What Stage of the Sub-Prime Crisis are We In?

May 6, 2008

Last week, former baseball player and steroid expose author Jose Conseco walked away from his home. On *Inside Edition*, he said “It didn't make financial sense for me to keep paying a mortgage on a home that was basically owned by someone else."

Like thousands of others, Conseco realized there was no point in paying a mortgage on a property that was underwater. He might have consulted www.youwalkaway.com, one of many web sites devoted to those caught in the sub-prime crisis.

Phenomena such as this, previously unheard of in American history, are keeping the sub-prime crisis in the headlines. One of the most frequently discussed topics concerns the stage of the crisis or, given Conseco’s former profession, “what inning are we in?”

We believe we are in the first or second inning.

A Look at the Data

To identify stage of the sub-prime crisis, we begin by looking at the volume of sub-prime loans that have passed their original reset date, and the volume with upcoming resets. According to First American CoreLogic, who provides mortgage data through their LoanPerformance service, approximately $400 billion of sub-prime mortgages reset in 2007, and another $125 billion reset in the first quarter of 2008.

There is a 12-15 month lag between the reset date and what the mortgage industry call an “E.O.D.” – event of default. Thus, defaults for the bulk of the $525 billion of sub-prime loans that have already reset will surface over the remainder of this year.

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In addition, First American confirmed that $264 billion of sub-prime loans will reset in Q2, Q3, and Q4 of 2008. Another $137 billion will reset in 2009 and beyond. In total, $925 billion of sub-prime mortgages have or will reset and are potential candidates for default.

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A few caveats apply to this data. First, the 12-15 month lag is a national average, and varies significantly by state and, within state, by metropolitan area. Second, as Mark Fleming, Chief Economist for First American notes, the reset date is not necessarily the trigger for when a property will default. Fleming notes that some properties are re-financed before their reset date. Conversely, once a property goes underwater, the homeowner may not wait for the reset date to walk away. Lastly, going forward, homeowners will be increasingly exposed to economic risk through job losses and inflation, and this may play a greater role in triggering defaults than the interest rate shock stemming from mortgage resets.

Fleming said the first determinant of whether a house will go into foreclosure is whether there is equity. "Where there is equity, there is a sale or refinance option," he said.

Since the majority of sub-prime mortgages were made with very little equity, and with the continued decline in housing prices (the most recent Case Shiller data showed a 12.7% year-to-year decline through February), we expect very few sub-prime mortgages have equity, and an even smaller number of those that will reset over the remainder of this year and beyond will have equity.

The default rate on sub-prime mortgages stands at 26.6%, up from 11.6% a year ago. It is reasonable to expect this rate to rise dramatically. A very conservative estimate would be that a third of the $925 billion problematic sub-prime loans will default. We believe real estate prices will continue to decline. For 100 years, until the beginning of this century, home prices tracked inflation. The housing bubble led to peak values 30% above the trend line of inflation. An additional 20% correction will be necessary to bring home values in line with historical data. A 20% decline would put virtually all sub-prime mortgages underwater, and rates of default would be double or triple their current value.

Alt-A and Other Prime Mortgages

Sub-prime mortgages are the most problematic aspect of the mortgage crisis, but they are not the only mortgages subject to default. We were provided the following data by Credit Suisse, showing the volume of all mortgages scheduled to reset going forward:

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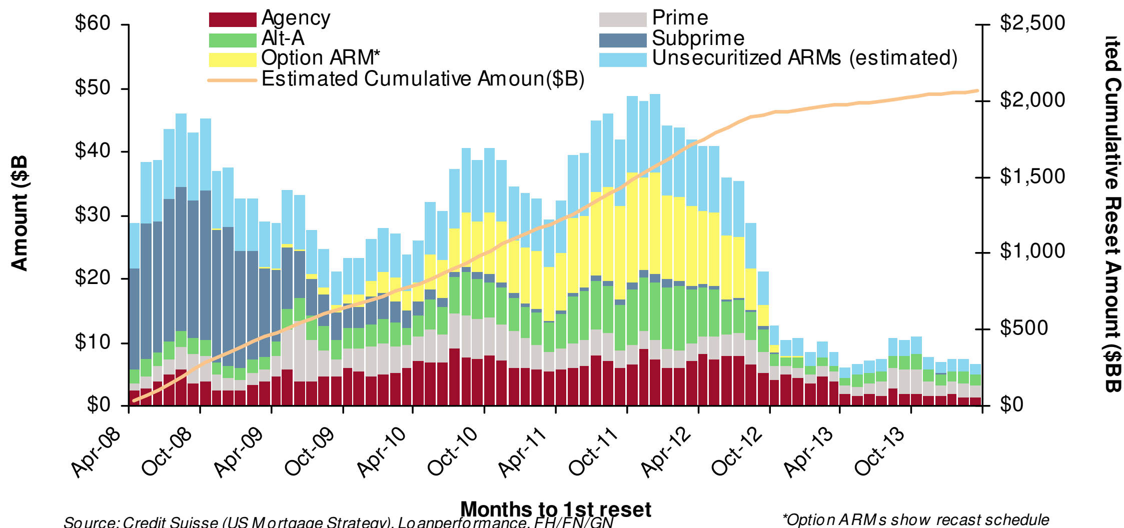

The Credit Suisse data shows over $2 trillion in adjustable rate mortgages scheduled to reset, starting in April of 2008, including sub-prime mortgages. As the volume of sub-prime resets wind down in 2009, a wave of Alt-A mortgage resets emerges, peaking in late 2011.

The default rate on Alt-A loans is currently 9.3%, up from 2.1% a year ago. The default rate on prime loans is 0.9%, up from 0.4% a year ago. As with sub-prime default rates, these rates will increase as homeowner equity shrinks.

Mitigating Factors

Against this backdrop of impending resets and shrinking equity, a number of actions have been taken to address the crisis. Understanding the stage of the crisis requires assessing the impact of these actions.

The Fed has implemented a number of measures to increase the borrowing ability of banks. The goal of these measures is to provide liquidity, in part to restart the credit markets and the securitization process. If successful, these actions will create options for some homeowners to refinance. However, the likelihood of an underwater homeowner refinancing remains small.

The Fed has $800Bn on is balance sheet, with approximately one half of that committed. The Fed is clearly preparing for more bad news, and recently announced a contingency plan, whereby the Treasury would sell securities to the Fed, which the Fed would fund through additional borrowing. This would leverage the Fed, increasing both its assets and liabilities. It allows the Fed to use these securities in programs where they would be swapped for AAA sub-prime debt.

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The Fed's actions carry a cost. They will work as long as the borrower (the bank) remains solvent. In the event the borrower defaults, the Fed will need to borrow additional funds from sources such as sovereign wealth funds. If that is not possible, the Fed must print more money, which would be highly inflationary and would likely be the downfall of the dollar as the reserve currency. If we run out of lenders to the Treasury, we are in a doomsday scenario.

Congressional plans have been advanced to allow the FHA to provide refinancing assistance. The FDIC has proposed a program to provide loans to troubled borrowers to reduce the principal of their loans. These plans, if implemented, will provide relief for homeowners. However, the size of these plans currently under discussion would cover only a small portion of the loans that will potentially default. As with the Fed's actions, as the size of these plans increases, so does the stress they place on the Federal budget and their inflationary impact.

As many as half of the condominiums on the market today are unoccupied. Unoccupied properties are less likely to benefit from public policy measures. But the effect of their foreclosures and defaults still impacts owners of CDOs containing these loans, placing strain on the financial services sector.

Another possible route for easing the credit crisis is through a number of funds that have been raised to purchase distressed loans. We spoke with Cris Santa Ana, Managing Director of Mortgage Backed Securities for Trust Company of the West, about their fund and others like it. Santa Ana notes that hedge funds and private equity firms are investing, but they are buying the better quality loans, mostly the senior tranches of Alt-A securities. He estimates less than $10 billion in capital has been raised for such funds, and said that "a couple of billion is not going to make a dent in the sub-prime crisis."

Santa Ana believes we are in the fourth or fifth inning, although he confessed that "nobody really knows what inning we are in."

Banks may be unwilling to sell their most distressed assets because, by doing so, they would be forced to mark-to-market similar portions of their portfolios, creating large write-offs. It is likely banks have hedged their default risk on distressed loans through credit default swaps and, by doing so, are able to carry these loans at an inflated value.

What Inning are we in, and why does it matter?

Banks have written off approximately $200 billion thus far, a little more than half of that by US banks. This includes not just sub-prime mortgages; it includes Alt-

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A and other prime mortgages, leveraged loans, and consumer debt. In April, the IMF estimated the ultimate cost of the sub-prime crisis to be $1 trillion, and we suspect even this estimate is conservative. Hence, we believe we are in the first or second inning.

For advisors, the key question remains whether the market has already discounted the severity of these losses. We doubt this is the case. The 9.4% decline in US markets (the S&P 500) since their peak in October of last year does not reflect future sub-prime related write-offs and the inflationary pressures that will result from the proposed rescue measures. At the very least, equity investors should look to be broadly diversified internationally. The current environment also represents a once-in-a generation opportunity for value oriented investors. Market volatility and distressed securities lead to under valuation, and we are confident that those opportunities exist in the equities market today.

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