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Commentary

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Will Home Equity Loans Be The Next Stage In The Credit Crisis?

The following will appear in the June Edition of *Asia Asset Management*

“Nat City had argued that the debt should be non-dischargeable because the debtors made material false representations (namely, lying about their income) on which Nat City relied when it made the loan. The court agreed that the debtors had in fact lied to the bank, but it held that the bank did not "reasonably rely" on the misrepresentations. ” – **Calculated Risk (Blog)**, May 29, 2008

The losses associated with the credit crisis to-date largely have involved subprime debt. The hope is losses from previous subprime loans have been recognized, and as new subprime loans are not being originated, the overall subprime loss picture should have bottomed.

As the table below shows, the losses have been significant at nearly $400 billion. And since the financial system has raised only $277 billion to offset these losses, or roughly $110 billion less than needed, the credit crisis continues to drag on world economies and financial markets.

Worldwide Financial System Losses and Capital Raised
As of May 30, 2008
In Billions of Dollars

	Total		Q2 2008		Q1 2008		Q4 2007		Q3 2007		Prior	
	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital
America	165.4	141.3	3.6	64.8	65.7	48.0	69.7	27.7	25.7	0.8	0.7	0.0
Europe	199.6	126.0	0.0	75.2	79.1	23.7	102.0	16.8	15.7	5.4	2.8	4.9
Asia	21.6	9.7	0.0	6.2	2.6	3.5	13.7	0.0	5.3	0.0	0.0	0.0
Worldwide	386.6	277.0	3.6	146.2	147.4	75.2	185.4	44.5	46.7	6.2	3.5	4.9

Source: Bloomberg

We agree that losses associated with subprime should be bottoming. And, so long as the losses do not spread to other areas of the housing market, the banking system will, in time, raise the other $110 billion to fully re-capitalize itself.

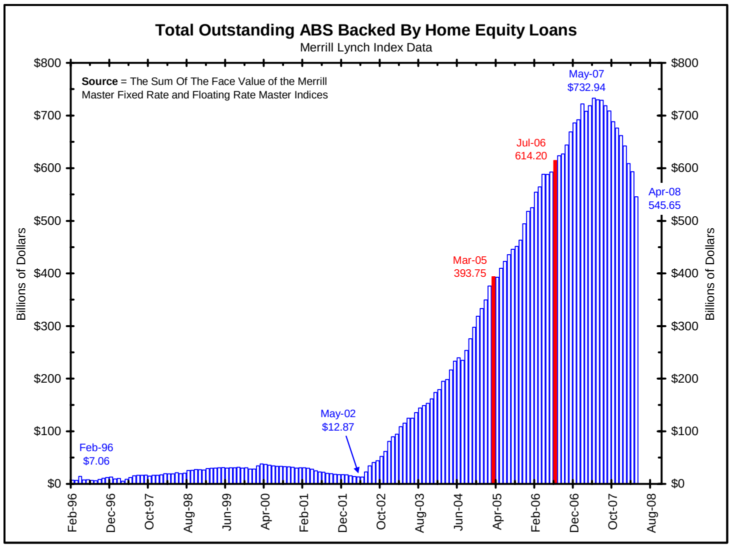
HELOC

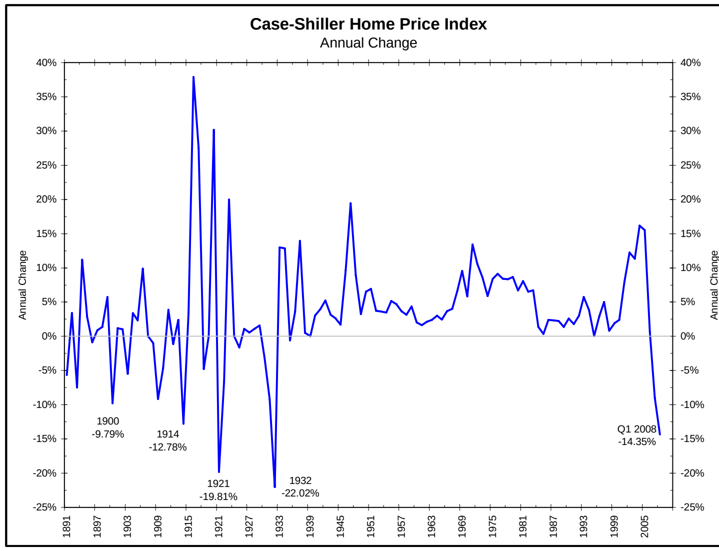
However, there is worrisome evidence mounting that the credit crisis might be spreading into another area of the housing market, leaving the banking system vulnerable to a fresh set of losses – namely home equity loans.

Home equity loans come in two broad forms, the second mortgage and the home equity line of credit or HELOC. The second mortgage is what the word implies, another mortgage written against a home backed by the equity built up thanks to rising prices. The loan is a set amount and payback is monthly via an amortization schedule similar to a first mortgage.

The HELOC is a line of credit against one’s house. The borrower is literally given a check book or a credit card to borrow against his home. Payment is variable as is the interest rate charged, usually tied to LIBOR. Of the two, the HELOC is the more popular form of borrowing.

Like many forms of consumer finance, home equity loans work on the “originate to distribute” model. Loans are packaged together as securities and sold to investors. The most basic form of these securities is the asset-backed security (ABS). The next chart shows the size of the ABS backed by home equity loans according to Merrill Lynch. Even though it has been shrinking with the credit crisis, it still measures in the hundreds of billions of dollars.





ABS backed by home equity loans, also known as “closed-end seconds,” are packaged into “hybrid CDOs. And, yes, many of these have also been guaranteed or wrapped by the monline insurers leaving them vulnerable to further losses.

Why Losses Now?

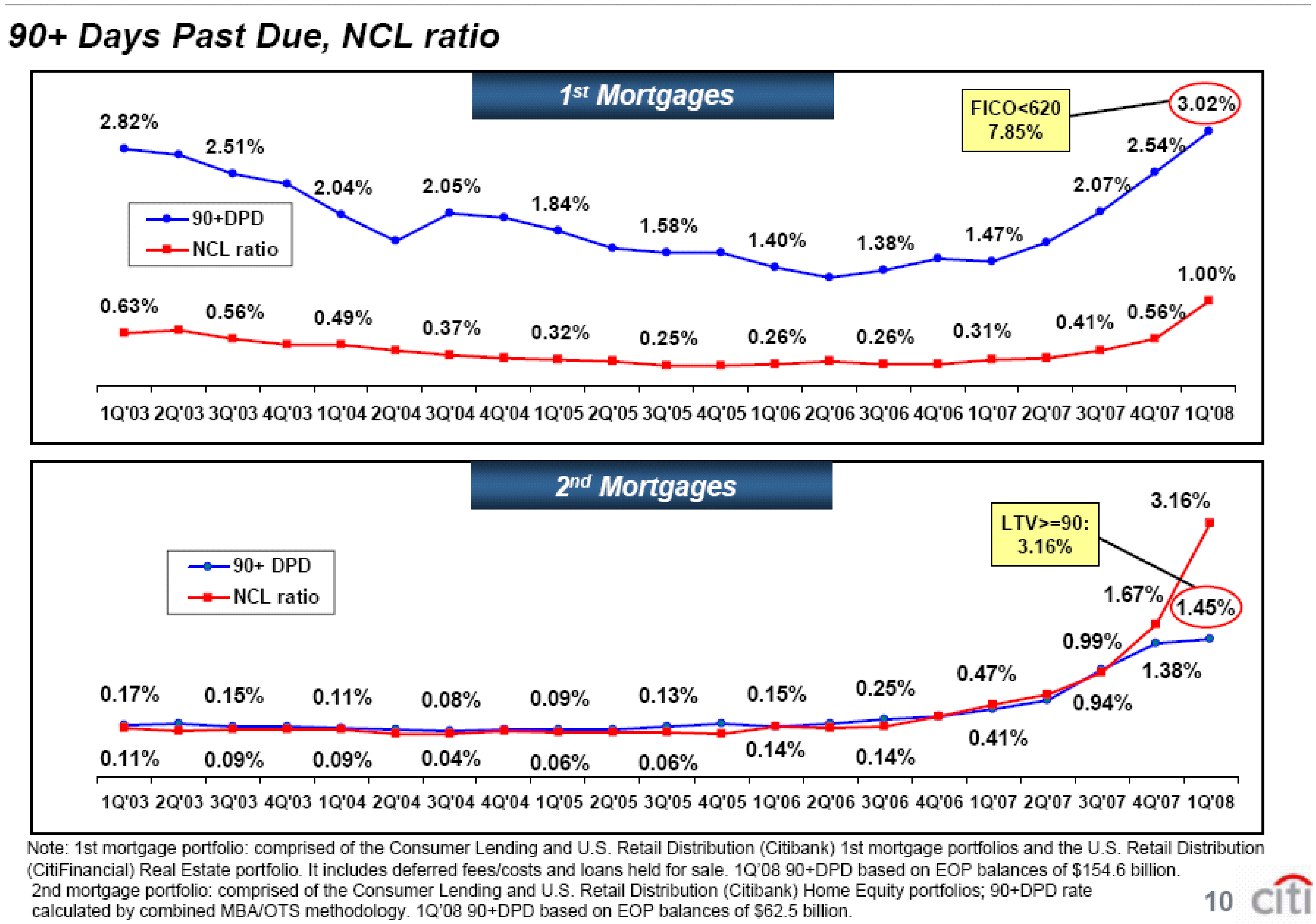
Until recently, it was argued that the home equity loan market was not vulnerable to losses like subprime. First, the home equity loan has been around for decades and not as unknown as the subprime mortgage. Wholesale fraud would be more difficult to pull off given the familiarity that many Americans have with the product. Second, these loans were given to more established borrowers with better credit ratings than subprime loans. Finally, only a severe drop in home prices would make home equity loans vulnerable to system wide losses.

Unfortunately, severe home losses are now a reality. The next chart comes from data compiled by Yale professor Robert Shiller and shows home prices are plunging at a rate not seen since the Great Depression 75 years ago. Virtually no one alive has a memory anything like the current home price market.

The consequences of this continued decline in home prices can be seen in the next set of graphs on the following page. They come from Citigroup's 2008:Q1 investor presentation (page 10). The bottom chart shows that home equity loans (second mortgages) 90 days past due (blue line, "90+ DPD") and the non-conforming loan ratio (red line, NCL ratio) have skyrocketed in recent quarters.

Two years ago (2006:Q1) these ratios were extremely low at 0.15% and 0.14% respectively. Further note that these “near-zero” rates were commonplace in the years leading up to 2006. This history drove to the belief that homeowners simply do not default on home equity loans and investors in securities backed by these loans need not worry.

Fast forward to 2008:Q1 and late payments and loans that are not performing have skyrocketed to levels thought not possible just two years ago at 3.16% and 1.45% respectively. More worrisome is that these ratios are accelerating higher.



Bankruptcy Ruling

As bad as the situation has been so far, it has actually gotten worse in just the last few days.

In the United States, all home lending is "non-recourse" lending. This means a lender cannot go after a borrower's assets, other than the home, to recover non-payment. So, given that a lender only has the borrowers' creditworthiness and the home value as collateral, the theory is they would be very careful in who would be extended a loan. We now know this theory was not operative in recent years.

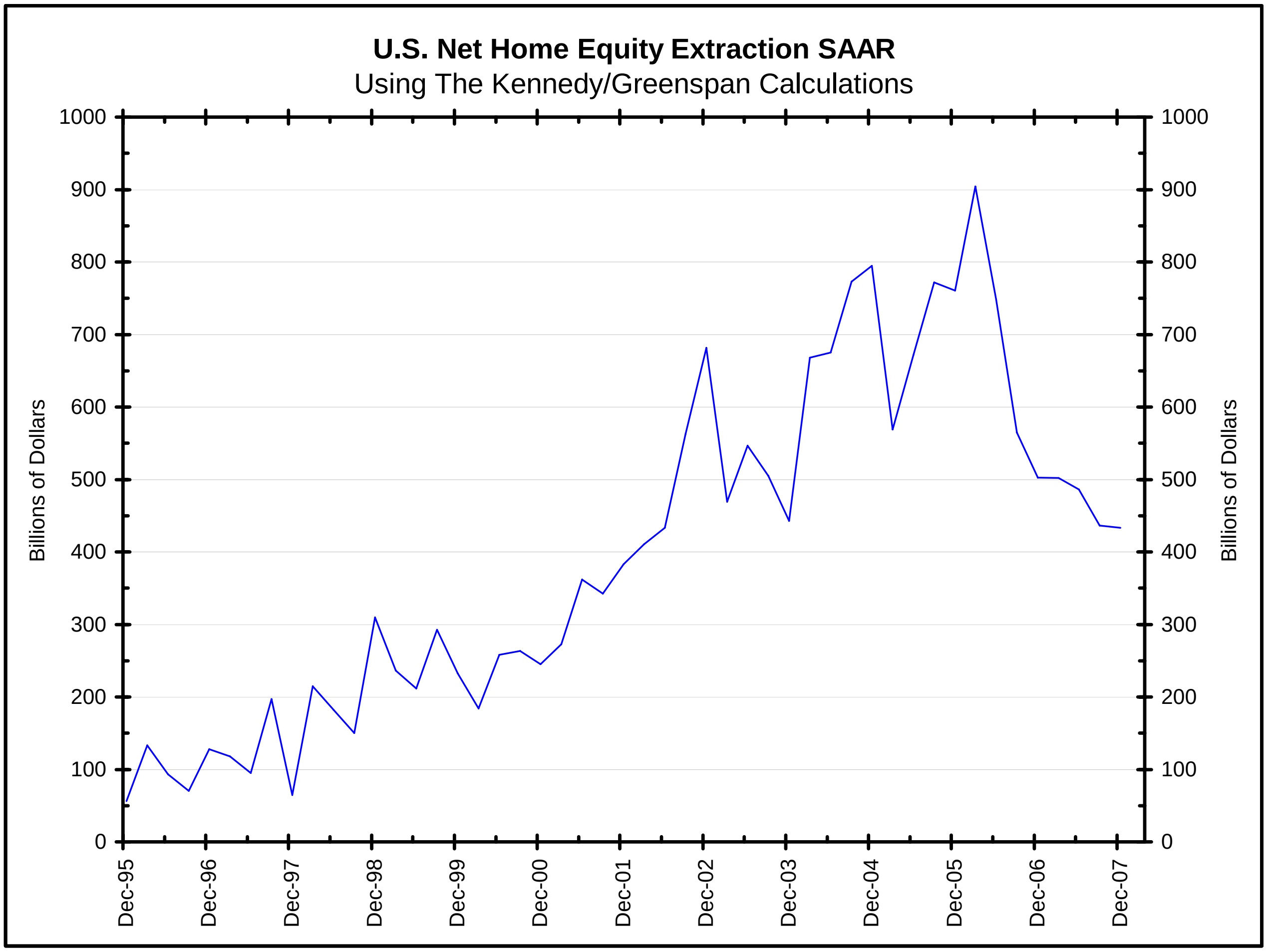
Further, most home equity lending is done with a credit review that relies on what is called "stated income." That is, the borrower only has to tell the lender what his income is, not actually verify it. Again, the theory is if the borrower files bankruptcy and the lender finds out the borrower lied about his income on his application form, they can claim fraud to waive the non-recourse nature of the loan. In other words, if you lie on your application, they can go after all your assets to get re-paid so you better be careful about lying.

As the quote leading this article says, the judge in a bankruptcy case in Northern California made a ruling that will strike fear in the hearts of all home equity lenders everywhere. The judge agreed that the borrowers did lie about their income on their loan application but that this was **not** an important consideration in making the loan. So, the fraud was not material and the non-recourse nature of the loan holds. This means borrowers are not required to use other assets to pay back the $220,000 they borrowed on their home equity line of credit. The lender only has the value of their severely depressed home that will not cover the amount they borrowed. Will this lead to borrowers filing for bankruptcy in order to escape paying back their home equity loans? This is indeed the worry.

MEW No More

The final consideration is the concept of mortgage equity withdrawal or MEW. This was popularized by none other than Alan Greenpsan a few years ago.

The idea is that home owners will use HELOCs to borrow against their homes, effectively using their homes as an ATM. It was argued by Dr. Greenpsan that this form of borrowing was supporting the entire economy by increasing the consumption ability of homeowners. While direct evidence that this is actually the case is spotty, many believe this to be true. How big is this activity? The next chart details net equity extraction or MEW.



Given the decline in home prices and the recent bankruptcy ruling, it should not come as a surprise that home equity lenders are pulling back in a big way. HELOC's are being canceled but not on a case-by-case basis. Rather, certain lenders are cancelling their programs in entire cities like Las Vegas, Cleveland and Los Angeles. If MEW was a driving force for the consumer, this support is now completely gone.

Conclusion

At the heart of the credit crisis is the plunge in home prices. Even though many have proclaimed the credit crisis over, home prices have continued to plunge. As long as they do, the credit crisis is at risk to morph into other forms. Home equity loans now look like one of the next areas of vulnerability for the financial system.

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