

## March 2, 2007 Review

### Summary

Once again a week has whisked by and I have had little time to gather links. However, rather than wait, I felt like there are some things I want to convey. I had written the following Thursday night:

Despite what the pumpers are saying, this is not some simple dip to buy. What it is remains to be seen, but at a minimum it is a real time test of the derivative/hedgefund/leverage complex as well as the correlation among sectors. My guess and at this time it is a guess is that the first will fail and the later will provide highly correlated among the domesticequity/realestate/foreingequity categories.

I guess what amazes me is the complete lack of concern about the drop and proliferation of “buy XYZ on the correction/crash/plunge” articles. No discussion that in light of such a big downward move caution might be your first thought.

Obviously Friday did not turn out well for the bulls. However, the headline on Barrons says “Stick with the Bull” and there is little fear evidenced in either the weekend journal, the financial times or investors business daily. Far from being heartening, this IMO is an additional reason to believe there is plenty more downside. As most of you know I thought the market was going to collapse last summer. One of the reasons it did not was that my opinion was actually fairly wide spread. That left lots of nervous money on the sidelines and when things did not keep going down, there was lots of money to take it up. I think this time is much different. The bull money is pretty much in. The leverage and derivatives risk is not only now much higher, but also the sub-prime situation has had another six-nine months to fester. This time there is little I see that can hold things up. In fact I suspect with the recent drop there are now significant losses at some large hedge funds (I have no idea who and what, I am merely relying on my belief that speculation was and is rampant and that human nature being what it is there are real problems now).

We will see (sooner than later now I think) . . .

### Credit

#### Commercial Real Estate

- Construction spending in January 2007 was \$1,180.2 billion, down -0.8% from the previous month and down -1.2% from one year ago.  
<http://www.economicindicators.gov>.

## Commodities

### Faber on liquidity, the Yen, and Gold

This is a [video interview with Marc Faber](#).

<http://globaleconomicanalysis.blogspot.com/2007/03/faber-on-liquidity-yen-and-gold.html>

## Currency

- March 5 (Bloomberg) -- The yen climbed to its strongest since December against the dollar and euro as global stocks slumped, prompting investors to reduce riskier investments paid for by borrowing in Japan. The currency is trading near a 14-week high against the British pound and at a three-month high versus the Australian dollar as traders unwind so-called carry trades, buying yen to pay their loans. It also rose against all 16 most-active currencies after a report showed Japanese companies investing at a faster pace than expected, which may prompt the government to raise its estimate for fourth-quarter economic growth. "Worries that we'll see another stock-market sell-off are spooking investors into paring risk," said Masashi Kurabe, a currency manager in Tokyo at Bank of Tokyo-Mitsubishi UFJ Ltd. "The yen is being bought." The yen gained to 115.87 against the dollar at 9:32 a.m. in Tokyo after reaching 115.46, the strongest since Dec. 8, from 116.75 in New York on March 2. It also advanced to 152.81 per euro after rising to 152.27, the highest since Dec. 8, from 154.06. Japan's currency may climb to 115.50 a dollar and 152.50 to the euro today, Kurabe said. The currency has surged 9.3 percent against the South African rand, 8.2 percent versus the New Zealand dollar and 6.2 percent to the Australian dollar over the past five days. Asian shares slid for a fourth day. Investment rose 16.8 percent in the fourth-quarter from a year earlier, the Ministry of Finance data showed. Economists had expected a 13.7 percent advance. A revision to gross domestic product on March 12 would add to the Bank of Japan's case for raising borrowing costs. The preliminary GDP report showed the economy grew at an annual 4.8 percent pace, the fastest in more than two years.
- March 1 (Bloomberg) -- The yen rose to an 11-week high against the dollar and gained versus the euro on concern falling stock markets are prompting investors to unwind trades they had financed by borrowing the Japanese currency. Traders exited the so-called carry trade as they cut their appetite for riskier assets in emerging markets and moved into U.S. government debt. Investors have taken advantage of the lowest interest rate among major economies in Japan to borrow yen and buy higher-yielding assets elsewhere. The dollar pared its losses after U.S. manufacturing unexpectedly expanded last month. "The market is getting nervous," said Alan Ruskin, head of international currency strategy in North America at RBS Greenwich Capital Markets Inc. in Greenwich, Connecticut. "You are going to see yen strength as risk appetite is compressed." **Yen Gains to 11-Week High as Investors Unwind Their Trades**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ajIHW5zodLFk&refer=home>

## Diversification

### Derivatives

- March 2 (Bloomberg) -- Goldman Sachs Group Inc., Merrill Lynch & Co. and Morgan Stanley, which earned a record \$24.5 billion in 2006, suddenly have become so speculative that their own traders are valuing the three biggest securities firms as barely more creditworthy than junk bonds. Prices for credit-default swaps linked to the bonds of the New York investment banks this week traded at levels that equate to debt ratings of Baa2, according to Moody's Investors Service. For Goldman, Morgan Stanley and Merrill that's five levels below the actual Aa3 rating on their senior unsecured notes and two steps above non-investment grade, or junk. **Traders of credit derivatives are more alarmed than stock and bond investors that a slowdown in housing and the global equity market rout have hurt the firms.** Merrill since 2005 has financed two mortgage lenders that subsequently failed and bought a third, First Franklin Financial Corp., for \$1.3 billion. "These guys have made a lot of money securitizing mortgages over the years in a mortgage boom time," said Richard Hofmann, an analyst at bond research firm CreditSights Inc. in New York. "The question now is what is the exposure to credit risk and what are the potential revenue headwinds if they're not able to keep that securitization machine humming along." Credit-default swaps on the debt of Goldman, the world's biggest securities firm, have risen to \$32,775 per \$10 million in bonds, up from \$21,500 at the start of the year, according to prices compiled by London-based CMA Datavision. The price touched \$35,000 on Feb. 28, the highest since June 2005. Spokesmen and spokeswomen for Goldman, Lehman, Merrill and Morgan Stanley declined to comment. A spokeswoman for Bear Stearns didn't immediately return calls for comment. **Goldman, Merrill Almost 'Junk,' Their Own Traders Say (Update2)**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=azrxhCZbHMLk&refer=home>

### Housing

- Sales of new homes plunged 16.6% in January to a seasonally adjusted annual rate of 937,000, the Commerce Department reported Wednesday. It was the lowest sales pace in four years, and was the biggest percentage decline in 13 years. Sales were down 20.1% compared with January 2006.  
<http://www.realestatejournal.com/buysell/markettrends/20070228-nutting.html>

### Housing Finance

- Is the Sub-Prime "Garbage" 6% or Rather 50% of the Mortgage Market? And the Worst Housing Recession in Decades... Where did the Mortgage Bankers Association (MBA) get the "sub-prime is only 6%" figure that it is spinning around in every possible media? Their trick is to consider all homeowners, even the 35% of homeowners who do not have

any mortgage and then argue that only 6% of homeowners are sub-prime borrowers. Why is this spin and why is the actual figure for “garbage” mortgages actually closer to 50% of the flow of new mortgages in 2005-2006 rather than the “6%” being spinned around? Sub-prime mortgages were at least 20% of mortgage originations in 2005 and 2006. **The same “monster” lending practices used for subprime mortgages were also used for most “near-prime” and “prime” mortgages. Many pseudo “near-prime” mortgages (such as Alt-A) are undistinguishable from sub-prime ones and have now sharply rising default rates** What is defined as sub-prime is subject to highly cosmetic accounting by banks: the rule that FICO scores of 660 or below are sub-prime is often diluted down to 630 or even 620 to exclude many Mortgages from a sub-prime classification. So whenever you hear the spin about the sub-prime meltdown not being such a big deal as “sub-prime mortgages” are only 6% of the housing market beware of such misleading spins. Properly measured sub-prime and near sub-prime and effectively sub-prime (because of creative accounting) mortgages accounted for almost 50% of all originations last year. So the mountain of “garbage” and “trash” that has been piling up in this sub-prime carnage includes a good half of new mortgages created in recent times. And the meltdown of these mortgages – both those that are formally sub-prime and those that are effectively sub-prime – will create a massive credit crunch in short order. At the end of the day “garbage” is garbage, whatever you name it. What is labeled as “Prime Garbage” stinks as much as the “Subprime Garbage”. And if it walks, ducks and quacks like garbage it passes the smell test of being garbage. Some of that garbage may rot more or faster than the rest but the overall state of the mortgage and housing market is the worst in decades. Also, note that with new home sales down 16.4% in January ( the biggest drop since 1994 as reported today) and housing starts down another 14% in January alone, both the demand and the supply side of the housing market are in literal free fall and collapse. The only things that are mushrooming in the housing market are cancellations (in the 30 to 40% range for major home builders) and the stock of unsold new and old homes that is at historically unprecedented highs. All this means home prices headed sharply south in the months ahead. As I argued last summer (see [here](#) and [here](#) and [here](#)) this is the worst housing recession in the last five decades. In a long paper with Christian Menegatti that I will publish next week I will flesh out in much detail the arguments on why the housing recession is nowhere close to bottoming out and why the housing recession will get much worse before it reaches any bottom.

<http://www.rgemonitor.com/blog/roubini/180573>

- March 2 (Bloomberg) -- **New Century Financial Corp. disclosed a criminal probe** and regulators told Fremont General Corp. to halt improper subprime loans, piling new scrutiny on two home lenders who've already lost about half their value this year. **Investigators are focused on New Century's accounting and trading in its securities, the Irvine, California-based company said in a filing with the U.S. Securities and Exchange Commission today. [and announced after the markets closed on Friday – sleazy in and of itself]** Fremont said a regulatory order will require it to stop giving mortgages to people who can't repay, and it plans to get out of the subprime home-loan business. “It just shows there was a lack of principles and standards,” said David Hendler, an analyst at CreditSights Inc. in New York. “**There was no real major guardian of conservative standards anymore, and that's a danger to the safety of the market.**” A surge in defaults on mortgages to the least-creditworthy borrowers has

forced more than 20 lenders to close or seek buyers since the start of 2006. Earlier today, the Federal Reserve told banks to scrutinize their underwriting standards on subprime mortgages and make lending terms easier to understand. New Century said in its filing that the U.S. attorney for the Central District of California is running a criminal inquiry ``in connection with trading in the company's securities, **as well as accounting errors regarding the company's allowance for repurchase losses.**" [this is only the tip of the iceberg and will be true of probably all the players in this industry] SEC Seeks Meeting SEC staff members also told New Century they want a meeting to discuss events that preceded the company's Feb. 7 disclosure of a pending restatement to earnings, according to the filing. NYSE Regulation Inc. is reviewing trades that took place before Feb. 7 and has requested information, the company said. New Century, the second-biggest subprime lender, said it will cooperate with the three inquiries. Laura Oberhelman, a spokeswoman for New Century, declined to comment on the filing. Earlier today, the company cut 300 jobs, or about 4 percent of its workforce, she said. **The company's lenders include units of Goldman Sachs Group Inc., which extended a loan agreement last month that was due to expire on Feb. 15 to May 14.** [there is incredible exposure for a number of investment banks to this industry due to the derivatives, which are a much bigger deal than loans] The filing said the company's auditor, KPMG LLP, will include a statement questioning New Century's ability to stay in business if the company can't get lenders to ease terms or find new financing. Fremont plans to report a net loss from continuing operations in the fourth quarter after setting aside more money to buy back loans that defaulted, the Santa Monica, California- based company said in a regulatory filing. **Cease and Desist Fremont General Credit, a unit of Fremont, is submitting to a cease-and-desist order by the Federal Deposit Insurance Corp. halting 14 violations that include ``unsatisfactory lending practices" and ``operating with a large volume of poor quality loans."** The proposed order was received Feb. 27, Fremont said in a statement. Shares of Fremont plunged 24 percent on Feb. 28 after the company postponed the release of its fourth-quarter results. The lender said it hired Credit Suisse Group to help sell the subprime residential business, and talks have started with ``various parties." **Two other California lenders, Impac Mortgage Holdings Inc. and Accredited Home Lenders Holding Co., said today they won't be able to file their financial reports on time.** Shares of both tumbled. Material Weakness Impac found a ``material weakness" in its cash-flow reporting, the Irvine, California-based company said today in documents filed with the SEC. Accredited Home, based in San Diego, delayed its report until March 16 because of ``sizable demands upon the company's management and staff," including a recent merger that may cause a writedown. Shares of New Century fell \$1.20 today, or 7.6 percent, to \$14.65, **before** the announcement in New York Stock Exchange composite trading. They dropped as low as \$10.60 in after-hours trading. Fremont, which fell 4.3 percent to \$8.71, has lost 46 percent this year. Both companies have lost about 63 percent in the past year. Impac shares fell 10 percent to \$5.96. The stock has declined 32 percent this year. Accredited Home's stock fell 3.7 percent to \$21.70 in Nasdaq Stock Market trading. Shares of the company have fallen 21 percent in 2007. **New Century Faces U.S. Probe; Fremont Quits Subprime**  
<http://www.bloomberg.com/apps/news?pid=20601206&sid=ahOvmhYLtOP4&refer=real estate>

- March 2 (Bloomberg) -- The Federal Reserve, seeking to limit defaults that have roiled the subprime mortgage-lending market, told banks to scrutinize their underwriting standards and be more transparent with customers about borrowing risks. Lenders must disclose more information about products such as adjustable-rate mortgages to people with poor credit histories and make sure borrowers are able to repay the loans, according to guidelines issued in Washington today by the Fed, the Federal Deposit Insurance Corp., and other U.S. regulators. The guidelines reflect growing concern among regulators about an increase in mortgage defaults by homeowners with weak credit after late payments last quarter rose to the highest level in four years. Fremont General Corp., a California lender, today announced the planned sale of its subprime unit and another California firm, New Century Financial Corp., said it faces a criminal probe. The intention is "to limit risks to both the borrower and the lending institution," Federal Reserve Governor Randall Kroszner said in a statement. Borrowers need "clear and balanced information on the risks associated with these loans." [as usual, much too late. In fact this will exacerbate the problem since the people falling behind will find it nearly impossible to qualify for refinancing even if rates drop] **U.S. Regulators Urge Scrutiny of Subprime Mortgages**  
<http://www.bloomberg.com/apps/news?pid=20601206&sid=a7jysY.RBrzY&refer=realstate>

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- March 1 (Bloomberg) -- Countrywide Financial Corp., the biggest U.S. mortgage lender, said payments were late on almost 20 percent of the subprime loans it manages for clients. Delinquencies of 30 days or more on "nonprime" loans, or those to borrowers whose credit ratings fell short of the highest criteria, widened to 19 percent as of Dec. 31 from 15 percent a year earlier, Countrywide said in a regulatory filing. The data reflect loans not owned by Countrywide where the company performs billing and record-keeping. A surge in bad mortgages has forced more than 20 lenders to close or seek buyers in the past year. Loan losses spurred a management shakeup at the U.S. unit of HSBC Holdings Plc, Europe's biggest bank by market value, and shares of U.S. lenders including New Century Financial Corp. and NovaStar Financial Inc. have fallen 50 percent or more this year. **Countrywide Says Late Payments on Subprime Loans Rose**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aAfTrKZokGRk&refer=home>

## Macro Economic

- March 1 - Personal income in January rose 1.0%, topping the Bloomberg estimate of a 0.3% rise, and spending for January rose 0.5%, also beating expectations of a 0.4% increase. The data suggest that job growth and favorable consumer sentiment continue to support income and spending. The core Personal Consumption Expenditures Index, a broad measure of inflation that the Fed keeps a close eye on, increased 0.3% in January, above the estimate of a 0.2% rise. Year-over-year, the rate met expectations, increasing to 2.3%. Weekly initial jobless claims increased 7,000 to 338,000, above an estimated decrease to 325,000. Last week's initial claims were revised slightly lower to 331,000.

The four-week moving average increased by 7,500 to 335,250, and continuing claims increased 134,000 to 2,640,000, the highest level since December 2005. Schwab morning news letter

- March 1 - Personal income in January 2007 increased 1.0%, to \$11,225.1 billion. Nominal disposable personal income (DPI) rose 0.8%, while real DPI increased 0.5%. Nominal personal consumption expenditures (PCE) rose 0.5%, while real PCE increased 0.3%. The personal savings rate as a percentage of DPI was -1.2% in January.
- March 1 (Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke's carefully worded reassurances enhanced his stature with investors, one day after the stock market's biggest slump in four years. The chairman used a question-and-answer period during congressional testimony yesterday to say that markets were "working well" and that the economy is poised to strengthen. Investors endorsed the message, bidding up stock prices and pushing yields on Treasury notes higher. "He was playing a little bit of a financial firefighter," said Scott Anderson, senior economist at Wells Fargo & Co. in Minneapolis. "Part of the Fed's role is to ensure stability of financial systems. He was assuring everyone they are not asleep at the switch." Bernanke's performance came almost a year after communications stumbles led some investors to question the new Fed chief's commitment to keeping inflation low. His response may elevate his economic credibility at a time when some investors are calling for interest-rate cuts this year. "He has learned from his mistakes," said Paul Kasriel, director of economic research at Northern Trust Securities in Chicago and a former Fed economist. "He is very much aware the markets are hanging on his every word." Officials from the Fed and other U.S. financial regulators who are part of a presidential working group have been "closely monitoring the markets," Bernanke said yesterday. He said the Fed's economic outlook wasn't shaken by the worldwide market turmoil sparked by China's plunge in stocks. Paulson Comments Bernanke's comments were echoed today by Treasury Secretary Henry Paulson, who has consistently stated a preference for markets to freely set asset prices. "I am watching developments carefully, and I believe that the U.S. economy is healthy," Paulson said in a speech to the Economic Club of Washington that otherwise focused on the benefits of free trade. The 416-point slump in the Dow Jones Industrial Average two days ago came at a time that both Bernanke and Paulson, who took office in July, are relatively new at their jobs. Investors look to the Fed and Treasury leaders in times of stress because of their roles as chief economic policy makers, presiding over interest rates and overseeing the financial industry. Past Pitfalls Not all of Bernanke's and Paulson's predecessors avoided pitfalls. **Paul O'Neill, Bush's first Treasury secretary, was a cheerleader for stocks on the first day of trading after the Sept. 11, 2001, terrorist attacks. "People who bought today are going to be the happy people," he said after the Dow fell 7.1 percent. A year later, the index was down another 8 percent.** Subprime Risks **Bernanke's optimism yesterday about the mortgage market may also carry some risk. He told the House Budget Committee that rising delinquencies on subprime mortgages, designed for borrowers with poor credit, are "a concern, but at this point we don't see it as being a broad financial concern or a major factor in assessing the course of the economy."** [keep in mind, there was no governmental "perceived" risk in sub-prime until it blew up. To the contrary Al had been touting sub-prime for all its "benefits"] The Fed chief, responding to the first question from Democratic committee Chairman John Spratt of South Carolina, said the stock plunge

didn't have ``any single trigger." Asked if he thought growth would slow, he stressed ``there's a reasonable possibility that we'll see some strengthening of the economy sometime during the middle of the year." **Bernanke, Learning From Mistakes, Reassures Markets (Update1)** [we will see how predictive he is the upcoming days and weeks. My guess is he is dead wrong and has hurt the little guys as set forth above] <http://www.bloomberg.com/apps/news?pid=20601109&sid=aU7mMzddpKwQ&refer=home>

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## Retail

## Retirement

## Risk

## Savings Rate

## Tech

- The self-proclaimed "anti-Cramer," Doug Kass, anchors *Street Insight's* "The Edge," a diary about stocks and investing. As a dedicated short-seller, Kass can seek out the bear market in any environment This week, he discussed [why the short side never looked so good and the next shoe to drop](#). [note he wrote this on feb 27] [http://www.thestreet.com/\\_tsclsii/markets/activetraderupdate/10342201.html#first](http://www.thestreet.com/_tsclsii/markets/activetraderupdate/10342201.html#first)
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- March 1 (Bloomberg) -- Dell Inc., the world's second-largest personal-computer maker, posted fourth-quarter profit and sales that trailed analysts' reduced estimates after the company lost customers to rivals over the holidays. Dell, which stopped providing financial forecasts in May 2006, had already announced in January that profit and sales for the quarter missed analysts' estimates. The warning led analysts to reduce their profit estimates to 30 cents from 33 cents for the three months ended Feb. 2, according to a Bloomberg survey. Price cuts aimed at winning back market share have weighed on profit margins, and **Dell's sales growth has fallen to its lowest level in more than four years**. PC Woes Dell is also cooperating with probes into its accounting by the U.S. Securities and Exchange Commission and the Justice Department. The company said in September the investigations indicate possible errors in its accounting for so-called accruals or reserves, or estimates of future obligations. Dell's shipments fell 8.4 percent in the calendar fourth quarter, according to Framingham, Massachusetts-based IDC. Orders in the U.S., which accounts for more than 50 percent of Dell's sales, fell almost 17 percent. ``When the problems become so bad and so public, like they've become at Dell, we think that time is certainly going to be one of the key components here," Fearnley said. ``It's not going to snap back in a quarter." **Dell Profit, Revenue Fall Short of Reduced Estimates (Update1)** <http://www.bloomberg.com/apps/news?pid=20601087&sid=aepvSOWZ8kmQ&refer=home>

## Wall Street

- March 5 (Bloomberg) -- Asian stock strategists are calling for investors to buy shares after last week's rout, which wiped out more than \$300 billion of the region's market value, because the losses are unlikely to be sustained. **Asian Stock Markets' Drop Presents Buying Opportunity [I could not have made up this headline. There is a saying in trading that trying to catch a stock on a downtrend is like trying to catch a falling knife. Should you choose to follow the "experts" make sure you have lots of butterfly bandages handy]**  
<http://www.bloomberg.com/apps/news?pid=20601208&sid=a.xhjtPe8hiU&refer=finance>
- March 2 It didn't take very long for the spinmeisters to get busy. Numerous reasons were spun out as to why stocks fell -- ranging from merely uninformed to misleading to utterly false. I have seen, read or heard each of the following reasons offered either on the major networks, in the business press, or on the radio. While you have likely seen most of these, I doubt you have seen the facts figures and analyses that follow each [Top 10 Myths of Tuesday's Correction](http://www.thestreet.com/newsanalysis/investing/10342162.html) <http://www.thestreet.com/newsanalysis/investing/10342162.html>
- March 1 (Bloomberg) -- A UBS AG executive, a former Morgan Stanley compliance officer and 11 others were charged with participating in insider trading and bribery schemes involving hedge funds that netted \$8 million. The schemes involved tipping investors about imminent changes in stock recommendations by analysts and taking kickbacks in exchange for allocations of shares in public offerings, the U.S. Attorney's Office in New York said in documents unsealed today. "Each of the defendants violated a trust imposed upon them," U.S. Attorney Michael Garcia said at a press conference. "These defendants had a sure thing and they capitalized upon it." Separately, the U.S. Securities and Exchange Commission sued 14 people including Mitchel Guttenberg, an executive director in UBS's stock research department, for a scheme that allegedly involved clandestine meetings, disposable phones and secret codes, the agency said in a statement. Guttenberg was among those charged by Garcia with conspiracy to commit securities fraud. Also charged was Randi Collotta, a lawyer in Morgan Stanley's global compliance division. She is accused of leaking insider information. "Hundreds of Thousands' Guttenberg, a member of UBS's investment review committee, sold bank inside information on ratings changes to David Tavdy and Erik Franklin for "hundreds of thousands of dollars," prosecutors claimed. The two men, in turn, used the data to earn more than \$4 million by making trades through brokerage accounts they controlled. **UBS Executive, Ex-Morgan Lawyer Charged With Fraud**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=azsy05AAs92U&refer=home>

[Article of the week:](#)

Mortgage Defaults start to spread

The mortgage market has been roiled by a sharp increase in bad loans made to borrowers with weak credit. Now there are signs that the pain is spreading upward.

At issue are mortgages made to people who fall in the gray area between "prime" (borrowers considered the best credit risks) and "subprime" (borrowers considered the greatest credit risks). A record \$400 billion of these midlevel loans -- which are known in the industry as "Alt-A" mortgages -- were originated last year, up from \$85 billion in 2003, according to Inside Mortgage Finance, a trade publication. Alt-A loans accounted for roughly 16% of mortgage originations last year and subprime loans an additional 24%.

The catch-all Alt-A category includes many of the innovative products that helped fuel the housing boom, such as mortgages that carry little, if any, documentation of income or assets, and so-called option adjustable-rate mortgages, which give borrowers multiple payment choices but can lead to a rising loan balance. Loans taken by investors buying homes they don't plan to occupy themselves can also fall into the Alt-A category.

## BORROWED TIME

Default rates are increasing on so-called Alt-A mortgages, which include the following:

- Loans to borrowers with midlevel credit scores that fall between "prime" and "subprime."
- Many mortgages made to borrowers who provide little, if any, documentation of their income or assets.
- Option adjustable-rate mortgages, which give borrowers multiple payment choices but can lead to a rising loan balance.

Borrowers who take out Alt-A mortgages are considered less risky than subprime borrowers because of their higher credit scores. But as the housing market cooled and loan volume declined, some lenders lowered their standards for Alt-As. Now a rising number of borrowers who took out these loans are running into trouble.

Data from **UBS** AG show that the default rate for Alt-A mortgages has doubled in the past 14 months. "The credit deterioration has been almost parallel to what's been happening in the subprime market," says UBS mortgage analyst David Liu. The UBS report contrasts with testimony Federal Reserve Board Chairman Ben Bernanke gave to Congress yesterday. "Our assessment is that there's not much indication that subprime issues have spread into the broader mortgage market," Mr. Bernanke said.

To be sure, defaults have remained very low in the prime market -- and despite the uptick in bad loans, the problems in the Alt-A sector aren't as severe as those that have roiled the subprime market. Some 2.4% of Alt-A loans are at least 60 days past due, according to UBS, which looked at mortgages that were packaged into securities and sold to investors. That is well below the 10.5% delinquency rate for subprime mortgages. (During the housing boom, delinquencies were low for all types of loans because borrowers who wound up in trouble could refinance or sell.)

Some borrowers who took out Alt-A loans in recent years are starting to feel the strain. Johnny and Shirley Johnson, retirees in Cleveland, took out an option ARM when they refinanced their \$92,700 mortgage in July 2005. The loan carried a 3.5% introductory rate that began moving upward a few months later. The couple, who live on a fixed income, are currently making the minimum payment on their loan. But they are afraid they won't be able to keep up with their loan and other debts once their monthly mortgage payment adjusts upward later this year.

"We don't want to lose our home," says Ms. Johnson. The couple is working with Acorn Housing Corp., a nonprofit group that provides housing counseling, in an effort to refinance into a 30-year fixed-rate mortgage. Though the monthly payment would be higher, the new loan would protect them against future increases.

Housing counselors and bankruptcy attorneys say they are seeing an increase in troubled borrowers who previously had good credit. "We have clients with 720-plus credit scores, and they are in awful products," says Jennifer Harris, executive director of the Home Loan Counseling Center in Sacramento, Calif. Some of these borrowers took out option ARMs with low introductory rates and are likely to fall behind when their monthly payment resets at a higher level, she says.

Thomas Gorman, a bankruptcy attorney in Alexandria, Va., says he is seeing more financially strapped borrowers who "probably bought more house than they could afford and then took on more credit-card debt" to furnish the house and pay for the move. When the housing market cooled, they were "caught in the middle," unable to sell their home or refinance and make their debt load more manageable.

Lenders are also tightening their standards. At a meeting with investors last week, **IndyMac Bancorp** Inc., the nation's largest Alt-A lender, said it had raised the minimum credit score at which borrowers could finance 100% of a home's value and took a number of other steps to tighten lending guidelines.

This week **Lehman Brothers Holdings** Inc.'s Aurora Loan Services unit raised the minimum credit score and reduced the maximum amount homeowners could borrow without documenting their income and assets.

**Impac Mortgage Holdings** Inc., which specializes in Alt-A loans, said recently that it had tightened its lending standards 17 times last year. The company cut back on riskier loans and began relying more on analytical tools to verify a borrower's income and creditworthiness. Other lenders were quick to scoop up many of those loans, but now they are also pulling back, says Impac President Bill Ashmore.

Lou Barnes, a mortgage banker in Boulder, Colo., says a client with a good credit score was turned down this week for a mortgage to buy an investment property with a small down payment and no documentation. That same borrower was approved for a "nearly identical" loan in August and November, he says. Still, Mr. Barnes calls the tightening "modest." Alt-A lenders are "nibbling at the edges," he says.

The UBS study found that the problems are greatest for Alt-A borrowers who took out interest-only adjustable-rate mortgages, which allow borrowers to pay interest and no principal in the loan's early years, with 3.71% of interest-only ARMs originated in 2006 at least 60 days past due. As in the subprime sector, the riskiest loans are those made to home buyers who put little, if any, money down and don't document their income or assets.

As delinquencies rise, some investors who bought lower-rated securities backed by these mortgages are likely to face losses, according to Mr. Liu of UBS. While defaults are expected to be lower than in the subprime sector, so are the reserves set aside to cushion bond investors against such losses.

Defaults are much lower for option ARMs. But the problems with these loans could be "backloaded," says Mr. Liu, because borrowers with these loans are still making the minimum payment.

Glenn Costello, a managing director at Fitch Ratings Inc. in New York, expects the foreclosure rate for Alt-A loans to ultimately be only 10% to 20% of the rate for subprime borrowers.

Yet investor concerns about Alt-A loans are rising, according to Walter N. Schmidt, a mortgage investment strategist at FTN Financial Capital Markets in Chicago. A report from mortgage analysts at Barclays Capital in New York this week pointed to fraud as one reason for early defaults on Alt-A loans. The mortgage industry is battling a rash of cases in which borrowers, loan officers and appraisers collude in providing false information to induce lenders to advance more money than homes are worth.

[http://online.wsj.com/public/article/SB117271866822722900-C0eoQJ8uX5b3DO\\_YqWeMLmt7mY8\\_20070310.html?mod=blogs](http://online.wsj.com/public/article/SB117271866822722900-C0eoQJ8uX5b3DO_YqWeMLmt7mY8_20070310.html?mod=blogs)

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