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BANKING

Subprime time

By Steven Brull

Rising interest rates? A cooling housing market? No sweat, say subprime lenders. But growing competition and new regulations spell trouble.

The television pitches have a come-hither feel: "Bad credit not a problem . . . rates near record lows . . . no money down!"

The sponsors of these ubiquitous ads are not fly-by-night outfits. They are fast-growing financial institutions that have found a way to attract scads of customers — and earn hefty profits — by offering home loans to borrowers with poor or nonexistent credit at prices as much as one third or more above regular mortgage rates.

Subprime lending — so called for the credit status of the borrowers, not the interest rates on the loans — has become the business-cycle-defying sweet spot of the $2.8 trillion U.S. mortgage market. Originations of subprime loans have grown by an average of more than 25 percent annually over the past decade. Reaching a projected $582 billion in 2004, subprime loans will account for a record 20.9 percent of total mortgage volume, says *National Mortgage News*. As overall mortgage lending slowed, the subprime lenders' share will have more than doubled from 8.8 percent in 2003, when their total volume was $390 billion. In 1995 subprime loans accounted for 5.5 percent of the market, or $35 billion.

Despite a recent slowdown, many subprime industry observers expect growth to accelerate again in the second half of 2005, allowing subprime lenders to boost market share even if interest rates rise and home-price appreciation eases. The boom has already made stars out of such little-known companies as San Diego–based Accredited Home Lenders Holding Co., Orange, California–based Ameriquest Mortgage Co. and Irvine, California's New Century Financial Corp. They have muscled in on — and built a significant business out of — what was historically a sideline for established mortgage giants like Washington Mutual and Wells Fargo & Co. And now the mainstream financial services companies are competing more aggressively than ever. Two of the ten most active subprime lenders are top-tier conventional mortgage lenders Countrywide Financial Corp. and Washington Mutual; three others are subsidiaries of Citigroup, HSBC Holdings and General Electric Co.

What accounts for these titans' interest? The subprime specialists are feasting: Net income for the first three quarters of 2004 rose by 73 percent at New Century, 32 percent at Accredited and 18 percent at Kansas City, Missouri–based NovaStar Financial.

Analysts see no reason to spoil the party. They say rising loan demand — caused by a growing population, more aggressive marketing and changing consumer attitudes toward borrowing — only plays into the industry's hands. "Demographic trends and the demand

Tim Tadder

Accredited Home Lenders' McKewon: "We have to go where the yield curve takes us" for subprime loans are sure to lead to faster growth rates than for conventional lending, and with less cyclicality," says Joseph Stieven, head of financial institutions research for St. Louis investment bank Stifel, Nicolaus & Co.

Indeed, interest-rate and credit cycles don't dampen the lenders' go-go enthusiasm. Says Raymond McKewon, executive vice president and co-founder of Accredited Home Lenders, "The nonprime lending industry is to a large degree acyclical — not cyclical or countercyclical."

Surely there's room for concern about a bubble in the making. HSBC U.S. chief economist Ian Morris is predicting a 10 percent to 20 percent correction in housing prices over five or six years. Such a gradual decline may not do lasting damage to the housing finance industry nationally, but it could cause serious pain in the frothier markets around major East and West Coast cities. A steep recession or a surge in consumer bankruptcies could stifle the market in general. But few economists are so bearish, and even if there were more skepticism, nobody seems ready to buy it.

GE entered the market in June by acquiring WMC Mortgage Corp. for an undisclosed sum. Citigroup has a sizable stake in the subprime business through its CitiFinancial subsidiary, the renamed consumer finance company Associates First Capital Corp., which Citi bought for $26.7 billion in 2000. Trade publication *Inside B&C Finance* estimates that the unit made $17 billion in subprime loans through September; it ranked seventh in the industry in third-quarter originations, with $6.1 billion. The top-ranked conventional mortgage bank, Countrywide, is embracing subprime as a way to compensate for declines in prime loans; it's now second behind Ameriquest in subprime lending (13 percent of its $91.8 billion in total loans were subprime in the third quarter).

Accredited's McKewon likes being among such company. Of GE's entry, he says, "Their blue-chip imprimatur is terrific for the industry."

Certainly the subprime lending business could use a little image-buffing right now. Banking and consumer protection agencies increasingly have placed so-called predatory lenders, with their seductive pitches of loans to marginal borrowers, in their sights. In May, CitiFinancial paid a $70 million fine to the Federal Reserve System to settle two-year-old charges of alleged abuses in subprime lending to low-income, high-risk consumers during 2000 and 2001.

Extra-vigilant regulators are not the only potential hazard for lenders in this alluring venue. Interest rates are rising, and home prices in some East and West Coast markets are showing signs of cooling. Subprime lenders will feel the squeeze as borrowers with adjustable-rate mortgages have a harder time covering their bigger monthly payments. Declining home prices stand to lower the value of borrowers' collateral, limiting their ability to increase borrowing and likely leading to more foreclosures.

Conforming, or prime, mortgage lenders have felt the unhappy effects of an end to the biggest refinancing boom in history. After setting records in each of the past three years as long-term rates sank to 45-year lows, industrywide refinancings this year will tumble an estimated 47 percent, to $1.39 trillion, with a further 41 percent fall expected next year, according to government-sponsored mortgage financing agency Fannie Mae. Total mortgage originations will slide about 22 percent in 2005 and a further 17 percent in 2006, Fannie estimates. As this decline erodes profits at prime lenders, many, like Countrywide, are diversifying into the subprime arena.

Subprime lenders, however, are less affected by these trends than prime lenders and in some ways actually benefit from them. They are largely insulated from the refinancing cycle, which involves mostly conventional loans at fixed rates. The subprime companies focus on two types of loans with more stable demand: Some two thirds of subprime loans are borrowings against home equity, and the rest are for home purchases. With interest rates on some credit cards climbing as high as 28 percent, cashing out equity to pay off a card balance remains a compelling choice, especially coupled with the added benefit of receiving a tax deduction on the mortgage loan.

Subprime borrowers typically pay 1 to 2 percentage points more than the benchmark 30-year fixed mortgage rate, which was averaging 5.74 percent in mid-November, 5 basis points higher than a year earlier, according to Fannie Mae rival Freddie Mac. Most lenders and analysts assume that rising rates go hand in hand with a strengthening economy and consumer confidence. "If we truly are in economic recovery, that should increase demand as more people get more income and financial assets to take out a loan," explains Richard DeMong, a University of Virginia professor of bank management who specializes in home equity and subprime lending. At the same time, higher interest rates will prevent many borrowers from qualifying for prime loans, leaving them no choice but to turn to subprime lenders.

For subprime lenders, the absolute level of interest rates is less critical than the shape of the yield curve — the usually positive gap between short- and long-term rates. Subprime lenders pool most of their mortgages and sell them as securities to institutional investors of all sorts. Lenders keep about a third of these securities on their books and use the assets as collateral for issuance of debt certificates that flow to the asset-backed-securities market. Increasingly, lenders are keeping loans on their books, hoping that the steady stream of income on those loans will make their shares more attractive to stockholders. At the same time, many subprime companies are converting to real estate investment trusts, a more tax-efficient structure, because REITs must pay out 90 percent of their earnings as tax-free dividends. But as the yield curve flattens — narrowing the gap between short- and long-term rates — the loans become less attractive to investors relative to Treasury securities with similar maturities.

"We have to go where the yield curve takes us," says McKewon of Accredited, which originated $9 billion in mortgages during the first three quarters of 2004, compared with $5.6 billion in the same period a year earlier — a 61 percent increase. "We're the unwilling surfer."

Under any conditions, subprime lenders must still contend with pressure from competition and increasingly zealous regulators. As big, deep-pocketed financial institutions like Countrywide and GE take on the upstarts, they are driving down margins. Even so, subprime is much more lucrative than conventional mortgage businesses, which have become tight-margin, commoditylike operations to conform to standards

Ann Summa

WMC Mortgage's Brandt: "The chief problem with predatory lending is defining it"

imposed by Fannie Mae and Freddie Mac.

"Every basis point counts to maintain costs," notes Amy Brandt, the 32-year-old president and CEO of GE's WMC Mortgage in Woodland Hills, California. "It's going to be difficult in the next few years for smaller players to compete with the guys at the top as economies of scale come into play."

The biggest mortgage banks are adept at navigating regulatory minefields — and subprime lending is a dangerous one. Consumer activists argue that predatory lending is epidemic and costs borrowers more than $9 billion annually. A predatory lender typically piles on fees or penalties that strip unsuspecting consumers of their equity and hasten default. Subprime lenders deny that they engage in such practices and add that they are rare to begin with. "The chief problem with predatory lending is defining it," says WMC's Brandt.

Defining the class of subprime home-loan borrowers — those who don't qualify for loans conforming to Fannie Mae and Freddie Mac standards — is a matter of cold computation. Borrowers are assigned a FICO score, using a formula developed by credit-data provider Fair, Isaac & Co. for rating creditworthiness based on income, assets, credit history and other characteristics. Applicants scoring below 620 (out of a maximum of 900) are considered subprime. Those with higher FICO scores may be deemed subprime if they cannot make a significant down payment, cannot document their income with pay stubs or tax returns or have recently gone through a foreclosure or bankruptcy.

Most subprime borrowers are low-income and minority homeowners. But about 20 percent of all subprime loans made in 2002 were to middle- and high-income borrowers, according to a New York Federal Reserve Bank study.

"Every tenth neighbor of mine is a subprime borrower," says Richard Eckert, a subprime industry analyst at Roth Capital Partners in Newport Beach, California. "They're people — like doctors, lawyers and investment bankers — with large incomes and even larger lifestyles."

THE NEW WAVE OF SPECIALTY HOME LENDING began to take shape with the Tax Reform Act of 1986, which eliminated the deductibility of consumer interest payments — except on residential mortgages. That incentive to borrow for a home or against a home, combined with technological advances in credit scoring and the advent of mortgage-backed-securities trading on Wall Street, created a bigger, increasingly streamlined and commoditized mortgage industry.

Subprime lending came into its own during the booming 1990s. Until then people who couldn't get bank loans had little choice but to go to such finance companies as Associates First Capital or Beneficial Finance, now a subsidiary of HSBC's Household International. The spread between conventional and subprime loans was often several times today's typical gap of less than 2 percent.

Many major financial institutions poured into the more profitable subprime mortgage market as the economy boomed. But in late 1998, as the Russian and Asian currency crises sent jitters through Wall Street, the industry nearly melted down. Investors cut back on purchases of mortgage-backed securities, depriving some lenders of liquidity. Outfits such as United Companies Financial Corp., Southern Pacific Funding and the Money Store went out of business or were closed by their parent firms. Those that survived, however, thrived as liquidity returned and low interest rates helped set the stage for a prolonged housing boom.

Some analysts acknowledge that the industry could face a nasty and unexpected surprise, especially if housing values fall sharply or the yield curve quickly narrows. "The capital markets can be very fickle and mercurial," warns Roth Capital's Eckert. "Now they can't buy enough asset-backed products, especially securities backed by subprime mortgages. Back in '98 they wouldn't touch them."

But Peter DiMartino, asset-backed-securities and mortgage-credit analyst at RBS Greenwich Capital in Greenwich, Connecticut, says that scenario "is less likely now than it was a couple of years ago. The market participants are stronger; there are many fewer marginal participants."

GE's entry bolsters that argument. For years the conglomerate's GE Consumer Finance unit had been eyeing the U.S. mortgage industry, which represents about 80 percent of the country's $8 trillion in consumer loans outstanding, the largest consumer finance market in the world. GE had some home-lending experience overseas and issued mortgage insurance domestically; its other U.S. consumer credit activities centered on private-label retail credit cards and personal loans.

"Moving into mortgages was a natural extension," says Mark Begor, president and CEO of GE Consumer Finance–Americas. GE plans to subsume WMC under its new global financial services brand name, GE Money.

GE preferred the subprime space because it is less crowded than prime lending, Begor explains. It also had an available vehicle: WMC was owned by private equity firm Apollo Management, which was eager to sell. GE saw WMC as a relatively low-risk play because it focuses on borrowers at the upper end of the subprime spectrum, known as the Alt-A market. These applicants, many of them self-employed, would ordinarily qualify for prime, or A, loans but have inadequate income documentation or are unable to verify assets. Alt-A lenders — others include Lehman Brothers subsidiary Aurora Loan Services and IndyMac Bancorp of Pasadena, California — originated a total of $48 billion in loans in the second quarter of 2004, a 50 percent jump from the year-earlier period, according to *National Mortgage News*.

Reflecting overall subprime growth — and Alt-A activity in particular — WMC's volume in the first three quarters of 2004 was $12.1 billion, compared with about $8 billion for all of 2003, and it is poised to continue growing at annual rates of more than 20 percent, says CEO Brandt. As a triple-A-rated parent, GE will lower WMC's funding costs by 60 to 70 basis points; that's equivalent to more than half of WMC's profit margin, and it's sure to put competitive pressure on rival Alt-A lenders. "It gives us the best cost of funds, bar none, in the business," boasts Brandt.

WMC plans to grow in large part by wholesaling its services to prime lenders. Through a private-label Web site operated by WMC, which will underwrite the loans, a bank could offer credit to customers it would normally turn away. CEO Brandt hopes to make as much as 30 percent of WMC's originations this way over the next few years.

If WMC represents conventional lenders' moves down-market, Ameriquest aspires, by contrast, to swim upstream, into the prime-lending pool. The privately held lender's determination to reach a broader market became clear in May, when it pledged $75 million over 30 years for the right to call the Texas Rangers' baseball stadium "Ameriquest Field at Arlington." Ameriquest has also put up advertisements at other ballparks and sponsored the All-Star Game fan balloting process — all building on its designation as "the official mortgage company of Major League Baseball."

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"Baseball is America's pastime," notes Adam Bass, senior executive vice president of Ameriquest Mortgage and its holding company, Ameriquest Capital Corp. "And home ownership, the business we're in, is part of the American dream."

Explaining Ameriquest's desire to broaden its appeal, Bass adds, "We are already touching many potential customers every month, and we would like to be able to make loans to more people than we currently do." Some of these customers will be existing subprime borrowers who have improved their credit histories and now qualify for conventional loans. Says Bass, "We're not sure how many more of these we're going to get, but we know it will be a significant number."

Ameriquest started out in 1980 as Long Beach (California) Savings & Loan. Its originations tripled from 2002 to 2003, then doubled again in the first nine months of 2004, to $39.9 billion, compared with the year-earlier period, according to *National Mortgage News*. Because Ameriquest doesn't disclose results, its performance is a subject of speculation among its peers. Some in the industry say it booked nearly $1 billion in pretax profit last year. Bass, a lawyer who oversees Ameriquest's government, communications and legal affairs, chortles at that "nice rumor," adding that the company has no plan to go public. "We're quite comfortable the way we are," he asserts.

The biggest publicly traded subprime specialist is New Century Financial. Second only to Ameriquest in the subprime field, nine-year-old New Century originated a total of $31 billion in loans in the first nine months of 2004, up 60 percent year-over-year, and its share price, about $64 in early December, was up 74 percent over the preceding 12 months.

The share prices of other specialist competitors have also performed well: Accredited Home Lenders is up 48 percent in the 12 months through December 3, NovaStar 33 percent and West Palm Beach, Florida–based Ocwen Financial Corp. 28 percent.

But most of these companies' price-earnings multiples remain in the single digits — trailing, for example, Washington Mutual, which has a one-year forward P/E of 13, through year's end — because of concerns about slower loan growth, a narrower yield curve and tougher competition. Even those that have converted to tax-advantaged REITs, including New Century (forward P/E 7.3) and Saxon Capital (8.2), are still waiting for a pop.

SUBPRIME LENDERS HAVE TO be good at assessing credit risk, but one risk they don't pay much mind to is a housing bust. "I don't believe there's a bubble that will burst, but I do expect a flattening of values for some time," says WMC's Brandt, who remains bullish even on overheated California's prospects. "There are so many environmental restrictions to building new homes, and there's such a limited supply of land in high-density areas, that values will probably remain at high levels in the near term."

The median price of a California home will rise to $522,930 in 2005, a 15 percent jump from 2004, the California Association of Realtors projects. In August only 18 percent of households in the state could afford a median-priced home, the group says.

Federal Reserve Bank of New York economists Jonathan McCarthy and Richard Peach also think that the prospect of a housing bust is remote. In a June report they wrote, "Home prices have risen in line with increases in personal income and declines in nominal interest rates. Home prices are not likely to plunge in response to deteriorating fundamentals to the extent envisioned by some analysts."

On the bearish side, HSBC's Morris predicts that real estate prices will begin to fall in late 2005 or early 2006. A deeper bust, or one more sudden than the five- or six-year slide Morris foresees, could erode the value of collateral and likely lead to more subprime foreclosures, which in the second quarter were running at 4.61 percent. That's well above the rate on conventional first mortgages — 0.49 percent, according to the Mortgage Bankers Association — but subprime specialists say it's not alarming by their historical standards.

Even so, a drop in home values would be far more painful for conventional lenders. They are more exposed to the expensive housing markets on the coasts that are likely to feel more pain than the slowly appreciating, more modestly priced heartland locales where subprime loans tend to be concentrated.

As for interest rate increases, subprime lenders believe they have more to gain than to lose. If higher rates freeze borrowers out of the conventional market, what choice do they have but to pay up for subprime? Says WMC's Brandt, "It's hard to imagine a scenario where short-term rates would be higher than long-term mortgage rates, so with tax advantages, it's still a compelling proposition to take out an equity loan."

Even as a flatter yield curve makes subprime securitizations relatively less attractive, they benefit from being more predictable than packages of prime mortgages. The reason? Prepayments of prime loans usually move in the opposite direction from interest rates — when rates fall, borrowers prepay to refinance; when rates rise, borrowers stay put. But subprime prepayment rates tend to hold steady in all rate environments. That's because a loan's interest rate is usually fixed for two to three years, and early prepayments are penalized. Also, borrowers have an incentive to keep up a steady flow of payments to improve their credit status. When their prepayment penalties disappear, creditworthy customers can always benefit from getting out from under a subprime loan, points out RBS Greenwich Capital's DiMartino.

The predatory lending cloud, however, is likely to linger for a while. The National Home Equity Mortgage Association, a trade group representing subprime lenders, wants Congress to enact federal anti-predatory-lending guidelines. So does a consumer group, the Center for Responsible Lending in Durham, North Carolina. But the CRL also wants states to continue to be able to augment the federal guidelines. One consumerist gripe: The Homeowners Protection Act of 1994 capped subprime loan fees at 800 basis points, but that doesn't include prepayment penalties and other noninterest costs that can add another 100 to 150 basis points, says CRL general counsel Michael Calhoun.

The two sides are also at loggerheads on assignee liability — the ability of borrowers to sue purchasers of securitized mortgage pools that include predatory loans. Nhema says assignee liability boosts the risk, and therefore the cost, of these packages and can limit the availability of credit. "If there's assignee liability, there's no liquidity," argues Mitchell Feinstein, chairman of Nhema and chairman of Budget Finance Co., a consumer and commercial lender in Los Angeles.

But as the subprime industry grows in stature as well as size, predatory lending is likely to become less of an issue. Operating at higher levels of efficiency and professionalism, the lenders face greater risks to their reputations should they make a mistake. Perhaps more important, intense competition has narrowed the spread between prime and subprime loan rates — and blurred the distinctions between lenders and their mortgage products. Will the financial industry giants prevail over the smaller specialists? Hard to say, but one thing is sure: The competition will benefit the long-maligned subprime sector — and the subprime borrower. ii