Forbes.com

Financial Strategy

The Deadbeat Economy

A. Gary Shilling, 12.23.02, 12:00 AM ET

Subprime lending is a curse that is afflicting a scary array of industries far beyond credit cards. Wireless, autos and housing are also guilty of this foolishness.

The raging bull market and booming economy of the late 1990s removed the word "risk" from lenders' vocabularies. Since they had already saturated creditworthy borrowers with loans, they ascended to what they thought would be lending heaven. Instead, they descended to subprime hell.

Lenders figured they could profit handsomely off the spread between their (low) cost of funds and the (sizable) interest rates they charged downscale borrowers. Sure, they would have to suffer some bad loans, but not enough to erase that spread. They didn't stop to think that exuberant conditions were temporary and that bad loans would spiral upward. And they didn't see that when myriad lenders pile into the same sandbox, the profit margins thin out. As competition increased for these dubious customers, standards became absurdly loose.

Credit cards are the most obvious weak point. Hell-bent on growth, issuers pumped up solicitations from 1 billion in 1991 to 5 billion last year. With 37% of credit card loans now subprime, defaults have doubled since 1991.

When problems surfaced last year, subprime credit card king Providian's stock collapsed from $59 to $3. This year the stock of another big subprime lender, Household International, was cut in half before the firm sold out to London-based bank HSBC Holdings. My firm subsequently shorted HSBC. Sears, Roebuck & Co. recently confessed to unexpected credit card weaknesses that clipped third-quarter profits by 28%, and Sears expects rising defaults on customer credit cards, which account for 60% of pretax earnings. Its stock dropped an instant 32%. Target and Capital One also report big trouble. But the danger extends far beyond credit cards.

Take manufactured housing. In the mid-1990s, lenders dropped down payments from the 10%-to-20% range to 5%, and stretched repayments to 20 to 30 years, from 12 to 15. They also rushed to finance dealer inventories, spawning a big school of thinly capitalized dealers. Manufactured-home shipments leaped. Amid the inevitable crash to earth, top-name lenders retreated from the business, including Citigroup's Associates First Capital, United Cos. Financial and Deutsche Bank. Conseco faces bankruptcy as punishment for buying Green Tree, the leader in mobile-home

financing.

Wireless providers, with cell phone market penetration nearing 50%, have gone after students and other questionable prospects. Sprint issued phone accounts with abandon, allowing subscribers to its Clear Pay service to make up to $125 in calls without any payments and, starting in May 2001, no deposits. During last year's second quarter half of all new customers enrolled in Clear Pay, which accounts for one-third of Sprint's 14.6 million subscribers. No surprise: Sprint is ending service for accounts 110 days delinquent. And 1,600 Sprint employees and 500 outside contractors are getting pink slips.

What's next in this parade of subprime disasters? My Oct. 14 column said the Achilles' heel of the strong housing market is the low-income and other high-risk borrowers that Fannie Mae and other government-sponsored lenders are attracting with down payments of 3% or lower. The second recessionary dip I forecast, led by consumer retrenchment, seems to be unfolding. Mounting layoffs will eliminate those subprime house buyers with few other assets. Then the whole housing sector will be in jeopardy as their exit ripples through the move-up market.

Already homeowners in bankruptcy have swelled from 450,000 five years ago to 750,000, and 1.2% of mortgages are in foreclosure. Bankruptcy filings under Chapter 13, which is homeowner-friendly, were up 8% in the second quarter from a year earlier. Mortgage delinquencies are jumping, especially in the FHA category dominated by subprime loans. Are you aware that H&R Block, in addition to its other woes, is a big mortgage lender whose portfolio is loaded with subprime loans that don't meet Fannie's standards?

Don't think Fannie is risk-free. Its required core capital is only 2.4% of on-balance-sheet assets. Delinquencies are worse than they seem. With its new PaymentPower program, borrowers can skip two payments every 12 months. But they'll show up on the bad-loan list someday.

We'll soon learn how Detroit is part of the problem, too. Automakers' desperate attempt to keep auto plants humming will lead to subprime lending rot. Lots of marginal buyers may simply mail back their car keys when the zero-zero-zero grace periods expire. Even BMW is extending low interest rate loans to flawed borrowers to keep used cars from clogging dealer lots.

Avoid stocks of subprime lenders. When nonpayments become a deluge, the subs will be underwater.

A. Gary Shilling is president of A. Gary Shilling & Co., economic consultants and investment advisers. Visit his home page at www.forbes.com/shilling.