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Mortgage defaults: Latest woe for housing

Borrowers with less than stellar credit could find mortgages out of reach - the last thing the struggling real estate market needs.

By Chris Isidore, CNNMoney.com senior writer

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NEW YORK (CNNMoney.com) -- Just as the struggling real estate market seems to be stabilizing, a fresh problem is brewing far from real estate offices or home construction sites: a jump in defaults by higher-risk borrowers.

News of rising default rates by buyers with less than stellar credit could put a crimp in financing for home purchases - and prices. That's because the rapid growth of new types of mortgages was one of the key factors behind the boom that sent home buying, and prices, to record highs for five straight years through 2005.

Last week, some serious problems cropped up due to rising defaults. [HSBC \(Charts\)](#) announced its bad debt charge last year would be about \$1.8 billion higher than expected as problems grew in U.S. mortgage securities it had purchased, particularly loans to borrowers of less than top credit, a sector of the industry known as subprime mortgages.

And lender [New Century Financial \(Charts\)](#), which specializes in subprime loans, announced it would have to restate results for 2006 to account for losses on defaulted loans it would be required to repurchase. That news sent its shares tumbling by more than a third on Thursday, and hit lenders throughout the subprime sector.

Beyond whatever problem the rising defaults in the subprime sector might cause to those lenders and their investors, the news was a setback for the struggling real estate market, according to experts in the field.

The problems with subprime loans are likely to lead to problems for many potential home buyers with less than top credit ratings. That's because most lenders don't hang onto their mortgage loans. Instead, they package them with other loans of similar quality and sell them as securities, providing cash to make additional loans.

Some experts estimate that rates for subprime mortgage loans could rise a half to three-quarters of a percentage point because of the higher default rates, and that could top a full percentage point if the default problem gets worse.

"Market forces in general will exert discipline on the process," said Sandler O'Neill analyst Mike McMahon, who follows the nation's largest mortgage lender [Countrywide Financial \(Charts\)](#) along with others in the field.

"Investors in lower-rated (mortgage securities) will demand higher yields, or alternately they'll pay less for the securities, which will force the underwriters of this product to demand higher quality mortgage loans."

McMahon and other experts say either move is likely to stop some potential home buyers from getting the financing they need to buy a home - money they might have been able to get in recent years.



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"At the margins what this is doing is making mortgage credit less accessible to some people," said Bose George, an analyst with Keefe, Bruyette & Woods who follows New Century and other subprime lenders. "Maybe it's a cohort that shouldn't be borrowing in the first place. But it will mean less money to buy homes."

David Berson, chief economist of mortgage financing firm [Fannie Mae \(Charts\)](#), said there will be a negative impact on the overall home buying market, though he sees the impact as limited. But he said whatever hard-to-assess impact there is will be more pronounced given the slowdown in home sales over the last year.

"Given the slowdown overall, it'll have a bigger impact than if we were still at record levels," he said of the rise in problems with subprime loans.

Officials with Mortgage Bankers Association also argue the impact will be limited. The trade group estimated that about 17 percent of home purchases are now made using subprime loans. If those buyers get squeezed out, that's bound to be felt throughout the real estate market, according to experts, although George, McMahon and others say it's tough to quantify by how much.

"It's not like subprime loans are going to go away completely - it won't be anything that drastic," said George. "But I think there is going to be an impact on home purchases, even if it's hard to quantify at the moment. In the past few years there's been an explosion in mortgage credit. It makes sense there would be some retrenchment."

Mike Fratantoni, senior economist with the Mortgage Bankers Association, said there would be a greater risk to the housing market if defaults were rising across the board, noting that so far the rise in borrowers who are late on mortgage payments is still mostly in the subprime sector. And he said even the growing problem in the subprime sector is not a big shock for the market.

The rate of subprime borrowers who are more than a month late on a mortgage payment was 13.2 percent in the third quarter of 2006, the latest numbers available, up from a 10.5 percent delinquency rate in the third quarter of 2005.

The overall mortgage delinquency rate was 4.7 percent in the third quarter, just slightly above the 4.4 percent rate of a year earlier, when it was a historic low.

"We don't agree they (subprime home buyers) are all going to be cut off from mortgage credit," said Fratantoni. "It is going to have something of a negative effect, but that's not a big enough part of the market to be a macro concern."

Fratantoni said the mortgage securities market will make the proper adjustments based on news about defaults and losses. He said the more serious problem for the housing market is if there is legislation or regulation that restrict such loans because of concerns about the risks to borrowers.

"We are watching to make sure no regulatory action takes place to choke off the supply of this type of financing," he said. "This is an important source of mortgage credit for borrowers."

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