# EIR Economics

BAILOUT, OR REGULATED-WRITEDOWN?

# Securitizers Who Made Housing Bubbles Now Hide Big Losses

by Paul Gallagher

The Spring months are likely to see extremely large securities losses breaking out in "mortgage-backed securities" (MBS) which have been the international banks' essential tool in creating the now-exploding U.S. and other housing bubbles. These losses, which various investment bank reports are now estimating at up to $100 billion, may, in fact, become much larger than that, as the fall in home prices accelerates. They will hit those banks, and commercial banks as well, exposing how worthless are the large part of their assets which are based on the mortgage bubbles.

Since 2005, two-thirds of all mortgages have been "securitized"—sold by the lending companies to investment banks, which in turn package and sell them as high-profit securities, building a huge mortgage bubble over $15 trillion. In 2006, one-quarter of all the U.S. banking system's $12 trillion in assets were based on residential real-estate mortgages and residential MBS, the bubble which is now blowing out.

House and Senate hearings and emergency Federal regulators' meetings in the third week of April, showed that while, on the one hand, Congressional committees are slowly working toward legislation that could rein in and force a writedown of the $6 trillion-plus MBS; on the other hand, the Federal Reserve and accomplices are moving for a rapid bailout of the same banks and financial corporations, using huge amounts of Federal credit.

Unless the banks, their hedge funds, and other financial corporations are made to write down and reorganize their books full of these bankrupt assets, any Federal attempt to intervene in the worsening mortgage foreclosure crisis, with new Federal (or state) mortgage credit, will throw hundreds of billions down a bailout hole, without stopping the mortgage bubble collapse. If that writedown and reorganization is forced on the banks and MBS market players, the collapsed bubble of housing-financial assets can be replaced by new Federal credit for modern infrastructure—and for new housing.

Economist and Democratic leader Lyndon LaRouche said on April 22, "The only thing to do is to freeze all the problem mortgages and to stop the foreclosures. We have to prevent massive evictions. If what I propose is not done, we are entering a phase in which what is occurring will blow out the entire financial system." LaRouche said that even hundreds of billions of dollars of bailouts would not be sufficient to the real scope of the problem.

## Thin Wall Holding Back Sea of Losses

Bloomberg news service on April 24 reported a Merrill Lynch estimate that the MBS of 2006, the most hyperinflated bubble year, have now sunk in trading value by up to 37%. The large bond fund Pacific Investment Management (PIMCO) estimated losses at about $75 billion as of late April. A *New York Times* column April 21 reported Lehman Brothers' estimate that MBS securities losses so far are $20 billion, but will rise during 2007 to 11-13% of the entire outstanding volume of "subprime" mortgages, which is over $1.5 trillion.

These losses are broadly hidden because securitization has completely atomized much of the $16 trillion of U.S. mortgage debt—it is extremely difficult to determine who owns it!—and because the only real "regulators" of the MBS markets are the credit rating agencies like Moody's and Standard and Poor's. The hedge funds, banks, and other funds holding these securities will not book the losses unless they sell their MBS, or the rating agencies "officially" downgrade them. The rating agencies thus far have obliged the banks; no MBS have been downgraded, although trading deep in the red. This thin wall will collapse soon, and the crash will be on, as the fall in home prices nationwide gets serious.

The real plunges in market value of homes, are still to come in future months. The National Association of Realtors ruefully reported on April 24 that March's U.S. existing-home sales fell by 8.4% from February (the largest month-to-month drop since 1989), and are down 11.3% from March 2006. The median existing-home price in March was still only 0.3% below March 2006, and 0.9% below for single-family homes. But the separate Schiller/Case home sales report, says that March prices in the 20 largest metro-area markets, were 1.5% down from March 2006; the unsold inventory of homes rose from 6.8 to 7.3 months, and over eight months for new homes. "No bottom in sight for the housing market," was one S&P analyst's response to the unexpectedly large drop.

## Bernanke's Fed Wants a Bailout

Beginning April 16, there was an intense week of panicked private and public meetings. On that day, a seven-hour meeting was held behind closed doors, at the Washington, D.C., headquarters of the Federal Deposit Insurance Coporation (FDIC), involving the heads of the FDIC, Fannie Mae, Freddie Mac, Fed officials, and representatives of banks, lending institutions, and consumer groups. According to statements released afterward, those at the meeting "agreed on a goal of keeping deserving borrowers with high-risk mortgages in their homes."

On April 17, the Federal Reserve Board of Governors released a statement, entitled "Statement on Working with Mortgage Borrowers," signed by the Fed, the U.S. Department of Housing and Urban Development (HUD), the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. It read in part: "The Federal financial institutions' regulatory agencies encourage financial institutions to work constructively with residential borrowers who are financially unable to meet their contractual payment obligations on their home loans. . . . Many residential borrowers may face significant payment increases when their adjustable rate mortgage (ARM) loans reset in the coming months. These borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. . . . The [supervisory] agencies will . . . not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems. *Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties"* (emphasis added).

The highlighted sentence will be remembered from the 1989-92 period, when in 1991, the Federal Reserve and other regulatory agencies issued a directive to bank examiners that urged "leniency" and "wide discretion" in deciding what a bad loan is. An emergency meeting was held Nov. 7, 1991, in Baltimore, Md., to emphasize that point. At that moment, Citibank, America's largest bank, and other banks, had their books full of bad loans, and were hanging by a thread. The Fed feared a strict interpretation would push Citibank et al. over the edge.

Also on April 17, a "wall of money" policy began to emerge. Daniel H. Mudd, the chief executive officer of Fannie Mae, testified before the House Financial Services Committee, that Fannie Mae was altering its lending standards so that it "could help the subprime market through this turmoil," adding, "We are concerned about a liquidity crunch in the subprime segment." Mudd announced that Fannie Mae, the giant secondary housing market agency, was starting a new program, "Operation Home Stay," that would funnel funds into the subprime market.

While Mudd did not give a funding figure, Freddie Mac, the other giant secondary housing market agency testifying to the House committee April 17, announced the next day, that it will commit $20 billion to buy fixed-rate and adjustable rate mortgage (ARM) products, in an effort to provide mortgage-lending institutions with more "choices" to offer subprime lenders. Also, on April 18, the Seattle-based Washington Mutual, one of the nation's largest mortgage lenders, announced a $2 billion program; Citigroup Inc. and Bank of America Corp. announced that they will provide $1 billion each in mortgage refinancing,

Thus, in a 96-hour period, the Federal Reserve and Plunge Protection Team had organized Fannie Mae, Freddie Mac, and the large money center banks to commit to perhaps $30-45 billion. This sum is between seven and ten times the size of the bailout that the Fed organized in September 1998, to save the LTCM hedge fund. Their interest is the same this time: to save their bankrupted system.

The investment banks, hedge funds, mutual funds, and pension funds that hold these MBS are going to keep those losses undeclared as long as they can, while waiting for a Federally sponsored bailout—through sales of new MBS by Fannie, Freddie, and FHA—to put a floor under the prices of those securities.

## MBS and Foreclosures

The mortgage-crisis legislation which Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee, has, so far, only threatened to introduce, takes a first swipe at the core of the problem—it would force mortgage-backed securities (MBS) holders to "take a haircut" by making them liable for the underlying problems in the mortgages they discounted.

In this context Frank's bill is being attacked on Wall Street speculators' more extreme websites—like Minyanville, run by former Drexel and Lehman traders: "The legislation proposed by Barney Frank is dangerous: It will punish investors that have absolutely no control over what goes into the mortgage pool. . . . How can they analyze the appropriateness of the purchase to the homebuyers? They cannot. . . . Buyers of mortgage-backed securities will require a higher rate of return from borrowers to be compensated for extra costs which Mr. Frank's proposed legislation would bring. This will raise the banks' financing costs and thus raise the cost of credit to all mortgage borrowers. Actually this legislation would spill over across the whole economy, as credit cards, auto, and other consumer loans are securitized as well. Securitization oils the wheels of capitalism and provides a needed liquidity for the U.S. financial system; take it away and liquidity in the system will dry up."

The House and Senate committee hearings on the mortgage crisis on April 17 established clearly, even from the very reluctant head of FDIC, Sheila Bair, that the securitizers—the MBS issuers and holders—*alone,* have a self-serving interest in mass foreclosures, all across the "exploded" subprime and Alt-A mortgage markets. Foreclosures—even if they result only in the repurchase of the home by the originating mortgage lenders or builders, for a low price, or in a "short sale"—provide cash flow to pay off the multiple tranches of the MBS. The market prices of the foreclosed homes are still above their prices in 2004-05 when the huge volume of the ARMs, subprimes, etc., peaked, so for now, most tranches will be paid off in a foreclosure wave. The substantial prepayment penalties of homeowners who get even part of their mortgages paid off by a forced "short sale" provide more MBS cash flow. The MBS holders' securities contracts allow them to demand that the mortgage-originating lenders and servicing banks pay the securities where the mortgagee payments have disappeared—until, that is, these mortgage lenders disappear, as some 50 have already.

The huge flows from these funds, banks, and foreign central banks into MBS is what drove up *both prices, and effective mortgage interest rates* (that is, very big, and ostensibly very profitable mortgages) since 2000, to the point that 1) tens of millions of "homeowners," including speculative "homeowners," had acquired mortgages they couldn't actually pay with-

## Foreclosure Tsunami, McMansions 'Underwater'

National rates of home foreclosures kept rising in the first quarter of 2007, more than 25% above the last quarter of 2006, and nearly 50% higher than a year ago. According to the online foreclosure data firm RealtyTrac, foreclosure filings nationwide in the first quarter reached 434,498. If the wave keeps rising, as home prices fall and homeowners go "underwater" on their mortgage debt, more than 2 million homes could be foreclosed on in 2007, one on every four or five blocks all across the nation.

"[I]t's not just low-end homes that are going into foreclosure; we're seeing a rising percentage of foreclosures with an estimated market value of more than $750,000," James Saccacio, chief executive of RealtyTrac, said in a statement. "The rise in foreclosure activity was quite dramatic and widespread in the first quarter, with 37 out of the 50 states reporting year-over-year increases," he added.

In fact, at 2.5% annually, the foreclosure rate for homes whose recent market "value" was over $800,000, is higher than the overall national rate. Of the ten states with the highest current rates of foreclosures, the top five are not rust-belt states of the upper Midwest hard-hit by jobs losses, as was the case in 2005 and the first half of 2006; these have been surpassed by the "hot market" or "high-cost" states of Colorado, California, Florida, Nevada, and Massachusetts. In sections of southern California, 75-85% of the houses for sale are foreclosed homes.

The "national foreclosure tsunami" is a strong factor in causing unsold-home inventories to continue to rise—to about eight months' worth for both new homes and existing homes, at current sales rates—whereas inventories are usually sold down during a so-called "housing recession."

As of March, median home prices in the 20 largest metropolitan regions had fallen by only about 1.5-2% from the level of one year earlier; as that price drop continues to accelerate, more and more homeowners will be foreclosed on because they have gone "upside-down," or "underwater" on their mortgages—they owe more than the house is "worth" on the falling market. They will lose home, savings, or both.

Dr. Christopher Cagan, a First American Bank economist analyzing the impact of rising interest rates in the huge mass of "adjustable-rate" mortgages, estimates in a recent study that *each 1% fall in national median home prices increases foreclosures by 70,000 for adjustable-rate mortgages alone.—Paul Gallagher* out continued home-price escalation, and 2) the MBS holders were "covered" and "hedged" for levels of delinquencies, defaults, and foreclosures which, as one witness told the Senate, would ruin a lending bank both financially and in reputation.

The MBS-investing banks and funds are separated by a multi-layered process of securitization, from the mortgages themselves, whose cash flow, penalties, charges, etc., they own. Known as "holders in due course," they are *legally protected from changes in the mortgages made by renegotiations or refinancings, and legally untouched by any degree of fraud or underlying lack of soundness exposed in the mortgages.* This was detailed in very useful testimony to the Senate Banking Committee on April 17 by Prof. Kurt Eggers of University of California at Orange.

Under the regime of "securitization," millions have gotten mortgages through mortgage brokers who were paid "yield spread premiums" to place them in higher-interest loans than they qualified for! Under the securitization regime, home appraisers were paid for bigger and bigger overassessments, and cut off from work by banks and brokers if they insisted on maintaining honest assessments. Under the regime of securitization by MBS, big builders and lenders, like Beazer Homes and JP Morgan Chase, planted virtual "large-scale foreclosure farms" under the guise of new starter-home subdivisions.

All of the House Federal witnesses, including CEOs of Fannie and Freddie, heads of FHA and FDIC, told the committee that as far as homeowners refinancing and renegotiating MBS-securitized mortgages, "Forget it—those loans are wrapped, sealed, and gone."

## Grim Forecasts

With the housing bubble now shrinking, the Mortgage Bankers Association's Douglas Duncan is forecasting that total mortgage originations for 2007 will be at only about $2 trillion—below the 2001 level, and more than 50% below the level of 2006. Wells Fargo bank—the nation's largest mortgage-servicing bank—just issued new figures revising the value of its residential loan-servicing portfolio downward by $100 billion, or about 7%. Of the six biggest mortgage-servicing financial corporations, all except JP Morgan—that is, Wells Fargo, Countrywide, Bank of America, Citigroup, and ResCap/GMAC—have reported substantial drops in the volume of the mortgages they are servicing (i.e., collecting and transferring payments). This was reported by Mortgage-Daily.com on April 21.

Under rapid price shrinkage, even the MBS holders take large, disorderly losses eventually; and even the bailouts announced by Freddie and Fannie don't work. Without a banking-asset reorganization, they are throwing away tens of billions of Federal dollars and credit into a futile attempt to stop mass foreclosures, and prop up the falling prices of the collapsing $20 trillion housing bubble.