

Critics Say Companies Are Reacting Too Late To Subprime Debt Woes

By SERENA NG and RUTH SIMON July 11, 2007; Page A1

The widening meltdown in the subprime-mortgage market caught up with the nation's two big debt-rating companies yesterday, with Standard & Poor's and Moody's announcing plans to downgrade hundreds of bonds backed by the risky home loans.

Downgrade Wave

Number of bonds backed by subprime mortgages downgraded or placed on review for credit-rating downgrades yesterday

Original Rating	Moody's	Standard & Poor's
AAA	0	0
AA	0	3
A	7	88
BBB	239	366
BB (junk)	185	155
Total	431	612

Source: Moody's Investors Service; Standard & Poor's

The moves jolted jittery financial markets as investors adjusted to the idea that the downturn in the nation's housing market is worsening and that a rebound might be months away, at best. The Dow Jones Industrial Average tumbled 148.27 points, or 1.1%, to close at 13501.70 as investors fled stocks and low-quality bonds, and some of them criticized the ratings giants for being too slow to act.

In an acknowledgment that it severely misjudged the risk of bonds tied to subprime mortgages, Standard & Poor's Ratings Service said it is looking to slash credit ratings on as many as 612 such bonds, with a value of \$12 billion, because of mounting delinquencies on the underlying mortgages. Subprime mortgages are made to borrowers with shaky credit profiles.

S&P said its action reflected several factors, including persistent mortgage delinquencies, weak home prices and lax loan-underwriting standards. It also cited mortgage fraud, a concern highlighted yesterday when the U.S. attorney for the Southern District in New York charged 26 people with taking part in "a wide-ranging scheme" to commit fraud at mortgage brokers.

S&P said it would take a tougher look at the steps lenders were taking to minimize fraud and misrepresentation of the data it receives.

Hours after S&P's move, Moody's Investors Service said it was downgrading 399 mortgage-backed securities issued in 2006 and reviewing an additional 32 for downgrade, affecting \$5.2 billion of bonds. It also downgraded 52 bonds issued in 2005.

"The level of losses continues to exceed historical precedents and our expectations," said Susan Barnes, an S&P managing director, in a conference call with investors to discuss the looming downgrades.

The ratings actions come after months of intensifying turmoil in the market. They drew howls from some investors who have complained that S&P and Moody's put excessively high ratings on many classes of bonds backed by subprime mortgages during the housing boom and then were too slow to lower those ratings when the housing market started sinking.

"Why now?" said Steve Eisman, managing director at hedge fund Frontpoint Partners, in the S&P conference call. "Delinquencies have been a disaster for many months. It couldn't be that you just woke up to it. The rest of the world was yelling and screaming about your ratings for months," added Mr. Eisman, whose fund has been bearish on the subprime market.

"We did it as fast as we could given the information we had," Tom Warrack, an S&P managing director, said in response.

Shares of Moody's parent Moody's Corp. fell \$1.11, or 1.8%, to \$60.39 yesterday, and shares of S&P parent McGraw-Hill Cos. dropped \$2.98, or 4.4%, both in 4 p.m. composite trading on the New York Stock Exchange.

Subprime loans have played an increasingly important role in the mortgage market, accounting for 20% of all mortgages originated in 2006, according to Inside Mortgage Finance. In all, \$2.3 trillion of subprime loans were taken out by borrowers between 2002 and 2006, according to Inside Mortgage Finance. Key to their growth was the ability of lenders to spread the risks by packaging the loans into securities and selling them to a large number of investors from pension funds to hedge funds, who used the S&P and Moody's ratings to help gauge the quality of the bonds.

Ratings on such bonds are critical because many investors depend on them to decide whether a bond is safe enough to own. Lower ratings could force some investors to dump bonds they had in their portfolios or mark down their value.

One kind of investment could be especially vulnerable -- collateralized debt obligations, or CDOs -- which are bundles of bonds that often contain many subprime-mortgage-backed securities. CDOs have been sold by investment banks to many pensions, insurance companies and hedge funds. S&P said it is assessing whether these investments might also require ratings downgrades.

Until recently, mortgage defaults were relatively low by historical standards, thanks to low interest rates and rising home prices, which made it easy for borrowers who ran into trouble to refinance or sell their homes. Lenders also relaxed their standards for approving loans, making them easier for borrowers to get.

But as credit becomes harder to get and house prices soften in many parts of the country, more borrowers are falling behind, with subprime borrowers among the hardest hit. The delinquency rate for subprime loans rose to 13.77% in the first quarter from 11.5% a year earlier.

So far the nation's economy has managed to withstand the trauma in the subprime-mortgage market and the broader housing slowdown. Many economists believe the economy has already started to improve after a slowdown that set in last year, a view that has helped to keep the stock market on a rising trend.

But yesterday's downgrades could alter that view, in part because they were coupled with earnings warnings from Home Depot Inc., the home-improvement retailer, and home builder D.R. Horton Inc. The news rippled through markets, unleashing a bout of risk aversion that hurt the values of junk bonds, bank loans and credit derivatives. The ABX index, which tracks subprime bonds, dived to a record low.

A flight to the relative safety of US Treasury bonds sent the price of the 10-year Treasury note up 29/32, or \$9.06 for each \$1,000 invested, pushing the yield down to 5.040%.

Tension has been building in credit markets for weeks. One trigger was the near collapse of two hedge funds run by Bear Stearns Cos. The funds made bad bets on the mortgage-bond market and in June had to turn to Bear Stearns for a secured loan of as much as \$3.2 billion as other lenders to the struggling hedge funds demanded their money back.

It has since hit the corporate-lending market hard. In the past two weeks, investors have balked at five separate offerings of junk bonds used to finance leveraged buyouts. The latest rebuff came Monday, when meat processor Swift & Co. had to withdraw a \$600 million offering. Much bigger financings from the likes of DaimlerChrysler AG's soon-to-be-sold Chrysler Group and First Data Corp. are coming to the market in the weeks ahead, an important test of the market's appetite for risk, which seems to be waning.

Yesterday, S&P said it is likely to lower its ratings on most of the 612 bonds under review very shortly. Many of them already had low ratings. But some bore investment-grade single-A or double-A ratings. In all, they represented 2.13% of the \$565 billion in residential mortgage-backed securities that S&P rated between October 2005 and the end of 2006.

S&P also said it is revising its methodology and assumptions for rating new subprime bonds and will require more collateral to provide bigger cushions against losses.

Moody's latest downgrades affected around 1.2% of the dollar value of 2006 subprime bonds it rated, most of them investment grade. Some of the downgrades hit bonds backed by loans originated by

Fremont Investment & Loan and New Century Mortgage Corp., lenders whose problems have been well-known for months.

New data from credit bureau Equifax Inc. and Moody's Economy.com show delinquency rates continued to climb across the broader economy in the second quarter, reaching 3.15% of all mortgages, compared with 2.87% in the first quarter. In some bonds targeted for downgrade by S&P and Moody's, delinquencies were around 20%.

S&P and Moody's reaped millions of dollars in fees during the housing boom for assigning ratings to mortgage bonds and other "structured finance" securities backed by subprime assets.

Typically, the bonds are diced and sliced so that some investors bear more risk than others. Some bonds get single-A, double-A or even triple-A ratings because holders of these bonds are the last to suffer when defaults on underlying mortgages start rising. The fact that they are now being scrutinized for downgrades is a sign of the potential depth of the fallout.

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QUESTIONS:

1. Rating agencies issue grades for debt. What primary characteristic of debt does a grade represent?
2. Why did S&P and Moody's downgrade some bonds' grades? What type of bonds were affected? What effect did the recent downgrade have on the stock market?
3. What kind of investors in these bonds relied on the ratings? Should they base their investment decisions on ratings? How are these bonds different from standard corporate bonds?
4. How do the raters make money? How are the subprime debt woes affecting them?
5. What percentage of all mortgages do subprime mortgages represent? How did mortgage-backed securities and bond ratings fuel their growth?
6. What is the near term outlook for the housing market?
7. How are the subprime debt woes affecting credit markets? Mention at least three fallouts.
8. It seems that Hedge fund Frontpoint's director Steve Eisman, is complaining about something. Do you think that he liked what happened? Show how his hedge fund would have made profits?