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Guest Column: Recovering mortgage industry providing plenty of good news



Friday, December 07, 2007

The mortgage industry has experienced dramatic changes in the past year, and some unfortunate national economic ramifications have occurred as a result.

Nevertheless, some of the changes within the mortgage marketplace have been welcome news to professionals, like myself, who have long been a part of it (in my case, for more than 12 years).

About three years ago, I was surprised to see lenders relaxing their guidelines to the point of providing financing for loan applicants who had credit scores in the low 600s (the borderline for acceptable credit), not requiring borrowers to provide any documentation of assets, and lending for the full value of the property being purchased.

I was even more surprised to learn that mortgage companies were starting up all over the country, hiring inexperienced loan officers, and specializing in interest-only or negative-amortization products.

The subprime market was a market that should have structured products to service it. There are certainly many reasonable mortgage products that have been created and continue to serve a useful purpose for deserving clientele.

But the trends I saw developing from lackadaisical lending policies clearly pointed to a strong potential for catastrophe. These lending patterns were not sustainable, and certainly were not a long-term solution for the residential-financing industry - or for consumers.

CDOs (collateralized debt obligations) and CLOs (collateralized loan obligations) - in this case, investment pools that sold bonds to investors, using these mortgage obligations as collateral - became very popular during that time. Wall Street was selling these instruments more quickly than new ones could be put together and encouraged lenders to fill these large pools as quickly as possible. This spurred the continued easing of underwriting requirements.

Lenders already had reached their capacity in extending mortgages, so the only way to produce even more loans fast enough to meet demand was to create a new type of market for mortgages. Unfortunately, the only way to create a new mortgage market was to compromise (recklessly) long-standing underwriting guidelines and to ease credit requirements for borrowers.

Many existing lenders - along with the many new lenders that sprang up all across the country - decided that the only way to keep up with demand for new mortgages was to shelve common sense and provide such loans to clients under almost any terms. These mortgages became the substantial basis for many of the new CDOs and CLOs.

Real estate prices were soaring. So it seemed like a sure bet that the collateral - i.e., the value of the residence securing the loan - for these pools, these bonds and, ultimately, these mortgages would cover any potential decline in investment returns.

As we know now, such thinking was severely flawed. Fortunately, not all the news about the subprime-mortgage problem is bad.

For example, the amount of real financial losses incurred by lenders that made subprime loans have been relatively small when you consider that the total mortgage market consists of about \$10 trillion in outstanding loans. About \$1.25 trillion of those are subprime. Furthermore, only about 15 percent of subprime loans are delinquent.

Of those in delinquency, only one-third are in foreclosure - representing about \$60 billion. From that amount, fortunately, there has been (or is projected to be) a recovery of at least 50 percent, based on the actual value of the real estate providing the collateral for the mortgage.

This means that the final, total losses to lenders have been, thus far, limited to \$30 billion to \$40 billion. Yes, this is a large amount, but it is small compared to the overall mortgage market. This amount is very small when compared to the \$1 trillion in value lost by the U.S. stock market in reaction to the supposed subprime "catastrophe."

The general impression that one might glean from the media has been that the mortgage marketplace has virtually evaporated. This, however, is not the case. It is true that overall loan volume is down, home prices are lower, and profits are smaller. But this translates into a more reasonable set of circumstances; for instance, we don't see lines around the block to put a down payment on a new residence.

Moreover, mortgages still are available for every market segment. Conventional loans, jumbo loans, Federal Housing Administration loans - even subprime loans - are still being made.

What about the future? Because investors now recognize the emotional reaction to stop buying *any* kind of collateralized debt obligation or collateralized loan obligation was unreasonable, we are again seeing such offerings being filled (slowly but surely). Ultimately, we will have a return to normalcy.

We will, most likely, not see loans being made again to clients with poor credit or who have few or no assets. Furthermore, documentation requirements have become more stringent. In short, the mortgage business is returning to its original practices. These include making high-quality loans - while using skilled personnel and long-established underwriting practices.

The mortgage marketplace, once again, makes sense.

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