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Mortgage Stress Seen for '06

Delinquencies on Subprime Loans Likely to Spike, Report Says

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Mortgage delinquencies among homeowners with high-cost loans will rise by 10 to 15 percent in 2006, as borrowers struggle with higher interest rates, high debt levels and higher energy costs amid flattening home prices, a new report from investment analyst Fitch Ratings predicts. Consequently, overall mortgage delinquencies are likely to rise next year, as well, according to the report's authors.

"We think borrowers will be under more stress and have more propensity to be delinquent," said Glenn Costello, managing director of Fitch, which follows the market for bonds backed by residential mortgages. Recently, prices of such bonds have been falling, particularly those with lower-credit-quality loans.

Most high-rate mortgages, known as subprime loans, have adjustable interest rates, Fitch said. That means borrowers are more sensitive to fluctuations in rates, because rising rates mean their mortgages payments rise as well. About 19 percent of home loans nationwide are subprime, up from about 5 percent a decade ago, as homeowners take on heavy debt burdens. Many people have used the equity in their homes to pay off high-interest credit cards, reducing their monthly obligations, but those with poor credit have done so by shifting to subprime loans. Prime loans, those at the best rates, are given to only borrowers with good credit.

Costello said the increase in subprime lending meant more people could "come under financial pressure" than in the recent past, when home values were rising.

About 4.3 percent of all loans were delinquent in the second quarter of 2005, and about 1 percent of loans had passed the overdue category and were actually in foreclosure, according to the Mortgage Bankers Association. But the rate for subprime loans was much higher – about 10.3 percent of such loans were in default, and about 3.5 percent were in foreclosure. Most borrowers find ways to catch up on their payments, refinance or sell their homes before they go into foreclosure.

"Some of that is these are inherently riskier borrowers," said Keith Ernst, senior policy counsel with the Center for Responsible Lending in Durham, N.C. "Research also shows that the loan terms increase the likelihood they'll go into foreclosure."

Many subprime loans, for example, feature prepayment penalties that make it too costly for borrowers to refinance, even after they have mended their credit. A study by researchers at the University of North Carolina found that 20 percent of subprime loans went into foreclosure within four years, Ernst said.

A recent government analysis of which borrowers have subprime loans found that they were disproportionately black and Hispanic. Whites and Asians were less likely to hold subprime loans.

Investors in the mortgage-backed securities that own the borrowers' loans will be only slightly affected by an increase in delinquencies, in that the returns may not be quite as good as they were, Costello said.

"Actual losses from foreclosures would have to happen before investors are adversely affected," said Arthur Frank, director of mortgage research at Nomura Securities International Inc.

He said that higher-rated mortgage-backed securities, such as AAA, AA and A-rated, usually are well-insulated from losses but that investors in lower-rated securities, the BBB-rated and below, could be more adversely affected. In addition, delinquencies may or may not lead to foreclosures, and only foreclosure losses hurt investors. But rising delinquencies means that the performance of the pool of mortgages is declining.

Frank said bigger problems for borrowers will come in 2007, because many of the subprime loans that feature adjustable-rate mortgages “reset,” or change rates, that year. People who will be “stressed” will be those who were unable to refinance before their rates begin rising or whose home prices have fallen so that it becomes too difficult to sell and get out from under the mortgage, he said.