The Real Estate Bubble, Subprime Loans, and International Finance.

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The media is replete with articles and data about how subprime mortgages are hurting homeowners, lenders, investors, the U.S and international economies. The media reports involve wide ranging and complex issues. The problems run the gamut from individual homeowners losing their homes through mortgage fraud or through various forms of unaffordable gimmick mortgages, to the plight of international investment funds that have made loans to hedge funds that have used collateralized pools of dubious sub-prime or Alt A (a mortgage also with a high risk factor) mortgages as security. Surprisingly, even with all of the media reports, regulatory, and congressional investigations, at this point in time the true nature and extent of how sub-prime and other forms of subprime related securities were transformed into other forms of debt, remains to be seen.

Subprime mortgages were targeted to inexperienced borrowers who could not (or believed that they could not) qualify for prime mortgages. Subprime mortgage have fees and interest rates that are substantially higher than those of prime mortgages. For example, the commissions earned when originating subprime mortgages ranged up to 3%, while the origination fee on prime mortgages was 1% and the interest rate on subprime mortgages ranged up to 6% higher that its prime mortgage counterpart. Because of these high interest rates and fees, the return for subprime mortgage investors was substantial. Given the strong housing market, investors in the subprime funds believed that they were facing little or no risk. Unfortunately, mortgage delinquency and foreclosure rates have soared.

In 2000, $150 billion in subprime mortgages were underwritten. As a result of their profitability and low risk appearance, by 2005 annual subprime mortgage originations had climbed to $650 billion. A heightened competitive spirit in the lending community accompanied the rapid growth in subprime mortgages, buyers and refinancing homeowners were offered a wider-ranging variety of mortgage financing gimmicks to entice them into new mortgages. The gimmick mortgages included zero down payments, low adjustable interest rates that would reset after a few years, mortgage qualification without employment, credit checks, or income verification, and the ability to defer payments or pay only the mortgage interest. Mortgage fees were built into the loan amount making the financing or refinancing that much easier.

It is fairly easy to trace the steps that brought the housing and credit markets to their current positions. From 2001 to 2006 home prices increased 50% nationally. In the 13 county Twin Cities area, the median home price increased from $ 124,900 in 1998 to $225,000 at the beginning of 2008. In 2000, the amount of subprime mortgage financing nationally was about $150 billion. By 2005, U.S. subprime mortgage originations grew to over $650 billion annually. The estimated amount of U.S. subprime mortgages range from $1.5 trillion to $2 Trillion. About 50% of the subprime mortgages are securitized, in effect spreading the risk to banks and investors.

Securitization fueled the rapid growth in subprime mortgages. Wall Street firms purchased subprime mortgages from the originating lenders and repackaged the mortgages as Asset Backed Securities (ABS) sold to banks, conduits and investors. The subprime ABS were often combined with other debt instruments and took on the form of Collateralized Debt Obligations (CDO). Because of the unjustified high grade (AAA) which was typically given to CDO bonds, the bondholders could use the bonds as collateral for short term financing and commercial paper. The rating agencies concurred that the subprime mortgages were safe and because the securities were comprised of large diversified pools of low and high risk debt, ratings were unjustifiably high. The rating agencies (Moodys Investors Services, Standard and Poor's and Finch Ratings) have since lowered their expectations on the value of the subprime mortgage funds. But this was too late. The investors holding the ABS and CDOs needed the subprime mortgage payments to meet their own respective principal and interest payments. When subprime mortgage defaults increased, the cash flow chain was broken and ignited investor panic. Commercial paper investors ran from the structured debt market creating the current liquidity crisis.

When the problems with defaults on sub-prime loans first surfaced last summer, the European Central Bank stated that the crisis could potentially be as devastating as conditions of the depression in the 1930s. This strong comment received little media attention. Since then the European Central Bank, and the Federal Reserve Bank, have made vast sums of money available to maintain the flow of credit and prevent a world wide recession. So far this has worked, but the underlying problems of the sub-prime mortgage defaults and the resetting of adjustable rate mortgages will continue to present challenges to the banking systems and investors for the next few years. The subprime mortgage default problem is international in scope. Indeed, a good illustration of this is that in Cleveland, a city hurt by subprime lending and in which one out of every ten homes is in foreclosure, Deutsche Bank Trust, acting for bondholders, is the largest residential property owner in the City.

The sub-prime mortgage default problems and its ramifications for investors are similar to events of the late 1920s where investment trusts, using at that time a new vogue term called "high leverage," created huge paper profits. One 1920s investment trust, United Founders Corporation, built a company worth over $686 million on a $500 investment and another trust had assets over $1 billion---but its major holding was an electrical company that was valued at $6 million in 1921. Providing credit for subprime mortgages without sound mortgage underwriting, like the almost pure speculation of the late 1920s, works in reverse once a market breaks.

Where do we go from here? Over the next few years we will continue to see a correction in housing prices. The decline in home prices will vary substantially throughout the country. Markets that had steep increases in prices, high levels of investor speculation, or face regional economic problems, will adjust by the greatest degree. Homeowners who purchased their properties at the high point of the market, will be hurt the most. Gimmick mortgages will continue to contribute to the housing bubble. This will be most common in subprime and prime adjustable rate mortgages that will reset over the next two years from their initial low interest teaser rates to a current market rate. If a property cannot be sold and the owners cannot qualify for refinancing, the property will likely go into foreclosure and contribute to a downward trend in home prices. While several federal and private sector programs will soon be underway, the two issues that will present themselves are the immense cost to correct the problem and the ability of troubled housing consumers to qualify for mortgage financing under any terms. The high foreclosure rates in states like Michigan and Ohio are in large part a reflection of employment and the economy. The role and effectiveness of the government sponsored Fannie Mae and Freddie Mac also remains to be seen. Both agencies reported losses in 2007 and have small combined capital reserves ($65 Billion) supporting over $3 trillion in mortgages.

The housing bubble has had a direct impact on new home construction and we can expect to see employment and construction related manufacturing impacts. The housing bubble will have an effect on durable goods purchases but also may creep into retail spending where consumers, aware of their loss of wealth reflected in property and investment values, cut back on discretionary purchases. What is unknown is how financial derivative contracts, the value of which is derived from underlying assets (stocks, bonds or securities), will be affected by mortgage foreclosures. Derivatives have increased from about $6 trillion in 1990 to about $380 trillion in 2006 and have a substantial presence in subprime and other home mortgages. The answer to this question has yet to unfold. But in a financial environment which allows the securitization of just about anything from home mortgages and car loans to the recording royalties of the Rolling Stones, expect the unexpected. In 2002, Warren Buffett described speculative derivatives as “financial weapons of mass destruction.”