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How the failure of subprime mortgages hurts the overall economy

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Given the huge piles of consumer and business debt out there, many U.S. residents seem to think easy credit is their birthright. That cozy feeling that a loan is always within reach is getting rudely shaken. An international credit crunch is upon us. The subprime mortgage crisis spawned it, but everything from home-equity loans to business lines of credit may be touched before it's over.

Sectors as disparate as auto-parts suppliers and developers of riverfront condos in Detroit are feeling the pinch of tighter credit, battering an already weak Michigan economy. "The unwinding of debt is all encompassing. It's from the little homeowner out there to the big corporation," said Larry Moss, senior vice president for the Raymond James investment firm in Birmingham.

The credit crunch overlaps with other negative trends, most noticeably the poor housing market and weakening consumer spending. The fear is that tighter credit and weaker spending will reinforce and amplify each other, creating a downward spiral leading to a recession.

"Once you get in that cycle, then it becomes really, really scary," said Amiyatosh Purnanandam, a professor of finance at the Ross School of Business at the University of Michigan who has studied tight-credit periods.

Key to survival

Credit -- the ability to get a loan -- will determine much of the course of economic activity in 2008. Among much else, credit or the lack of it will determine whether several auto suppliers survive a trip to bankruptcy court, whether condominium projects along Detroit's east riverfront get built, and whether millions of consumers take a vacation, buy a car or purchase a house.

For Ray Parker, a Detroit commercial real estate broker, the weakening economy has meant some personal tightening up. Parker recently refinanced his Southfield condominium with a new mortgage. He got a shock when the home appraisal came in \$20,000 below what he had paid for his condo because of a real estate market battered by the subprime crisis.

"I'm trying to pay my credit cards off in case things don't get much better in the real estate business. They have not been great," he said.

Easy credit is a distinctly modern phenomenon. In the tight-money era of the 19th Century and early years of the 20th, farmers, tradespeople and ordinary working folks found credit hard to come by. An old joke defined a banker as a man who would lend money only to those wealthy enough not to need it.

After World War II, however, the G.I. Bill helped millions of U.S. families buy houses with government-backed mortgages. Banks eager to grow began to look for new customers and new

ways to lend money.

The advent of computers opened new possibilities in mass marketing of credit cards in the 1980s and '90s. Niche marketing -- creating a loan product or line of credit for every conceivable borrower -- became the norm.

Today, it's the rare U.S. adult who doesn't carry at least some debt: a mortgage, a car loan, a student loan, a home-equity line of credit or credit card debt. And the amount of that debt is rising rapidly.

Ten years ago, consumer debt in the United States, excluding home mortgages, totaled \$1.24 trillion. Today, Americans have roughly doubled the amount of non-mortgage debt they carry, to \$2.5 trillion, or \$8,300 for every man, woman and child in the country.

This easy credit helped make consumers the drivers of the U.S. economy, with consumer spending accounting for an estimated 70% of economic activity in the nation.

But at a price: A typical homeowner's debt burden including mortgages and other types of credit now stands at about 18% of disposable income, up from under 14% in 1980, according to the Federal Reserve Board.

For businesses, too, credit is lifeblood. Lines of credit and, for larger corporations, commercial paper, bonds and other forms of borrowing are as essential as any raw materials.

"I don't think businesses ever got to the point where credit was thrown at them the way consumers did," said Justin Moran, a Grosse Pointe banking consultant, "but certainly the so called middle market, small business credit, is a growing phenomenon."

That's why the current credit crisis has so jarred the U.S., and global, financial system. In an economy greased by relatively easy credit, the inability to lend or borrow on the usual terms threatens not just consumers, but industry after industry.

Suppliers socked

Take auto suppliers. The credit crunch has come at a bad time for auto suppliers trying to leave bankruptcy. Troy-based Delphi Corp. and Rochester Hills-based Dura Automotive Systems Inc. expected to leave Chapter 11 by the end of 2007. But they have delayed their exits until this year because they've had trouble securing financing.

Only making things worse, U.S. vehicle sales are expected to drop below 16 million this year, perhaps even hitting a 10-year low, prompting banks to become more cautious when it comes to lending in the automotive sector.

"The widespread belief that there's going to be a very slow six months in the first half of 2008 is making people nervous," said Jim Gillette, an auto analyst with CSM Worldwide.

Relaxed standards

In theory, bankers make loans only to credit-worthy borrowers.

"We used to say, the best way to train a loan officer is to make him collect his bad loans," Moran said.

But through the years, lenders occasionally relaxed standards to such a degree that billions of dollars were risked on shaky loans, triggering an eventual collapse. The savings and loan debacle of the late 1980s proved one such episode, which devastated commercial real estate markets in Detroit and elsewhere.

This time around, the slack standards allowed millions of high-risk borrowers to get easy home mortgages. When this so-called subprime market collapsed beginning about a year ago, ordinary working people bore the brunt.

By some estimates, nearly 2 million U.S. residents will lose their homes to foreclosure this year, with more foreclosures coming in 2008 as low-rate adjustable mortgages reset to higher and less affordable rates.

But the damage from the credit crunch, while concentrated in the subprime mortgage market, has spread far beyond it. Already, borrowers with good credit ratings are paying higher fees and having to put more money down to get a standard mortgage.

Linda Ross, a veteran real estate agent with Hall & Hunter in Birmingham, said that just a few years ago bankers would lend homebuyers whatever amount they wanted. Recently, though, she had a client who, even with a secure job and a salary in the range of \$60,000 a year, couldn't get a mortgage without having a parent co-sign the loan.

"They've really tightened up because they've gotten stuck with all those houses," Ross said of lenders.

The credit crunch, combined with the slump in home sales, has delayed many planned residential developments, like the east riverfront condominium developers in Detroit. Those projects, including those being developed by sports and business leaders Dave Bing and Jerome Bettis, were supposed to have groundbreakings in 2006, but skepticism by banks has delayed construction until this year at the earliest.

How it happened

How did a home mortgage problem seep into the auto supplier and other unrelated industries?

It begins with what happens to a home mortgage once the loan is made. Banks and other lenders typically bundle up hundreds or thousands of their mortgage loans and sell them to an agency or company such as Fannie Mae or Freddie Mac, which create an investment security, or bond, backed by the underlying mortgage payments.

The creators of these bonds then sell them to major pension funds, insurance companies and other investors handling billions of dollars. Wall Street went one step further by spinning off a whole range of exotic investment vehicles tied to these underlying mortgage assets.

As the subprime loans began to fail a year ago, many of these major investors realized that the mortgage-backed assets they held in their portfolios were not worth what they thought. So financial giants like Merrill Lynch, Citigroup, UBS and others began to take billion-dollar write-offs, fire their chief executives and otherwise scramble to stay ahead of the debt bomb.

With so much uncertainty over which assets are still good and which are fatally weakened by the subprime disaster, these major lenders have begun to tighten up credit lending of all kinds.

Purnanandam of U-M has looked at the impact of a previous credit crunch in the late '90s on the U.S. steel industry. The impact was two-fold: A general economic slump meant fewer orders for steel producers, and then bankers' skittishness about lending meant fewer dollars lent to steel companies to carry them through the rough spot.

Auto analyst John Casesa of Casesa Shapiro Group told the Financial Week news service in December that the credit crunch is hurting Cerberus Capital Management, the private-equity owner of Chrysler, and might seep into Chrysler's operations.

Other credit sources

Nervousness on the part of lenders is pushing many business borrowers toward alternative sources of credit.

As home values drop, it is becoming harder for people who want to start businesses to get the money they need through home equity loans. So they're turning to places like Ann Arbor's Center for Empowerment and Economic Development, which offers commercial loans of as much as \$35,000.

"What we're also seeing is not only people coming to us, but that the banks are coming to us to ask us to participate in the loan," said Michelle Richards, executive director of the Ann Arbor group.

And there's no question that the economic outlook is worsening. Moody's Investors Service reported in December that it had given negative outlooks or reviews for possible downgrade to over 90% of homebuilders, 32% of restaurant companies and 33% of building material companies.

The real threat is that this lending squeeze will so choke off new investment and consumer spending that the nation's economy tips into a recession. If that happens, the easy credit of the past few years could morph into something a whole lot more painful.

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