

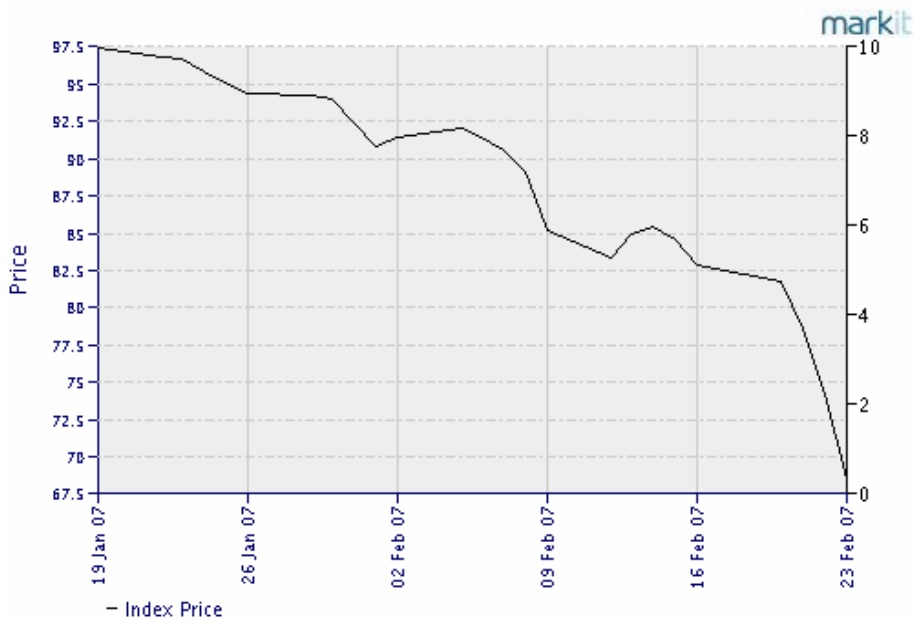
Subprime Mortgages Continue to Suffer

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The last few weeks were marked by yet more significant cracks in the mortgage market. As expected, the most risk burdened sector is feeling the pinch. Novastar Financial reported a bleak picture last month as the subprime mortgage sector soured. Write downs of impairments resulted in a \$14M quarterly loss vs. a \$26M profit a year ago. Furthermore, the company did not foresee any taxable income for the next five years. (NFI restated later that it expects GAAP profits)ⁱ The net effect was to send NFI shares plunging 42% along with its peers amid a slew of downgrades. The pessimism continued this week with a series of announcements.

- US Homebuilders Confidence Index fell to 36 (below 50 means poor conditions expected)ⁱⁱ
- The fourth quarter saw sub prime delinquencies at a 4 year high. More worrisome was that foreclosures on all types of loans also hit an all time high.

Fed Chairman Ben Bernanke commented, "This distress in the subprime area is a significant concern...There are some loans that have been made that are not turning out well, and to the detriment of both the lenders and the borrowers. We will certainly be watching that carefully and trying to provide guidance and oversight to minimize that risk going forward."ⁱⁱⁱ The Fed is not the only concerned party in this area. Larger investment banks, through their mortgage warehousing arms, have provided much of the short term funding liquidity that allow these subprime lenders to operate. These banks are wary of the credit crunch and are reducing exposure through additional margin calls. In some cases, they may shut off the funding pipe completely and put some firms effectively out of business. Moody's Investor Service reacted during the week by announcing that it may downgrade the servicer quality rating of Novastar and some of its peer.^{iv} With over a dozen subprime lenders seeking bankruptcy or outright sales over the last year, it is becoming apparent that there may be cracks in this once profitable business model.



ABX-HE BBB- Index ^v

A further indication of the deterioration in the sector is the sharp decline in credit default swap market (as shown above) for these subprime loans. The increased cost for "insurance" against defaults will put additional pressure on this sector of the mortgage business. Looking ahead, analysts are also watching the effect of increases in energy prices. According to Jim Awad (Awad Asset Management), "The subprime borrower is the one who would be hurt the most if gas and heating oil prices went up further."^{vi} Factors such as increases in adjustable rates and declining housing prices add fuel to the fire that burdens these borrowers.

The question remains whether this recent fallout is the bottom of the market. This recent trouble is the first significant downturn in the last 10 years of extreme growth in subprime lending. Companies like Countrywide and Novastar are thought to be strong enough to survive this downturn in the market. However, it remains to be seen how deep the troubles in the mortgage market will be in the next few quarters. The collapse last week of New Century Financial added fuel to fire. Furthermore, we have seen the stock market take a hit as a result of the deterioration in this segment. Some larger firms like HSBC may have to increase reserves for loan losses in their businesses with US mortgage exposure. Finally, the effects on the US economy

are still to be seen. Consumer spending has been the backbone of the nation's growth for some time. A problem in the mortgage markets may reduce discretionary income and signal trouble ahead for the economy in general.

The hope is that the credit problems of this sector are unique and isolated to this particular segment. However, the HSBC announcement shows that there are some connections to larger institutions. A prudent analysis would require one to gauge the risk exposure of a number of large banks to this credit crunch among subprime lenders. The consensus is that it is indeed isolated and therefore, less troubling. However, with some notable banking names taking a haircut on the back of this news, there is always a cause for concern.

ⁱ NFI Press Release, Feb. 21, 2007 <http://ir.novastarmortgage.com/phoenix.zhtml?c=84748&p=irol-newsArticle&t=Regular&id=965772&>

ⁱⁱ "U.S. Homebuilder Confidence Index Falls This Month", Courtney Schlisserman, Bloomberg, March 19, 2007

ⁱⁱⁱ "Big Banks Control Fate of Subprime Lenders", Alistair Barr, Marketwatch, Feb 16, 2007

^{iv} Subprime Lenders Sector Wrap, AP, Feb 23, 2007

http://biz.yahoo.com/ap/070223/apfn_subprime_mortgage_sector_wrap_corrective.html?.v=4

^v <http://www.markit.com/information/affiliations/abx>

^{vi} "Subprime woes seen worsening if oil hits borrowers", Ellis Mnyandu, Reuters, Feb 23, 2007