Wall Street hides impact of subprime mortgage meltdown

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4 September 2007

The August 3 edition of Asset Back Alert (www.ABAlert.com) (a weekly report that goes out to major finances houses and investors willing to pay nearly $2,500 for an annual subscription) carries an article titled "Merrill Ducks Asset Markdowns, But How?" The article raises serious questions about the dubious accounting measures taken by Wall Street giant Merrill Lynch to avoid writing down billions of dollars in losses resulting from the subprime mortgage meltdown.

While according to *ABAlert*, what Merrill did with investments in the subprime market estimated at $15 billion is not yet known. "One often-cited theory is that the bank transferred the banged-up investments from an *available for sale* account within its brokerage unit to a *hold to maturity* portfolio at affiliate Merrill Lynch Bank in late June.

"Such a move," the article continues, "would have enabled the company to follow friendlier accounting procedures, since the contents of the for-sale portfolio must be marked to market [assigned a value based on what they would fetch at current market rates] on a routine basis and the values of assets in the hold book don't have to be updated until they come due or are sold."

"Thanks to this accounting maneuver, Merrill posted second quarter earnings that were stronger than expected," according to *ABAlert*. Moreover, "The institution reported last month that its profits surged by 31%, to $2.1 billion, during the April-June stretch."

Merrill is the largest underwriter of CDOs, or collateralized debt obligations—securitized debt instruments into which subprime mortgages are bundled together with other asset- and mortgage-backed securities. The global market in CDOs has soared from $160 billion in 2004 to half a trillion in 2006.

Merrill is by no means the only firm resorting to accounting ploys to hide losses. *ABAlert* reports that "Citigroup has been making moves resembling Merrill's. The same goes for Lehman Brothers and Morgan Stanley," who are also hunting "for internal accounting maneuvers that can lessen the impact of the market dislocation."

The monies correspond to multi-billion dollar mark-to-market accounts opened by the major investment banks in their role as "warehouse lenders for unaffiliated CDO issuers. The plan was for the issuers to utilize the temporary lines of funding to build up inventories of subprime-mortgage securities that could serve as collateral for future CDOs, and then use the proceeds from those offerings to repay the banks. But as the subprime-mortgage business headed south in recent months, so did the issuers' ability to complete new CDOs," *ABAlert* said.

The move raised questions about the legitimacy of Merrill's accounting procedures and "outsiders have been plumbing into the financial statements of those institutions, among others that somehow managed to avoid reporting losses, for clues about where they're stashing the assets and what the true effect on their financial health might be."

Furthermore, the *ABAlert* report sounds an alarming note regarding the "growing urgency by investment banks... to minimize the impact on their businesses or at least dress up their books."

Under conditions in which all financial markets are suffering from the longest and most severe liquidity crunch in recent history, losses by a major investment bank, following the debacle at Bear Stearns Asset Management's hedge funds, could endanger the entire financial system upon which the US economy rests.

In other recent developments, unable to place an estimated $300 billion that they have warehoused, several banks have been forced to circulate bid lists realizing that future CDO issuance will not materialize. *ABAlert* cites the *New York Post* as reporting that Goldman Sachs wrote down $1.5 billion of CDO inventory in July.

ABAlert attributes the source of the problem to the mortgage industry: "The subprime-mortgage industry has been slumping since early this year, besieged by rising defaults and delinquencies among loans extended to borrowers with histories of credit problems—many of whom couldn't afford their homes to begin with."

This self-serving statement seeks to absolve the magazine's customers on Wall Street of any serious wrongdoing. It places the blame instead on working people who signed onto subprime mortgages to obtain a home.

But what was the role played by the banks in this process?

In the first place, defaults and delinquencies started to rise as early as the second half of 2005. This was well known on Wall Street since statistics put out by both mortgage associations and rating agencies were readily available. Nevertheless, spreads of home equity loans—the securities backed by subprime mortgages—continued to decline throughout 2006 until January of 2007, when news of New Century's financial problems hit.

The first signs of the approaching crisis appeared in November of last year, when hedge funds began shortening the ABX, a credit default swap index that tracks the credit-worthiness of home equity loan securities. By placing huge bets, some hedge funds were positioning themselves to reap major profits from the impending crisis.

Nevertheless, home equity loan securitization remained unaffected. Why? There was one very immediate reason. Why would Wall Street executives take corrective action in November and put at risk the fat bonuses that they were all counting on for Christmas? And in spite of all these developments, Wall Street continued its warehouse business in anticipation of the issuance of new CDOs in 2007. This irresponsible behavior points to the grossly parasitic nature of today's financial industry.

"Creative accounting" has made the news with increasing frequency in a series of scandals involving CEOs "cooking the books" to keep share prices from falling. A key incentive for this criminal activity was that senior executives receive a large portion of their annual compensation in the form of stock options. This meant that if stock prices fell or stagnated, executives would not be able to cash in tens of millions of dollars.

The same motivation lies behind Merrill's accounting maneuvers, where the compensation of executives and those responsible for structuring CDOs depends on performance, and reports of warehouse losses would have had a negative impact at year's end, when Wall Street announces bonuses.

The media routinely blames people for buying houses that they cannot afford, while at the same time justifying the subprime business as a means of making housing affordable to millions who otherwise would have no access to mortgages. In the end, according to this line of reasoning, there are "more winners than losers."

There is no doubt that the biggest winners were to be found on Wall Street itself—at the hedge fund speculators and banks like Merrill Lynch, Citigroup, Lehman and Morgan Stanley—where executives paid themselves tens of billions in bonuses last Christmas, thanks in large part to the securitization of subprime mortgages in 2006. Spreads that have averaged 5 percent over prime mortgage rates became a major vehicle for transferring wealth from the working class to a tiny minority of Wall Street cronies.

However, the fate of the losers, those who "couldn't afford their homes to begin with," is often tragic.

Among them are millions of working families, single mothers and immigrants who see their modest savings wiped out. Add to them the poor and elderly who took out second mortgages to make ends meet. Many of those who manage to hold onto their homes do so by cutting back on other basic necessities like food, healthcare, clothing, education and transportation. One should not forget that financial stress is a major factor in the break-up of marriages and the negative psychological implications it has on children.

In its report "State of New York City's Housing and Neighborhoods 2006" (www.furmancenter.nyu.edu/SOC2006.htm), The Furman Center for Real Estate and Urban Policy offers statistics documenting the vast gap between the Wall Street's bankers and the city's poor in terms of the housing market.

For example, in the trendy Manhattan districts of Greenwich Village, Soho and Chelsea, as well as in the more traditional quarter of wealth and privilege, the Upper East Side, the percentage of home purchases and refinancing loans that are subprime amount to only about 1 percent, and foreclosures are less than 1 in 1,000.

In contrast, in the South Bronx—the Mott Heaven-Melrose district—where the median household income stands at $15,500, home purchases with subprime loans have grown from 7.1 percent to 40.9 percent between 2002 and 2006; refinancing with subprime loans has escalated from 29.4 percent to 42.4 percent. The home foreclosure rate here hit a high of 23.7 per 1,000 in 2005, which will soon be eclipsed by the current crisis.

Figures published in the *New York Post* last week indicate that foreclosures have soared in the city's predominantly working-class "outer boroughs." For the period July 2006 to July 2007, the paper reported, foreclosure filings increased by 54.3 percent in the Bronx, 50.6 percent in Brooklyn and 126.1 percent in Queens. This compared to a relatively modest hike of 12.4 percent in Manhattan.

In the final analysis, the spectacular growth in subprime mortgages in New York City's poorest districts—as well as elsewhere across the country—has amounted to a usurious instrument for transferring wealth from the working class straight into the pockets of the banks, who have then used accounting gimmicks to hide their own losses.

For months, the media and specialized press have used terms like "market correction" or a "technical" crisis to describe the present situation, on the theory that economic fundamentals remain robust. Lately, this view has given way to a more pessimistic one that a consumer-induced crisis may be unfolding.

A brief examination of the history of subprime mortgages sheds some light on how "technical" vs. "fundamental" today's crisis is.

subprime originators came on the scene in the mid-1980s as a product of the Reagan administration's de-regulation of the banking industry. In its early years, they were used to consolidate credit card debt built up by poor people. Recently divorced women were particularly targeted. Next came financing manufactured housing in poor rural areas.

Following the recession of 1990-1991, subprime mortgages began playing an increasingly significant role in the longest post-World War II economic expansion. The growing housing industry was crucial in compensating for the loss of jobs and industrial production to new emerging markets like China, India and Eastern Europe. Construction—commercial or residential—is one industry that cannot be exported or imported.

After the dot-com bust six years ago, subprime financing was taken to new levels with originators offering all sorts of products to attract customers from the poorest and most oppressed sections of the working class.

This included the use of initial teaser rates as well as 80/20 deals, i.e., financing 80 percent with a first mortgage and the additional 20 percent with a second mortgage, in effect, buying a home with no money down. Such schemes were predicated on the ability of borrowers to refinance after two years, on the assumption that housing prices would continue to rise.

Statistics show how importance subprime mortgages have been to the housing industry and the economy as a whole:

* Statistics for the three major government mortgage agencies show the spike in mortgage lending began in the mid 1980s. Total volume for GNMA, FNMA and FHLMC stood at $370 billion in 1985; it grew to $1 trillion in 1990, $2.5 trillion in 2000 and will reach an estimated $4.1 trillion by the end of 2007.

* According to the Mortgage Bankers Association, total mortgage origination for 2006 was around $2.5 trillion. Seventy-six percent was securitized into mortgage-backed securities (MBS). subprime origination was approximately $475 billion, or 25 percent of total MBS. In 2002, home equity loans (HEL—mainly composed of subprime and Alt-A mortgages) represented about 35 percent of asset-backed securities, with auto loans standing at a little less than 30 percent and credit cards slightly below 20 percent. By 2006, HEL had spiked to the 65-70 percent range with the share for auto loans and credit cards shrinking to barely 20 percent combined. That is, in four year's time, the share of HEL as a percentage of total asset-backed securities (ABS) had doubled, while that of auto loans and credit cards was reduced by half.

* The August 2007 edition of the Securities Industry and Financial Markets Association (www.sifma.org) reports security issuance of $3.57 trillion for the first half of 2007. The largest markets were mortgage-related, with $1.1 trillion (31 percent), and ABS—of which HEL is the largest component—with $580 billion (16 percent). In contrast, corporate bond and equity issuance stood at $647.3 billion and $133.4 billion respectively, (together accounting for just 22 percent).

These figures underscore the growing dependence of the US economy—and Wall Street in particular—upon the housing industry.

With house prices stagnating or declining, millions will not be able to refinance as promised by lenders. The question is: could the construction-driven US economic expansion over the last two decades have taken place without subprime mortgages?

Quoting Richard Bove, an equity analyst at the Punk Ziegel investment bank who covers Merrill Lynch, the *ABAlert* article provides some insight into the magnitude of the problem. Bove compares the present situation to the Latin American debt crisis of the early 1980s. "In that case," says *ABAlert*, "scads of banks got stuck holding bad loans, and were subsequently sent searching within their own operations for places to unload them.

"The difference, according to Bove, is that much of the Latin American debt eventually recovered its value, while the jury is still out on how subprime-mortgage products will fare in the long run."

The other factor that kept the subprime market growing in recent years was the stability of the job market, which in turn is largely dependent upon the construction industry. Thus, the spike in foreclosures and delinquencies may signal the beginning of a “fundamental” crisis of colossal proportions that no accounting gimmick will be able to stave off.