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ECONOMIC NEWS UPDATE

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24 March 2007

Polonius Redux

Borrowing occurs when a borrower has confidence in his future, and a lender has confidence that the price he is getting for the use of his money -- the interest rate -- compensates him for the risk that he will not be repaid. Both borrower and lender sometimes miscalculate, and wish they had heeded Polonius' interdiction, "Neither a borrower not a lender be."

That's the dominant sentiment in the so-called sub-prime market, where lenders last year made \$605 billion in mortgages to people with poor credit. Those borrowers, who account for about 20% of home-loan market, include couples with comfortable incomes who find that they cannot meet the mortgage payments on the too-large and too-expensive homes they bought, and low-income buyers who fall behind in payments, sometimes in the first month, because of an interruption in their employment, a family illness or one of the other problems that those living on the economic margin often experience. The lenders include such as HSBC,

which may be out-of-pocket to the tune of almost \$7 billion.

There is blame enough to go around. Lenders, attracted by the 2-3 percentage point premium they could charge, thought that perpetually rising house prices would protect them in the event that they had to foreclose: take back the property, and resell it quickly and at a profit. So they offered no-down-payment, no-income-verification loans, known as "liar loans" in the trade, to people with checkered credit histories. Borrowers closed their eyes to the fact that interest rates on these loans would rise after the initial "teaser" period.

One result is that delinquency rates on subprime mortgages topped 14% last year, a record. A spate of foreclosures will inevitably follow. Another consequence is that the problems in this market threaten to spread to the rest of the mortgage market, chocking off the flow of credit to the shrinking band of consumers still interested in buying a home. Such an additional blow to the housing market

might reverberate through the economy, triggering a recession.

Never one to allow the market to sort things out, congress is calling for regulation of the subprime market. These are the same legislators who forced banks to make loans to inner city borrowers, and who were enthusiastic about the way in which subprime lending encouraged the spread of home-ownership to lower income constituents (some 70% of American households now own their own homes, compared with about 65% in 1991, due in good part to looser lending standards). Democrats in congress now claim that the borrowers were duped by lenders who did not inform them adequately that their incomes were inadequate to service the mortgages they were seeking. "There oughta be a law," a good old American saying seems set to trump "Borrower beware."

The banks, meanwhile, are trying to hand these troubled mortgages back to the lenders who originated them, before selling them on to the banks. Without much success, since the loan originators simply don't have the cash to honor their commitments to take back the loans. More than two-dozen mortgage lenders have closed down in recent months, and 100 more are expected to follow suit. One of the largest, New Century Financial Corp, is teetering on the brink of bankruptcy, and will go over the edge if its creditors demand that it honor all of its \$8.4 billion of repurchase commitments.

Most important of all is the effect that this collapse of the subprime market might have on the American economy. Thirty-two of the 58 economists (55%) responding to a survey by The Wall Street Journal expect the problems in the subprime market to spread to the

broader mortgage market as lenders get skittish and tighten their lending standards. But the majority believe even this will not prevent the economy from reaching a 3% annual growth rate by the end of this year.

The economists seem to be cheerier than the many investors who rushed to dump shares when the woes of the subprime market became obvious. These share-sellers, forerunners of the newest crowd of bears, fear a liquidity shortage as federal regulators tighten lending standards, and lenders become pickier about the sorts of creditors they choose to deal with.

The tremors in the subprime market are already being felt in what is called the Alt-A market, designed for borrowers who are better than subprime risks but not as sound as prime borrowers. It turns out that 80% of all Alt-A loans last year were of the no- or low-documentation variety, best described perhaps as fibber loans.

Finally, if you want to do what one respected adviser, impressed by "truly horrific anecdotal evidence" from the housing market suggested to me - "be worried, be really worried"-- consider the prime market. Even prime borrowers will feel the pinch when the low teaser rates in their adjustable-rate mortgages (ARMs) start to rise -- just as the values of their homes start to decline at an accelerating rate. That is a sure prescription for an outbreak of consumer fright, a zipping of wallets, and, as a consequence, a recession.

Even if the prime market is unaffected, the problems in the subprime and Alt-A markets will hit the economy hard by pushing back any recovery in home construction. Some 40% of homes sold last year were to

borrowers in those less-than-prime categories. Experts guess that about half of such borrowers will now be turned away, unable to get mortgages. That means that 20% of the demand for homes has been obliterated, and that the housing market is not likely to get a "Spring buying-season bounce" (more than half of US home sales are usually made in

Spring months) -- surely an indication that the economy will tip into recession by year end, a downturn exacerbated, perhaps, by a general credit tightening that will raise rates paid by such higher-risk borrowers as hedge funds.

Possible, but not likely. According to the latest available data, about 33% of all homes in America are owned free and clear of any mortgage, and another 57% carry traditional, fixed-rate mortgages. At the time of the latest survey, 2005, ARMs accounted for only 10% of all mortgages (that figure probably rose somewhat since the survey was completed).

So -- housing will remain weak; less-than prime borrowers will face stonier-faced lenders; people with ARMs will have to forego trips to the malls to meet higher mortgage payments; tighter lending standards and falling home prices will reduce consumers' ability to tap the equity in their homes. But so long as the job market remains strong, which it has done even though some 100,000 workers in housing-related industries have been laid off, and so long as real incomes continue to rise, consumers might grumble, but they are unlikely to go on a buyers' strike on a scale that will convert slow-down into recession. So don't be very worried. But don't relax completely: even Ben Bernanke is watching incoming data

with a bit more apprehension than just a few months ago.



THE SUNDAY TIMES

A version of this Update appeared in
The Sunday Times (London)