



# GLOBAL STRATEGY & INVESTMENT CONSULTING

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## COOLING DOWN

# THE SUBPRIME LENDING CRISIS

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PREPARED BY SUBHANKAR OJHA



**COOLING DOWN THE SUBPRIME LENDING CRISIS**

“About 320,000 foreclosures were initiated in each of the first two quarters of this year (just more than half of them on subprime mortgages), up from an average of about 225,000 in the past six years”.

Ben S. Bernanke, Chairman Federal Reserve Bank of New York

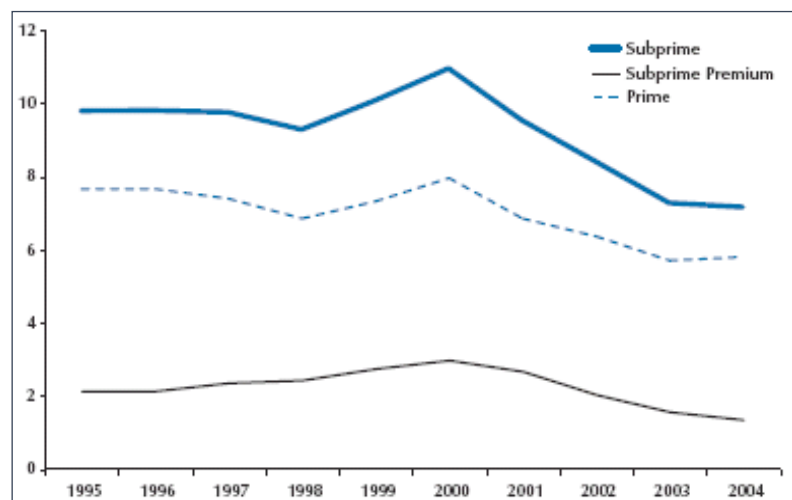
**WHAT MAKES A LOAN SUBPRIME?**

Subprime mortgages are residential loans to those who do not fulfill the criteria for market (prime) mortgages. The evaluation is done on the basis of past credit record, debt service-to-income (DTI) ratio and/or the mortgage loan-to-value (LTV) ratio. Subprime mortgage loans have a lower expected probability of full repayment. Subprime loans are differentiated from prime loans on two fronts namely the upfront costs (include application fees, appraisal fees etc) and the continuing cost (include principle & interest payments, fees for delinquent payments etc.) which are higher in subprime loans than prime loans.

Study suggests that the probability of default in subprime loans is at least six times higher than that in prime lending. The following exhibit depicts that in 2002, subprime loans had a delinquency rate of 5.62 times higher (14.28 versus 2.54) than that of the prime rates. Therefore, the inclination of subprime borrowers to repay is much lower than that of the borrowers of prime loans.

**INTEREST RATE GAP BETWEEN PRIME & SUBPRIME MORTGAGE LOANS**

Exhibit – 1

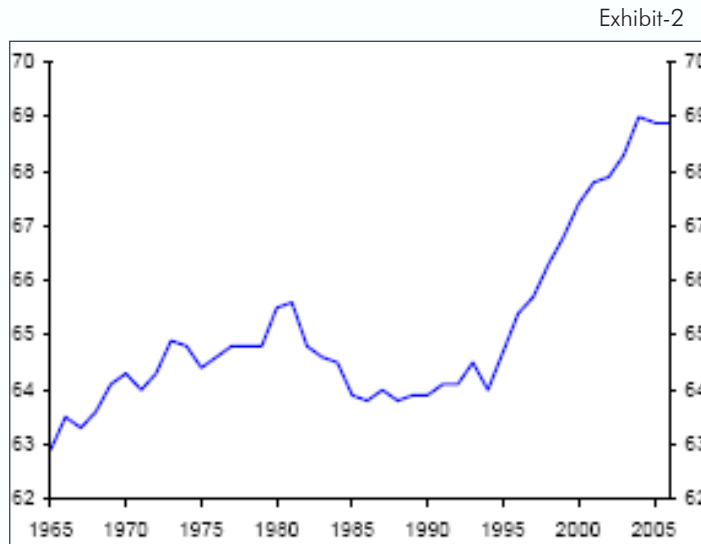


Source: Freddie Mac Primary Mortgage Market Survey & Loan Performance

Subprime lending is a relatively new concept and it was developed as a special financial product in the mid of 90s, at a time when the concept of homeownership became popular in USA. The following exhibit shows the rate at which homeownership surged over the last 40 years. One has to remember the fact that this happened at a time when the average y-o-y appreciation in housing prices had been between 8-10 percent. Therefore, the homeowners had an opportunity to make enough wealth out of it.

Lending practices for residential purposes has become illegal because of the aggressiveness displayed during the last five years. During that period, millions of people bought houses who may not have otherwise done it.

**HOMEOWNERSHIP RATE IN US**



Source: Census Bureau

**WHERE DID THE PROBLEM START**

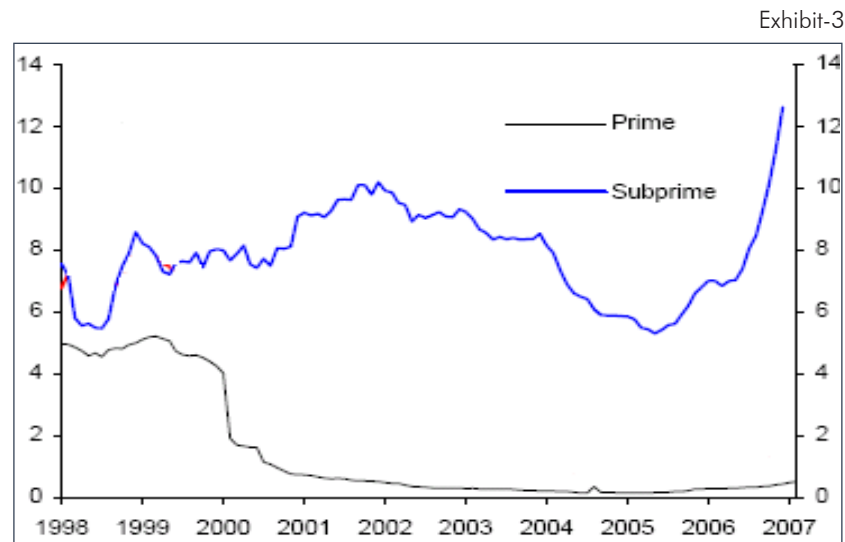
There are two simple reasons. First, the extraordinary growth in U.S homeownership from 64 percent in 1995 to around 69 percent in 2006 and second, the easy availability of mortgages loans without any down payment which has resulted in the current crisis in the U.S. mortgage lending market. According to the National Association of Realtors (NAR), in 2005 and 2006, 40 percent of the first time home buyers in USA didn't make any down payments and the sub-prime lending exploded at around same time. Here is the evidence:

- 2000 – USD 110 billion**
- 2001 – USD 175 billion**
- 2002 – USD 300 billion**
- 2003 – USD 474 billion**
- 2004 – USD 647 billion**
- 2005 – USD 805 billion**
- 2006 – USD 722 billion**

Subprime loans were once predominantly guaranteed by the Federal Housing Association (FHA) but because of lack in flexibility with changing market conditions and high processing costs, FHA was made to reduce the limits in the guaranteed portion of subprime loans. Since 1998, FHA loans have declined from 30 percent to less 10 percent of the residential lending market and subprime loans have increased from 2 to 14 percent of the total outstanding mortgage market during the same period. As depicted in the following exhibit, the guaranteed part of the subprime loans in 2006 were equivalent to what it was in 1995 and during that period, total subprime lending gained 8 times.

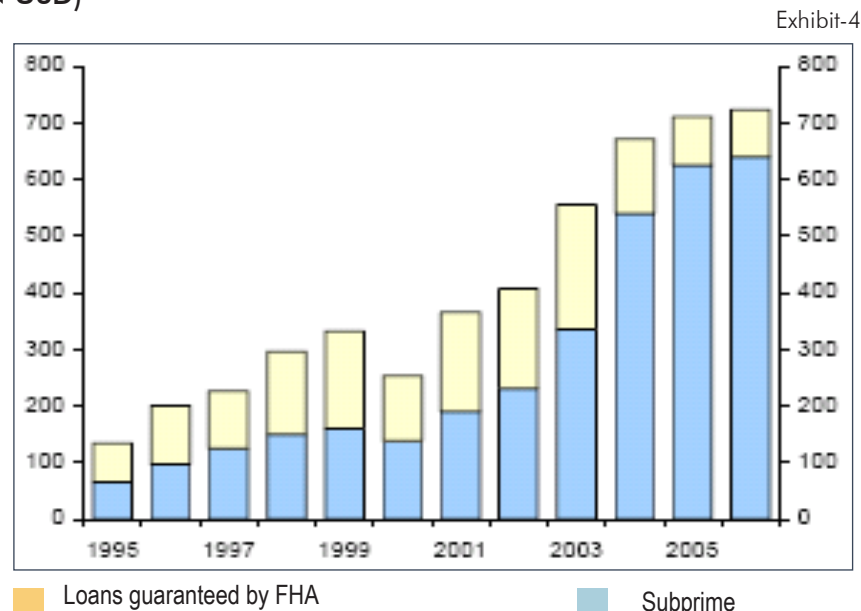
The roots of the current subprime crisis go back to 2005 and 2006 when the US housing market prices was rocket high and interest rate was low. The present scenario has reversed in a sense that the home prices in US have started falling and interest rates have gone up. During the same frame, a new innovative mortgage product called adjustable-rate subprime mortgages originated in the late 2005. These are the ones which have performed the worst, with some of them defaulting after only one or two or even zero payments.

**ARM DELINQUENCIES AND FORECLOSURES (PERCENT OF OUTSTANDING LOANS IN FORECLOSURE FOR SIXTY DAYS OR MORE THAN THAT)**



Source: IMF

**MORTGAGE LOANS GUARANTEED BY FHA VIS-À-VIS SUBPRIME LOANS (ALL FIGURES ARE IN BILLION USD)**



Source: Inside Mortgage Finance



### IMPACT ON FINANCIAL INSTITUTIONS

The subprime crisis had badly affected specialized subprime lending banks (like HSBC) and a number of players which had substantial exposure towards the subprime lending market. New Century Financial, Fremont General, and Accredited Home Lenders suffered the worst massacre and even lenders and bankers as diverse as Wells Fargo, Washington Mutual, Merrill Lynch, and Bear Stearns were affected. The current shock of subprime lending gave a clear indication that it's going to be a survival of the fittest, the small players would not get a second chance to be operational.

Lenders who had an exposure to the mortgage market started to sub-prime mortgages resetting at shockingly high rates, with homeowners missing payments and foreclosing accounts. As a result, banks and other financial institutions holding the mortgage-backed securities incurred losses and had to sell their assets to meet margin calls.

It is forecasted that in the next five years USD 1 trillion in adjustable rate mortgages will reset, with sub-prime mortgages making up the majority of the loans. Banks and other institutions cut back their lending, not only for mortgage-related activities, but also for other legitimate activities. The credit system that oils the economy stopped working. It also became clear that with mortgage security holders spread even outside the US; this might be heading for a global problem.

As liquidity and credit problems became visible, the European Central Bank (ECB) was the first to respond with an injection of £ 95 billion (USD 131 billion) as additional funds on August 9. This is even more than what it had injected on September 12<sup>th</sup>, 2001. The signs of illiquidity also became visible in various money markets and credit markets in the US. For example, 3-month Eurodollar loans carried an interest tag of about 247 basis points more than the yield on 3-month treasury bills in recent days. The spread between these two short-term securities was only 50 basis points a month before August.

### REGULATORY (FEDERAL RESERVE BANK OF NY) RESPONSES TO THE CRISIS

Subprime and other nontraditional mortgage products are riskier than the traditional mortgage loans. The increased number of delinquencies and foreclosures reflect reality. According to Fed Chairman Ben Bernanke, "about 320,000 foreclosures were initiated in each of the first two quarters of this year (just more than half of them on subprime mortgages), up from an average of about 225,000 during the past six years". By the end of 2006, the foreclosures rate in subprime mortgage market was 9 times higher than the prime loans foreclosures stated by the Mortgage Bankers Association (MBA). Although the current subprime foreclosure rate is less than half the peak rate reported during the 2001 recession, the issue needs certain measures from the Fed.

Firstly, although subprime loans are without any doubt high-risk loans and have higher delinquencies and foreclosures, these are very much useful for people with low, bad or no credit. Therefore, it must not be abolished. The credit scoring mechanism has to be tighter and uniform across the states. The quality of underwriting practices by all lenders has to be raised to a uniformly high standard.

Secondly, Fed is in talks with almost all government housing assistance units to educate borrowers. Many homebuyers have little or no knowledge of the complexities involved in purchasing a home. Foreign buyers have difficulty with language also therefore; these small yet important issues need to be addressed by the regulatory body.



Thirdly, to make the impact less drastic, the US Federal Reserve made similar interventions to ensure that the markets continued to function normally, with the Fed injecting 62 billion dollars into the market (\$24 billion on August 9th and another \$38 billion the day after).

Fourth, in the next monetary policy on Sept 18, the Fed cut the discount rate by 50 basis points to make the credit easier and home loans dearer.



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