

## **The Subprime Mortgage Mess**

Subprime mortgages are a small part of the U.S. residential mortgage lending market. Yet, this year, these financial instruments have taken center stage in global financial markets. We will attempt to give you some perspective as to how and why this has occurred and what we may expect as fallout.

### **How the subprime market works**

Most home mortgages in the United States are securitized, creating bonds called mortgage backed securities (MBS). The U.S. residential MBS market is larger than any other fixed income sector, including treasury, corporate or agency securities. The MBS market is normally segmented by credit quality. There are three broad categories of mortgage credit:

- A quality: the highest rated segment
- Alt-A (Alternative A): not quite A quality
- Subprime: the riskiest segment

The credit quality of a mortgage loan is determined by the borrower, the collateral of the loan, and the terms of the loan. Loan terms would include fixed rate versus variable rate, amortizing versus interest only loans and the documentation used to underwrite the loan. In terms of all mortgages, the subprime category represents approximately 12% of the mortgage market. Alternative-A mortgages make up approximately 10% of the total residential market. The balance would represent A quality mortgages.

Most subprime mortgages were not held by the financial companies that originated them. They were pooled, securitized and held in a trust that issued a series of “tranches” or bonds. These bonds were then given a rating by the major rating agencies. These bonds were sold to institutional investors around the world. It was through the ratings given to the bonds by the rating agencies and the supposed diversification of the bonds themselves that led many institutions to feel that they were managing their risk effectively in investing in these instruments.

### **What happened?**

There were several factors that occurred over the last few years to create this financial issue. Coming out of the tech stock bubble, investors looked for investments other than equities. The economy was in a recession and the Fed moved to lower interest rates. Lower interest rates created liquidity and fewer constraints to borrow money. U.S. home prices had risen rapidly for several years and investors believed that prices would not fall, but rather have a “soft landing.” The current subprime mess was largely due to three things:

- The originators of these mortgages had an incentive to sell them and were largely unregulated. It is important to note that banks, Fannie Mae (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) were not generally involved in subprime

lending. During the peak of the subprime loan originations, “low documentation” or “no documentation” loan underwriting became commonplace.

-Buyers of subprime mortgage-backed securities relied too heavily on the ratings given by the rating agencies and did little independent credit work.

-The rating agencies were wrong. They made overly optimistic assumptions on new, untested mortgages. They used a backward looking approach to evaluating the risk of these securities and assumed a soft landing for home prices.

### **What’s next?**

Unfortunately, we still have a way to go before this crisis is over. At the peak of the subprime loan originations, approximately 80% of these mortgages featured artificially low teaser interest rates. Many of the loans underwritten in 2005 and 2006 were hybrid adjustable rate loans. These loans would start with a fixed rate for two or three years and then adjust to variable rates for the balance of the loan. For most conventional mortgages, a total debt service of 33% of gross pre-tax income is allowed. Most subprime borrowers have an initial debt service burden of approximately 45% at the initial teaser rate, BEFORE any interest rate reset. The assumption was that home prices would continue to appreciate and these borrowers would be able to refinance into a fixed rate mortgage.

Now, with home prices falling and interest rate resets coming, there very easily could be an increase in the default rate among subprime mortgages. These mortgages could only perform in an environment of continued easy credit and ever rising home prices. This environment no longer exists.

### **Conclusion**

The financial institutions that have purchased the MBS backed by subprime mortgages may face additional write-downs on these loans and further pressure on their earnings and stock prices. This could lead to continued liquidity issues in the credit markets and tightening of lending standards going forward.

The effects of the unwinding of these mortgages have yet to be seen fully in the financial markets. We anticipate further defaults on these loans, continued home foreclosures, and overall weakness in the housing market.

Overall, we view this as a time when we need to approach the investment markets with caution. We have positioned our portfolios in a more defensive stance and will continue to monitor this closely to see what additional moves should be made.

Should you have any questions on the subprime issues and how they may affect your investment portfolios, please give us a call. We thank you for your continued support and confidence.

