# Old Subprime is New Again – Why Subprime Will Return

Analysis and Opinion by Whole Loan Capital

Summary

Banks have virtually no appetite for risk these days. With legacy issues, regulatory oversight, and increased capital and compliance requirements, bankers want only ultra clean residential mortgage loans that have almost zero chance of default. This has created an A+ credit requirement for conventional borrowers, leaving many with nowhere to go. Today private capital / non-bank lenders are just starting to fill this void by using *traditional* subprime lending strategies.

Analysis

Traditional subprime loans always demanded large down payments, income verification, and higher note rates. Due to competitive pressures, rating agency missteps, rising house prices (duh!), and a general sense of collective genius, subprime lenders started to dramatically lower these standards in 2004. I remember a prominent portfolio manager telling me there was 'no risk' in these loans in 2005 and I was crazy not to buy them. Knowing something was wrong, not only didn't I buy them but I shut down the prime jumbo program I managed in early 2006.

Six years on its obvious the market's collective genius was <u>very</u> wrong. The issues are still keeping bankers up at night writing big checks.

The proof about the credit environment today is shown by the fact that the ten largest mortgage lenders (eight of whom are banks) declined 26.8% of all mortgage applications received in 2010 according to the Wall Street Journal*. That is up from 23.5% in 2009. These tight credit conditions won't change for many years to come.

The opportunity today is for private capital to team up with an experienced lender that will use a traditional subprime lending strategy to fill this void. There is ample demand by borrowers that just miss the bank credit grade and have no alternatives. These borrowers will pay a much higher interest rate to get the credit, provide full income and asset information, and many have the ability to provide a substantial down payment. In addition the lender can fully vet the property's current value. This is the exact opposite of 2005 in every respect and very compelling in my opinion.

It goes without saying that that having a lender with a knowledgeable and experienced management team, a fully licensed and operating lending and servicing platform, and a well thought out lending, servicing and compliance strategy are absolutely vital to executing on this opportunity.

Relative to the loans, there are four strategies a resourceful portfolio manager can use to diversify risk while adding sustainable or even permanent modest leverage; modest leverage will substantially increase equity returns.

Using these strategies, a well thought out and planned execution, and a proven and experienced management team will create equity returns easily in the high teens over the next three to five years.

*Tighter Lending Crimps Housing by Nick Timiraos and Maurice Tamman, June 25, 2011