

For the degree of bachelor of arts essay

[Business](#), [Management](#)



Executive SummaryThe pressing issue such as the rising default rates in Sub-prime mortgage lending in the USA, have without a doubt caused tremendous hurdles in the way of the lenders. The problem has taken a toll to the extent of lenders filing for bankruptcy. The Regulators strongly believe that there should be tapering the underwriting standards. Analyst feel that the standard variables that they so much depended upon to understand the loan portfolio default risk was loosening their grip of accurate predictive power very early in the year 2006. The entire issue revolving the sub-prime market and the issue of mortgage lending are the working of numerous combined factors. The foremost issue is that the default rates on mortgages are much higher than what is considered as a distinctive. It could be that the people involved in the mortgage business must have taken an improper action, but the issue primarily is atop on one point or thing.

That could be someone unable to make the payment, which was readily agreed initially. The default rate ripples to the rest of the secondary market affecting with alarm ringing in the ears of investors who must have given a thought of Collateralized Debt Obligations, a risk assessed security associated with fixed return. There was a sharp rise of default rates, the delinquencies for the sub-prime mortgages soared to 14.

57% on December 2006. Relying mainly on the consumer credit scores is also one of the major reasons why some of the mortgage banks failed to realize the delinquencies say analysts. The sub-prime mortgage lending in the USA has a network of reaction in the stock market and the foreign exchange markets. **Introduction**The mortgage lenders in the US sub prime market have undergone a rollercoaster. The sector once upheld as the

hottest mortgage market has seen a spiraling default rates, which has forced most of top names in the sub prime area to file bankruptcy or write off losses.

New Century Financial, a sub-prime mortgage lender and a real estate investment trust also joined the bandwagon of revealing significant losses. The firm in the conference call of February 7 gave warning of a 20% decrease of loan production. However, the mortgage originator hold responsible, the early defaults that began late 2006 and further deepened later. The rising losses were a serious issue of concern for many and analysts feel that there could be a chain reaction to overall housing market. The worry has pulled in national regulators to step into the scenario. Five regulators i.

e. the US Federal Reserve, the Office of the controller of currency, the Federal Deposit Insurance Corporation, the office of the Thrift Supervision and the National Credit Union Administration advised the US mortgage lenders to address few risks in regards to sub-prime lending practices. To be precise the lenders will have to calculate the borrowers capacity to pay the debt back at fully indexed rate by final maturity, by considering or assuming installments, contrary to their decision on borrower's capacity of paying preliminary teaser rate. The Loopholes So what initiative will the mortgage lenders will take while deciding whom to lend? Moreover, what is the motive behind underestimating potential losses? The input discrepancies that few models predict default rates are have shown the way that have resulted in

big differences, in the forecast of credit risk, which in turn resulted as major losses for the banks.

The inputs include the present and the future, loan to value ratio combination, and the Fico credit score of the borrower. If the interested investor with enough capital to lend to the mortgage company feel that the chances of their receiving the money is bleak, they will hardly make any move to offer the mortgage lenders any cash. Here, is where the chances of liquidity arise and further it makes less possibility for a loan. If the investors who have the capital to lend to the mortgage companies do not feel their chances of getting the return of their money is good they will not offer the cash to mortgage lenders. This causes liquidity problems for the lenders. Therefore, they will not be able to make loans. No money equals any loans.

Variable Rate MortgageA variable rate mortgage is just a mortgage loan that has a fluctuating rate. Mostly these kinds of loans are based on the COFI, the Cost of Fund Index, or LIBOR that is the London Interbank Offer Rate. If one goes through the Federal Reserve one will find that in the past two years, it has hiked the rate of the charges that it offers to the borrowing bank.

To be precise the raise in rate was seventeen times. When Reality StrikesWhen you find that these facts coupled along with the reality of most families are loaded with bills, and to make things worse, the credit card bills come with enforced minimum payment, with additional revised rules derived from the Thrift Supervision office. That means paying the minimum in double, and an increased credit card rates because FED affects these. When the Federal Reserve makes a raise of discount rate, the Prime Rate is

affected, this in turn affects the credit card rates, because the credit card rates are prime rate based. The affect on MassWhen all these factors are combined, it ultimately adds up to form a strong blow to the average American family to really juggle to make things going. The result being tumbling of the stock and the people who invest in the stock market, will look for safer grounds, typically in bonds that start reducing the mortgage rates, further it will create a turmoil in the property rates and reduce their values. SkewedThe Fico scores that were otherwise the credit risk models, have a decreasing weighting now, Soren Capital has definitely given the final verdict of so.

The Fico data is believed to have skewed of late, due to the appreciation in home price and low interest rates. Borrowers with minimal Fico scores are successful in taking out loans second and third time at a low interest rate and are successful in securing a refinance to their existing loans because of the increased value of their property, hence avoiding default. In the year 2000, the Fico score 580 for the sub-prime mortgage borrower would mean cumulative loss of somewhat 5 to 6%. But, by year 2006, the same score implied a cumulative loss of 3 to 4%. Many factors are beyond understanding why the banks underestimate the loan losses. The unprecedented market history makes it very difficult to base and build historic models of a kind. For example, the house prices have experienced a tremendous growth, in the past few years.

The growth rate is 55. 21% according to the report of the US Office of Federal Housing Enterprise Oversight. The greatest challenge lies in predicting the speed and the reason of the house appreciation.

The appreciating of the home prices have made the borrowers easily secures large loans based on the inflated value of their houses. The securitization process in context to mortgage originators' future mortgage lending Shouldering the blameThe lenders are partially to blame for the increasing default risk. Mostly due to the increasing competition among the mortgage originators and to seek, a steady flow of the loan that ignited default. This fierce competition's consequence is the reduction of underwriting standards. Few analysts believe that flexible underwriting standards may not necessarily be termed as bad, provided more people possess a home for themselves.

Generally, reduced underwriting standards are considered as a negativity when it comes to understanding how they affect default risk. Many analysts believe that stated income loans where the borrower need not provide proof of one's income are problematic areas. The piggy bank loans are also a good example for the same.

The condition where the borrower achieves a loan at a loan to value of 80% ratio and similarly receives a second loan to value of 20%, provides the borrower a platform of entering a mortgage without putting any of his or money down. This means that loan to value ratios can no longer be relied on, as it is the common input of default models. But there have been many arguments provided for the same. Few believe that most mortgage

originators possess underwriting standards and one lender, irrespective of the reason, and on deciding, not to originate a certain product there will be the competitor quick enough to snatch the market share. The future of US Residential Mortgage MarketThe home ownership has steadily increased, with the number of factors such as low interest rates, new mortgage products, and high employment reasons.

The \$200 million per year American Dream Down payment Act, promises to help 40, 000 families each year. But the point to ponder is how will these new homeowners cross the surge of economic downturn? Do we know enough about the loans that are securitization's part? And is the market functioning with transparent viability? What was it that prevailed a pause in the securitization? The originator and the underwriter and in the offering document, there are representation by the originator on the loans to be scrutinized in offering that have been made in conformity with the applicable laws. But, in most cases these warranties and representations are not accurate, which made the New York State Department to issue letter urging the best practices in order to avoid improper and abusive lending ways by the originators of sub-prime mortgages. Mortgage delinquency now is at its peak, the parts of the country that has experienced high home price appreciation are invariably the areas that have also recorded high rise in the delinquency levels. There is no doubt that the speculators in these areas have a lot to put into the rising delinquency level.

On the other hand, it also throws light into the fact that the rise in delinquency level is also because of the mortgage products that are

affordable for the consumers to buy in the market, or else it would have not been possible to afford and in some cases they are also the consequence of 'made to order' evaluations. In the soaring real estate market, the concern about the lending without limits and mortgage fraud may seem like paternalistic. However, in the cooling real estate market, this is more of an enlightened self-interest.

Mortgage originators and future mortgage lendingThe list of sub-prime lenders who have closed the shop includes, Rose Mortgage Corp., Harbourton Mortgage Investment Corp., Mortgage Lenders Network, Sebring Capital Partner, Equibanc Mortgage Corp., Secured Funding Corp., Funding America, & Popular's non-prime wholesale mortgage business. Rest of the sub-prime will definitely be able to avoid the drastic fate by selling out to diversified financial lender or Wall Street firm. However, this not mean that the perfect storm will happen on a systemic basis, but it definitely is a probable scenario.

In case, this scenario unfolds, the spiral of losses will be difficult to control. Ultimately, the losses will work all the way through markets and the system and mean will relapse. Perhaps we must take some steps to improve the climate voluntarily. The underwriters in order to avoid loans that are abusive should sample the sub-prime loans. The originators should learn a lesson by conducting reviews of the lending practices, risk management system they follow; this will help them to identify the gap and best practices. Greater transparency and increased due diligence can definitely secure the investors

in maintaining their confidence. This will help maintain liquid and a stable market.

Similarly, such transparency and diligence in our deal documents will help us ascertain that the issuers do not become aggressive excessively while lending to those pursuing American Dream. And that can be viable through our enlightened self-interest. Conclusion In conclusion, there are few things I would once again like to make clear, mortgage lending in itself a part of securitization process. The secondary market place that sees loans selling in bundles to big investment companies, typically to 401 (k) companies, hedge funds, retirement programs etc. The concluding part of my opinion is that what if there are high numbers of loan default, this also indicates that the involved companies are making money.

No bad situation continues forever, nor can it be as bad as we at times perceive it to be. If in case 9% of loan default, this means that 91% are still involved with doing well. However, we tend to concentrate on the negative sides of things always. Keeping the fingers crossed we can also say that Adversity lead to new opportunities. The sub-prime market will not go away, but it will alter, qualifying for a loan will become difficult.

The best part not to forget, when market is there, there will be products. That is the way of free enterprise. BIBLIOGRAPHY1. Incisive media Plc Investment 2006, under mortgage-risk. com 06.

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