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NEWS ANALYSIS

Crisis Looms in Market for Mortgages

By GRETCHEN MORGENSON

On March 1, a Wall Street analyst at Bear Stearns wrote an upbeat report on a company that specializes in making mortgages to cash-poor homebuyers. The company, New Century Financial, had already disclosed that a growing number of borrowers were defaulting, and its stock, at around $15, had lost half its value in three weeks.

What happened next seems all too familiar to investors who bought technology stocks in 2000 at the breathless urging of Wall Street analysts. Last week, New Century said it would stop making loans and needed emergency financing to survive. The stock collapsed to $3.21.

The analyst's untimely call, coupled with a failure among other Wall Street institutions to identify problems in the home mortgage market, isn't the only familiar ring to investors who watched the technology stock bubble burst precisely seven years ago.

Now, as then, Wall Street firms and entrepreneurs made fortunes issuing questionable securities, in this case pools of home loans taken out by risky borrowers. Now, as then, bullish stock and credit analysts for some of those same Wall Street firms, which profited in the underwriting and rating of those investments, lulled investors with upbeat pronouncements even as loan defaults ballooned. Now, as then, regulators stood by as the mania churned, fed by lax standards and anything-goes lending.

Investment manias are nothing new, of course. But the demise of this one has been broadly viewed as troubling, as it involves the nation's $6.5 trillion mortgage securities market, which is larger even than the United States treasury market.

Hanging in the balance is the nation's housing market, which has been a big driver of the economy. Fewer lenders means many potential homebuyers will find it more difficult to get credit, while hundreds of thousands of homes will go up for sale as borrowers default, further swamping a stalled market.

"The regulators are trying to figure out how to work around it, but the Hill is going to be in for one big surprise," said Josh Rosner, a managing director at Graham-Fisher & Company, an independent investment research firm in New York, and an expert on mortgage securities. "This is far more dramatic than what led to Sarbanes-Oxley," he added, referring to the legislation that followed the WorldCom and Enron scandals, "both in conflicts and in terms of absolute economic impact."

While real estate prices were rising, the market for home loans operated like a well-oiled machine, providing ready money to borrowers and high returns to investors like pension funds, insurance companies, hedge funds and other institutions. Now this enormous and important machine is sputtering, and the effects are reverberating throughout Main Street, Wall Street and Washington.

Already, more than two dozen mortgage lenders have failed or closed their doors, and shares of big companies in the mortgage industry have declined significantly. Delinquencies on loans made to less creditworthy borrowers — known as subprime mortgages — recently reached 12.6 percent. Some banks have reported rising problems among borrowers that were deemed more creditworthy as well.

Traders and investors who watch this world say the major participants — Wall Street firms, credit rating agencies, lenders and investors — are holding their collective breath and hoping that the spring season for home sales will reinstate what had been a go-go market for mortgage securities. Many Wall Street firms saw their own stock prices decline over their exposure to the turmoil.

"I guess we are a bit surprised at how fast this has unraveled," said Tom Zimmerman, head of asset-backed securities research at UBS, in a recent conference call with investors.

Even now the tone accentuates the positive. In a recent presentation to investors, UBS Securities discussed the potential for losses among some mortgage securities in a variety of housing markets. None of the models showed flat or falling home prices, however.

The Bear Stearns analyst who upgraded New Century, Scott R. Coren, wrote in a research note that the company's stock price reflected the risks in its industry, and that the downside risk was about $10 in a "rescue-sale scenario." According to New Century, Bear Stearns is among the firms with a "longstanding" relationship financing its mortgage operation. Mr. Coren, through a spokeswoman, declined to comment.

Others who follow the industry have voiced more caution. Thomas A. Lawler, founder of Lawler Economic and Housing Consulting, said: "It's not that the mortgage industry is collapsing, it's just that the mortgage industry went wild and there are consequences of going wild.

"I think there is no doubt that home sales are going to be weaker than most anybody who was forecasting the market just two months ago thought. For those areas where the housing market was already not too great, where inventories were at historically high levels and it finally looked like things were stabilizing, this is going to be unpleasant."

Like worms that surface after a torrential rain, revelations that emerge when an asset bubble bursts are often unattractive, involving dubious industry practices and even fraud. In the coming weeks, some mortgage market participants predict, investors will learn not only how lax real estate lending standards became, but also how hard to value these opaque securities are and how easy their values are to prop up.

Owners of mortgage securities that have been pooled, for example, do not have to reflect the prevailing market prices of those securities each day, as stockholders do. Only when a security is downgraded by a rating agency do investors have to mark their holdings to the market value. As a result, traders say, many investors are reporting the values of their holdings at inflated prices.

"How these things are valued for portfolio purposes is exposed to management judgment, which is potentially arbitrary," Mr. Rosner said.

At the heart of the turmoil is the subprime mortgage market, which developed to give loans to shaky borrowers or to those with little cash to put down as collateral. Some 35 percent of all mortgage securities issued last year were in that category, up from 13 percent in 2003.

Looking to expand their reach and their profits, lenders were far too willing to lend, as evidenced by the creation of new types of mortgages — known as "affordability products" — that required little or no down payment and little or no documentation of a borrower's income. Loans with 40-year or even 50-year terms were also popular among cash-strapped borrowers seeking low monthly payments. Exceedingly low "teaser" rates that move up rapidly in later years were another feature of the new loans.

The rapid rise in the amount borrowed against a property's value shows how willing lenders were to stretch. In 2000, according to Banc of America Securities, the average loan to a subprime lender was 48 percent of the value of the underlying property. By 2006, that figure reached 82 percent.

Mortgages requiring little or no documentation became known colloquially as "liar loans." An April 2006 report by the Mortgage Asset Research Institute, a consulting concern in Reston, Va., analyzed 100 loans in which the borrowers merely stated their incomes, and then looked at documents those borrowers had filed with the I.R.S. The resulting differences were significant: in 90 percent of loans, borrowers overstated their incomes 5 percent or more. But in almost 60 percent of cases, borrowers inflated their incomes by more than half.

A Deutsche Bank report said liar loans accounted for 40 percent of the subprime mortgage issuance last year, up from 25 percent in 2001.

Securities backed by home mortgages have been traded since the 1970s, but it has been only since 2002 or so that investors, including pension funds, insurance companies, hedge funds and other institutions, have shown such an appetite for them.

Wall Street, of course, was happy to help refashion mortgages from arcane and illiquid securities into ubiquitous and frequently traded ones. Its reward is that it now dominates the market. While commercial banks and savings banks had long been the biggest lenders to home buyers, by

2006, Wall Street had a commanding share — 60 percent — of the mortgage financing market, Federal Reserve data show.

The big firms in the business are Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, Deutsche Bank and UBS. They buy mortgages from issuers, put thousands of them into pools to spread out the risks and then divide them into slices, known as tranches, based on quality. Then they sell them.

The profits from packaging these securities and trading them for customers and their own accounts have been phenomenal. At Lehman Brothers, for example, mortgage-related businesses contributed directly to record revenue and income over the last three years.

The issuance of mortgage-related securities, which include those backed by home-equity loans, peaked in 2003 at more than $3 trillion, according to data from the Bond Market Association. Last year's issuance, reflecting a slowdown in home price appreciation, was $1.93 trillion, a slight decline from 2005.

In addition to enviable growth, the mortgage securities market has undergone other changes in recent years. In the 1990s, buyers of mortgage securities spread out their risk by combining those securities with loans backed by other assets, like credit card receivables and automobile loans. But in 2001, investor preferences changed, focusing on specific types of loans. Mortgages quickly became the favorite.

Another change in the market involves its trading characteristics. Years ago, mortgage-backed securities appealed to a buy-and-hold crowd, who kept the securities on their books until the loans were paid off. "You used to think of mortgages as slow moving," said Glenn T. Costello, managing director of structured finance residential mortgage at Fitch Ratings. "Now it has become much more of a trading market, with a mark-to-market bent."

The average daily trading volume of mortgage securities issued by government agencies like Fannie Mae and Freddie Mac, for example, exceeded $250 billion last year. That's up from about $60 billion in 2000.

Wall Street became so enamored of the profits in mortgages that it began to expand its reach, buying companies that make loans to consumers to supplement its packaging and sales operations. In August 2006, Morgan Stanley bought Saxon, a $6.5 billion subprime mortgage underwriter, for $706 million.

And last September, Merrill Lynch paid $1.3 billion to buy First Franklin Financial, a home lender in San Jose, Calif. At the time, Merrill said it expected First Franklin to add to its earnings in 2007. Now analysts expect Merrill to take a large loss on the purchase.

Indeed, on Feb. 28, as the first fiscal quarter ended for many big investment banks, Wall Street buzzed with speculation that the firms had slashed the value of their numerous mortgage holdings, recording significant losses.

As prevailing interest rates remained low over the last several years, the appetite for these securities only rose. In the ever-present search for high yields, buyers clamored for securities that contained subprime mortgages, which carry interest rates that are typically one to two percentage points higher than traditional loans. Mortgage securities participants say increasingly lax lending standards in these loans became almost an invitation to commit mortgage fraud. It is too early to tell how significant a role mortgage fraud played in the rocketing delinquency rates — 12.6 percent among subprime borrowers. Delinquency rates among all mortgages stood at 4.7 percent in the third quarter of 2006.

For years, investors cared little about risks in mortgage holdings. That is changing.

"I would not be surprised if between now and the end of the year at least 20 percent of BBB and BBB- bonds that are backed by subprime loans originated in 2006 will be downgraded," Mr. Lawler said.

Still, the rating agencies have yet to downgrade large numbers of mortgage securities to reflect the market turmoil. Standard & Poor's has put 2 percent of the subprime loans it rates on watch for a downgrade, and Moody's said it has downgraded 1 percent to 2 percent of such mortgages that were issued in 2005 and 2006.

Fitch appears to be the most proactive, having downgraded 3.7 percent of subprime mortgages in the period.

The agencies say that they are confident that their ratings reflect reality in the mortgages they have analyzed and that they have required managers of mortgage pools with risky loans in them to increase the collateral. A spokesman for S.& P. said the firm made its ratings requirements more stringent for subprime issuers last summer and that they shored up the loans as a result.

Meeting with Wall Street analysts last week, Terry McGraw, chief executive of McGraw-Hill, the parent of S.& P., said the firm does not believe that loans made in 2006 will perform "as badly as some have suggested."

Nevertheless, some investors wonder whether the rating agencies have the stomach to downgrade these securities because of the selling stampede that would follow. Many mortgage buyers cannot hold securities that are rated below investment grade — insurance companies are an example. So if the securities were downgraded, forced selling would ensue, further pressuring an already beleaguered market.

Another consideration is the profits in mortgage ratings. Some 6.5 percent of Moody's 2006 revenue was related to the subprime market.

Brian Clarkson, Moody's co-chief operating officer, denied that the company hesitates to cut ratings. "We made assumptions early on that we were going to have worse performance in subprime mortgages, which is the reason we haven't seen that many downgrades," he said. "If we have something that is investment grade that we need to take below investment grade, we will do it."

Interestingly, accounting conventions in mortgage securities require an investor to mark his holdings to market only when they get downgraded. So investors may be assigning higher values to their positions than they would receive if they had to go into the market and find a buyer. That delays the reckoning, some analysts say.

"There are delayed triggers in many of these investment vehicles and that is delaying the recognition of losses," Charles Peabody, founder of Portales Partners, an independent research boutique in New York, said. "I do think the unwind is just starting. The moment of truth is not yet here."

On March 2, reacting to the distress in the mortgage market, a throng of regulators, including the Federal Reserve Board, asked lenders to tighten their policies on lending to those with questionable credit. Late last week, WMC Mortgage, General Electric's subprime mortgage arm, said it would no longer make loans with no down payments.

Meanwhile, investors wait to see whether the spring home selling season will shore up the mortgage market. If home prices do not appreciate or if they fall, defaults will rise, and pension funds and others that embraced the mortgage securities market will have to record losses. And they will likely retreat from the market, analysts said, affecting consumers and the overall economy.

A paper published last month by Mr. Rosner and Joseph R. Mason, an associate professor of finance at Drexel University's LeBow College of Business, assessed the potential problems associated with disruptions in the mortgage securities market. They wrote: "Decreased funding for residential mortgage-backed securities could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy."