



The risk in subprime

During the boom, lenders gave homeowners loans they couldn't afford. Now they're feeling the consequences.

By **Ellen Florian Kratz**, Fortune writer

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FORTUNE

NEW YORK (Fortune) -- When a certain \$126,000 subprime loan on a \$696,000 house on the West Coast failed to produce a single mortgage payment, alarm bells went off at Clayton Holdings, a company that monitors credit risk.

Closer scrutiny revealed other red flags. The borrower's previous rent payment had been \$1,000, compared to the \$4,482 she was supposed to be shelling out for both the primary loan and the \$126,000 piggyback. And her stated income was \$84,000 even though she was an hourly worker at Target.

"We do an autopsy to find out what caused the loss of blood," says Keith Johnson, Clayton's COO. "It's a CSI subprime."

In the past few weeks, the bodies have been piling up fast and furiously. Fallout from subprime mortgages - that is, home loans to borrowers with a blemished credit history - gone bad has wreaked havoc on the industry.

Big names Washington Mutual (Charts) and HSBC have reported hits tied to their subprime business and there has been a nonstop barrage of bad news for major subprime lenders, including New Century Financial (Charts) and NovaStar Financial (Charts).

Now the worry is what happens to the economy if enough homeowners go into default and to the financial markets if enough investors take a bath on mortgage-related securities.

The market may want to brace itself for more surprises. "To one degree or another, all of these lenders are facing the same kind of difficulty," says Mark Zandi, chief economist with Moody's Economy.com.

Last year, 13.5 percent of mortgages originated in the U.S. were subprime, according to the Mortgage Bankers Association, compared to 2.6 percent in 2000. Overall, the subprime market was \$600 billion in 2006, 20 percent of the \$3 trillion mortgage market, according to Inside Mortgage Finance. In 2001, subprime loans made up just 5.6 percent of mortgage dollars.

By the end of 2006, subprime delinquencies more than 60 days late jumped to almost 13 percent, compared to 8 percent a year earlier, according to LoanPerformance.

As for foreclosures, they're currently running 25 percent higher than they were this time last year, according to RealtyTrac. "We don't have high unemployment, high interest rates or a slowing economy, but we're seeing the number of foreclosure filings pushed above historic averages," says Rick Sharga, a marketing exec for RealtyTrac. "You can't underestimate the effect of higher risk loans."

Adding to the problem are jittery lenders who have suddenly begun to tighten their standards. "You're seeing credit score requirements being increased. You're seeing documentation firming up," says Bob Walters, chief economist with Quicken Loans. "Fewer people will get loans and maybe rightly so."

The higher hurdles, while perhaps healthy for the long term, will cause a short-term credit crunch: Translation:

delinquencies and foreclosures should rise, which will create more credit problems in a vicious cycle that will probably weigh on housing for the rest of the year.

None of this is good news to investors in U.S. residential mortgage-backed securities, which now account for some 20 percent of the global fixed income market, the largest component.

And plenty of investors have been drawn into the riskier subprime pieces of these mortgage-backed securities that yield higher payoffs, instead of sticking with highly rated mortgage securities.

Particularly troubling for investors is the rapidly deteriorating quality of subprime vintages originated in 2005 and 2006, years when lenders were downright promiscuous about who they loaned money to.

Serious delinquencies - defined as loans at least 60 days late or in foreclosure or bankruptcy - for a 5-month old loan originated in 2006 is running at almost 4 percent, according to Moody's, compared to 2.2 percent for a similar loan originated in 2004.

The scariest part of that statistic is the fact that 2006 borrowers are still in their fixed-rate period. "What will they do when their payment starts to rise?" says Glenn Costello of Fitch Ratings.

The worry then is that somebody, somewhere has been overly aggressive in their subprime investments and goes belly up, spooking investors and sparking a world financial crisis.

That, of course, is just the nightmare scenario and not everybody is convinced the fallout will be so widespread. "I think [the risk] is containable," says Lewis Ranieri, Chairman of private equity firm Hyperion, who developed the idea of mortgage-backed securities in the 1970s when he worked at Salomon Brothers. "I don't think this is going to be a cataclysm."

Many point to last fall's implosion of hedge fund Amaranth as a sign that markets can handle these kinds of setbacks.

But not everyone finds that argument soothing. "If there is a fault line in the global financial system, it runs through the U.S. mortgage market," says Zandi. "Everyone throws up Amaranth, but that involved a small market with little implication for any other asset class. If some hedge fund blows up on a residential mortgage-backed securities investment, that has very different kinds of implications because it is the biggest chunk of the global fixed income market. So the ripples will be more like waves, and it could turn into a tsunami."

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Subprime woes: How far, how wide?

Problems loans to home buyers with less than top credit has become a big threat to the markets - and the economy.

By Chris Isidore, CNNMoney.com senior writer

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NEW YORK (CNNMoney.com) -- Lending to homeowners and buyers without good credit has suddenly become a very bad business - and possibly a very big problem for the U.S. economy as a whole.

The sector is known as subprime mortgages, which pumped \$640 billion into the economy through facilitating home purchases and refinancings in 2006, according to trade publication *Inside B&C Lending*. That's nearly twice the level of this kind of lending seen as recently as 2003.

But now, with delinquencies and defaults by borrowers rising, experts in the field see more lenders filing for bankruptcy and a sharp pullback in subprime lending. In addition, banking regulators are proposing tougher lending standards and regulations in the sector. All that sent shares of some major financial firms sharply lower Monday.

"Everyone in the subprime sector this year is going to lose money," said Bose George, analyst with Keefe, Bruyette & Woods, a Wall Street firm specializing in banking and finance. "They're getting squeezed on all sides. Going into the year, we were looking for a decline of 15 percent [in subprime lending], but clearly now that is far too low. It's now looking like a 25 to 30 [percent] decline."

On Wall Street, the biggest loser Monday was New Century Financial (Charts), the No. 2 subprime lender according to *Inside B&C Lending*. Its shares plunged nearly 70 percent in midafternoon trading Monday after the company said in a filing late Friday that it was facing a criminal probe of its practices by the Justice Department and that its outside auditor, KPMG, said it now believed there was substantial doubt about New Century's ability to function as a going concern.

But other lenders in the sector also got hit. For example, Fremont General Corp. (Charts) lost a third of its value after it announced it would exit the subprime sector because of the demands of regulators and market conditions.

While it's the smaller subprime lenders whose shares have taken a beating, many of the nation's biggest financial services firms are also leading subprime lenders.

Some economists say that choking off more than \$100 billion in home financing will cause problems for real estate and home prices overall by keeping some buyers out of the market and by forcing some current homeowners to sell or face foreclosure.

"People who a year ago could have purchased a house with a subprime mortgage aren't going to be able to purchase," said Paul Kasriel, chief economist with Northern Trust in Chicago. "Increased foreclosures will mean more inventory on a market that already has a glut of homes for sale."

Kasriel said the additional hit to real estate from the subprime meltdown is likely to mean serious problems for the economy overall.

"Housing has played a very large role in this expansion and one of the reasons it's played that role is there has been a change in the mortgage market," he said. "This has been a credit-induced housing boom that lifted other sectors of

the economy and it's all in reverse now."

One watchdog group, the Center for Responsible Lending, forecast recently that 19 percent of subprime mortgages originated during the past two years will end in foreclosure.

"This rate ... exceeds the worst foreclosure experience in the modern mortgage market, which occurred during the 'Oil Patch' disaster of the 1980s," the group said in a report issued in December.

The group praised a call from federal regulators Friday for much tougher standards for lenders making subprime loans. But the tougher standards will mean many borrowers will be cut off from financing, according to requests for public comment on the proposal.

The proposed new rules come after mortgage financing firm Freddie Mac (Charts) said it would no longer buy subprime loans on the secondary market that have a high likelihood of excessive payment shock and possible foreclosure. Freddie Mac's new guidelines, and the proposed federal rules, would require that a borrower qualify at the highest rate possible under adjustable-rate loans, a move that would leave many not able to qualify.

The proposed rules on new standards and the action by Freddie Mac are important since most subprime lenders package their loans into securities to sell in the secondary market in order to get additional funds to make further loans.

In the new, tougher financing environment for subprime lenders, ACC Capital Holdings, the closely held owner of Ameriquest, the No. 7 subprime lender, said last week it secured additional working capital from Citigroup (Charts). In return, Citi got an option to buy ACC's wholesale mortgage business as well as its mortgage servicing operations. CitiMortgage is already the nation's No. 4 subprime lender.

"This relationship is a result of ACC Capital Holding's thorough review of the current market and the different strategic alternatives currently available to an independent mortgage lender," it said in a statement.

Citi is not the only major financial services firm in the subprime sector. Last Thursday, Countrywide Financial (Charts), one of the nation's largest mortgage lenders, warned that 19 percent of the nonprime loans it collects payments for are delinquent. Its shares slid another 3 percent Monday on concerns about the sector.

Other leaders in subprime mortgage lending in the United States are units of some of the nation's biggest financial services firms, including HSBC (Charts), the No. 1 subprime lender, which took a \$10.6 billion charge for bad loans, as well as General Electric (Charts), Wells Fargo (Charts) and Washington Mutual (Charts).

And some businesses that aren't generally thought of as subprime mortgage lenders, such as H&R Block (Charts) and General Motors (Charts), also have subsidiaries in that business.

One cause of GM's delay in reporting fourth-quarter results is the attempt to look at how changes in the real estate loan market affect the value of GMAC, the financing subsidiary that GM sold a 51 percent stake in during the quarter.

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