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It's too early to tell who'll survive subprime crisis



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By Lisa Kassenaar

NEW YORK: They dubbed it “The Survivors’ Conference.” In early November, 2,000 people who handle asset-backed securities for a living crowded into a ballroom at the JW Marriott hotel in Orlando, Florida, just 3 miles from Disney World, to hear speaker after speaker explain why 2008 may be their worst year ever.

The subprime crisis, which has claimed the jobs of three chief executive officers and prompted more than \$45bn in writedowns at the world’s biggest banks, may end up spilling into 2009.

“These events tend to become deeper and play out longer than most people initially expect,” says Michael Mayo, an analyst who covers securities firms at Deutsche Bank AG in New York. “This is one of the slowest-moving train wrecks we’ve seen.”

The tumbling US housing market will continue to inflict the damage. Mortgage-backed securities and collateralised debt obligations containing those securities are falling in price and won’t find their footing anytime soon. That is because most of the subprime mortgages, which provide collateral for \$800bn in securities, have yet to go bad, says Christopher Whalen of Hawthorne, California-based Institutional Risk Analytics.

“The collateral is not yet problematic,” Whalen says. “That’s the next big shoe to drop.” Whalen says defaults will soar as the rates of low-interest “teaser” mortgages held by borrowers with poor credit move up. At the end of August, about \$46bn in subprime loans, representing 225,000 homes, had defaulted, according to Credit Suisse Group. The number will more than triple to \$143bn by the middle of 2009, the bank forecasts. Total subprime loan defaults will top out at about \$270bn, or 1.52mn homes, in 2010 or later.

US housing starts probably fell to a 14-year low in October, a report today is likely to show, as the prospect of further declines in property values weighs on demand. Construction fell 1.8% to an annual rate of 1.17mn homes, according to the median forecast of economists surveyed by Bloomberg News.

“Until housing prices bottom out, the writedowns won’t stop,” says Peter Kovalski, who helps manage more than \$12bn at Purchase, New York-based Alpine Woods Investments. “The Street wants things right away, but it doesn’t work that way.”

Banks’ writedowns include assets that they classify as level 3, an accounting category which indicates the holdings are so illiquid that they can only be priced using the firm’s own valuation models.

Goldman Sachs Group Inc’s level 3 assets rose by 33% in the third quarter of 2007 from the prior period because it was stuck with loans when the leveraged buyout market froze. Level 3 assets accounted for 6.9% of the firm’s \$1.05tn total at the end of August, according to a government filing.

Citigroup Inc classified 5.7% of its assets as level 3 on September 30.

The total global loss from the subprime mess, Deutsche Bank’s Mayo said on November 12, may reach \$400bn. Rating companies, under fire from investors for applying their highest ratings to CDOs that included securities backed by subprime loans, are downgrading the debt. Late last month, Moody’s Investors Service cut ratings on CDOs tied to \$33bn of subprime mortgage securities. The ratings firm also threatened to downgrade structured investment vehicles with CDOs managed by Citigroup and HSBC Holdings after two SIVs defaulted in

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October.

Moody’s says it assumes the SIVs are unwinding their assets, selling at distressed prices, to refinance their maturing commercial paper. The so-called Super SIV, a fund set up by banks at the urging of the US Treasury to buy the highest-rated securities, will seek to prevent a meltdown of the 30 SIVs globally holding \$320bn as of October. 5.

Wall Street profits are also plunging in the fourth quarter. Citigroup, the second-largest CDO issuer in the first half of 2007, may post a loss in the final period, according to the average estimate of 23 analysts compiled by Bloomberg News. That is after the bank reported a writedown of as much as \$11bn, which cost CEO Charles Prince his job.

Merrill Lynch & Co, which replaced CEO Stan O’Neal with New York Stock Exchange head John Thain on November 14, may report that profit fell 49% in the fourth quarter. Bear Stearns Co also may have a loss.

At the five biggest securities firms – Lehman Brothers Holdings Inc, Morgan Stanley, Bear Stearns, Goldman Sachs and Merrill Lynch – earnings are expected to fall 8.3% in 2007 from a record \$30.6bn in '06, according to analyst estimates.

Lower profits mean more firings. Bank of America Corp, JPMorgan Chase & Co, Bear Stearns, Citigroup, Lehman Brothers and Morgan Stanley announced more than 24,000 job cuts in the first 10 months of 2007.

Gustavo Dolfino, president of New York- based executive search firm Whiterock Group, says he expects the firms to fire another 5,000-10,000 people in '07. The subprime debacle may echo through the economy the way the popping of the Internet bubble did – hurting consumers and growth years later. The 39% drop in the Nasdaq Composite Index in 2000 eventually led people to yank money from their mutual funds, Mayo says. The US economy fell into recession in March '01.

At the conference in Orlando, investors concerned about another recession were in no mood for the usual festivities. The party thrown by Bear Stearns – the first Wall Street bank to have a subprime blowup – was almost empty at 9pm, with 10 people commiserating over beer and calypso music.

Bose George, an analyst at Keefe, Bruyette & Woods Inc attending the conference for the first time, has an equally glum outlook on the already slowing US economy.

He says a decline in home equity loans will curtail consumer spending. “Credit is a huge driver of growth, and it’s hard to see how this isn’t going to have an impact on the economy,” George says. “Things are going to get worse.” – Bloomberg



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