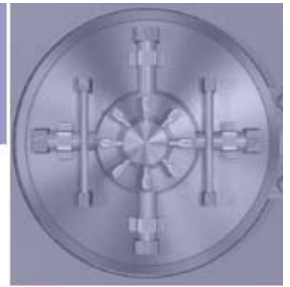


Finance and Banking Committee

To analyze and report on financial issues and trends of interest to turnaround professionals, accountants, commercial and investment bankers, institutional lenders and others.



Eyeing the Pile-up: Subprime Mortgage Industry

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For the past year or so, regulators and investors have been eyeing the subprime-mortgage industry as spectators on an expressway might a fender bender or a flat tire.

Although onlookers usually don't know what they're slowing down to see, it's more often than not a harmless event, rather than a major catastrophe. Nonetheless, the viewing continues, and so do the endless commutes.

A similar situation is brewing in the subprime-mortgage industry. Business analysts continue to speculate about possible outcomes, and regulators (*i.e.*, Federal Reserve and others) and Congress are weighing the possibility of additional regulation and oversight. With the exception of hedge funds, many argue that the subprime-mortgage industry represents a fender bender and is already self-correcting. Others, however, believe that they face a multi-car pile-up — the kind that recently claimed many major lenders.

Liberal lending standards, rising short-term interest rates and stagnant or declining home prices led to the current fallout in the subprime-mortgage lending market. In effect, lax lending practices delivered a “double punch” to this sector. First, these practices enabled lenders to approve unqualified borrowers. Early payment defaults then began forcing Wall Street to demand buybacks from selling lenders. Lenders were also allowed to offer teaser-rates that are designed to spike dramatically when the “fixed” loan period expires, in turn leaving borrowers with unaffordable payments. Many homeowners who mortgaged homes under these terms are now facing imminent foreclosure.

Due to increased housing inventory, prices are softening, making it increasingly difficult for subprime borrowers to exit their circumstances through the sale of the home. First-time homebuyers have been, and will continue to be, particularly affected by the stringent lending standards coming down the regulatory pipe. As time progresses, it will be more difficult for first-time homebuyers to meet the heightened lending requirements.

For investors, the decline of the subprime-mortgage industry has various implications. A majority are expecting losses on investments in subprime mortgage pools. Lower tranche holders (*i.e.*, investors that receive payment only after the higher tranche holders receive payment), are already

experiencing poor performance in their investments. In turn, the available credit in the industry is tightening, and the investment community is demanding increased rates of return. Simply put, investors are becoming more risk-averse. Even investment banks, a large provider of warehouse lines, are reducing their exposure. It's no surprise that the industry, which is already over capacity, will require restructuring. As a result, investors can expect to see further consolidation and loss of value.

The distress in the subprime market is contributing to a sharp decline in mortgage originations and purchase activity. Combined with more stringent underwriting criteria, the drop in qualified homebuyers and the wariness of investors is paralyzing this industry across the country. Although regional and local-level housing markets vary significantly, the statistics are mostly illustrative of the national trend. For instance, a few regions are seeing deeper cuts in purchase and refinancing activity and higher default rates as the combined effect of lower real wages and higher interest rates affects the volume of activity.

The U.S. Department of Housing and Urban Development (HUD) Down Payment Assistance (DPA) program is also under fire, throwing yet another monkey wrench into the picture. Should the program be eliminated, it could further challenge the first-time homebuyer's ability to enter the market. Increasing the percentage of homeowners in the United States has been an important political card. Members from both parties and numerous individual politicians often tout increased homeownership as an achievement. HUD is thus under pressure to foster the upward trend. However, the forecasted foreclosures (foreclosures are expected to increase significantly as compared to numbers recorded in the past few years), regulatory impact and underwriting changes may reverse this trend.

As a result of the fallout in the subprime mortgage industry, persisting profitability pressures and decreasing subprime mortgage originations, it's apparent that it will be difficult for monoline subprime-mortgage lenders to survive in their current state. As the industry continues to consolidate, larger, more diversified financial institutions — investment banks, hedge funds and private equity firms — are getting into the fray. These larger financial institutions are well-capitalized with diversified businesses and are in a far better position to remain afloat as the shakeout continues. Notable transactions include: Citigroup's purchase of Ameriquest's remaining assets, Cerberus' purchase of H&R Block's Option One business, and Ellington Management Group's purchase of loans and interests in securitization trust from New Century. In addition, Farallon Capital and Newcastle Investment Corp., a real estate investment trust (REIT) managed by Fortress Investment Group, continue to purchase pools of subprime loans. Clearly, vast opportunity remains for consultants and legal advisors offering services to potential investor groups as they pursue attractive investments in this niche.

All else aside, the element of social responsibility cannot be ignored. For those who truly need subprime mortgages, there is a need to address the issues and not throw the baby out with the bathwater. Although increased regulation and oversight may be necessary to prevent future abuses, there remains a need for responsible subprime lending — lending that makes refinancing and homeownership a possibility for a large segment of qualified borrowers.

In the meantime, the constant monitoring of the subprime mortgage industry in its seeming “freefall” will undoubtedly continue. Some maintain that: (1) the U.S. mortgage market is the most vulnerable in the global financial system, and (2) that the delinquency in subprime mortgages could cause the implosion of hedge funds, and other “investor-types,” that are heavily invested in residential mortgage-backed securities. Other industry observers believe that the potential impact on the financial markets appears entirely containable.

Ultimately, we’re all stuck on the expressway. Some are nervous, preparing for the worst. The others are probably working on their PDAs — waiting out the snarl so that they can get to work.

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