SUBMERGING SUBPRIME

by Steve Brown

Defaults in the subprime mortgage market have surged to a 7Y high, leaving many lenders in the sector sinking toward the bottom of the financial ocean. So many independent banks are CRE lenders, it really isn't all that shocking that so few have been monitoring events closely in the subprime space. Regardless of a bank's lending specialty, there is much that can be learned. To understand the enormity of the subprime problem and the potential impact on independent bankers, we begin with some background. As of the end of 2006, subprime mortgage volume had reached $640B (a 400% increase from 5Y earlier). Overall, 54% of loans in the mortgage market are considered "Prime," 26% are "Alt A" (generally prime borrowers, but non-conforming in some way) and 20% are subprime (typically a credit score below 620). When times were good, no one really worried about defaults, as delinquency rates were relatively low. Loans were typically funded without tax returns or other evidence of income and funding as high as 100% of the home value was common. The game ended when the FRB raised interest rates and housing prices began to fall. Since December, more than 30 mortgage lenders have gone out of business and 100 more are estimated to be on the bubble. Delinquencies are surging (running at 2x historic averages), reaching their highest level in 7Y and nearly 20% of loans in the sector are now past due (with more than 10% 60 days or more). Perhaps even more startling, 2% of subprime loans become past due only 5 months after origination. If subprime were the only problem, the economy could absorb it and we could move on. Unfortunately, the broader mortgage market is also seeing pressure. Late payments on all mortgages have risen to their highest level in 4Y, while nearly $1T in adjustable rate mortgages will see their rates reset higher in the next 12 months, adding strain to the consumer. Homes are also staying on the market longer. Consider that homes now remain empty an average of 4.8 months (the longest in 7Y). In addition, with just over 4mm homes currently on the market, experts predict subprime defaults could add another 500k. Keep in mind that the number of homes on the market is also understated, because it does not capture customers that cancel their purchase contracts (creating a significant shadow inventory). Adding even more pressure to the outside hull of the sector, home sales plunged 17% last year, further hurting prices. All of these issues could eventually impact consumer spending, which accounts for 67% of the economic engine of the country, leading to FRB rate cuts and impacting even bankers focused on CRE lending. As if that weren't enough, slippage in subprime has led to a predictable response from regulators. Banks have been warned to tighten up underwriting and some have even been slapped with C&Ds. Regulators also worry that subprime ARMs, which represent about 8% of all outstanding mortgages, are just beginning to see their rates reset higher. This has increased concern of a potential "payment shock," with projections running as high as 2.2mm more home loan defaults. The more homes that are abandoned, families are evicted, mortgage lenders fail, stock prices plunge, prices soften and firings increase; the more impact independent bankers will feel. While most independent bankers do not need to worry about whether or not their bank will sink to the bottom as a result of subprime, the impact on the industry overall may be deeper than many project. The sinking feeling in subprime is yet another real life example of why regulators are pressing banks to improve and adopt risk management processes, stress testing and credit simulation.

BANK NEWS

M&A

The La Porte Savings Bank ($266mm, IN) will acquire City Savings Financial Corp. ($137mm, IN) for 1.55x book.

Competition

Wachovia said it plans to open 50 new branches in TX each year for the next 2Y, boosting its presence from a current level of 174.

Subprime

New Century Financial Corp. said Thursday that it will no longer accept loan applications due to "constrained funding capacity." Meanwhile, the FDIC ordered Fremont General to amend its real estate lending risk management policies and address management and capital issues.

Competition

In 2006 credit unions increased their business lending by 110% over the prior year. By year-end, real estate loans had reached $17.2B, while construction and development was $1.7B.

Healthcare

A study finds that in the past 6Y, company paid health insurance premiums have climbed 87% and at some companies now equal about 20% of overall net profits.

Forecast

An updated forecast of 75 major economists finds GDP will expand (2.4% in the 1Q, 2.5% 2Q, 2.9% 3Q and 3.0% 4Q); consumer spending will rise (annual rate of 3.2% 1Q and 2.6% 2Q) and inflation will increase to 2.5% for the year (compared with 2.3% forecast last month).

Regulators

Federal regulators have set May 7th as a deadline for banks to comment on proposed guidelines tightening underwriting of subprime mortgages.