

Plan to freeze some subprime mortgage rates

Bush administration intervenes to shield Wall Street from housing meltdown

Barry Grey
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The Bush administration is seeking to obtain the agreement of major US banks, mortgage lenders and servicers, and financial institutions holding subprime mortgage-backed securities to freeze the interest rates on some subprime loans that are scheduled to reset at higher rates in the coming months.

As first reported in the November 30 *Wall Street Journal*, Treasury Secretary Henry Paulson, officials of the Federal Reserve Board and other US financial regulators met last Thursday with top Wall Street and home mortgage executives as well as housing counselors to discuss the plan. The newspaper said Paulson might speak publicly about the scheme at a housing conference today.

Calling itself the “Hope Now Alliance,” the government-Wall Street consortium is casting its deliberations as an altruistic effort to rescue homeowners overwhelmed by mortgage debt from foreclosure when their adjustable-rate loans reset upwards by as much as 30 percent. However, press reports make clear that, should the plan come to fruition, only a minority of the 2 million families whose subprime mortgages will reset over the next 18 months would get temporary relief in the form of a rate freeze or some other mortgage restructuring arrangement.

The motivation behind the discussions is the growing alarm on Wall Street and in Washington over the potentially catastrophic financial implications of the accelerating housing slump and related crisis on credit markets. The proposals under discussion are calibrated to avert—at the least possible cost to the banks and big investors—a collapse of major US banks and other financial institutions that could be triggered by spiraling home foreclosures and the implosion of hundreds of billions of dollars in speculative investments tied to the subprime housing boom of previous years.

In essence, the scheme is aimed at containing the home foreclosure epidemic sufficiently to shield the major financial institutions from the full consequences of years of rampant speculation, accompanied by accounting manipulations that concealed the immense levels of risk behind the soaring profits and gargantuan salaries reaped by Wall Street executives.

Were the plan implemented, it would allow holders of

mortgage-backed securities to put off marking down their assets.

Most of those who stand to lose their homes —after having been lured into high-interest rate mortgages by predatory lenders, including some of the biggest US banks, when their “teaser” rates expire and their monthly payments shoot up by hundreds of dollars— will not benefit from the plans being thrashed out between the administration and Wall Street.

Among those involved in the negotiations are Citigroup, JPMorgan Chase, Wells Fargo, Washington Mutual and Countrywide Financial (the country’s largest home mortgage lender). Also at Thursday’s Washington meeting were representatives of the American Securitization Forum, whose members issue, buy and rate securities backed by bundles of mortgages.

According to the *Wall Street Journal*, key aspects of the plan have yet to be agreed upon, and some press reports suggest that the entire project could founder, primarily because some big holders of securities backed by subprime loans object to foregoing the increased profits they anticipate once the higher mortgage rates take effect. However, according to the *Journal*, the American Securitization Forum has come around to the position that the potential losses from foreclosed homes would be far greater than the losses from an interest rate freeze on some subprime loans.

Citigroup, the largest US bank, Wells Fargo, Washington Mutual and Countrywide Financial all face potentially disastrous losses from the accelerating housing and foreclosure crisis. Citigroup has already announced \$13 billion in write-offs of securities linked to subprime mortgages, and may be forced to absorb another \$65 billion in losses from off-balance-sheet speculative investments that are crashing.

Just last week Moody’s Investors Service announced it had downgraded or put on review \$119 billion in debt issued by so-called “structured investment vehicles” (SIVs). This includes \$64.9 billion in debt issued by six SIV’s set up by Citigroup.

According to some estimates, between \$400 and \$500 billion in assets of international banks, investment houses, insurance companies and hedge funds will be wiped out by the collapse of

the US housing market and resulting credit crunch.

Among the issues still under discussion between the administration and financial houses, according to press reports, are the length of any temporary freeze on subprime interest rates and the criteria for deciding which subprime borrowers would be eligible.

The *Journal* wrote on Friday: “Treasury officials say financial institutions are likely to set criteria that divide up subprime borrowers into three groups: those who can continue to make their payments even if rates rise, those who can’t afford their mortgages even if rates stay steady, and those who could keep their homes if the maturity date of their mortgages were extended or the interest rates remained at the teaser rates. Only the third group would be eligible for help.”

The newspaper added that creditors would take into account whether the borrowers had equity in their homes, despite falling house prices, and whether their incomes were steady. Because of the precipitous decline in house prices, many subprime borrowers now owe more than the market value of their homes.

The criteria outlined above make it clear that the most distressed homeowners would be excluded from a temporary interest rate freeze and left to be thrown onto the street.

Harvey L. Pitt, a former chairman of the Securities and Exchange Commission, who is now working for some hedge funds with a stake in the negotiations on a possible subprime rate freeze, said that even a generous freeze would help only a minority of subprime borrowers. He said a freeze would do nothing to help people who took out a “no documentation” loan, overstated their incomes and borrowed more than they could repay. Nor would a freeze help those whose mortgage is higher than the market value of their homes.

The increasingly desperate state of the US financial system and the precarious position of some of the biggest banks, has led the administration to shift its previous position of a hands-off approach, aside from urging mortgage lenders to provide relief to mortgage borrowers on a one-by-one basis.

It is estimated that there are \$1 trillion in US subprime loans. Interest rates are scheduled to reset next year on \$362 billion worth of adjustable-rate subprime mortgages, and another \$85 billion in these mortgages is resetting in the course of the current quarter. These include loans that are bundled into so-called “collateralized debt obligations” that are held in the portfolios of banks, hedge funds, mutual funds and insurance companies.

In recent months, the foreclosure rate on subprime loans has soared to 10 percent, and top Treasury officials fear that unless some relief is provided, the foreclosure rate could spiral even higher.

The announcement of the subprime negotiations was the second major step taken last week by government and finance officials to reassure the stock market and financial institutions in response to a raft of reports showing a deepening credit crunch, rapidly falling home sales and prices, soaring

foreclosure rates, declining durable goods orders, rising unemployment claims and sagging personal incomes and consumer spending—all pointing to a sharp contraction in economic growth in the current quarter and the likelihood of a full-scale recession in 2008.

The vice chairman of the Federal Reserve Board, Donald L. Kohn, and the chairman, Ben Bernanke, both delivered speeches broadly hinting at a further interest rate cut when Fed policy makers meet again on December 11. Financial interests are clamoring for a cut of at least 0.25 percent—the third since last August—to further open the credit spigot and forestall catastrophic losses on Wall Street.

The Fed officials’ remarks helped spark a two-day rally of 546 points Tuesday and Wednesday in the Dow Jones Industrial Average and similar sharp gains in the other major stock indexes, and further, more modest gains, on Thursday and Friday. Reports of the subprime negotiations led to large gains for the stocks of financial companies involved in the talks in Friday trading on the New York Stock Exchange. Shares in Citigroup rose 3.1 percent, Countrywide Financial shot up 16 percent, and Wells Fargo rose 6 percent.

Another factor driving the administration’s subprime initiative is a desire to preempt legislation being introduced by Democrats in the House of Representatives and the Senate to halt predatory lending and restrict some practices that are widespread among subprime lenders. Some Democrats are also seeking to pass a bill that would allow bankruptcy judges to change the terms of mortgages to help people retain their homes.

The initial response of prominent Democrats to news of the government-led negotiations indicates that they are more than willing to seize on the plan to drop any serious legislation to curb mortgage lending abuses. The liberal *New York Times* columnist Paul Krugman offered “kudos to the Bush administration” on his blog, and House Financial Services Chairman Barney Frank said he was “encouraged by reports of progress” in efforts to help borrowers facing foreclosure.



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