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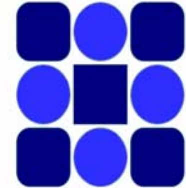

# SUBPRIME MORTGAGES

*October, 2007*

## What they are

The subject of subprime mortgages is certainly timely, as the mainstream media has recently devoted considerable attention to this issue. While there is no single accepted definition of "subprime" currently used across the industry, the U.S. Office of Thrift Supervision provides a widely accepted definition: "Subprime borrowers may display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria…." To compensate for these additional risks that subprime borrowers present, mortgage originators generally charge a premium above the rate available to prime borrowers. This premium is not only a distinguishing feature of a subprime mortgage, but also a potential source of excess return for investors.

## Our position at Opus Investment Management

We have no exposure to subprime mortgages in any of the accounts we manage. Our mortgage investments are characterized by strong borrowers, prudent underwriting and good liquidity. We primarily take prepayment risks in our mortgage portfolio, with a very limited exposure to credit risk and only with prime borrowers.

## The market

By all accounts, the market had shown great growth over the last 5 years. In 2000, $56 billion of subprime mortgages were originated. This jumped to $508 billion in 2005, before dropping slightly last year, and plummeting more than 40% so far in 2007. Approximately 14% of all existing mortgages are subprime.

Several factors drove the growth of this market:

1. More borrowers qualified due to initial attractive interest rates and strong employment.
2. Steadily rising prices enticed first-time home-owners, as well as some speculators, looking for profits in real estate.
3. New originators entered the subprime market, including firms that had originated only prime mortgages.
4. Investment banks and other intermediaries purchased these subprime loans and repackaged them as investments for a secondary market. Even though these investments consisted of nothing but subprime loans, by layering risk so that the lowest tranches absorbed any initial losses, AAA-rated tranches could be created. In a world of low interest rates and tight spreads, these "safe" investments, with lucrative excess returns, could appear very attractive indeed.

## The evolving crisis

In retrospect, a number of dangers were masked by the strong economic conditions that had prevailed for the past several years:

1. Originators and intermediaries had very different financial incentives. Originator compensation was largely driven by volume, while intermediaries were presumably seeking quality mortgages that would be profitable over the life of the loan.
2. As competition increased and interest rates rose, originators were motivated to continue to generate equivalent volumes. As a result, underwriting standards were lowered, with no money down and limited documentation (e.g., stated income) loans becoming prevalent. It is believed that there was considerable fraud -- anecdotally, 50% of all subprime mortgages originated in 2006 may have involved borrower income being overstated by at least 50%. In addition, more exotic mortgage products were created that served to qualify marginal borrowers. These included loans in which rates reset, generally after 2 years, as well as negative amortization loans, in which scheduled payments could be less than the interest due.
3. Not surprisingly, experience on these new loans began to deteriorate. As delinquencies increased and losses emerged, intermediaries refused to purchase loans. As the "pipeline" clogged up, cash-strapped originators found it difficult, if not impossible, to advance new loans. In many cases, bankruptcy was the only answer; approximately 130 originators have recently ceased operations. This represented the first stage of the current subprime crisis.
4. Mortgage investments are somewhat unique; establishing the value of a large pool of loans can be extremely difficult. The delinquency and foreclosure processes generally evolve over many months, and ultimate loss recovery on a foreclosure is uncertain as to timing as well as amount.
5. With the media beginning to focus on the sector, bond-holders in the subprime secondary market attempted to redeem their positions. Unfortunately, in many instances, it was extremely difficult to value these investments. When sales did occur, the actual market prices usually turned out to be considerably lower than where the bonds had been previously valued. To make matters worse, the additional supply drove market prices still lower. Such price discovery tended to make remaining investors increasingly anxious, and more forced redemptions took place, primarily by levered hedge funds.

In some instances, huge mortgage investment funds were left with little value. In other cases, investment managers froze their funds, refusing to allow additional redemptions. Finally, in a startling and largely unexpected development, these pressures migrated to the commercial paper (CP) and money markets. The asset-backed CP market, which stood at $1.2 trillion, began to experience problems "rolling over" loans, since investors started to question the underlying collateral, which in some cases consists of subprime mortgages. These pressures on liquidity represent the second stage of the crisis. This is where we stand as we go to press.

**How we get out of this crisis**

First, the Fed and other central banks have addressed the liquidity crisis. On August 9, the Fed added $24 billion of liquidity through open market operations. Later in the month, the Fed took steps to strengthen its position as lender of last resort. The discount rate, the rate at which banks borrow from the Fed, was lowered from 6.25% to 5.75%. In addition, loan conditions were liberalized, permitting longer maturities and a broader range of collateral, in order to encourage activity at the discount window.

Second, the Fed has recently cut the funds rate, and the market expects additional easing. This will almost certainly impact favorably upon a broad array of markets – corporates (especially financials), CP, and prime mortgages. The marginal home-owner or borrower would certainly benefit from a drop in interest rates and an improvement in liquidity.

Third, Fannie Mae and Freddie Mac have already played a large role. Traditionally associated with the underwriting of prime mortgages, the agencies have recently liberalized their approval process. It is estimated that over 50% of subprime borrowers will qualify for an "expanded approval" agency mortgage.

Fourth, a lot of time and a lot of patience will certainly be required. There is currently no significant source of funds for the remaining subprime borrowers. Many of these borrowers will face higher interest rates when their mortgages reset in 2008 and in 2009. The impact of these higher mortgage payments will likely weaken overall consumer spending. In addition, the anticipated spike in foreclosures will depress prices in an already tenuous housing industry. Some analysts feel that this slowdown will spread into the general economy, representing the third stage of the subprime crisis.

**Risks and Opportunities**

Although subprime investments have cheapened considerably over the past several months, we do not believe investments in this sector to be appropriate for client portfolios. First, the most elementary data – essentials such as borrower income, credit, and loan-to-value -- remain suspect. It is simply not possible to evaluate a mortgage bond if these data are unreliable. Second, although rating agencies have certainly increased their scrutiny of this sector, their ratings actions have not yet caught up. Finally, price discovery is still evolving. There remains a huge and unacceptable gap between bond bid and ask sides. Bottom line: this sector is still extremely volatile and it will be many months before prudent investors should consider entering this market.

Fortunately, some interesting opportunities have now emerged in other mortgage sectors. The magnitude of the current subprime crisis is such that several significant market dislocations have occurred. This is not uncommon in flight-to-quality trading.

First, spreads for agency pass-throughs and CMOs have widened even though they contain no credit risk. There are admittedly some challenges here, including higher prevailing volatility, general aversion to mortgages, and increased supply given that subprime pipelines have closed. However, this sector should be one of the first to snap back when market conditions stabilize.

Second, prime jumbo mortgages have cheapened even more than agencies, and now deserve careful consideration. Although there are credit concerns with non-agency mortgages, recent delinquency and default experience has been within historical ranges. The prime borrower presents income, credit, and loan-to-value characteristics that are consistent with agency mortgages. With spreads at historical wides, some allocation to AAA-rated prime mortgages may prove far-sighted.

Finally, the Alt-A sector has been crushed. Alt-A mortgages were originally restricted to prime applicants (hence the "A") who could provide only limited documentation. More recently, however, Alt-A has come to include credit-impaired borrowers who score much closer to subprime. Given this complexity, there appear to be opportunities for investors who are willing to do some careful analysis. We would continue to limit our Alt-A exposure to AAA-rated investments with prime borrowers.

Given the current volatility, as well as the protracted time-frame before these subprime issues begin to resolve themselves, it is not possible to predict the bottom of this market. Accordingly, investments in this environment should involve some scaling in to positions over time. Leaving some powder dry for future opportunities has never been a better call.