

Primer on subprime loans, troubles in the mortgage industry

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subprime lenders	Top subprime
Bank	The top 15 subprime
Financial, California	five Bay Area markets
Financial, California	loans in each market
New York	Rank Metropolitan
	1 Rural (no met)

The subprime mortgage mess is a major contributor to this month's stock market swoon. Here are answers to questions about the situation.

Q: What is a subprime loan?

A: There is no official definition. It's generally described as a loan to a borrower with a FICO credit score lower than 620 or in some cases 580.

Five years ago, lenders required subprime borrowers to make large down payments and carefully document their income to make up for their sketchy credit, says Keith Gumbinger, a vice president with HSH Associates. As competition heated up, many lenders lowered or eliminated these requirements. Some even let subprime borrowers make interest-only payments.

Q: What are the terms of a subprime loan?

A: Subprime interest rates are typically two to five percentage points higher than prime loans. The rate is often fixed for two or three years, then becomes adjustable. The hope is that the borrower's credit score will then be higher and he can refinance into a traditional loan, says Victoria Wagner, a credit analyst with Standard & Poor's. Subprime loans usually have a prepayment penalty in the first few years.

Q: How big is the market?

A: The comptroller of the currency estimates that 20 percent of new mortgages originated during the past two years were subprime, up from 10 to 12 percent historically, Wagner says. Subprime loans are prevalent in parts of California, but make up a small percentage of loans in the Bay Area.

Q: Who makes subprime loans?

A: The largest subprime lender is HSBC Finance, which was Household International until it was acquired by HSBC in 2003. Some lenders, such as Wells Fargo and Washington Mutual, make prime and subprime loans. Many lenders specialize in subprime loans. Almost all subprime loans are packaged into mortgage-backed securities and sold to investors.

Q: How does this work?

A: Most specialty subprime lenders don't lend their own money. Typically, they borrow from what is called

a warehouse lender, usually a bank or investment bank. They lend that money to homeowners, then quickly line up a buyer for the mortgage.

These loans can be sold individually or in groups to a securitization trust. The trust, usually put together by an investment bank, sells bonds to investors, often hedge funds. The trust uses the investor money to buy loans from the originator. The mortgages are placed in the trust as collateral for the bonds, also called mortgage-backed securities.

The originator uses money from the trust to repay the warehouse lender. The originator or another firm is usually hired to collect monthly payments from homeowners. These payments are sent to the trust to repay bondholders.

Often, the trust will buy insurance to protect bondholders in case homeowners default. This can be purchased from a bond-insurance company or through a product known as a credit default swap. The insurers often obtain insurance to offset their risk.

Q: Why would investors buy these risky loans?

A: Investors wanted the higher interest rates on subprime loans and thought they had the financial technology to manage the risk. Also, as long as real estate prices were rising, these mortgages were seen as fairly safe because borrowers who got into trouble could sell their homes and repay their loans.

Q: What went wrong?

A: Last year, subprime loans started defaulting at a higher-than-expected rate. Many borrowers were becoming delinquent in the first three months of the loan.

One cause was bad underwriting: The loans were made to people who had no way to repay. Another was that housing prices in many parts of the country were coming down. Homeowners who had put little or nothing down owed more than their homes were worth. Selling to repay a mortgage was not an option.

Foreclosure activity started rising, which put more homes on the market, further depressing prices.

Meanwhile, regulators started encouraging lenders to tighten their standards and agencies that rate mortgage-backed securities started raising their loss expectations, says Vincent Barbiero, managing director with Fitch Ratings.

This made investors nervous. In the fall, the demand for risky mortgages started to dry up.

Some trusts started exercising their right to force originators to repurchase mortgages that defaulted in the first few months. This caused many originators to lose money, which violated agreements they had with warehouse lenders that required them to be profitable, Barbiero says. Many warehouse lenders cut off originators, forcing them out of business. Since December, a dozen smaller subprime lenders have been shut or merged, according to Origination News.

Q: Why are we hearing so much about this now?

A: Many large lenders are now reporting rising delinquencies and losses in their subprime portfolios. New Century, the second-largest subprime lender, is teetering on bankruptcy. The New York Stock Exchange has suspended trading in its stock.

Q: How bad is the problem?

A: In the fourth quarter, 13.33 percent of subprime loans were delinquent, up from 12.56 percent in the third quarter. Only 2.57 percent of prime mortgage were delinquent, up from 2.44 percent. Subprime delinquencies are likely to get worse when loans made in 2005 and 2006 that become adjustable after two years reset. When they do, payments will rise.

Q: Who will eat the losses?

A: It could be warehouse lenders, subprime lenders and their shareholders, the owners of mortgage-backed securities, investment banks that packaged them (many retained the riskiest pieces) and firms that insure them. Everyone is hoping the losses will be widely spread and no institution will suffer in a way that could ripple out.

Q: Then why worry?

A: Subprime lending helped fuel the spectacular run-up in housing prices. A decline in subprime financing means fewer people will be able to buy homes or cash in their equity. That could put a crimp in home prices and consumer spending, slowing the economy.

The last subprime meltdown, in 1998-99, was overshadowed by the Asian financial crisis, Russian sovereign debt default and the Long Term Capital Management collapse, says Rick Antonoff, a bankruptcy lawyer with Pillsbury Winthrop Shaw Pittman. He believes this implosion will have wider repercussions.

"The subprime market today is \$3 trillion today versus less than half-a-trillion dollars in 1998," he says. Also, the 2005 bankruptcy law makes it harder to qualify for Chapter 7, which lets people discharge their debts. Instead, more will be forced to repay their debts, at least for a while, in Chapter 13. And that will mean less spending on other goods.

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