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OUR TOP STORY TONIGHT (THIS YEAR)
Subprime Lending Threatens Stock Market, Housing Rebound

Just a few short months ago, most investors had never heard of subprime mortgages (unless they couldn't qualify for a more traditional loan). These days, lenders like ***New Century***, ***Novastar***, ***Fremont***, and ***Accredited*** have been prominently featured in the daily business press. Unfortunately for them, the words "ailing" and "bankrupt" are often included in these articles. Misled subprime borrowers believe they have been wronged by improper sales tactics; nervous investors have cleansed their portfolios of related stocks; and grandstanding political officials and bank regulators continue to threaten harsh actions. (Where were they a few years ago?) Some equity analysis believe that the subprime debacle has hindered the equity market performance this year, while postponing the much anticipated rebound in housing.

So What Exactly is Subprime?

Subprime mortgages are made to the "riskiest" of borrowers with poor or limited credit histories or high debt burdens relative to their income levels. In many cases, these individuals are better candidates to be apartment renters; however, in our society (where home ownership is often considered an entitlement), they may be able to qualify for such loans at higher rates of interest. The most prudent of such borrowers are working to improve their financial conditions, at which time, they plan to refinance into more affordable loans.

Perhaps they suffered injuries or illnesses or unexpectedly lost their jobs and underwent some financial hardships for a short period. Perhaps, they were bullish on the housing market in a certain region and intended to "flip" the properties and book profits once they appreciated. In such cases, a higher rate of interest seemed a small price to pay for the tidy windfall expected to follow. In fact, many of the subprime loans start with initial "teaser" (below market) rates that adjust upward after two or three years. While the borrowers may not have been able to afford the loans at the higher rates, they surely would have already refinanced or sold the property before the monthly payments increased.

So What Happened?

With interest rates at relatively low levels, institutional investors sought out opportunities to enhance yield within their fixed income portfolios. Wall Street attempted to oblige them by structuring new mortgage-related securities that were collateralized by subprime loans. This growing demand for such products over the past several years prompted lenders to dramatically increase production, often at the expense of underwriting standards.

Additionally, the strength in housing from 2000-2005 was another cause for the expansion of the subprime markets. Less qualified borrowers were able to reap the benefits of home ownership, while they attempted to get their credit issues resolved. If they found they were unable to afford the loan, they were able to refinance or sell into the strength in housing. According to the Mortgage Bankers Association, subprime mortgages accounted for about 20 percent of all mortgage originations in 2006.

As the domestic housing market began to falter, subprime loan defaults increased significantly. Tighter credit and strict underwriting reduced the number of individuals who qualified for such loans. The fewer number of buyers lowered the demand for housing which depressed prices even

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more (especially in certain regions of the country like California and Nevada where foreclosures are high). High "early payment defaults" (EPD) further hindered liquidity and future operations of the subprime lenders whose warehouse lines of credit were cut or subject to tightened standards and increased fees. Many lenders could no longer afford to buy back the bad loans (as required by debt covenants) or originate any new ones. The fallout has resulted in several large specialty subprime originators filing for bankruptcy with others restating financials and suffering from major liquidity concerns. Needless to say, their stock prices have suffered as well.

Worse Before Better?

While defaults have dramatically impacted certain lenders, as the loans become more seasoned, new risks may be on the horizon. Many of these loans are scheduled to reset rates in two or three years (to something like 11% or 12%), and numerous borrowers will have "sticker shock," unable to afford the new payments. Unlike the recent past when housing prices were increasing, they will not merely be able to refinance or sell the house to avoid default. Substantial challenges may occur in the next few years as the loans originated in 2005 and 2006 move closer to reset date.

While much of the focus remains on subprime product, other borrowers may face similar difficulties as well. Alt A is a category of mortgages that falls between prime and subprime on the risk scale; some analysts expect this area to be the next to suffer. While these borrowers maintain higher credit scores (but still below prime borrowers), the underwriting has been considered "sloppy" as Alt A lenders historically were required to provide very little financial histories or income confirmations on these "stated income" loans. While these borrowers may have generated a decent track record in reducing credit card and auto debt, a large mortgage loan with a very small (or no) down payment represents a far greater drain on personal cashflow. Should housing not rebound any time soon, the default rate on ALT A loans may increase dramatically. Analysts project that Alt A loans account for 10% of outstanding mortgage debt.

Business is Here To Stay

While many analysts had predicted that housing would rebound in 2007, the fallout from this debacle is slowing the process. With that said, the subprime (and Alt A) markets may shrink and struggle throughout 2007 (and beyond), but they are not going away. Homeownership remains the American Dream and individuals will always attempt to determine whether they are qualified to afford this dream. After a nice run during the housing boom of the past few years, industry evaluation and consolidation have been needed. The survivors (originators, investors) will be stronger and better prepared to face the upcoming challenges and will benefit in the future.

What's a Nervous Investor To Do?

As investors read these frightening articles, they grow more concerned about the overall impact that subprime will have on the economy and the investment markets. Many have engaged in a "flight to quality" strategy and reduced equity positions in favor of the perceived safe-haven of treasury securities. In reality, a well-diversified portfolio should be structured to withstand the challenges that portfolios face from time to time from these financial predicaments.

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