

SUB PRIME LENDING

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ABSTRACT

This paper examines the liquidity crisis in the US financial markets in 2007. This liquidity crisis was not altogether unexpected but widely predicted by market watchers. Nevertheless it seems to have taken several market participants by surprise causing considerable market volatility and losses to investors.

INTRODUCTION

In March of 2000 the US Equity markets began crashing following six consecutive increases in the Federal funds rate by the US Federal Reserve Bank. On November 17, 1998 the Federal funds rate stood at 4.75 percent. Then from June 30, 1999 to May 16 2000 the Federal Reserve raised the Federal funds rate by 0.25 percent five consecutive times with the last increase occurring on March 2000. The NASDAQ hit its peak crossing 5000 in early March of year 2000 and began a precipitous and prolonged slide thereafter. This slide was accelerated by the Fed raising interest rates by an additional 0.50 percent on May 16, 2000 and the events of September 11, 2001. The Federal Reserve Bank began cutting interest rates in January of 2001 when the NASDAQ stood at 2291, full 55% below its all time high. But the NASDAQ continued to fall as the unexpected terrorist attack on the world trade Center on September 11, 2001 deepened investor risk aversion. So despite eleven rate cuts bringing the Fed funds rate from 6.5% to 1.75%, the NASDAQ continued to fall bottoming out on Oct 8, 2002, at 1109.64. The Federal Reserve Bank continued to cut rates two more times and the thirteen rate cuts brought the Federal Funds rate to one percent and interest rates in the United States to a forty year low [1]. The low interest rates made credit cheap and easily available to both businesses and consumers in the United States.

FINANCING THE AMERICAN DREAM

Owning ones own home is part of 'The American Dream' and lenders like Countrywide Financial grew rapidly by providing first time mortgage and refinance solutions for millions of American home owners. In the company's website [2] Countrywide Financial (which trades on the NASDAQ exchange under the ticker symbol CFC) advertises itself as a firm that was founded in 1969 with the "commitment to break down the barriers to owning a home." The company which was rated in 2006 as "America's #1 Home Loan Lender" by Inside Mortgage Finance, states it "has helped millions of families find ways to accomplish their home ownership needs, whether buying a first home or refinancing their current loan." The firm's advertising slogan is "*No one can do what Countrywide Can.*" The company's website also states that it has been one the best performing financial services companies in the past twenty five years and that it is ranked #91 in the Fortune 500.

SUB-PRIME LENDING

Sub-prime loans are loans made to people with poor credit histories. A borrower's credit worthiness is measured by a credit score. Credit scores generated by the Fair Isaac Corporation or the FICO credit score are the most well known and used by mortgage lender. FICO scores range between 350 and 850 and sub-prime borrowers usually have credit scores below 620. Considerable published research exists about predatory lending practices among lenders to sub-prime borrowers. Bernstein [3] reports "abusive lending practices often involve lower-income and minority borrowers...Elderly homeowners, in particular, are frequent targets of some sub-prime home equity lenders, because they often have substantial equity in their homes, yet have reduced incomes" Squires [4] writes "After decades of redlining practices that starved many urban communities for credit and denied loans to racial minorities, today a growing number of financial institutions are flooding these same markets with exploitative loan products that drain residents of their wealth. Such "reverse redlining" may be as problematic for minority families and older urban neighborhoods as has been the withdrawal of conventional financial services. Instead of contributing to homeownership and community development, predatory lending practices strip the equity homeowners have struggled to build and deplete the wealth of those communities for the enrichment of distant financial services firms." One of the commonly adopted practices by lenders to sub prime borrowers is to convince the borrower that he could afford the loan using a very low adjustable teaser rate that would be reset at a later date.

LIQUIDITY CRISIS AND FIRM VALUE

Firms like Countrywide relied for their liquidity and continued operation on their on their ability to resell the loans they made. The loans that were resold were securitized by financial institutions and distributed among investors across the globe. Hedge funds hungry for high returns were often purchasers of such mortgage backed securities. In spring of 2007, in the midst of rising defaults in the sub-prime sector and a steep increase in foreclosures, the demand for non agency asset back securities abruptly dried up. Countrywide Financial found itself unable to resell a large section of its loan portfolio. The firm was forced to draw upon a \$11.5 billion credit facility in mid August 2007 to stay in operation. Additionally on August 22, 2007 the firm availed itself of \$2 billion in assistance from Bank of America. The market value of the stock reflected the firm's troubles. The stock which had traded as high as \$41.31 per share on May 17, 2007, traded at less than half that and well below its book value just three months later. Countrywide Financial stock had clearly succumbed to its own sub-prime lending practices.

REFERENCES

[1] <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>

[2] <http://about.countrywide.com/about/about.aspx>

[3] Bernstein, Jodie, "Prepared Statement of the Federal Trade Commission to the Seante Special Committee on Aging on Home Equity Lending Abuses in the Sub-prime Mortgage Industry", March 16, 1998 <http://www.ftc.gov/os/1998/03/grass5.htm> accessed on August 26, 2007

[4] Squires, Gregory D, "Predatory Lending: Redlining in Reverse", NHI Shelterforce Online, Issue #139, Jan/Feb 2005, <http://www.nhi.org/online/issues/sf139.html> accessed on August 26, 2007

