Thoughts on the Subprime Mortgage Crisis

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Thank you for inviting me to join this panel discussion on the subprime crisis and the contagion concern.

One of the responsibilities of the Federal Reserve is the promotion and preservation of financial stability. The possibility of contagion, or the spreading of volatility and illiquidity from one market to another, is one threat to financial stability. With this background, I would like to offer brief comments on three questions related to the past, present, and future of the subprime/financial markets story.

The first question is: How did problems in the relatively small asset class of subprime mortgage-backed securities morph into a much broader financial (system) stability problem? Second, as of today, what is the broad state of risk to financial stability and more broadly the overall economy? Third, what will it take to return to stable conditions in the affected financial markets?

First question—how did it happen?

Let me begin by trying to place the subprime market in quantitative context. Although problems with the subprime market have caused widespread concern, the actual size of the subprime mortgage-backed securities market is relatively small. Based on our estimates, the size of the subprime market is more than $1 trillion, which was around 3 percent of the approximately $30 trillion of domestic nonfinancial debt last summer.

Since that time, this relatively small asset class has been the biggest factor—but by no means the only factor—contributing to unstable conditions in a broad array of credit (or debt) markets. There have been two phenomena at work, in my view. First, some markets—for example, the asset-backed commercial paper market—are closely linked to subprime. Other markets have been affected indirectly through a more general repricing of risk.

To understand how subprime mortgages could have triggered such major changes in financial markets, let’s recall the credit environment of a few years ago. Credit losses had been unusually low in many U.S. markets for an extended period of time. With the strength and relative stability of the U.S. macroeconomy and the strong performance of housing in many geographic markets, lenders projected low losses even on the riskiest of loans.

The decline in credit quality first became apparent in the subprime market. In many cases aggressive mortgage originators were writing loans to borrowers with weak credit history, little or no equity invested in the house, and little or no verification of the borrower’s ability to repay. Under the assumption of ever-increasing housing prices, mortgages written on these low standards were valued as though they were low risk. Once housing prices stopped rising and began declining in some markets, the potential for increases in subprime default rates and the increased riskiness of the mortgages became obvious to financial markets.

Subprime losses began to contaminate structured instruments in which they were held such as collateralized debt obligations, or CDOs, that were assets of structured investment vehicles, or SIVs. What followed was a dramatic decline in liquidity in many markets.

In response to this generalized illiquidity, particularly in the interbank market, the Fed in coordination with other central banks in December implemented a term auction facility.

I would argue that root causes of problems in the subprime market brought into question some fundamental practices, incentives, and even institutions of other markets. By fundamentals, I mean the integrity of origination (that is, the quality of assets that went into securitization pools), the structure of the securities into which loans and individual securities were packaged, and the value of these securities as collateral for margin financing.

Also, rating agencies had greatly underestimated the risk of many mortgage-backed securities. This led to a loss in confidence in the ratings assigned to other complex financing structures with further reductions in liquidity and increases in the volatility of prices across a variety of debt markets.

Through this spread of suspicion, subprime losses exposed related problems elsewhere, such as the syndication market for leveraged loans. Some leveraged lending underwriting was in its own way very aggressive in the period before the markets turned rocky starting last summer.

Finally, the subprime crisis generated a thicket of doubts concerning counterparties. Uncertainty about valuations of securitized debt fed uncertainty regarding the exposure of large banks and other market participants, which led to concerns about executing trades with these counterparties.

Second question—what is today’s risk to financial stability?

I would characterize the current state of affected financial markets (those most affected by the subprime problem) as evolving positively but still fragile—in other words, unusually vulnerable to shocks. Affected markets are working through problems of counterparty mistrust, lower or no trading volume, reduced new origination, and plummeting market prices that may be well below eventual economic value. For instance, investors have been reluctant to roll over asset-backed commercial paper because of the linkages to subprime mortgage-backed securities purchased by structured investment vehicles, or SIVs. The asset-backed commercial paper (ABCP) market has shrunk over $400 billion since August of last year, and major investors have exited, possibly permanently.

The markets for municipal bonds in general and especially the markets for auction-rate municipal bonds are under stress because of their historic reliance on monoline credit insurers to strengthen the credit of municipalities by adding their credit enhancement. The monoline insurers are exposed to CDOs with subprime positions.
Additionally, the decline in the value of housing is starting to create concern about other consumer loan and mortgage markets including the markets for credit cards, auto loans, student loans, and prime mortgages.

In this context, financial institutions, in the United States and abroad, recently have booked some large write-offs. Several have negotiated investments of new capital. But, there's still widespread uncertainty about what might follow.

**Third question—what will it take to restore stability?**

Looking ahead, I believe resolution of the current financial market problems requires some stabilization of U.S. housing markets. At this time, it's difficult to determine when that stability will materialize.

A key prerequisite to financial stability is clarity of loan and security performance. In the latter half of 2007 and early weeks of 2008, writedowns of exposures to subprime securities, CDOs, and other instruments have reflected projections of future performance of underlying loans. As securities season with the passage of time, and as the reality of actual defaults and foreclosures is clarified, valuations should have a firmer basis.

Securitization of fundamentally sound loans has continued in recent months, but it's unlikely there will be a resurgence of new issue and secondary markets for riskier asset classes such as subprime mortgages. With regard to other debt markets, the new issue and secondary markets will stabilize as soundly originated new product works through the pipeline. In time, I believe investors will regain confidence in both product and counterparties, and buying will resume for a broader range of asset classes.

Also, generally favorable economic conditions should help improve financial market stability. In recent quarters, economic growth has slowed considerably. The Federal Open Market Committee (FOMC) lowered the federal funds rate from 5.25 percent last September to the current level of 3 percent. This reduction should encourage stronger economic growth in the second half of 2008.

In closing, let me provide a succinct answer to this panel's central question, and that is, "Is the subprime crisis contagious?" In short, the answer is yes.

The subprime mortgage crisis has not been isolated but is part of a highly integrated, complex, and dynamic global financial system. Subprime market problems have not been limited to what is, as I said, a relatively small market because they raised questions about the fundamental institutional, incentive, and practices framework of several modern markets.

Thank you for your attention.

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