

Risk Returns, Not Just to the Subprime Market



Opinion

by Caroline Baum

Feb. 28 (Bloomberg) -- Problems in the subprime loan market have been front-page news for weeks, with a total of 27 mortgage lenders going belly up since December, according to The Mortgage Lender Implode-O-Meter, a Web site that tracks cases of sudden death syndrome among lenders. (The figure includes subsidiaries of lenders as well.)

For a while, rising delinquency rates, plunging share prices and increased risk perceptions about securitized loans were confined to the subprime market. In other words, it was a niche sector of the loan market (borrowers with a checkered credit history) affecting a niche sector (housing) of the economy.

Gradually the notion that the bust part of the housing boom/bust cycle might not be quite so benign started to manifest itself elsewhere.

The U.S. Treasury market caught that old flight-to-quality bid. Interest-rate futures markets started to re-price for a Federal Reserve interest-rate cut in the second half of the year -- absent any encouragement from Fed officials and following an inflation report last week that was supposed to put the kibosh on easing. Stock markets across the globe plunged yesterday following a 9.2 percent dive in China's benchmark index, reportedly a reaction to the government's efforts to curtail speculation.

The punishment meted out worldwide hardly fits the crime, but it does reflect a degree of nervousness about risk -- a concept that has been pretty much off the table in recent years.

Alternative Distress

It should come as no surprise that the distress is spreading beyond the subprime market to "Alt-A" loans, according to Andy Laperriere, managing director at the ISI Group in Washington.

"The risky characteristics of Alt-A loans are eerily similar to subprime loans and are likely to experience larger- than-expected losses," Laperriere writes in a Feb. 26 report to clients.

Alt-A loans (alt is short for alternative) are made to borrowers with a prime credit rating who for some reason don't want to provide full documentation on income or assets. (Alt-A loans are not to be confused with Alt-B, which are made to subprime borrowers who are willing to document their financials.)

Data from First American Loan Performance, a mortgage research firm in San Francisco, bear out Laperriere's suspicions. The more recent Alt-A adjustable rate mortgages -- those originated in the 12 months through December -- are performing worse than loans of similar age in recent years. The 3.1 percent delinquency rate for the 12 months ended December is the worst since 2000, according to Mark Carrington, director of analytical sales and support at the company.

Imprudent Lending

Subprime and Alt-A loans account for 12 to 15 percent of current originations, up from 8 percent two years ago, Carrington says.

There is no reason to think that "the boom-time dynamics that led to the funding of imprudent subprime loans didn't lead to imprudent loans to borrowers with higher credit scores as well," Laperriere says.

After all, human nature hasn't changed. Borrowers were comfortable financing 100 percent of the purchase price of a house, no questions asked, as long as home prices were rising.

When the party stopped, the risks became apparent. Borrowers could no longer refinance or sell the house at a profit if they had trouble making the interest payments.

From the lender's perspective, it's rare for home prices to fall on a national average basis. That's small consolation to regional lenders in hot areas of the country where prices rose to dizzying heights. Their portfolio of loans -- and perhaps homes, should owners with no equity in their houses turn in the keys -- is unlikely to reflect the national average.

Too Much Supply

According to the National Association of Realtors, the median price of an existing home fell 3.1 percent in January from a year earlier. Single-family home prices fell in half the major metropolitan areas in the fourth quarter, the NAR reported earlier this month. Economists at the NAR were optimistic that the fourth quarter would prove to be the bottom for the housing market.

I don't think so. Inventories are still near historically high levels. Since 1998, housing supply has exceeded household formation by a record, according to economist William Wheaton of the M.I.T. Center for Real Estate. The shift from renting to home ownership was also "unprecedented," he says, a result of "explosive growth of the subprime market."

With loan standards tightening, either voluntarily or with a nudge from regulators, it will be harder to buy a house -- and even harder to see how demand can put a dent in the supply of unsold homes at current prices anytime soon.

Still Cruising

The Fed's January senior loan officers survey found that 15 percent of domestic banks had tightened credit standards on residential mortgage loans over the past three months, the highest net increase posted since the early 1990s, the last time banks were reeling under the weight of bad real estate loans. Yesterday Freddie Mac announced it would stop purchasing subprime loans and securities with a high risk of default. (Isn't that what subprime implies?)

Some lenders still haven't gotten the joke. At least once a week I get a fax from a nameless company encouraging me to "refinance and win a \$1.6 million Southern California dream house or \$1.5 million in cash" on closing a loan. The ARM has a teaser rate of 1.99 percent, and I'm offered "100 percent financing," "no income verification" and "unlimited cash out." A history of bankruptcy and foreclosure seems to be "OK."

Based on the state of the residential real estate market, I'll pass on the dream house and take the cash.

(Commentary. Caroline Baum, author of "Just What I Said," is a columnist for [Bloomberg News](#). The opinions expressed are her own.)

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