

Deflating Mortgage Bubble

Remarks by Christopher Whalen

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www.institutionalriskanalytics.com

The Risk of Subprime

- The subprime crisis is about the collapse of the \$3 trillion over-the-counter market for complex structured assets, some of which happen to contain subprime mortgages.
- The subprime crisis represents a reversal in how global investors view securitized assets and custom derivative structures, such as collateralized debt obligations or CDOs.

Subprime Causation

- The [National Homeownership Strategy](#) was prepared by HUD under the direction of Secretary Henry G. Cisneros and in response to a request from President Bill Clinton.
- GSEs, HUD, the Congress, regulators and private industry all worked to push up the rate of home ownership in the US by making mortgages available to marginal borrowers.

Subprime Symptoms

- Global banks, funds and bond insurers have written off billions of dollars in subprime assets, mostly against illiquid structured assets and OTC derivatives positions.
- Vast majority of these losses are non-cash, mark-to-market losses taken under “fair value” accounting rules. Through 2007, loan defaults by banks remain low by historical measures.

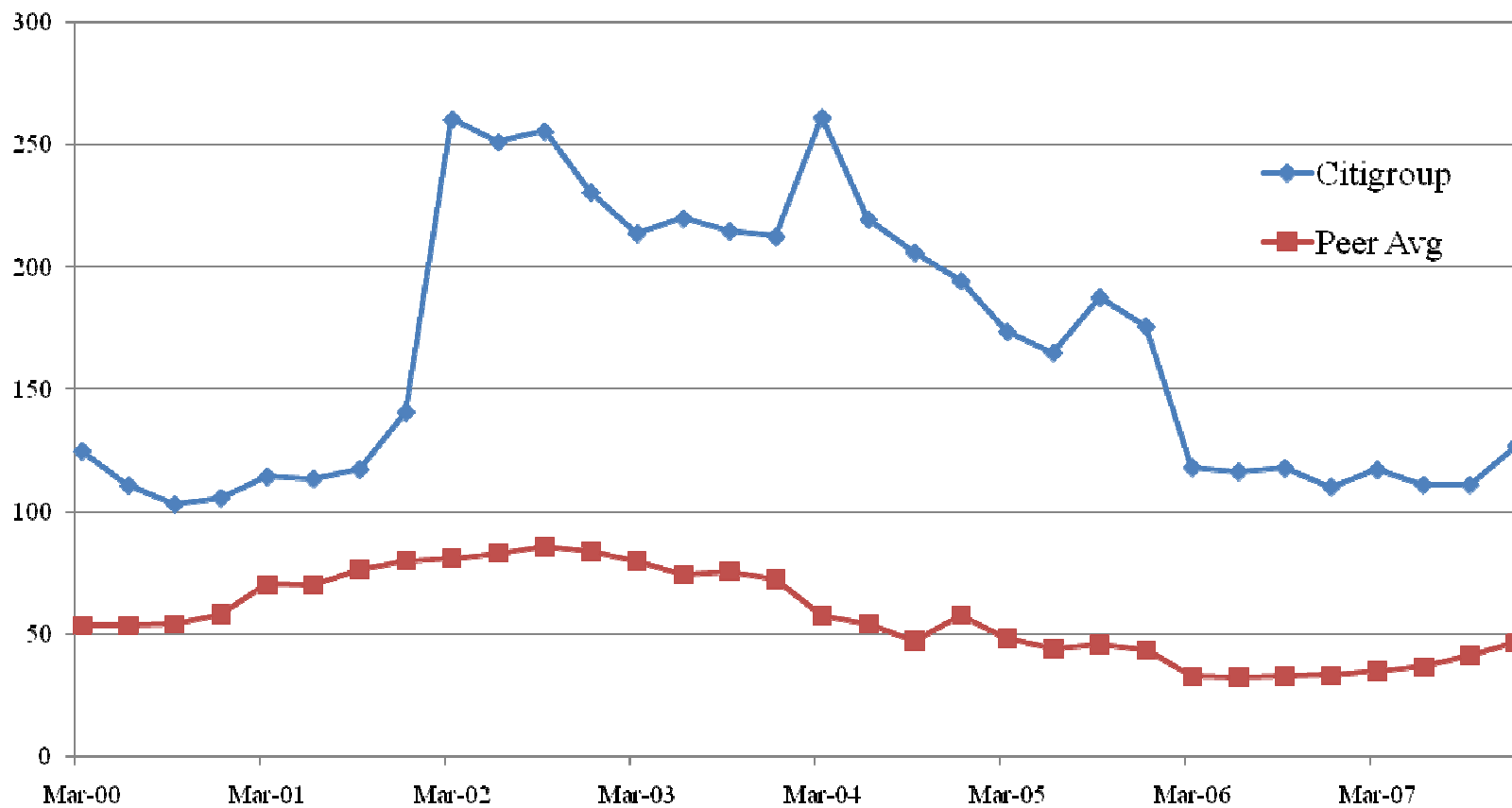
Q4 -- US Banking Industry

	2007	2006	2005	2004	2003	2002	2001
Return on assets (%)	0.86	1.28	1.28	1.28	1.38	1.3	1.14
Return on equity (%)	8.17	12.3	12.43	13.2	15.05	14.08	13.02
Core capital (leverage) ratio (%)	7.98	8.22	8.25	8.11	7.88	7.86	7.79
Noncurrent assets plus OREO (%)	0.94	0.54	0.5	0.53	0.75	0.9	0.87
Net charge-offs to loans (%)	0.59	0.39	0.49	0.56	0.78	0.97	0.83
Net operating income growth (%)	-23.72	8.5	11.39	4.02	16.39	17.58	-0.48

Source: FDIC – Quarterly Banking Profile

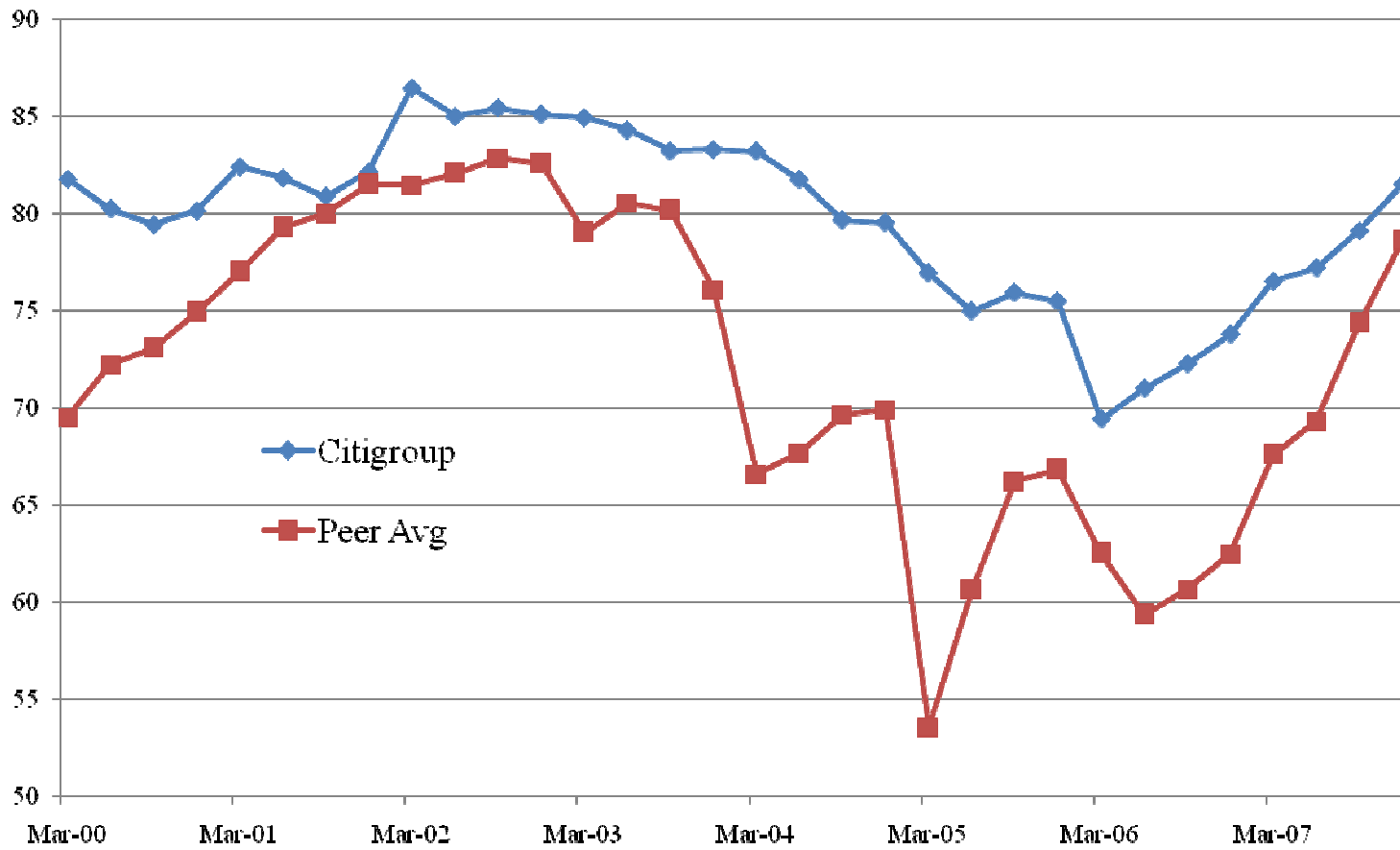
Gross Defaults

(bp -- annualized)

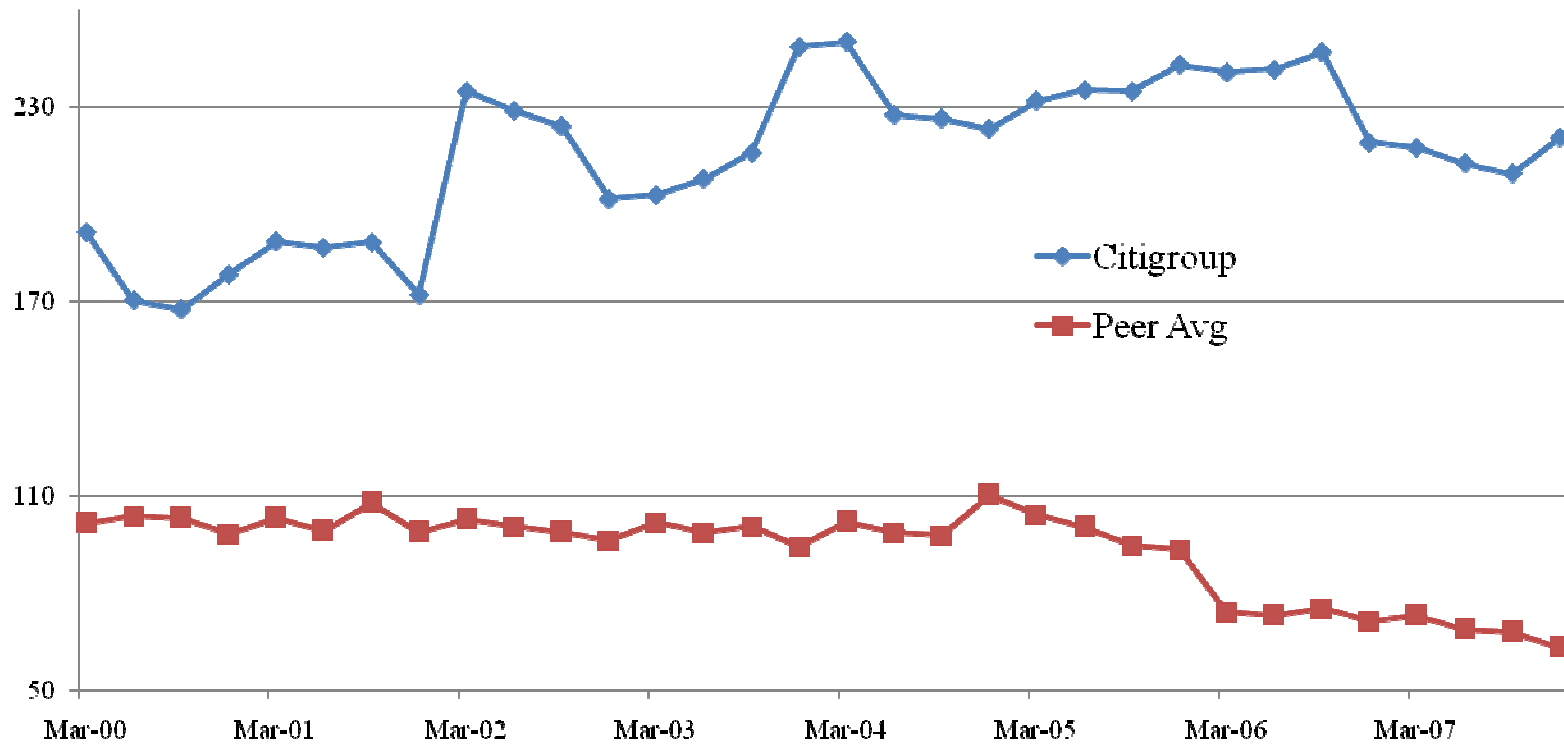


Source: FDIC/IRA Bank Monitor

Loss Given Default (%)



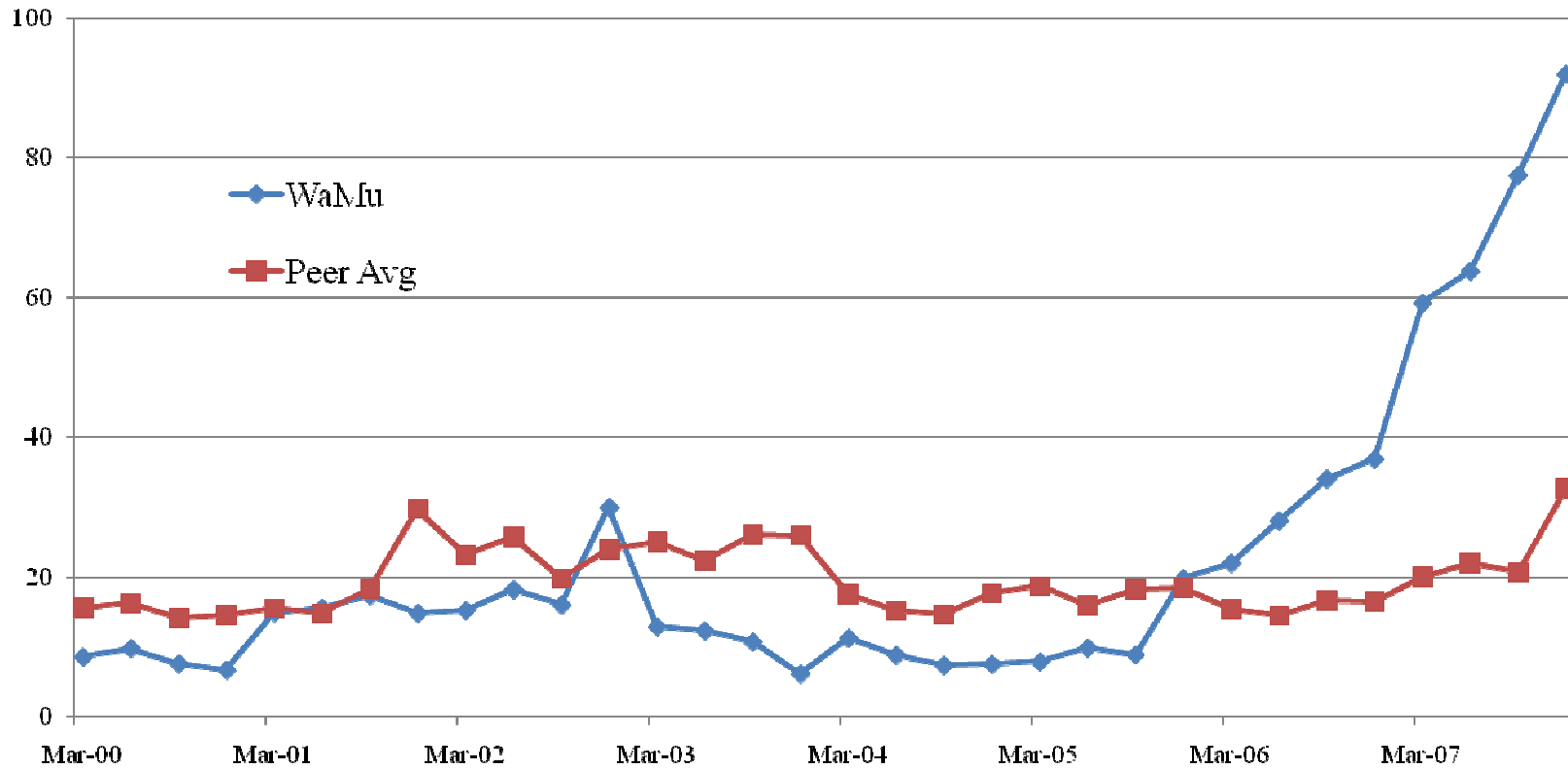
Exposure at Default (%)



Source: FDIC/IRA Bank Monitor

Mortgage Sector Defaults

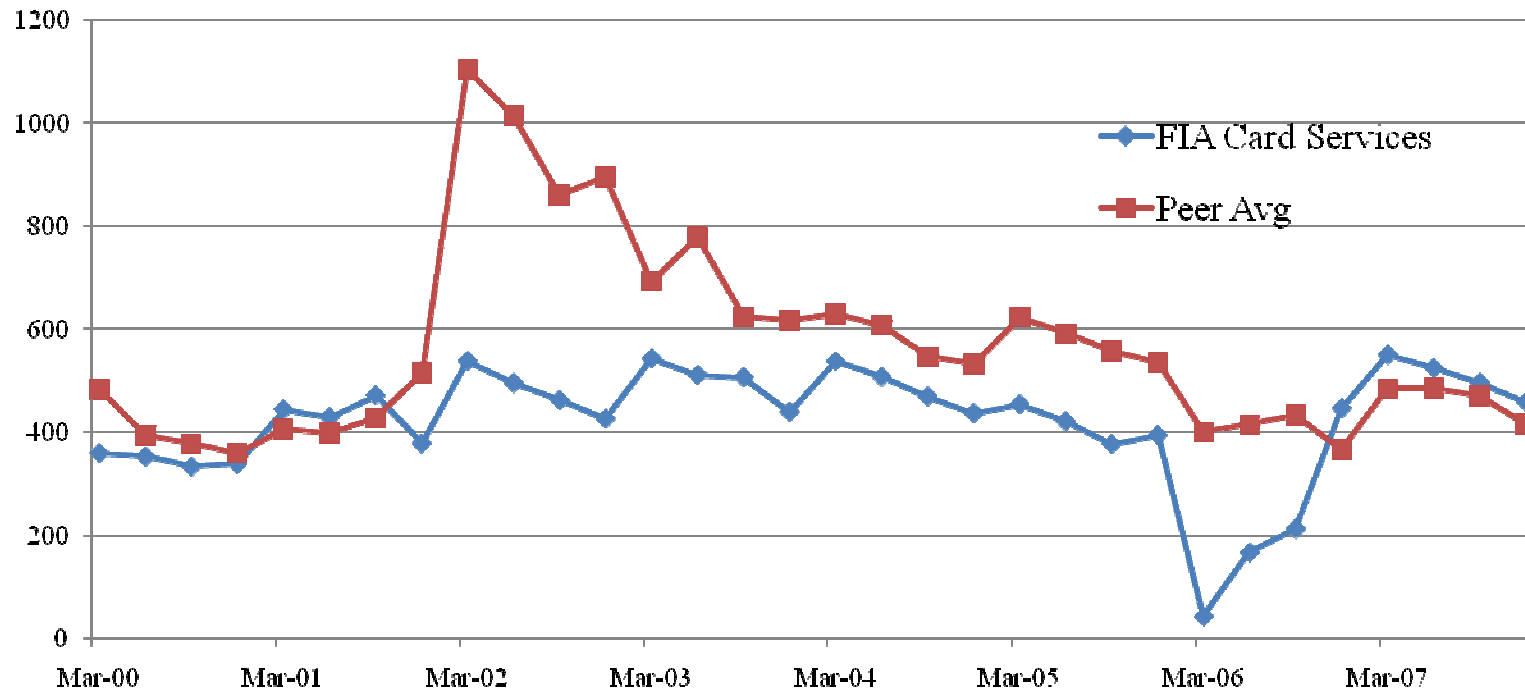
(bp -- annualized)



Source: FDIC/IRA Bank Monitor

Credit Card Sector Defaults

(bp – annualized)



Source: FDIC/IRA Bank Monitor

Effect: Banking Industry

- Immediate: Subprime crisis tears gaping hole in bank business models, eliminating volume and income while limiting ALM options. Net effect is large % reduction in credit available.
- Long-term: The clock has been wound back decades. Loan origination now implies retention of the asset as default option. Banks have limited funding, revenue options.

Effects: Risk Preferences

- The subprime crisis has changed investor and lender preferences dramatically. Structured assets of all ratings grades are being shunned in favor of simpler cash securities.
- Dealers are walking away from low-risk markets such as Munis due to concerns about capital availability and “fair value” risk. Huge reduction in market liquidity overall.

Effects: Litigation

- The subprime crisis has made lenders and their advisers extremely vulnerable to a number of different types of claims.
- Borrowers are bringing claims against lenders for violations in TILA as well as loan suitability rules.
- End-investors are likewise suing lenders, dealers and rating agencies for fraud, KYC suitability of complex structured assets.

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