

# How Missed Signs Contributed to a Mortgage Meltdown

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All through last year, Jim Melcher saw the signs of a rapidly deteriorating American housing market — riskier mortgages, rising delinquencies and more homes falling into foreclosure. And with \$100 million in assets at his hedge fund, Balestra Capital, he was in a position to do something about it.

So in October, as mortgage-backed bonds were still flying high, he bet \$10 million that these bonds would plunge in value, using complex derivatives available to any institutional investor. As his gamble began to pay off in the first months of 2007, Mr. Melcher, a money manager based in New York, plowed the profits into ever bigger wagers that the mortgage crisis would worsen further, eventually risking some \$60 million of the fund's money.

“We saw the opportunity of a lifetime, and since then events have unfolded on schedule,” he said. Mr. Melcher's flagship fund has since doubled in value, even as this summer's market turmoil cost other investors billions, forced the closing of several major hedge funds and pushed the stock market down 7 percent since mid-July. This week, Mr. Melcher is heading to Paris for a vacation with his wife.

The extent of the turmoil has stunned much of Wall Street, but as Mr. Melcher's case makes clear, there were ample warning signs that a financial time bomb in the form of subprime mortgages was ticking quietly for months, if not years.

As far back as 2001, advocates for low-income homeowners had argued that mortgage providers were making loans to borrowers without regard to their ability to repay. Many could not even scrape together the money for a down payment and were being approved with little or no documentation of their income or assets.

In December, the first subprime lenders started failing as more borrowers began falling behind on payments, often shortly after they received the loans. And in February, HSBC, the large British bank, set aside \$1.76 billion because of problems in its American subprime lending business.

Over the last two weeks, this slowly building wave became a tsunami in the global financial markets.

On Friday, the Federal Reserve was forced into a surprise cut of the discount rate it charges banks to borrow money, a move that steadied shaky stock and credit markets and reassured investors, bankers and traders who were reeling from a month of market turmoil. And for the first time, the Fed bluntly acknowledged that the credit crisis posed a threat to economic growth.

“Until recently, there was a lot of denial, but this is a big deal,” said Byron R. Wien, a 40-year veteran of Wall Street who is now chief investment strategist at Pequot Capital. “Now the big question is: Will this spill over into the broader economy?”

The answer to that question will be revealed over the coming months. But the cast of characters who missed signals like the rise of delinquencies and foreclosures is becoming easier to identify. They

include investment banks happy to sell risky but lucrative mortgage debt to hedge funds hungry for high interest payments, bond rating agencies willing to hope for the best in the housing market and provide sterling credit appraisals to debt issuers, and subprime mortgage brokers addicted to high sales volumes.

What is more, some of these players now find themselves in a dual role as both enabler and victim, like the legions of individual borrowers who were convinced that their homes could only keep rising in value and were confident that they could afford to stretch for the biggest mortgage possible.

“All of the old-timers knew that subprime mortgages were what we called neutron loans — they killed the people and left the houses,” said Louis S. Barnes, 58, a partner at Boulder West, a mortgage banking firm in Lafayette, Colo. “The deals made in 2005 and 2006 were going to run into trouble because the credit pendulum at the time was stuck at easy.”

Oddly, the credit analysts at brokerage firms now being pummeled were among the Cassandras whose warnings were not heeded. “I’m one guy in a research department, but many people in our mortgage team have been suggesting that there was froth within the market,” said Jack Malvey, the chief global fixed income strategist for Lehman Brothers. “This has really been progressing for quite some time.”

Others on Wall Street echoed Mr. Malvey’s stance. “We’ve contended for a while that there was an issue in subprime debt,” said Neal Shear, global head of trading at Morgan Stanley. “A year ago, we were aware that delinquencies were going to rise.”

### *A Ripple Expands*

So why did many of the smartest minds on Wall Street somehow miss the signposts that these insiders now claim to have seen coming?

Few professionals on the losing end of these trades are willing to talk publicly about how what started out as a crisis in an obscure corner of the credit market — subprime debt, for borrowers with weak credit — managed to infect stocks and bonds. For example, officials at Goldman Sachs, Wall Street’s most dominant firm, have provided little detail into how one of their hedge funds lost 30 percent of its value in just weeks.

But the precipitous fall in the value of mortgage-backed bonds was spurred by a mad rush by so many holders to dump them simultaneously. That is because they might not have understood what they were buying in the first place, instead focusing only on the bonds’ higher yields. Unlike Mr. Melcher, they had not considered the circumstances under which the risky mortgages they essentially owned had been granted.

“Buyers didn’t fully understand what they were getting,” said Rajiv Sobti, a portfolio manager at Proxima Alfa Investments, a New York hedge fund. In Wall Street parlance, Mr. Sobti added, “They were sold, not bought. The actual buyers were often not mortgage specialists, but generalists who looked at these bonds as a way of earning higher yields.”

Once the mortgage-backed bonds finally started plunging for the very reasons Mr. Melcher spotted long before, the dominoes moved swiftly. Hedge funds and other holders of this risky debt also began to sell more solid investments like corporate bonds and even stocks in an effort to raise money. These hedge funds, in turn, were under pressure from their own backers to return their investments. The same was true for the Wall Street brokerage houses that had provided them with credit.

The blame game is already beginning. The spotlight will focus first on rating agencies like Moody’s and Standard & Poor’s, because the mortgage-backed bonds that plunged in value in recent weeks were highly rated by these agencies until they downgraded billions worth of them in July.

## *A Toll on the Economy*

Other companies face far more immediate problems. Countrywide Financial, the nation's largest independent mortgage lender, found itself fending off reports this month that bankruptcy could be looming as its stock plunged 41 percent.

Yet as recently as March, Angelo R. Mozilo, the chief executive of Countrywide, appeared on CNBC and proclaimed that worries about the subprime sector were "clearly an overreaction." He promised that "this will be great for Countrywide at the end of the day, because all the irrational competitors will be gone."

Along with chief executives like Mr. Mozilo, central bankers also apparently failed to anticipate the threat posed by subprime debt. In a May 17 speech in Chicago, Ben S. Bernanke, the chairman of the Federal Reserve, acknowledged the "recent sharp increases in subprime mortgage loan delinquencies."

But he said, "we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."

That same month, a former Federal Reserve governor, Edward M. Gramlich, was preparing to publish a book titled, "Subprime Mortgages: America's Latest Boom and Bust." Even earlier, in April, the usually bullish National Association of Realtors said that home prices across the country would decline in 2007 because of the widening fallout from subprime loans. And in March, the head of the Federal Deposit Insurance Corporation, a banking regulator, had urged Congress to create standards to protect borrowers with poor credit.

Federal regulators did eventually tighten lending standards on June 29, but by then the meltdown on Wall Street was already in progress. Exactly one week earlier, Bear Stearns disclosed that two hedge funds specializing in subprime debt run by its asset management arm were facing a sudden wave of withdrawals by investors, the hedge-fund equivalent of a run on the bank.

"This was the match that lit a very dry field of risk on fire," Mr. Malvey said. When he first heard the news coming out of Bear Stearns, Mr. Malvey recalled, he was busy writing his weekly report to clients in his corner office on the 15th floor of Lehman's Midtown Manhattan headquarters. Now it seemed as if the broader market was catching up to what Mr. Malvey and his team had been talking about all along.

Bear Stearns' failure to sense the early tremors was especially glaring. In 2006, it was rated as the best risk manager among United States brokerage firms in 2006 by Euromoney, a respected trade publication. Unlike other firms, though, Bear's problems eventually claimed a high-profile casualty — in early August, the brokerage firm's co-president and heir apparent, Warren J. Spector, was forced to resign.

The company has emphasized that in spite of the damage to its reputation, its actual financial losses were relatively small.

Within weeks after the Bear Stearns disclosure, the action shifted to the rating agencies. On July 10, Standard & Poor's announced it was downgrading \$7.3 billion worth of securities sold in late 2005 and 2006, and the ensuing conference call quickly turned testy. Steven Eisman, a portfolio manager at Front Point Partners, an investment firm that had made a major bet against the subprime mortgage market, did not mince words.

"I'd like to know why now?" Mr. Eisman demanded to know. "Why didn't you do this many, many months ago?"

## *Regulatory Scrutiny*

The European Union says it plans to examine the agencies' role in the debacle and investigate possible conflicts of interest between the agencies and the issuers of mortgage bonds.

In Washington, Representative Barney Frank, the chairman of the House Financial Services Committee, is planning hearings in October that will also examine this issue. "The fact is the rating agencies didn't do a very good job," Mr. Frank said. "They had no way of knowing whether some of the loans were imprudently granted."

In a written statement, Chris Atkins, a spokesman for Standard & Poor's, said that for 18 months leading up to July 10 the company had been adjusting its assumptions about the housing market, downgrading selected bonds and publicly highlighting potential problems. Even in light of the crisis, S.& P. expects that only the riskiest mortgage bonds could default and that holders of securities with its top AAA rating will continue to receive interest and principal payments.

"Our concerns and actions have coincided with the worst housing recession in recent history set against a backdrop of loosened lending practices," Mr. Atkins said. Still, Mr. Atkins seemed to acknowledge that his company was also caught by surprise.

"The market continues to deteriorate, with the level of loss continuing to exceed historical precedents and our initial expectations," he said.

Some mortgage executives take a different view. Larry A. Goldstone, president of Thornburg Mortgage, said the trajectory of the current crisis in subprime closely resembled the arc of past mortgage crunches. Thornburg is not a subprime issuer, but like Countrywide it was also hit with rumors that it could go under last week.

"I've been in this business since 1983, and this is the fourth time we've had this in subprime," said Mr. Goldstone, ticking off similar squeezes in 1987, 1993 and 1998. Maybe so, but what is different now is how much bigger the subprime market is than in the past, totaling \$600 billion last year, up from \$120 billion in 2001, according to Inside Mortgage Finance, a trade journal.

To make matters worse, all borrowers are now likely to face higher borrowing costs for years to come, even those with stellar credit histories. Already, mortgages of more than \$417,000, known as jumbos, carry interest rates of 7.5 percent to 8 percent, up from 6.5 percent last month.

"It's going to come down a little, but it won't go back to 6.5 percent," Mr. Goldstone said. He also predicts the rate of about 6.25 percent on smaller government-backed mortgages will probably rise to 7 percent. That may not sound like much, but for a homebuyer borrowing \$400,000, the higher rate means \$200 more in monthly payments.

There are signs that this added burden is already having an effect on the economy. Last week, the nation's two largest retailers — Wal-Mart and Home Depot — stoked those fears when they reported disappointing earnings and warned that consumer spending was slowing as a result of the weakness in the housing sector. New car purchases have also been slipping, and earlier this month General Motors and Ford lowered their sales forecasts for 2007.

Although Mr. Malvey believes the short-term turmoil in the stock and bond markets will subside by the fall, he said the added financial strain on homebuyers increases the odds of a recession in 2008 or 2009. That, in turn, makes it more likely that the Federal Reserve will announce a cut in its benchmark rate when it next meets on Sept. 18, Mr. Malvey said.

And while the Fed's rate cut on Friday will help stabilize the overall credit and equity markets in the near term, it will take months for the benefits to filter down to individual borrowers.

“This will have no effect on local market conditions,” Mr. Barnes said. “While smaller government-backed loans and mortgages for extremely high-quality borrowers are available, everything else is very hard to get it.” As for no-money-down loans, he said, rates now stand at 10 percent, in the unlikely event that they can be found.

In the coming months, foreclosures are expected to keep mounting.

What is more, the interest rates on the subprime mortgages offered to homebuyers in 2005 and 2006, when credit standards were at their most lax, will soon begin to rise, forcing up monthly payments for the weakest borrowers practically overnight. As a result, Mr. Goldstone predicts that banks and other lenders could eventually see losses reach into the tens of billions.

### *Homebuyers Affected*

Now, some would-be buyers like Matthew Hennig are having to put off their dream of homeownership. In early July, Mr. Hennig, an air-conditioner repairman, signed the contract to buy his ideal home, a two-bedroom condo overlooking a swimming pool in a Phoenix suburb.

A day later, however, as he was on the job in a sweltering attic, his loan officer at Fairway Independent Mortgage called to tell him that the \$185,000, no-money-down loan Mr. Hennig thought was a sure thing had been denied. Why? He was a first-time buyer with little credit history.

Unlike the professionals on the trading floors of Wall Street who lost billions and now seem shell-shocked, Mr. Hennig has moved on. Mr. Hennig, who earns about \$40,000 a year, is now renting a room from a friend and saving up the money for a down payment when he tries to buy again in a year or so. He has also recently opened a charge-card account to bolster his credit score.

If Mr. Hennig does eventually get a mortgage, however, his monthly payment could well be higher, because of the same factors Mr. Melcher first noticed long ago. “This is the first time I have ever tried to buy anything,” he said. “It is just my luck.”