

Mortgage Credit & Subprime Lending: Implications of a Deflating Bubble

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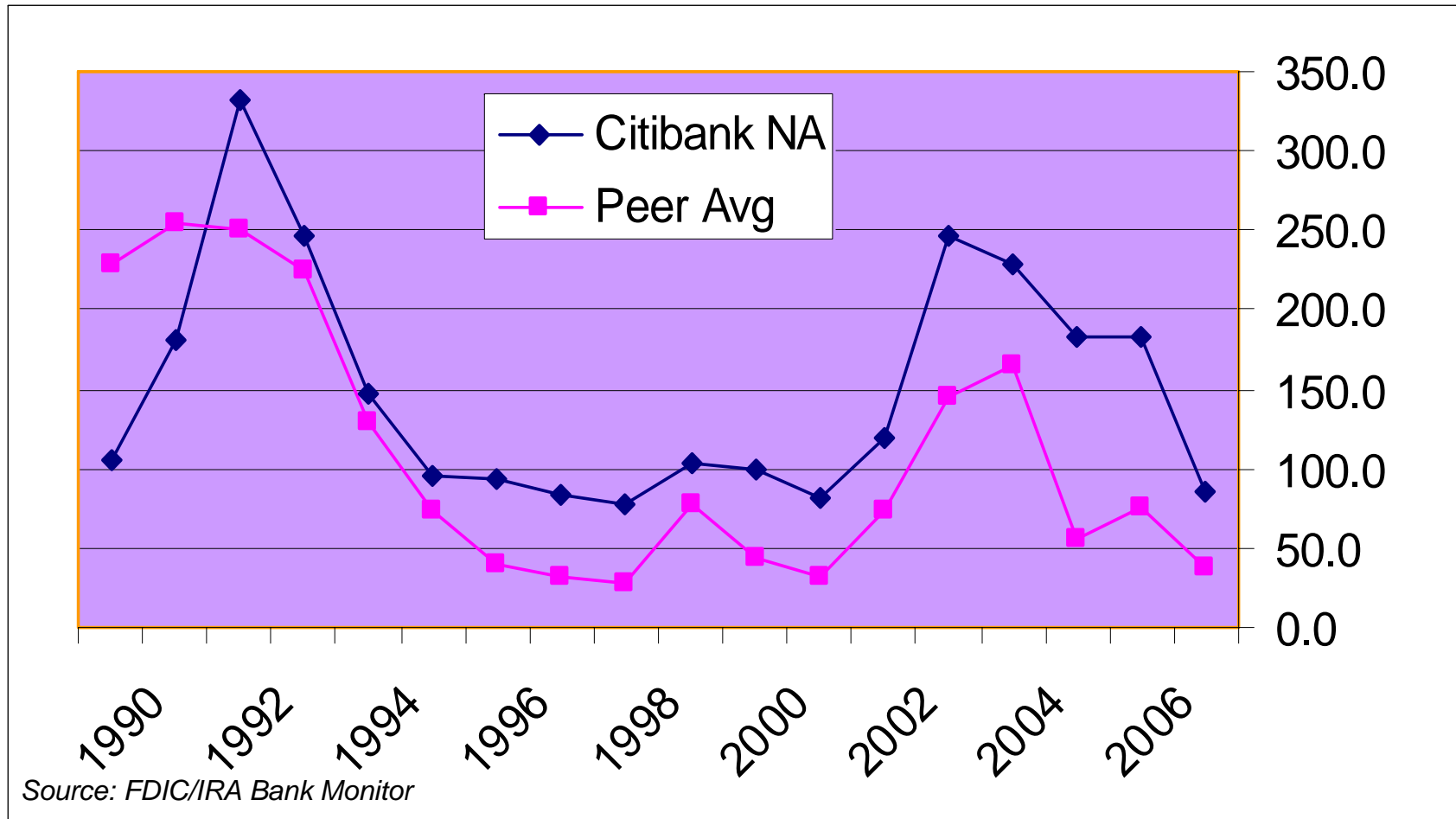
How Far is Down?

- The last serious trough in terms of the quality of US consumer loan defaults was 1991, although 2001-2002 was also severe.
- In areas like retail mortgage credit, default rates remain well-below long-term averages, even now, half a decade into a Fed interest rate tightening phase.

Commercial Lending

- Citibank NA, the \$1 trillion asset lead bank unit of Citigroup (NYSE:C), peaked at 332 basis points (3.32%) of aggregate loan defaults in 1991 vs. 246bp in 2002.
- In 2006, aggregate loan & lease defaults for Citibank NA were < 100bp and bank-only rates for all of C was just 110bp. Peers such as BAC (77.9bp), JPM (80.9bp) and WB (15bp) even lower.

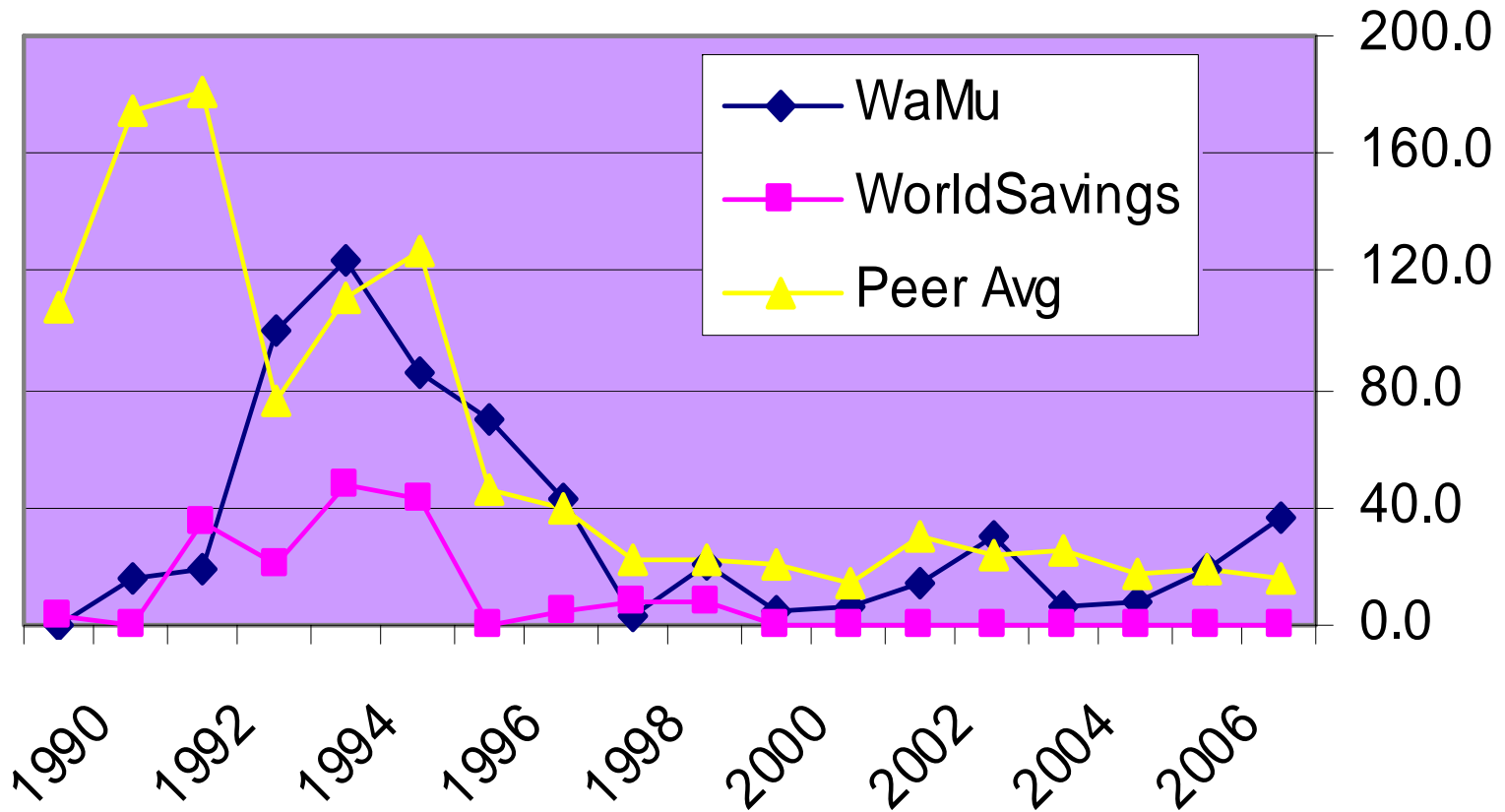
Gross Defaults (BP)



Mortgage Sector

- Defaults in the US mortgage sector began a secular decline in mid-1990s and default rates remained very low for next decade.
- Some larger mortgage lenders such as World Savings, now a unit of WB, actually reported zero or negative aggregate defaults for consecutive quarters during 2001-2006 period.

Gross Defaults (BP)



Source: FDIC/IRA Bank Monitor

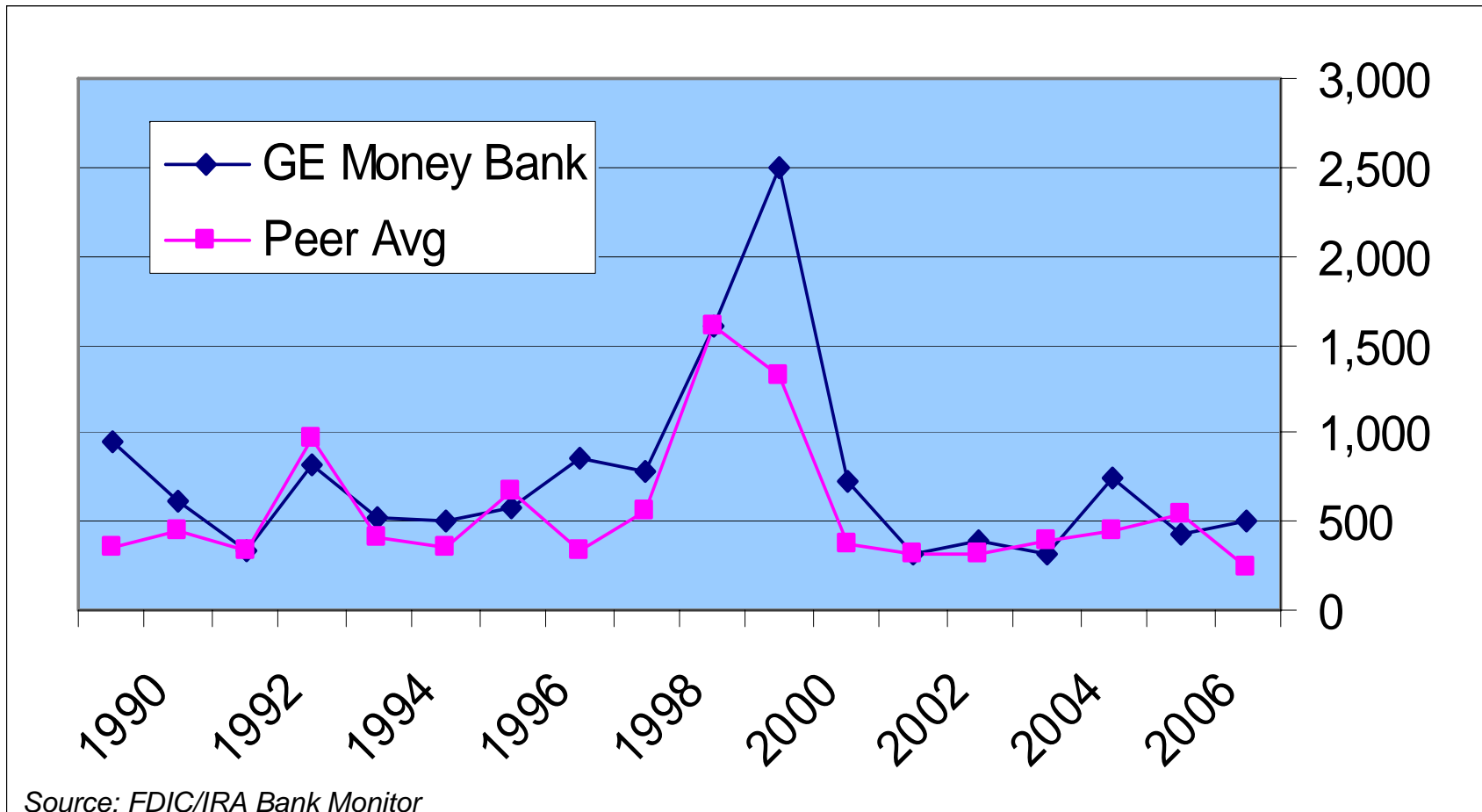
Subprime Lending

- Historically, subprime lending has been a business dominated by smaller, privately-owned lenders ranging from local players to giants such as Household Finance, which was acquired by HBC in 2003.
- Hard nosed, cash business with 20-30% annual default rates possible. Mid-teens loan yields promise mid-double digit equity returns – but high loan loss rates require double digit capital levels.

Subprime Banks

- A decade ago, approximately one third of the subprime lenders registered with HUD were banks or thrifts, but few were affiliated with large holding companies.
- Of 200 subprime lenders registered with HUD in 2005, roughly half affiliated with commercial banks, thrifts or CUs, and include affiliates of large BHCs such as WFC and C.

Gross Defaults (BP)



Subprime Lending

- Notice that the default experience of the GE unit looks nothing like the experience for the commercial lender and the mortgage lenders shown in the previous slides.
- ROA for peer group is 2.3%, ROE 22.2%, higher than GE Money Bank and reflecting high loan yields and default rates.

Observations

- Notice that the time series for the default experience of the commercial lender, the mortgage lender and the subprime consumer lender do not evidence similar patterns.
- Notice how low mortgage loan default rates have fallen, a good surrogate for bond/credit default swap market spreads. Connect between loan origination and securitization is the key point. It's all about liquidity.

Future Issues

- The year 2006 may be the near-term low for defaults, credit risk spreads in the cash and derivatives markets.
- Borrowers, lenders and end-investors in mortgages and unsecured consumer debt have same issue: being underwater.

Future Issues

- The retail home buyer in the 2004-2006 timeframe may be significantly underwater compared with current prices.
- The lender holding mortgage paper originated in this timeframe is also facing a steeper discount to book in the secondary loan market.

Future Issues

- The end investor in securitized mortgages and/or consumer loans is seeing a 10-20% discount to face in the current market for paper originated in 2004-2006 period.
- Spreads on cash and derivative transactions are widening considerably, but are still below “economic cost” of insuring against default risk.

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