LESSONS FROM THE SUBPRIME MARKET

by Steve Brown

Occasionally, a little voice goes off inside your head that says "seize the day, throw caution to the wind." This is the voice of Satan. It happened last week when we were talked into skateboarding with the kids and ended up with a Manzanita bush implanted in our GI tract. It also happened 6Ys ago when several banks and finance companies expanded into subprime mortgages. After several specialty lenders produced 25% ROEs in 1999, more capital gravitated towards this market. Several weeks ago HSBC, New Century and a host of other subprime and second-lien home originators declared huge write downs due to buy back provisions with conduits. Those firms were the lucky ones, as 27 underwriters have called it quits and 100 more are predicted by year end. Before independent bankers wipe their brow and say "whoa, thankfully we are not in that business," we say "hold on." There is a lesson to be learned. The subprime loan debacle playing out before our eyes is a perfect underscore to proper risk management. Subprime loans to borrowers with lower than a 650 FICO score carry interest rates 2% to 3% more than traditional loans extended to "A" borrowers. Subprime loans made up 20% of the market in 2006, so we are talking a sizable chuck of exposure. The issue at hand is not really if these loans carried risk, because no one ever disputed that fact. What has been in question is whether the risk was priced correctly. As late as the fall of 2006, subprime lenders used the justification that the 2Y history of subprime defaults has been relatively low and competition was forcing down prices. Some smart underwriters, such as Household Finance, recognized that anytime you can get a home loan with nothing down (without proof of income and with downward price pressure), it is time to sell (as they did to HSBC). The less fortunate argued that the market had changed and the risk was reduced. The reality was that competitive pressures and the triumph of greed over risk management forced many subprime firms to reduce underwriting standards and decrease pricing. Many firms failed to model and price the contingent liability that hung on their books. Fewer still modeled both a shock to credit and a simultaneous decrease in liquidity. When credit began to deteriorate, warehouse lines dried up, forcing many into bankruptcy. Ironically, many subprime lenders paid their top salespeople and management based on volume, instead of risk-adjusted return. In the end, firms compensated staff to book the very loans that destroyed their respective companies. While the final tally is still pending, it appears that taking into account the contingent liability and a default history going back to 2000, pricing should have been a minimum of 110bp more on many of these loans. It is too early to tell if the problems of the subprime market will spill over to the broader mortgage sector. Regardless, this period of financial history reminds us that credit is indeed tied to interest rate risk, proper loan and risk modeling is mandatory, profitability analysis must be conducted and the right compensation structures must be in place to mitigate the risk of that little voice.

BANK NEWS

The HC for Getting Worse

The FRB reported that the delinquency rate on single family residential loans climbed in the 4Q to its highest level in 4Y. The percentage of loans with payments 30 days or more overdue climbed to 2.11%, up from 1.72% in the 3Q.

IT Survey

A new survey analyzing where banks spend their IT budgets finds the top 3 uses are for security, regulatory compliance and customer-centric initiatives

Competition

The CEO of Bank of America indicated in a recent speech that the bank would only pursue acquisitions if they filled a hole in the company's product set, geography, or accelerated the company's growth rate.

Credit Unions

The CU industry reported loans grew by 8% for the year ended 2006. The fastest growing segment was business and real estate loans, which jumped 24% from the prior year.