts on subprime ARMs, and are responsible for most of the nationwide increase in foreclosure actions."

## Subprime Loans Set to "Reset"

Much of the high-risk lending that helped drive the housing boom dried up in the summer of 2007 when investors backed away from these loans after tens of billions of dollars worth of mortgage-backed paper all but disappeared. Economists say that the credit scare has chilled all mortgage lending, threatening to prolong the ongoing housing slump.

Countrywide Financial said in November 2007 that it had financed \$22 billion worth of home loans in October, down 48 percent from November 2006. The lender, which was one of the biggest suppliers of subprime loans to borrowers with risky credit backgrounds, said it wrote \$42 million worth of subprime loans in October 2007. That figure was down \$3 billion from 2006.

Although lenders reported in late 2007 that they were avoiding stretched borrowers with risky credit, economists warned that millions of existing loans with two- and three-year introductory "teaser" rates would begin resetting in 2008.

Federal Reserve Board Chairman Ben Bernanke told Washington lawmakers in November 2007 that nearly 2.3 million subprime mortgages would reset at higher rates through the end of 2008. An estimated one million to two million borrowers would be unable to avoid foreclosure, Bernanke said.

When foreclosures cannot be avoided, borrowers lose their homes. The losses also extend beyond borrowers. The foreclosure process typically costs lenders added legal fees, taxes due until the property is sold and lost equity in a house that must be priced to sell in a falling market. The added inventory of unsold homes further weakens local housing markets, depressing the value of other nearby homes.

## **U.S. Conference of Mayors Adds to Gloom of Subprime Meltdown**

In what many economists called “the grimdest assessment to date,” the U.S. Conference of Mayors reported at the end of November 2007 that the subprime mortgage meltdown and resulting foreclosure fallout would have massive economic consequences for the nation’s 361 metro areas.

The mayors’ report projected \$166 billion in lost gross domestic product growth, stemming from plunging real estate values.

The report, prepared by the economic and financial analysis firm Global Insight, projected that the foreclosure crisis would result in 524,000 fewer jobs being created in 2008 and a potential loss of \$6.6 billion in tax revenues in 10 states.

“Not that long ago economists said housing was the backbone of our economy,” Mayors Conference President Doug Palmer, Mayor of Trenton, N.J., said at a meeting of mayors, mortgage industry representatives and community advocates in Detroit shortly after the release of the report.

“Today the foreclosure crisis has the potential to break the back of our economy, as well as the backs of millions of American families, if we don’t do something soon,” Palmer said.

## **Foreclosures Hit New Record in Third Quarter 2007**

Home foreclosures shot up to an all-time high in third quarter 2007. The Mortgage Bankers Association (MBA) in its quarterly snapshot of the mortgage market released on Dec. 6, 2007, reported that the percentage of all mortgages nationwide that started the foreclosure process jumped to a record high of 0.78 percent in the third quarter.

Homeowners with adjustable rate mortgages were especially hard hit. The percentage of subprime ARMs that entered the foreclosure process soared to a record 4.72 percent, up from 3.84 percent in the second quarter. Late payments also reached a record high.

MBA's Doug Duncan stated that:

As conditions in the housing finance market continue to deteriorate, several factors are clear:

- This is the first quarter which registers the full combined effects of the seizure of the nonconforming securitization market, broad-based home price declines, continued weakness in some regional economies and rate adjustments on monthly payments. The predictable results are increased delinquency and foreclosure.
- In areas where the supply of homes far exceeds demand at current prices, home prices are falling and leading to more foreclosures. In Michigan and Ohio the problem continues to be the declines in demand due to drops in employment and population that have left empty houses in cities like Cleveland, Detroit and Flint. In states like California, the problem is excess supply due to speculative over-building and properties coming back onto the market.
- While subprime ARM delinquencies and foreclosures are climbing in all states, in most states the actual number of loans involved is fairly modest. For example, the number of subprime ARM foreclosure starts in California during the third quarter equaled the starts in 35 other states combined.
- While this quarter's numbers show the highest level of foreclosure starts (on a seasonally adjusted basis) for prime fixed rate mortgages in the last 10 years, that increase is largely due to increases in Florida, Ohio, Michigan and California. In most states the increase in prime fixed rate foreclosure starts is due to borrowers who will fall behind on their payments for the traditional reasons (employment, medical, marital, etc.) but who cannot sell their homes due to market conditions.

## Moody's Reports Home Prices Could Fall Further

In addition to the dire reports on delinquency and foreclosure numbers for third quarter 2007 was a warning issued by Moody's Economy that the national average value of homes in the United States is likely to drop further before rebounding. The report, issued by the financial service in December 2007, indicated that the housing market will not begin to recover until 2010.

Nationwide, the price of the average home was forecast by Moody's at the end of 2007 to fall 13 percent from their 2005 peaks through early 2009. The report added that further incentives might be required to sell some property, which could push the average decline to as low as 15 percent.

## Housing Market Continues to Fall in 2008

In late March 2008, it was reported that Standard & Poor's/Case-Shiller index showed that U.S. home prices fell another 11.4 percent in January 2008, the housing market's steepest drop since S&P started collecting data in 1987.

Economists say the decline means prices have been growing more slowly or dropping for 19 consecutive months. The index tracks the prices of single-family homes in 10 major metropolitan areas in the United States.

A broader 20-city composite index also is down, falling 10.7 percent in January from a year ago. This is the first time that both indexes dropped by double-digit percentages, according to S&P.

Sales of new homes fell in February 2008 for the fourth straight month, pushing activity down to a 13-year low. The Commerce Department reported on March 25, 2008, that new home sales dropped 1.8 percent in February to a seasonally-adjusted annual rate of 590,000 units, the slowest sales pace since February 2005.

The median price of a home sold in February dropped to \$244,100, down 2.7 percent from a year ago.

Many economists and analysts believe that the prolonged housing slump has dragged overall economic activity down with it. Many say that the slump, combined with other problems including a severe credit crunch, high energy prices and low consumer confidence, could drive the country into a full-blown recession.

## Prime Borrowers Hit Hard

As home prices continue to fall and banks tighten their lending standards, people with prime credit histories now are falling behind on their payments for home loans, auto loans and credit cards.

Like subprime mortgages, many prime loans made in recent years allowed borrowers to pay less initially and face higher adjustable payments a few years later. As long as home prices continued to rise, prime borrowers could refinance their loans or sell their properties to pay their mortgages. With falling prices and stricter lending standards, homeowners with solid credit histories are starting to come under the same financial stress as those with subprime credit.

## Home Equity Falls to New Low

The Federal Reserve Board reported on March 5, 2008, that Americans' percentage of equity in their homes has fallen below 50 percent for the first time on record.

Homeowners' percentage of equity declined to 47.9 percent in the fourth quarter of 2007—the third straight quarter it was under 50 percent. The decline means that for the first time since the Fed starting tracking the data, in 1945, homeowners' debt on their houses exceeds their equity.

Economists expect the figures to drop even further as declining home prices strike at the value of most Americans' single largest asset.

Moody's Economy estimated that 8.8 million homeowners, or about 10.3 percent of homes, would have zero or negative equity by the end of March 2008.

## U.S. Crisis Sends Global Stocks Plunging

The subprime meltdown affecting the United States went global when stock markets around the world plummeted on Jan. 21, 2008. U.S. markets were closed for Martin Luther King Jr. Day, but all the world's other major economies experienced a sell-off. Stock prices fell more than 7 percent in Germany and India, 5.5 percent in Britain, 5.1 percent in China and 3.9 percent in Japan. Many countries reported their worst market declines since Sept. 11, 2001.

Analysts said that the markets fell as fears spread that massive losses on loans made to U.S. home buyers would cascade through the world financial system.

LaSalle Bank Chief Economist Carl Tannenbaum said the sudden wave on January 22 was hard to explain. "Much of the blame was placed on recession fears, but those fears have been expressed many times in recent weeks."

Tannenbaum said that there was no single trigger to the huge sell-off. However, other analysts believe that the biggest fear factor was a new wave of pessimism about the global banking sector.

First Trust Advisors L.P. Chief Economist Brian Wesbury said part of the problem stemmed from a major downgrade of a firm that insures municipal debts. When such debt is marked lower, banks are forced to write it down against their capital.

“This affects the ability of banks to lend, and it helped to create an overreaction among investors overseas,” Wesbury stated. “There is an incredible amount of fear in the world,” he added, even though he said that most economies remain robust. Wesbury felt that the fears were based in part on worries that derivative instruments could default.

Wesbury said that he believes such fears are “overblown,” but that they have become widespread.

Comments about the possibility of a recession by President Bush and Federal Reserve Chairman Ben Bernanke “may have helped to incite anxiety, even though we have a very sturdy and resilient economy,” he added.

## **Mortgage Meltdown Inflicts Collateral Damage**

As delinquencies and foreclosures rise and housing prices fall, the range of victims continues to broaden. Homeless rates are rising as families lose their own homes to foreclosure.

Renters also are suffering the effects of the crisis as landlords face foreclosures. RealtyTrac estimates that more than 20 percent of foreclosures involve investment properties. When landlords lose their properties, tenants lose their homes. Homeless shelters say that they are unprepared for the large numbers of people who have lost their homes because of foreclosure or landlord defaults and now are homeless.

Financial analysts warn that state and local governments will soon feel the effects of the resulting reduction in property tax revenue. “The housing market has put a big negative for local government revenues across the board,” said Stephen Levy, Director of the Center for Continuing Study of the California Economy in Palo Alto.

For example, the nonprofit Center for Responsible Lending warns that California could lose nearly \$3 billion in property tax revenue and another \$1 billion in sales and transfer tax revenue because of foreclosures.

“Property tax revenues are going to be a lot less than local governments built into their budgets, and there are going to be tough times at the local level,” Levy said.

Atlanta City Council member Mary Norwood noted that property tax revenues also would take a hit because foreclosed homes bring down property values in a neighborhood, leading to lower assessments on people who do pay taxes. Norwood said that neighborhoods with a number of foreclosed properties experience vandalism and house deteriorations that affect the property values of other homeowners in the community.

The ripple effect illustrates the wide-ranging impact the subprime mortgage crisis has had not only on the U.S. economy but on society in general.

## Conclusion

Economists and analysts have come to understand the causes of the subprime crisis. The resulting fallout of the mortgage crisis has been well-documented. Legislators, regulators, industry insiders and others have witnessed its devastating effect on U.S. and global economies. But the most crucial issue of the crisis still looms: what steps must be taken to “fix” the “mess?”

Resolving this issue has created a firestorm of dissension and debate among state and federal legislators, federal regulators, lenders and industry insiders. Criticism of proposed fixes is rife in the media, and economists and financial analysts have been divided over the plausibility of the cleanup theories.

As of publication, the questions remain unanswered.