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America's housing market

Cracks in the façade

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America's riskiest mortgages are crumbling. How far will the damage spread?

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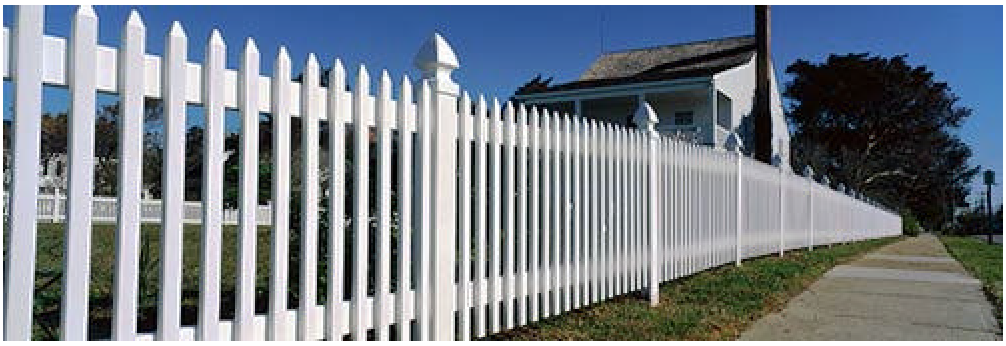

CASEY SERIN knows all about the excesses of America's housing bubble. In 2006 the 24-year old web designer from Sacramento bought seven houses in five months. He lied about his income on "no document" loans and was not asked for anything so old-fashioned as a deposit. Today Mr Serin has debts of $2.2m. Three of his houses have been repossessed; others could share that fate. His website, Iamfacingforeclosure.com, has become a magnet for those whose mortgages are in trouble.

Mr Serin and people like him are Wall Street's biggest uncertainty just now. How many Americans are saddled with mortgages they cannot afford on houses that are losing value? The answer matters to anyone who bought high-yielding mortgage-backed securities when a booming property market made mortgages look safe. It also matters to investment banks, which packaged the securities and often own subsidiaries that originate mortgages. It may determine whether America's economy falls into recession. It could even affect the outcome of next year's elections.

Most of the damage so far is in the "subprime" mortgage market, which lends to people whose income is too low, or whose credit history too patchy, to qualify for an ordinary mortgage. On March 13th the Mortgage Bankers Association reported that 13% of subprime borrowers were behind on their payments. Some 30 of America's subprime lenders have closed their doors in the past three months. The cost of insurance against default for the riskiest tranches of subprime debt has soared. The worst effects may not be felt until the mortgage payments of many borrowers with no equity in their homes rise sharply.

Is this a mere irritant in America's vast economy, or the start of something much worse? Opinion on Wall Street is divided. Most argue that the mortgage mess, though a blight on anyone caught up in it, will not spread. The number of mortgages at risk is too small for defaults to threaten everyone else. Even if a fifth of the $650 billion of adjustable-rate subprime loans went bad, that would be a blip in the $40 trillion market for debt. If repossessions extended the housing downturn, it would not derail an economy that—housing apart—remains healthy, with unemployment of 4.5% and jobs growing strongly.

Cellar signal

Growing numbers of pessimists disagree. They think the subprime squeeze marks the start of a broader credit crunch that could drag the economy into recession. Stephen Roach, the famously gloomy chief economist at Morgan Stanley, recently called subprime mortgages the new dotcoms. Just as the implosion of a few hundred internet ventures in 2000 sparked a much broader stockmarket correction and an eventual recession, so the failure of the riskiest mortgages may distress the rest of a debt-laden economy.

To try to assess who is right, you need to know the share of mortgages potentially at risk. And you need to understand the channels through which subprime defaults could spread to the wider economy.

America's residential mortgage market is huge. It consists of some $10 trillion worth of loans, of which around 75% are repackaged into securities, mainly by the government-sponsored mortgage giants, Fannie Mae and Freddie Mac. Most of this market involves little risk. Two-thirds of mortgage borrowers enjoy good credit and a fixed interest rate and can depend on the value of their houses remaining far higher than their borrowings. But a growing minority of loans look very different, with weak borrowers, adjustable rates and little, or no, cushion of home equity.

For a decade, the fastest growth in America's mortgage markets has been at the bottom. Subprime borrowers—long shut out of home ownership—now account for one in five new mortgages and 10% of all mortgage debt, thanks to the expansion of mortgage-backed securities (and derivatives based on them). Low short-term interest rates earlier this decade led to a bonanza in adjustable-rate mortgages (ARMs). Ever more exotic products were dreamt up, including “teaser” loans with an introductory period of interest rates as low as 1%.

When the housing market began to slow, lenders pepped up the pace of sales by dramatically loosening credit standards, lending more against each property and cutting the need for documentation. Wall Street cheered them on. Investors were hungry for high-yielding assets and banks and brokers could earn fat fees by pooling and slicing the risks in these loans.

Standards fell furthest at the bottom of the credit ladder: subprime mortgages and those one rung higher, known as Alt-As. A recent report by analysts at Credit Suisse estimates that 80% of subprime loans made in 2006 included low “teaser” rates; almost eight out of ten Alt-A loans were “liar loans”, based on little or no documentation; loan-to-value ratios were often over 90% with a second piggy-bank loan routinely thrown in. America's weakest borrowers, in short, were often able to buy a house without handing over a penny.

Lenders got the demand for loans that they wanted—and more fool them. Amid the continuing boom, some 40% of all originations last year were subprime or Alt-A. But as these mortgages were reset to higher rates and borrowers who had lied about their income failed to pay up, the trap was sprung. A new study by Christopher Cagan, an economist at First American CoreLogic, based on his firm's database of most American mortgages, calculates that 60% of all adjustable-rate loans made since 2004 will be reset to payments that will be 25% higher or more. A fifth will see monthly payments soar by 50% or more.

Few borrowers can cope with such a burden. When house prices were booming no one cared. Borrowers refinanced or sold their homes. But now that prices have flattened and, in many areas, fallen, those paths are blocked.

The greatest difficulties threaten borrowers whose house is worth less than their mortgage. Just under 7% of all American homeowners had this “negative equity” at the end of December 2006 estimates Mr Cagan, using a sample of 32m houses (see chart 1). Among recent homebuyers, the share is even higher: 18% of all people who took mortgages out in 2006 now have negative equity. A quarter of all mortgages due to reset in 2008 are in the same miserable state (see chart 2).

House of cards? 1

Cumulative distribution of homeowners' equity in their houses, 2006

Equity*	%†	Equity*	%†
Less than 30%	39.7	Less than 5%	11.0
Less than 25%	33.1	Less than 0%	6.9
Less than 20%	26.7	Less than -5%	4.3
Less than 15%	21.0	Less than -10%	2.9
Less than 10%	15.8		

Source: First American CoreLogic

*Value of house less mortgage outstanding as % of house value †Of a sample of 2m mortgaged properties

Higher payments and negative equity are a toxic combination. Mr Cagan marries the statistics and concludes that—going by today's prices—some 1.1m mortgages (or 13% of all adjustable-rate mortgages originated between 2004 and 2006), worth $326 billion, are heading for repossession in the next few years. The suffering will be concentrated: only 7% of mainstream adjustable mortgages will be affected, whereas one in three of the recent “teaser” loans will end in default. The harshest year will be 2008, when many mortgages will be reset and few borrowers will have much equity.

Home to roost 2

Cumulative distribution of properties with adjustable-rate mortgages taken out in 2004-06*

Equity†	%‡	Equity†	%‡
Less than 30%	86.2	Less than 5%	40.1
Less than 25%	79.0	Less than 0%	25.4
Less than 20%	69.5	Less than -5%	12.7
Less than 15%	60.8	Less than -10%	6.5
Less than 10%	51.3		

*With 2008 as year of first reset †Value of house less mortgage outstanding as % of house value ‡Of a sample of 8.4m adjustable-rate first mortgages

Source: First American CoreLogic

Mr Cagan's study considers only the effect of higher payments (ignoring defaults from job loss, divorce, and so on). But it is a guide to how much default rates may worsen even if the economy stays strong and house prices stabilise. According to RealtyTrac, some 1.3m homes were in default on their mortgages in 2006, up 42% from the year before. This study suggests that figure could rise much further. And if house prices fall, the picture darkens. Mr Cagan's work suggests that every percentage point drop in house prices would bring 70,000 extra repossessions.

The direct damage to Wall Street is likely to be modest. A repossessed property will eventually be sold, albeit at a discount. As a result, Mr Cagan's estimate of $326 billion of repossessed mortgages translates into roughly $112 billion of losses, spread over several years. Even a loss several times larger than that would barely ruffle America's vast financial markets: about $600 billion was wiped out on the stockmarkets as share prices fell on February 27th.

In theory, the chopping up and selling on of risk should spread the pain. The losses ought to be manageable even for banks such as HSBC and Wells Fargo, the two biggest subprime mortgage lenders, and Bear Stearns, Wall Street's largest underwriter of mortgage-backed securities. Subprime mortgages make up only a small part of their business. Indeed, banks so far smell an opportunity to buy the assets of imploding subprime lenders on the cheap.

Discredited

Although subprime is a small direct threat to Wall Street it could still inflict pain on bankers—and the broader economy—in other ways. Investors are shunning subprime and all mortgages that seem risky. Spreads have dramatically widened on the securities backed by riskier mortgages and the pooled and debt-laden collateralised-debt obligations (CDOs) based on them. The issuance of subprime-related CDOs has plunged. That is a worry, because investors' appetite for these securities fuelled the boom in riskier mortgages.

Lenders' reluctance and tightening loan standards may combine to form a classic credit crunch. Several lenders, including Countrywide, America's largest mortgage lender, have stopped making no-money-down mortgage loans. HSBC has cut back on second-lien loans. Freddie Mac recently announced it would no longer buy some subprime loans. No one is sure how dramatic, or lasting, the pull-back will be, but Credit Suisse thinks the number of originations in subprime markets could fall by some 50% in the next couple of years and Alt-A loans may fall by a quarter. Even if the shift is confined to America's riskiest mortgages (and there is little evidence yet of tighter lending standards spreading), its effects may climb up the housing ladder.

Just when some would-be buyers find it harder to borrow, rising numbers of repossessions will increase the supply of homes for sale. The backlog of unsold homes is already high, at over 3.5m existing homes, or more than six months' sales. Counting the properties that have already been repossessed—and hence are all but certain to be for sale—that figure rises by about a fifth. Add the likelihood of some 1m more repossessions as adjustable-rate mortgages are reset, and you have the makings of a housing glut.

Falling demand and soaring supply bodes ill for construction and house prices, the main ways housing affects the broader economy. Builders have already cut back. The pace of housing starts is down 33% from its peak in January 2006. Plunging residential investment is the main reason America's GDP growth has slowed to 2.2%. But, as Nouriel Roubini and Christian Menegatti point out in a recent report, that retrenchment is modest by historical standards. In the seven construction busts since 1960, housing starts fell, on average, by 51% from their peak. The mortgage crunch makes matters worse. To work off inventories, builders will have to cut back more, dragging output growth down for longer. Job losses in construction and related industries, which have so far been mild, are likely to rise sharply.

A glut of unsold homes will also push down prices, particularly in areas such as California and Florida, which had a disproportionate share of riskier loans. House prices have already been falling in parts of both states, as they have in Midwestern states, such as Michigan, where manufacturing industry has shed jobs in recent years. Will those declines accelerate and spread?

By many measures, America's house prices are still too high. David Rosenberg of Merrill Lynch points out that the ratio of income to housing costs is still some 10% worse than its historical norm and 20% worse than levels at the end of the last housing downturn in the early 1990s. Take out a chunk of potential borrowers; add in some repossessed homes and house prices could be hit hard. If falling prices raise the rate of default, that could in turn worsen the credit crunch, putting yet more pressure on prices. Wall Street's gloomiest seers think average house prices could fall by 10% this year. If so, the economy could well enter a recession.

Consumers have shrugged off the housing slowdown thus far: real consumer spending is still growing at annual rate of some 3%, thanks largely to strong job and wage growth. But they are unlikely to shrug off a 10% plunge within one year, particularly since America's homeowners have become used to their housing wealth rising by well over 5% a year. No one is sure just how responsive consumer spending is to changes in house prices. Economists normally reckon that a $100 drop in wealth eventually reduces spending by $3-5 a year. But some recent studies suggest the “wealth effect” from housing may eventually be more than double that. Given that Americans have $20 trillion of housing wealth, a 10% price drop could easily halve the pace of consumer spending growth, sending the economy perilously close to recession.

Such a dramatic drop in national house prices this year is possible, but not yet probable. Unlike share prices, house prices rarely plunge in nominal terms. Unless repossession forces a sale, homeowners prefer to sit tight when markets are weak. If house prices stagnate, consumption may suffer a little, but not too much, so long as jobs stay plentiful and wages grow. If so, the mortgage crunch will be a grinding drag on America's economy; one that unfolds over several years, hitting some people and some regions hard, but not, in itself, a macro-economic disaster.

The bursting of the stock-market bubble in 2000 led to a plunge in investment at American firms. To stave off recession, the Federal Reserve loosened monetary policy. Short-term interest rates fell to historic lows, propping up consumer spending, but also fuelling the housing bubble and sowing the seeds of today's upheaval.

Any such loosening is much less likely today. As the statement at their meeting on March 21st made clear, America's central bankers are still more worried about inflation than about recession. And with reason. Core consumer price inflation, which excludes the volatile categories of food and fuel, has accelerated, to 2.6% at an annual rate in the three months to February. With inflation higher than they would like, the central bankers are in no hurry to slash interest rates. They would lose little sleep if output growth stays sluggish or unemployment rates inch up.

The Senate and the houses

In contrast to the dotcom bust, then, the consequences of the housing market's troubles may be felt more sharply on Capitol Hill than at the Fed. Politicians, particularly the Democrats now in charge of Congress, are clamouring for quick action. Hillary Clinton has declared the market "broken", accused the Bush administration of standing by and demanded something be done. Chris Dodd, chairman of the Senate Banking Committee and another Democratic presidential candidate, is also up in arms.

George Bush often boasts about rising rates of home-ownership under his watch. Hundreds of thousands of repossessed homes, many of them from borrowers who are black and poor, would be politically incendiary. The Centre for Responsible Lending reports that half of the mortgages taken out by blacks in the past few years were subprime. If a fifth of those default, one in ten recent black homebuyers may end up losing his house. Many of these people have stories to tell of being duped into taking on mortgages that they did not understand and could not afford.

Pressure is mounting to right the wrongs—real and perceived. Attorneys-general from New York to California have started to investigate fraudulent mortgage lending. Rather as after Enron, the securities regulator in Massachusetts has demanded that UBS and Bear Stearns hand over internal details of their research coverage of subprime lenders. Congress has already held hearings on predatory lending. More are planned.

Ideas abound on what must be done. Mrs Clinton has called for a " foreclosure time-out". Pressure groups want Congress to rewrite the rules of the Federal Housing Administration (FHA), a federal organisation charged with providing affordable mortgages to the poor, so it can refinance subprime mortgage loans in default. Calls for other types of bail-out will rise.

America's four federal bank regulators are also scrambling to respond. Earlier this month they proposed stricter lending guidelines on adjustable subprime loans. But federal regulators play a limited role in subprime markets. Many of the riskiest mortgages were made by independent, non-bank lenders—such as New Century, Ownit and Fremont. These outfits (which are now collapsing) are overseen by state regulators, not federal ones—and the quality of state oversight varies widely. Only half of states have laws against predatory lending. Many lack rules requiring lenders to perform criminal background checks on brokers, as federal guidelines require.

Few doubt that the subprime mess was, in part, a regulatory failure. But now the mistakes have been made, the biggest risk is that populist politicians rewrite the rules hamfistedly. Fraudulent activity should be punished. The vulnerable need protection from predatory lenders. But an ill-conceived swathe of new "consumer protection" could easily make matters worse. If restrictive regulation scared investors away from the subprime market for good, that really would hurt the poor.