Mortgage lending crisis sparks Wall Street plunge

Patrick Martin
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A three-day sell-off on Wall Street has slashed nearly 540 points from the Dow-Jones Industrial Average and wiped out hundreds of billions in stock market value. The sharp decline, following so closely the breaking of the 14,000 mark by the Dow last week, underscores the increasing instability of the US and world financial system.

The mood during Thursday's trading was widely described as one of “panic” and “fear,” as stock traders reacted to a torrent of bad economic news: sharp declines in the sales of new and existing homes, a further spike in oil prices, a poor showing for US durable goods orders, and financial difficulties for two high-profile corporate takeovers.

The Dow-Jones was down nearly 450 points by mid-afternoon Thursday, only to recover somewhat in the final hours of trading. Overall, declining stock issues led advancing ones by a 14 to 1 margin, and the trading was extremely heavy, with a record volume on the New York Stock Exchange of 2.78 billion shares.

Thursday's slide in New York was felt around the world, with European markets plunging during their final hours of trading Thursday as a result of the downdraft on Wall Street. The London Stock Exchange suffered its biggest loss in four years, with the FTSE 100 index falling 3.15 percent, and there were similar declines in Germany and France.

Triggering the initial selloff Tuesday, the top US mortgage lender, California-based Countrywide, announced it was compelled to take a write-off for losses due to late payments or defaults by borrowers. The company said that divorce and the loss of a job were the two leading reasons for borrowers failing to make payments, and that more borrowers with good credit were falling behind on their home equity loans, not just those with lower incomes and poorer credit who have taken out so-called subprime mortgages. The proportion of good-credit customers at least 30 days delinquent was 1.8 percent a year ago, and has nearly tripled to 4.6 percent now.

In a conference call with analysts, Angelo Mozilo, Countrywide's chairman and chief executive, said home prices were falling “almost like never before, with the exception of the Great Depression.”

Then came a report Wednesday by the National Association of Realtors that sales of existing homes fell by 3.8 percent in June to the slowest pace in more than four years. The following day, the Commerce Department reported that sales of new homes fell 6.6 percent in June, three times the drop expected and the largest in percentage terms since January.

The median sale price of a new home fell to $237,900—still nearly five times the annual income of the median family, but down 2.2 percent from a year ago. New home sales rose slightly in the South, but plunged 27.1 percent in the Northeast, 22.5 percent in the West and 17.1 percent in the Midwest. Sales of existing homes fell in all four regions, by amounts ranging from 1.7 percent to 7.3 percent.

There were other numbers contributing to the negative mood in the markets. The Commerce Department reported a 1.4 percent increase in durable goods orders, but if a huge one-time order for new aircraft is discounted, there was actually a drop in orders. Oil prices reached as high as $77 a barrel Thursday before dropping, and the US dollar fell by 1 percent against the yen, a large drop for a single day's trading. But it was the quantitative and qualitative evidence of a collapse in the housing market that did the most damage.

Pulte Homes, of Bloomfield Hills, Michigan, the second largest US home builder, reported a second quarter loss of $507 million, as opposed to a profit of $243 million last year, including a special charge for plummeting land values.

D.R. Horton Inc., the largest builder, reported a similar swing, from a $293 million profit in the second quarter last year to a loss of $824 million this year, including substantial write-offs for the declining value of houses and land. During a conference call with investors and financial reporters, Horton CEO Donald Tomnitz said that the crisis in subprime mortgage lending was having a direct impact on his company. “In some of our instances across the country we are trying to qualify the same buyer two and three times based upon the changing conditions in the mortgage industry,” he said. “We’re not predicting when there’s going to be a recovery because we don’t see one on the horizon.”

In the largest and most expensive housing market, California, foreclosures rocketed a staggering 799 percent for the three months ended June 30, compared to the same period a year ago. Some 17,408 homes were foreclosed during the quarter. Default notices were up 158 percent statewide during the same period.

Stock investors and the financial press have paid increasing attention to the crisis in subprime lending, because the exploitation of poor and vulnerable borrowers has become one of the most lucrative enterprises for mortgage originators and the various financial middlemen, from mortgage bankers to hedge funds, who collect their slice of profit from this high interest debt.

More than $1.2 trillion in subprime mortgages were originated in 2005 and 2006, the bulk of them sold to big mortgage brokers and repackaged as complex financial instruments bought and sold by hedge funds, private equity firms and other Wall Street high rollers, in a process known as “securitization.” The two largest credit rating agencies, Moody’s and Standard & Poor, have only recently begun to review and downgrade these securities, known as collateralized debt obligations or CDOs, to reflect the increasing number of defaults in mortgage payments.

The total amount of securitized subprime mortgages now tops $1.8 trillion, according to recent estimates by the financial press. Leading Wall Street figures have sought to stanch the growing concern that CDOs are a financial house of cards that will come crashing down as mortgage borrowers default. Federal Reserve Chairman Ben Bernanke told Congress last week that losses for big lenders on subprime mortgages could be as high as $50 to $100 billion, but he claimed that the wider impact would be limited.

Some analysts, however, have pointed to far-reaching dangers in the subprime meltdown. William Gross of Pimco Bonds warned July 24, in his monthly commentary, of a “sudden liquidity crisis in the high-yield debt markets.” The chain-reaction effect would be to undermine the availability of easy credit to finance leveraged buyouts, stock buybacks and mergers and acquisitions, the main forces driving up the price of stocks. He concluded, “No longer will stocks be supported so effortlessly by the double-barreled impact of LBOs and company buybacks.”

The practical effect of this process was visible already on Wednesday, as DaimlerChrysler was compelled to postpone the financing for the sell-off of its Chrysler division to the private equity firm Cerberus, which encountered difficulties in obtaining bank loans. The same day, bankers for another private equity giant, Kohlberg Kravis Roberts, withdrew $10 billion in loans meant to finance the buyout of Alliance Boots, a British drugstore chain. All told, some 20 such debt offerings have been postponed or revised because of growing pressure in the credit markets, including a plan by General Motors to sell its Allison Transmission unit to the Carlyle Group, another huge private equity firm.

A front page article in the *Washington Post* Thursday noted the common thread among events like the collapse of share prices for the Internet travel company Expedia, the mortgage lending crisis, and plunging value of shares in Blackstone, the private equity firm that went public last month.

“At the root of those seemingly unrelated events is a single new reality, one that could portend trouble for the broader US economy: The era of cheap money appears to be ending,” the newspaper observed. For years, easy credit had fueled a seemingly effortless rise in financial markets, “but now, the investors who a few months ago were willing to lend money to Wall Street at low interest rates, on loose terms, are balking as they worry about having to pay the price for lax lending standards.

“The trouble started in one of the shakiest sectors of finance, home mortgages for people with bad credit, but it is spreading. As easy credit dries up, some huge corporate deals are being delayed and could unravel. The question now is how far will the pain spread, and how many people will get hurt as it does.”