Subprime Market's Sinking Fortunes

Contributed by Richard Caudle

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By Kenneth R. Harney
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The omens are unmistakable:

Delinquencies in the $1.3 trillion impaired-credit mortgage market hit 12.6 percent in the latest quarter, up from 11.7 percent. Delinquencies exceeded 13 percent among borrowers with subprime adjustable-rate loans.

Some of the companies that make or invest in subprime mortgages are themselves facing financial distress, and some have shut their doors or filed for bankruptcy protection. HSBC Holdings, Europe's largest bank and a major subprime lender in this country, shocked Wall Street recently by announcing that home-loan delinquencies have gotten so bad that it has set aside $10.6 billion to cover potential losses.

New Century Financial, a California-based subprime lender, saw its stock plunge 36 percent on Feb. 8 when it announced that "buybacks" of delinquent loans have been more numerous, and more costly, than anticipated. Subprime lenders are required by Wall Street bond investors to repurchase loans that go into serious default early in their terms, suggesting poor underwriting, bad appraisals or other issues.

Ownit Mortgage Solutions, another high-profile California subprime mortgage lender, abruptly went out of business when buyback demands reached a reported $100 million. Ownit's chief executive, William D. Dallas, acknowledged problems in underwriting but also blamed bond investors' voracious demands for high-yielding no-income-verification loans.

Dozens of smaller subprime originators have ceased operations or are scaling back new lending. One of the mortgage industry's top executives, Angelo Mozilo, chief executive of Countrywide Financial, was quoted as saying: "There's probably 40 or 50 [subprime loan originators] a day throughout the country going down in one form or another. And I expect that to continue throughout the year."

What's going on here? At a recent Senate hearing, a leading consumer-protection advocate, Martin Eakes, chief executive of the Center for Responsible Lending, called the subprime market "a quiet but devastating disaster."

The "ultimate effects are very much like Hurricane Katrina," he said, but "the difference is that this disaster . . . is occurring every single day across the country, house by house and neighborhood by neighborhood."

Eakes's organization published a study last month that estimated that 2.2 million overextended subprime mortgage borrowers will lose their homes to foreclosure -- a projection hotly disputed by the mortgage industry. Eakes told the Senate Banking, Housing and Urban Affairs Committee that subprime lenders have "virtually guaranteed" high levels of delinquency and foreclosures by offering borrowers excessively risky loans with teaser rates and low payments for the initial two or three years that later explode into sharply higher payments.

Lenders also have allowed unqualified borrowers to merely "state" -- not verify or document -- their incomes, putting large numbers of them into loans they should never have been granted, Eakes said. He quoted industry research that found that 90 percent of stated-income mortgage applicants "had inflated incomes compared to IRS documents" and that 60

percent of them exaggerated their incomes by 50 percent or more.

Representatives of the lending industry challenged Eakes's analysis of rising subprime defaults and told the Senate committee that the real reasons for homeowner defaults are unanticipated economic difficulties such as job loss, income curtailment, illness, high consumer debt loads and marital problems.

Douglas G. Duncan, chief economist of the Mortgage Bankers Association, challenged the idea that "delinquencies are at crisis levels" or that unusually high numbers of borrowers, subprime or otherwise, are losing their houses to foreclosure. In mid-2002, for instance, subprime delinquencies exceeded 14 percent, then fell to just above 10 percent in 2004 and 2005, and have risen since then, Duncan said.

Whichever perspective you prefer, Eakes's or Duncan's, this much you can be certain about:

? With major players such as HSBC and New Century taking financial hits, the entire subprime industry is likely to tighten underwriting standards and throttle back on the highest-risk loans. Home buyers with marginal or poor credit are likely to be quoted even higher rates and fees than they would otherwise. Look for big cutbacks on the availability of no-documentation loans for subprime applicants.

? Congress, with a new Democratic majority in charge, is certain to push for tougher standards on loans that combine multiple layers of risk -- low down payments, limited documentation and the potential for hefty payment increases.

? Consumer lawsuits against lenders with high early default rates on high-cost subprime mortgages are almost guaranteed. Likely allegations: Loan originators steered borrowers into inappropriate loans, didn't explain how they worked and walked away with fat fees in the process.

Richard Caudle

Principal

Longhorn Mortgage

8500 Shoal Creek Blvd Ste 4-103

Austin, TX 78757

(o)512-302-9410 (f)512-302-9450

(c)512-470-7506 web: www.longhornmortgage.com