STANDARD & POOR'S

RATINGSDIRECT®

March 15, 2007

Credit FAQ:

Will Subprime Lenders' Woes Trouble The Economy?

Credit Market Services:
David Wyss, Chief Economist, New York (1) 212-438-4952; david_wyss@standardandpoors.com

Table Of Contents

Frequently Asked Questions

572296 | 300017896

Credit FAQ:

Will Subprime Lenders' Woes Trouble The Economy?

Turmoil in the subprime home-lending market has clearly wracked the markets in recent days. Defaults on these mortgages, which lenders grant to homebuyers with low credit scores and who bought their houses with little or no money down, have increased sharply. As a result, Standard & Poor's Ratings Services has already downgraded two lenders that specialize in subprime mortgages, as well as 12 tranches of residential mortgage-backed securities (RMBS) subprime and second-lien transactions. While it's obvious that homeowner defaults hurt mortgage lenders (not to mention the homeowners), these defaults and the losses that occur from them must be put in a broader economic context. How are they related to other macroeconomic factors, such as housing prices or unemployment? And how might they affect the national economy? Here are some answers.

Frequently Asked Questions

Just how bad is the falloff in the subprime lending market?

It is significant, and we expect the weakness to last at least through the end of 2007. In the past two years, subprime home loans accounted for about 20% of all mortgages. In 2006, 40% of all adjustable-rate and interest-only home loans were subprime. Standard & Poor's foresees losses on 2006 subprime RMBS portfolios of between 5.25% and 7.75%. This would be a record loss—the previous high was 5% in 2000. But the last low point in a major housing cycle was back in 1991, before subprime securitization was a factor. A confluence of two factors is propelling today's losses: rising interest rates, which have made mortgages more expensive since late 2005, and stagnating home prices, as opposed to the galloping gains prior to 2006. We don't see low interest rates or double-digit gains in home prices returning in the near term. Thus, conditions in the subprime market will probably get worse before they get better.

How does this compare with credit downturns in other sectors?

While there's no way to paint a positive picture of default rates nearing 8%, it is useful to remember that this is still a shade healthier than the default rates corporate bonds have hit during tough economic times. During the last recession earlier this decade, defaults on speculative-grade corporate debt exceeded 8% for two consecutive years.

Will conditions in the subprime mortgage market hurt national economic output?

The difficulties of subprime lenders affect the economy because more foreclosed houses will be on the market, in addition to homes for sale by individuals. And new home construction should drop even more. During the second half of 2006, declines in residential construction cut GDP growth by a full percentage point. This pattern will likely hold through most of 2007, also depressing GDP. This falloff in construction will also exacerbate the loss of income in the construction industry. Government statistics show that 61,000 homebuilding jobs were already lost between October 2006 and February 2007.

The pain in the financial sector from rising subprime defaults should be minimal for major banks because of their diversified income streams and because they have only a limited presence in this market. The financial players most affected will be stand-alone companies that specialize in subprime lending, along with the few major banks that have subsidiaries in the business.

In recent years home equity spending has been a major strength of the economy. Will subprime defaults change this?

To a degree, yes, although higher interest rates and falling home prices will also be important. Last year Americans on average borrowed 3.5% of their annual income through home equity loans, second mortgages, or cash-out mortgage refinancing. With a slower housing market and higher interest rates, this borrowing will almost certainly slow in 2007. More homeowners will be faced with the choice of borrowing from other sources or not borrowing at all. While those with strong credit may be able to borrow from alternate sources, many subprime borrowers could find those alternatives closed to them.

Which areas of the economy could be hurt by the reduction in the availability of home equity money?

The two major reasons consumers give for borrowing against their homes are home remodeling and education. We anticipate the most immediate and noticeable damage will be on industries related to remodeling. Home remodeling retailers, building materials companies, furniture makers, and major appliance manufacturers might all show some weakness in the coming year as consumers opt to defer remodeling plans. The decline in new home construction will hurt many of these businesses even more. Instead of using home equity to pay college tuition, many homeowners will shift to government-subsidized or private-sector education loans.

Will this surge in subprime defaults have repercussions in any particular geographic region of the country?

Rising defaults are almost always tied, to some degree, to rising unemployment, so it's no surprise that a region with a troubled employment outlook will see more defaults. Metropolitan Cleveland and Detroit, two areas where the auto industry's woes are hitting hard, rank in the top-five metropolitan areas for home-price declines, according to the S&P/Case-Shiller home price index. Subprime defaults may also be more common in markets where home prices are dropping because of overvaluation, such as in Boston, Washington D.C., and San Diego. Note that the only city on the list of top-five price declines that has a significant amount of "creative financing" is San Diego; the other four look relatively conservative in their lending mix.

The impact of defaults on municipal and state finances in these regions should be minor. The relationship between assessed values and market values are, at best, vague. Because most housing is taxed at assessed values, a decline in home prices shouldn't affect taxes. Even if taxes aren't paid, the new owner will have to pay them to acquire title. However, some states and localities do get significant revenue from taxes on home sales and housing starts, and declines in these could have an effect. Some states and localities may also see an impact on their finances because the assessment on a home generally rises when it's sold. Overall, however, municipalities should remain in good fiscal shape

Writer: Robert McNatt

Click on this link to see other articles in “Special Report: Subprime Lending: Measuring The Impact.”

Click on this link to go to the Special Report Archive.