Follow Up: What Stage of the Sub-Prime Crisis are We In?

May 13, 2008

We hope that many of our readers saw the *New York Times* article "Mortgage Holders Find It Hard to Walk Away From Their Homes," which ran on May 10, four days *after* our "What Stage of the Sub-Prime Crisis are We In?" The *Times* story claims there is "little evidence that people who have the means to pay are walking away from their homes as values sink." Oddly, their article focuses on homeowners with FHLMC and FNMA mortgages, and not on sub-prime borrowers. The *Times* claimed the data was too hard to find for the sub-prime market. In fact, the data showing sub-prime borrowers are walking away from their homes is readily available, and is presented in our previous article as well as below.

Had the *Times* looked into the sub-prime market, they would have written an entirely different story.

In fact, they might have written *our* story.

We also received this letter from one of our readers:

> Keep in mind that mortgages reset at an index plus a spread. Interest rates are down 325 basis points from about 6 months ago. So, many resets will be lower or about the same as the teaser rate. Plus, people need a place to live and even if they have negative equity they may not walk away from the home if they can afford the payment. Demographics work in real estate's favor as over time new households are formed. Plus, the MBS (mortgage backed securities) market has priced into it probably greater than current defaults. Look on the bright side.

First American CoreLogic, who provides mortgage data through its LoanPerformance service, gave us the following data, which shows the initial "teaser" rate on sub-prime loans:

Year of Origination	"Teaser" Rate
2007	8.47%
2006	8.48%
2005	7.49%
2004	7.17%
2003	7.47%
2002	8.48%

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2001	9.53%
2000	10.64%
Average	7.93%

The term “teaser” is really a misnomer, because these rates are not particularly low. Mark Fleming, Chief Economist with First American CoreLogic, indicated the average spread for sub-prime loans that have not yet reset is currently 5.94%. Approximately 97% of sub-prime loans are indexed to the 6-month LIBOR rate, which today (May 9, 2008) stands at 2.88%. Thus, if the remaining sub-prime loans were to reset today, they would carry an interest rate of 8.82%, 89 basis points above the average initial teaser rate.

However, very few sub-prime borrowers ever intended to carry their loans to term. According to a December 2007 Federal Reserve paper, 71 percent of 2004 sub-prime 2/28 ARMS nationally were retired in two years, and 88 percent in three years. (A 2/28 ARM carries a fixed rate for two years and a variable rate for the remaining 28 years.) This same paper states what is commonly known, that “rising house prices and the abundant availability of financing were key factors allowing the re-financings.”

As we noted in our original article, virtually all sub-prime properties were financed with very little equity. Sub-prime borrowers cannot expect to refinance under present market conditions, even if housing prices do not suffer further major declines. These borrowers will be faced with a non-trivial 89 basis point increase in an already high interest rate, on a loan which they never intended to carry.

Fleming noted that today’s LIBOR rate, and the rates on adjustable rate mortgages in general, are low relative to fixed rate mortgages, and were brought down by the actions of the Federal Reserve Bank. A year ago the 6-month LIBOR rate stood at 5.36%, 248 basis points above today’s level. To believe sub-prime borrowers can afford today’s rates on a long-term basis is to believe the economy and the Fed can withstand a prolonged period of low interest rates. This course of action might benefit sub-prime borrowers. But it will have its costs, including discouraging savings by consumers and investment in Treasury securities, particularly by sovereign wealth funds, and would hasten the decline of the dollar.

Fleming also provided us with data on the rate of occupancy among properties financed with sub-prime loans:

	Owner Occupied	Second Home	Investor
Total	92%	1%	7%
Single Family Residence	93%	1%	5%
Condo	80%	2%	18%

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Overall, supply in the housing industry has not significantly contracted since the beginning of the sub-prime crisis. A sub-prime home occupant, faced with a lack of equity and high interest rates, will choose to rent rather than pay an onerous mortgage. The current rate of default (26.6%) on sub-prime loans attests to the fact that occupancy does not deter sub-prime borrowers from walking away from their homes.

Meanwhile, another phenomenon is accelerating the rate of vacancy in the condominium market. Monthly condominium fees must be paid by the association occupants on a pro-rata basis, and a foreclosed property does not pay these fees (at least in Florida, where the condominium problem is most pronounced). As condominium owners see their monthly fees escalate, they are choosing to sell or abandon their properties.

We do not believe demographics will work fast enough to resolve this crisis. For a reasonable discussion of this issue, see this article in *Seeking Alpha.* The upshot is that new household formation is just one part of the equation when considering demographics. Other factors, such as an increasing supply of homes vacated by retiring seniors as our population ages, must be considered. On balance, there is no clear evidence that demographics can solve the sub-prime crisis.

Finally, the mortgage markets may have already priced in reasonable default rates, but this affects the owners of CDO securities, who will need to correctly mark-to-market their portfolios. For existing sub-prime borrowers, to the extent that higher default rates are already priced into the mortgage market, it will make it even more difficult for them to refinance.

We stand by our thesis. We believe the $925 billion of sub-prime mortgages that reset in the last 12-15 months, or are yet to reset, are highly problematic. We are still in the early stages of this crisis.

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