

Subprime Mortgage Lenders Seeing Early Payment Defaults

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NEW YORK, August 29, 2006 -- More subprime borrowers are defaulting in the early months of their home loans, a trend that has led to greater fear among investors and lenders of rising delinquencies and losses.

For more than a year, shareholders in mortgage lenders and investors in mortgage-backed securities have worried that the end of the housing boom, along with higher interest rates, would cause more borrowers to default on their home loans, leading to more bank and investment losses. But credit quality industrywide has generally held firm, thanks to a still-strong economy and a robust job market. However, in recent months, an increasing number of lenders catering to borrowers with weak credit have reported a sharp rise in delinquencies that had occurred as soon as six months after origination.

Nationwide, about three and a half subprime loans out of every 10,000 originated between January and June had a delinquency on their first monthly payment, according to LoanPerformance, a subsidiary of First American Real Estate Solutions. By comparison, only one out of every 10,000 subprime loans granted last year had experienced missed payment in their first month. LoanPerformance's data also show that so far this year, there has been a 14% increase in the number of nonprime mortgages with at least one missed payment in the first three months after origination.

"If those borrowers are finding themselves in trouble very early on, it may give lenders an indication that the underwriting criteria or quality control are not sufficiently tight," says Damien Weldon, director of collateral risk analytics at LoanPerformance. Based on the year-to-date data, Weldon says early payment defaults on subprime mortgages are expected to increase this year.

Those early defaults have forced lenders such as NetBank Inc. (NTBK), Fremont General Corp. (FMT) and H&R Block Inc. (HRB) to buy back loans already sold to whole-loan acquirers, particularly Wall Street investment banks that pool and package those loans into asset-backed securities and then sell them to large investors like insurance companies and hedge funds. The buybacks, in turn, have led lenders to incur losses and set aside more money in their reserve funds for potential loan repurchases in the future.

For instance, as recently as a week ago, H&R Block told investors that it expects to take a \$102.1 million pre-tax charge, or \$61.3 million after-tax, for losses related to rising delinquencies by its subprime mortgage borrowers. The Kansas City, Mo., tax-services firm, which has expanded into mortgage and other financial services, said "an increase in early payment delinquencies" and the resulting "higher level of repurchase requests from loan buyers" led it to increase its loan reserves. The company, which is to release its first-quarter earnings Thursday, didn't specify the reasons for those early defaults in the press release.

Some investors and analysts view the early hiccups as a sign of weakening mortgage credit. Alan Fournier, who runs Pennant Capital Management LLC, a Chatham, N.J., hedge fund with more than \$1 billion under management, says although the housing market has already softened, as shown in a growing inventory of unsold homes and slowing home-price appreciation, "the credit cycle is just starting" to turn for the worse.

The secondary market, where lenders sell the new loans they create to manage risk as well as to have more funds available for making mortgages, could also see more pressure from rising delinquencies. Merrill Lynch analyst Kenneth Bruce wrote in a recent report commenting on H&R Block's announcement that "if the fixed-income market anticipates further losses, it could

begin to pressure spreads on lower rated bonds, thus undermining whole-loan pricing." A potential decline in whole-loan pricing would eat into lenders' mortgage gain-on-sale income.

The subprime mortgage market has grown substantially in recent years, with total subprime loans outstanding representing about 13% of total mortgage loans outstanding. Subprime borrowers, who pay higher rates than prime borrowers due to their weak FICO scores (typically lower than 640) or a lack of documentation such as no income proof, tend to take on more debt and have less disposable income. A typical subprime mortgage represents 80% of the house value.

Such highly leveraged borrowers also have a greater tendency to refinance and take cash out when home prices rise. However, when home prices decline, as is now happening in many parts of the country, those borrowers may have fewer choices to tap into their homes' wealth to pay down debt, leading to more defaults on their home loans.

Analysts at UBS Investment Research noted in an August report that they suspect "the squeeze high [debt-to-income] homeowners are facing" due to slower home-price appreciation and higher loan rates accounts for "a good portion of the higher delinquency and foreclosure rates on the 2006 subprime deals."

The analysts doubted whether worse underwriting or servicing standards could have accounted for the sharp rise in foreclosures, noting that "every subprime issuer we speak with has greatly expanded their loss mitigation efforts, and they will keep homeowners out of foreclosure if at all possible."

Mike Frantantoni, senior economist for the Mortgage Bankers Association, says strong economic growth has so far kept delinquencies in check. He predicts that delinquencies "are likely to increase modestly" over the next several quarters but will remain historically low.

To reduce early delinquencies and protect themselves against future buybacks, some lenders including NetBank in Atlanta and Fremont General in Santa Monica, Calif., have backed away from offering loans featuring higher loan-to-value ratios and lower credit scores.

Some subprime lenders have also raised the bar for qualifying borrowers for loans requiring only limited paperwork and implemented more stringent procedures to fend off fraud, another oft-cited cause for early defaults. Though some of the tightening measures might make it harder for some borrowers to swing a loan, they could prevent lenders from issuing loans they shouldn't make in the first place.

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