

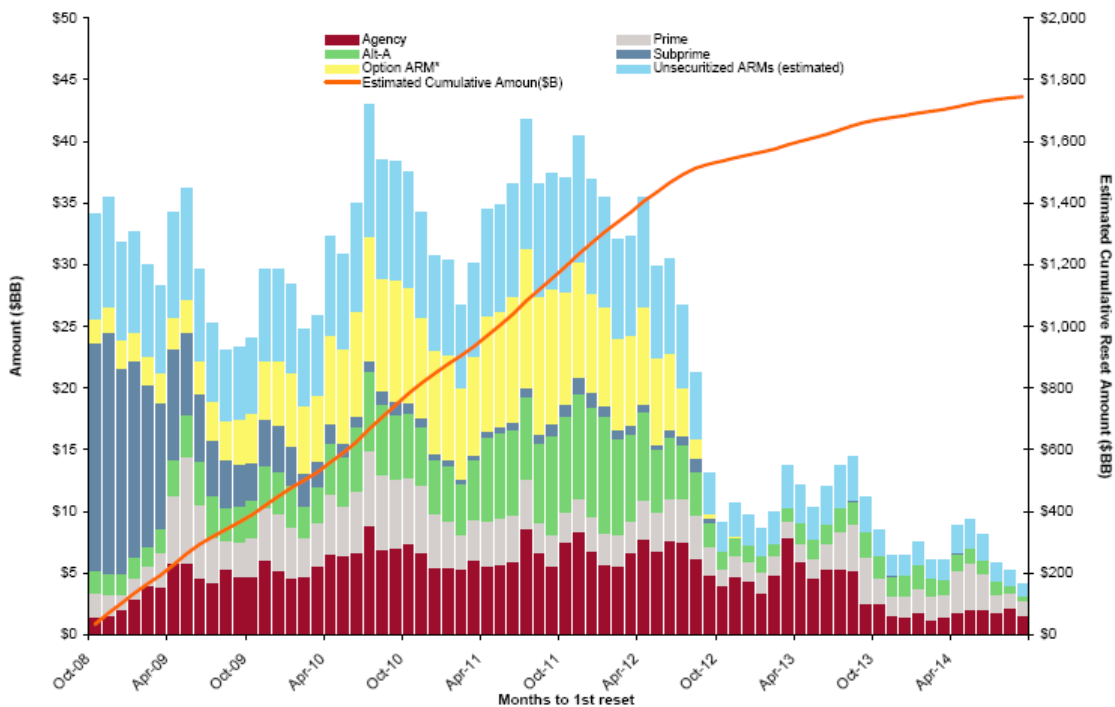


Son of Sub-Prime: Another Wave of Defaults

Eric Uhlfelder
February 10, 2009

You thought the subprime mortgage collapse was bad? Well, another mortgage tsunami is heading our way, and it could be just as devastating as the one that already crashed over the U.S. economy.

The leading edge of the new wave is made up of over \$300 billion of Alt-A and Option ARM mortgages, all of which are scheduled to reset by this summer, according to data from Credit Suisse. The wave swells to \$1 trillion worth of mortgages when one incorporates mortgages due to reset by mid-2011 (see graph below). As the wave crashes ashore, defaults are expected to soar — a process that’s actually already under way as recession and a collapsing home market have sent borrowers fleeing their mortgages.



*Option ARMs show estimated recast schedule based on current negam rate; Source: Credit Suisse (US Mortgage Strategy), LoanPerformance, FH/FN/GN

Data as of Nov 2008



According to *Inside Mortgage Finance*, a trade publication based in Bethesda, Maryland, the \$1 trillion of Alt-A exposure consists of approximately three million outstanding loans (approximately the same amount as was issued in subprime mortgages). Alt-A loans represent 20 percent of the current mortgage market, encompassing many borrowers who fall between subprime and prime status.

Fannie Mae, which owns or guarantees about one-third of all Alt-A mortgages, defines them as “a loan that can be underwritten with lower or alternative documentation than a full documentation mortgage loan. As a result, they generally have a higher risk of default than non-Alt-A mortgage loans.”

In early fall 2008, Bloomberg News reported that almost 16 percent of securitized Alt-A loans issued since January 2006 were at least 60 days delinquent. According to RealtyTrac Inc., an Irvine, California-based foreclosure data provider, “defaults will accelerate in 2009 through 2011 as these loans hit their three- and five-year reset periods.”

Adjustable rate Option ARMs, a form of Alt-A loan, were sold primarily to prime and near-prime borrowers between 2004 and 2007. Many were also low- to no-documentation loans, based on the borrowers’ safe credit scores, and these loans generally had ultra low introductory teaser rates, typically 2-3 percent during the first five years. Approximately 80 percent are currently negatively amortizing, i.e., loan balances that are actually increasing as home prices are falling sharply. Fitch Ratings analysts Roelof Slump and Stefan Hiltz project that up to 45 percent of these mortgages issued between 2004 and 2007 may default.

Writedowns and worse

Sue Troll, a credit analyst at T. Rowe Price, who in 2006 forecast the subprime meltdown, describes Option ARM mortgages as “subprime on steroids, with their underlying quality in many instances having been worse than subprime, despite involving higher-quality borrowers.” She says approximately 80 percent were low- or no-documentation loans — twice the rate for subprime loans — with significantly greater concentrations in the states experiencing the sharpest home price declines (California and Florida). Option ARM loans in those states also have longer maturities (up to 40 years), and lower teaser rates (initially as low as 1 percent) than typical subprime loans.

She estimates that \$800 billion of Alt-A mortgages (including approximately \$250 billion in Option ARMs) have been securitized. “Valuation of these securitizations,” Troll explains, “will remain very difficult, and most will prove to be worth only cents on the dollar.” This suggests the impact of the next wave of defaults could be far-reaching.



Troll expects the credit quality of 70 to 80 percent of Alt-A and Option ARMs to be downgraded. "Rating agencies in turn will adjust their models, lowering ratings on securitizations, leading to further write-downs for institutions holding them, reducing their profitability, and requiring more balance sheet replenishment." She believes that most related securitizations will be wiped out, except for the highest quality, AAA-rated tranches.

A predictable time bomb

"The greatest asset bubble in history is bursting, and the single biggest piece is the U.S. mortgage market," explains Whitney Tilson, managing partner of the New York-based asset manager T2 Partners. "We're probably only about halfway through the problem in terms of writedowns and recognized losses."

"The insanity" didn't end with subprime, Tilson says. He sees resetting Alt-A and Option ARM loans "causing mortgage payments to increase, likely pushing up already-high default rates to even higher levels, producing more foreclosures. This will further flood the housing market, which will keep downward pressure on housing prices, preventing a floor from being established, which everyone pretty much agrees is critical for stabilizing the economic crisis."

As a result, Tilson sees a predictable time bomb. "You can look back at what was written between 2005 and 2007, and you look at the reset dates and the current default rates, and it's pretty clear what's going to happen." For example, in a securitized trust of 2007 Alt-A mortgages Tilson examined, 43 percent of the loans were in default just 17 months after having been marketed. "This is typical of bubble-era Alt-A mortgage pools," he observes, "most of which are suffering catastrophic losses, with only the highest-rated tranches likely to perform."

Extrapolating from current nonperformance figures, he thinks that more than 50 percent — perhaps as many as 70 percent — of Option ARM mortgages are likely to default, with the balance of Alt-A loans close behind. Tilson fears that the current equity and debt markets are not reflecting the potential impact this will have on the economy going into 2010 and 2011. Future losses could be comparable to those recently experienced via subprime mortgage defaults, says Tilson.

Harvard and Oxford economic historian Niall Ferguson is equally pessimistic. "We are in an extremely powerful downward spiral that's fully underway," he says. "We are seeing defaults coming not only from households unable to make payments due to job losses and mortgage resets, but from borrowers who simply see no sense in continuing to pay a mortgage on properties whose worth is



substantially below that of the loans.” He too is struggling to see where the floor may be.

Unemployment risks

Michael Youngblood, a mortgage consultant who has been tracking mortgage trends since 1986 and is principal of the asset manager Five Bridges Capital, which invests in mortgage securities, is a bit more sanguine about the impact of pending resets. “We can’t presume that the action of resetting in and of itself will be detrimental,” he says. “With LIBOR falling in absolute and relative terms, there’s a chance that adjustable mortgage rates won’t be heading higher than they are today.”

Unlike when subprime first caught the market off-guard, Youngblood sees Fed and Treasury policy together holding down interest rates and lenders slowing default rates by restructuring loans. But many analysts, including Tilson, believe restructuring will not help much, especially when house values are underwater, well below the size of their mortgages.

And Youngblood cautions that if job losses continue to accrue at their current staggering rate, unemployment could trump all efforts to keep people in their homes, sending defaults rising anyway.

Eric Pellicciaro, managing director and lead mortgage investor at BlackRock, agrees that the second wave of defaults could be just as vicious as the one that just hit. But he believes that the Alt-A and Option ARM default rates projected for 2009 through 2011 will be less significant because the equity and debt markets have already significantly discounted this crisis. “Investors are aware of the severity of the problems,” says Pellicciaro, “while government is actively intervening by lowering interest rates and infusing liquidity into the markets to help offset financial pressures.”

He surmises that we could be nearing the bottom for the debt market. But that’s conditional on government intervention containing the fallout and stabilizing mortgage markets and housing prices.

Commercial real estate: the next domino?

Even if the market has largely priced in the meltdown of the housing market, Dan Schwartz, senior economist at Argonaut Capital Management, which runs a \$460 million global macro hedge fund, is very concerned about the pending fallout from commercial mortgage defaults. “This is just starting to register on analysts’ radar screens,” he says. “Looking at the schedule of interest rate resets, commercial defaults are likely to get much worse as the economy slides further



into recession.” Over the past year, commercial loans that are currently resetting have increased by 50 percent to \$300 billion. By 2013, the cumulative volume of loans subject to reset will have reached \$1.5 trillion, according to Schwartz.

Like subprime home loans, most commercial property debt has been securitized. If government intervention doesn't gain much traction, and if refinancing doesn't come back on line over the next several years, Schwartz is fearful the economy will be smacked from a collapsing commercial property market as well.

Based on the way the crisis has been reported, T2's Tilson believes there's a popular perception that as the impact of subprime winds down, the US may soon get back to business. But he sees not only another large residential mortgage shoe ready to drop but a significant rise in commercial mortgage defaults, along with the souring of auto loans, credit card debt, personal and business loans. All told, Tilson thinks “we are only about one-third through the bursting of the asset bubble.”

Eric Uhfelder, author of Investing in the New Europe [Bloomberg Press, 2001], covers global capital markets from New York. He can be reached at Uhfelder@hotmail.com

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>