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RUNNING ON EMPTY

SUBPRIME: ARE YOU IN OR OUT?

A VICIOUS CYCLE MORTGAGE WOES AND YOUR CUSTOMER

2Q AUTOMOTIVE FINANCING TRENDS

When the housing bubble popped, so did the financial system that guided the automotive retail industry to record sales. F&I expert breaks down the financial instrument responsible for today's financial woes, and provides some insight into the pressures your customers are facing.

PHOTO: ©ISTOCKPHOTO.COM/JOHN LONG

A Vicious Cycle

By Steven Palmieri

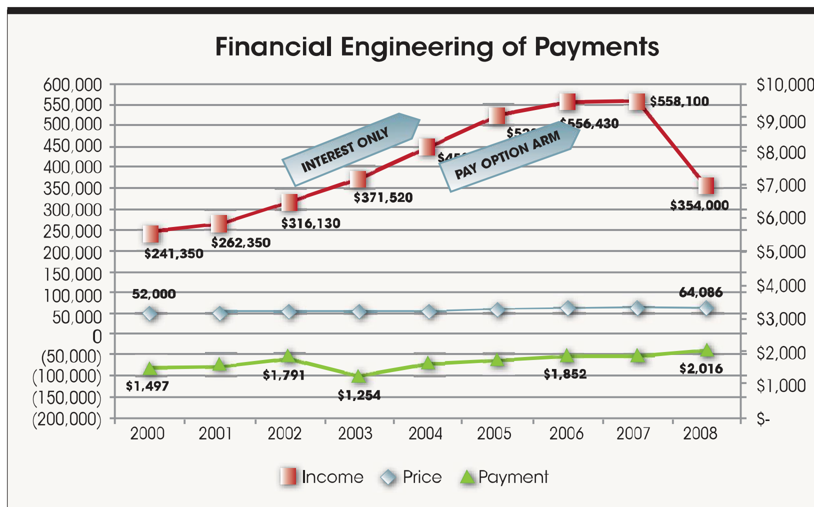
The U.S. government's historic seizure and expected 5.2 trillion bailout of mortgage finance titans Fannie Mae and Freddie Mac on Sept. 7 was the latest example of mortgage industry's fall. And while many auto finance experts maintain auto finance and the mortgage industry took different paths, recent announcements regarding leasing does reveal some parallels. Tracking the life cycle of a subprime mortgage and analyzing its impact on the typical consumer also exposes some similarities.

There are four components that affect the subprime segment: lender, home builder, realtor, and customer. Of these four, lenders can have the greatest influence on the economy because they deal with a form of money that's difficult for the Federal Reserve System to control.

The Federal Reserve recognizes four types of money, or monetary aggregates, which are classified by M0, M1, M2 and M3. M0 is actual currency such as cash that is directly controlled by the Federal Reserve. Cash is the most liquid form of money and the easiest to control by the Federal Reserve. M1 represents money that is held in bank reserve vaults and checking accounts. M2, which we'll call "bank money," includes savings accounts, money market accounts, and certificate of deposits. M3, which we'll call a "financial instrument," represents instruments which provide evidence of ownership of interest backed by a debt, such as a home mortgage or auto loans.

And as the auto industry has come to realize, a lender can create a financial instrument that, in large enough quantities and under the right conditions, can create a chain reaction large enough to slow the economy. That's because a financial instrument is the least liquid form of money. So, in a sense, lenders can gain a level of economic influence that overrides the authority of the Federal Reserve.

A great visual is the chart compiled by Mr. Mortgage and Foreclosure Radar called the "Financial Engineering of Payments." The chart shows the median house price from 2000 through 2008. Note that as home prices more than doubled, the mortgage payments only rose slightly as a result of "exotic" financial instruments. These instruments allowed people to purchase more home than they could afford,



Mr. Mortgage and Foreclosure Radar provides a great chart for visualizing how those "Exotic" financial instruments worked. Showing the median house price from 2000 through 2008, one can see that mortgage payments rose only slightly as home prices more than doubled.

similar to what long-term financing, flex-buy payments, leases, and balloons did for the auto industry. And if you don't think there are any similarities, listen to this response from one Chrysler executive the day the company's finance arm ended leasing.

"One thing that's not in the best interest economically is that leasing gives you a chance to have a lower payment because you're just renting the vehicle and you're only financing the piece that's the difference between what the residual value is the and the cost of the vehicle," said Jim Press, vice chairman and president of Chrysler, in response to a reporter's question during the company's conference call with the media. "It has been used to try and bring customers in who cannot make a high payment and through leasing their payment is lower. But at the end of the contract they own nothing. They're not building equity."

It is important to note that cash is created and controlled by the Federal Reserve, while bank money and financial instruments are created and controlled by for-profit companies such as banks and lenders. As long as these financial instruments meet legal requirements, including those mandated by the Truth in Lending Act, the lender can use those instruments to determine the risk vs. reward when qualifying customers.

When cash becomes cheaper for banks to attain and turn into bank money, as was the case a few years ago when the prime rate was low, bank money then becomes cheaper for lenders to borrow and turn into a financial instrument. If a bank or lender can increase the profit spread between the cost of the cash or the bank money relative to the market value of the financial instrument they created, they can benefit from a larger profit margin. The adjustable rate mortgage (ARM), which has many different variations, is the financial instrument this article focuses on as we follow the subprime customer's journey from pre-home ownership to post-foreclosure.

The ARM Scenario

Let's look at a 2/6 30-year Hybrid ARM amortized over 40 years with an adjustable rate that begins after 24 months (adjusting every 6 months thereafter to a rate equal to prime plus 5.95 percent). The starting APR is 10 percent, and the loan has a balloon payment due on month 360. This balloon is what allows the ARM to be amortized over 40 years, which creates a lower payment. The ARM does not have property taxes and escrow requirements included in the monthly payment, which creates a lower monthly payment.

New Century Mortgage Corporation is one lender that wrote financial instruments like this. The company is now in Chapter 11 bankruptcy and was unavailable for comment.

It is important to note that most ARMs such as these are very rarely kept by the original lender. The collateral manager (also known as an asset manager) moves these ARMs into other investment vehicles. The collateral manager will approach an investor on Wall Street to borrow, say, $500 million to make an investment vehicle called a collateralized debt obligation (CDO). The CDO will use the investor's money to buy and hold the ARMs, which are used to create asset-backed securities (ABS) through a process known as securitization. Because the CDO is composed of ARMs, the collateral used to create the ABS are the homes themselves.

Any cash-flow producing asset can be securitized by repackaging the cash flow as securities and selling them to investors. In this example, the securitization creates $500 million worth of ABS, which is then used to create and sell bonds (debt) to investors. The payments from these bonds are fueled by the monthly principal and interest payments the subprime customer makes on the original ARM. These bonds are valued on Wall Street by the anticipated future value of the assets (homes) and the anticipated future cash flow of the monthly payments of the ARM attached to the asset.

Prior to the declining mortgage industry, many of these bonds were erroneously given "Senior" and "Super Senior" triple A ratings by Wall Street credit rating agencies because the true risk was underestimated. John Dugan, the Comptroller of the Office of Comptroller of Currency of the United States, recognized on February 2008 that "these better-than-triple A tranches [of bonds] were supposed to be the least risky parts of the subprime securities pyramid. Instead they have generated the clear majority of reported subprime write-downs in capital markets." Dugan's office charters, regulates, and supervises all national banks. According to Dugan, non-bank lenders originated 90 percent

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of all subprime mortgages in 2006. National banks and their subsidiaries originated only 10 percent.

When the securitization criteria tightened in 2007 and Wall Street's demand for financial instruments decreased, small lenders found themselves unable to create the cash flow necessary to sustain their business models. This has resulted in a domino effect that now has lenders, home builders and realtors looking for other ways to maintain their business models.

Auto lenders are no exception. The July 2008 issue of *F&I Management and Technology* published a news story about Triad Financial Corporation's exit from the auto financing industry. In the article the company cited unfavorable financial markets as its reason for leaving the indirect dealer channel. "Conditions in the financial markets have been extraordinarily unstable, and have hindered our ability to adequately and cost-effectively fund future business through traditional methods, including asset-backed securitization (ABS)," the company said.

Perception is Reality

The need for profitability on Wall Street drives the use of ARMS on subprime customers. Lenders push these customers to ARMs, which fills the CDO created by the collateral manager. The lender is essentially a middle-man (or a loan originator) with no intention of keeping the mortgage because the collateral manager on Wall Street can buy these financial instruments to create profitable CDOs.

Lender default rates were low and lender competition made ARMs common for both prime and subprime customers. These ARMs were and are fundamentally sound options for customers who do not plan to keep a home beyond a few years, and who can pay their taxes annually. The amortization structure gives the customer a lower payment. It also gives the collateral manager a higher APR loan to securitize, package and sell.

Significantly more customers were able to afford the monthly payments on a dream home because the lender guidelines did not require taxes and insurance to be included in the payment. However, ARMs created problems for subprime customers who could not take the time to fully understand the risk involved with such a loan.

Let's go back to June 2006. We have a couple who just entered the market for a home. They find a real-estate agent who informs them of several housing options. The agent also assures them that affordable financing is available, too.

The couple shops for a home within the price range of $290,000 to $390,000.

HELPFUL SITES

- To view loan conditions in your area, click on the following Website: www.newyorkfed.org/mortgage-maps/.
- Also available is a site that allows one to compare mortgage payment options: www.federalreserve.gov/apps/mortcalc/.

But the agent persuades them to consider a home that has more bells and whistles, but is beyond their budget. The agent knows that because ARMs have become so common, she can sell a more expensive home to a customer who can't afford it by using conventional 30-year fixed financing. The agent is paid by commission, so it makes sense to push a more expensive home.

The deal is closed, but as soon as the last signature dries at the title company and the lender funds the deal, the true cost of ownership begins.

As the end of the first year approaches, the customer has property taxes due. He has not effectively budgeted to pay these since he was busy buying furniture and appliances for the home and is still adjusting to higher utility bills. Unfortunately, the customer was subprime before he bought the home and is now getting further behind by not budgeting his expenses. Then 2006 passes without the customer paying property taxes.

As 2007 begins, the customer really feels the strain of owning the new home. The customer and his wife become delinquent on other financial obligations as the cost of living rises. Then 2008 starts and the customer has not paid property taxes in two years. The lender pays the taxes for both years in January 2008 to protect the collateral. This amount is now added to the mortgage payment repayable to the lender over the next 36 months. Additionally, the lender now force-places an escrow requirement on the customer for all future taxes, which means the base mortgage payment will never return to the original amount before escrow. These events raise the customer's monthly payment nearly 40 percent and the ARM has not even adjusted yet. In June 2008 the ARM finally hits 24 months and adjusts.

Four months before the rate adjusted and the payment was raised because of the forced-placed taxes, the customer became delinquent on the mortgage. The customer attempted to refinance into a fixed-rate loan and was declined due to the current mortgage delinquencies. And now the customer can't sell the home because of too much negative equity. As the next few months passed with the customer unable to pay the mortgage,

this ARM loan became a non-performing asset (NPA) on the lender's books. This results when a lender holds a loan while the deed remains in the customer's name during the pre-foreclosure process. Several months later the lender forecloses on the NPA and the customer moves into an apartment.

The next step for the lender is to sell the home once it takes ownership. After 90 days of the home being unsuccessfully sold at the foreclosure auction and the open market, the lender pulls the home from the market. The home now becomes a type of property owned by the lender known as real estate owned (REO) property.

Some lenders have over 1,000 homes in their current REO portfolio, which can be packaged one of two ways — in bulk housing blocks or sold individually. When REO properties are packaged as bulk housing blocks and marketed to an investor, such as a hedge fund, the market price is below 40 percent loan to value (LTV). When REO homes are sold individually, the market price is around 65 percent LTV.

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Today's Reality

You can argue that in this current market the bankrupt lender has created its own enemy. You can also argue that the consumer must be more diligent when making big-ticket purchases. Regardless of what side you take, the end result we see today are bankrupt lenders, homebuilders struggling to move homes, subprime customers dealing with foreclosure, realtors fighting against tighter lending criteria, and auto dealerships trying to survive the aftermath.

In December 2007 Federal Reserve Chairman Ben Bernanke summed up the situation in the following statement: "Unfair and deceptive acts and practices hurt not just borrowers and their families, but entire communities, and, indeed, the economy as a whole. They have no place in our mortgage system."

I would add that unfair and deceptive practices also do not have a place in auto dealerships, which is why we need to heed the lessons learned by the mortgage industry. Not only will we better understand today's customers, but it will prevent this cycle from happening again. ■

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