From: Angelo_Mozilo@countrywide.com
Date: 02/27/2007 10:49:24 AM
To: Dan_Tarman@Countrywide.Com
Subject: Re: 2 WSJ stories today and Press Release RE: Freddie

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Remember what I said almost six months ago. "In my 53 years in the business I have never seen a soft landing". This one is going to be as hard as they come.

Dan Tarman/Managing Directors/CF/CCI

02/27/2007 07:16 AM

To

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Subject

2 WSJ stories today and Press Release RE: Freddie

Heard on the Street: Subprime Game's Reckoning Day --- Risky Lending Fallout Threatens to Spread; Uncertain ARM Strength
Deals & Deal Makers: Does Subprime Index Amplify Risk? --- ABX Bond Tracker, Depending on View, Is On Mark, Off Base

Heard on the Street: Subprime Game's Reckoning Day --- Risky Lending Fallout Threatens to Spread; Uncertain ARM Strength ---- By Karen Richardson and Gregory Zuckerman

The worst may be yet to come for mortgage lenders. And that could add to investor nervousness.

Shares of companies that specialize in lending to riskier borrowers or offer unconventional loans have tumbled because of concerns over how rapidly these mortgages are going sour.

If these so-called subprime borrowers continue to have problems paying their debts, the lenders that target them likely will have to boost how much money they set aside for bad loans, cutting into their bottom lines. That could mean even lower stock prices.

There also is a concern that if the real-estate market remains cool, some borrowers with better credit histories might also begin struggling to make payments on certain popular, but unorthodox, mortgages. These types of loans allow borrowers to skip monthly payments, carry low short-term teaser rates or don't require detailed financial documentation. If that happens, companies such as BankUnited Financial Corp. and Countrywide Financial Corp. could suffer.

When a company keeps its reserve low, it makes its earnings look better because it continues to increase its assets from loans it originates and sells off. That holds down expenses.

But when a company beefs up those reserves and the change hits its earnings, that can impair its ability to borrow the short-term funds needed to write new mortgages. Lenders need to set aside reserves to cover any possible losses when borrowers fail to make payments.

Subprime-mortgage lenders generally sell most of their loans to investors, but many keep some loans as investments. These portfolios have grown as the number of new mortgages has risen.

New Century Financial Corp. and NovaStar Financial Inc. hold billions of dollars of loans for investment. While they have been increasing their loan-loss provisions, delinquencies have been coming faster than anticipated.

NovaStar's reserves were 1.05% of its $2.1 billion in loans held for investment in the fourth quarter, up from 0.75% in the third quarter, but still ranked among the lowest in the industry, according to Zach Gast, an analyst at the Center for Financial Research and Analysis. New Century's ratio was 1.4% as of the third quarter. CFRA doesn't assign ratings on stocks.

Scott Hartman, chief executive of NovaStar, says the lender made a "substantial increase to our loan-loss reserve" in the past quarter, and that about half of those loans "tend to be of higher quality and generally performing very well."

New Century, which has said it will restate earnings for the first three quarters of 2006 to correct accounting errors regarding repurchased loans, declined to comment.

Subprime-mortgage lenders are likely to start reporting significant shortfalls in their loss reserves "as soon as the next several quarters," predicts David Honold, an analyst at Turner Investment Partners, which manages $23 billion and has avoided shares of subprime lenders. That is partly because some of the lenders could place into their investment-loan portfolio some poorly performing mortgages that they have bought back under terms of their sale agreement. That would required them to boost loan-loss reserves.

Subprime lenders already have seen their shares tumble -- NovaStar is off 50% and New Century is down 12% in the past 10 days -- and they could fall further if their credit-lines dry up because of poor loan-loss provisioning. NovaStar shares are trading at about 12 times estimated per-share earnings, but that valuation is likely to change as analysts adjust their projections to account for the company's steep fourth-quarter loss and poor earnings outlook. New Century shares also are trading at about 12 times estimated earnings for 2007.

Some investors urge caution about lenders that cater to borrowers with better credit but focus on mortgages that may suffer if weakness in housing continues, such as option adjustable-rate mortgages, or ARMs. These loans give borrowers multiple payment options, including a minimum payment that might not cover all of the monthly interest cost. The remainder of the interest payment is tacked onto the outstanding balance, causing it to rise.

About 59% of BankUnited's approximately $11.5 billion loan portfolio is made up of these loans and the bank is making more of them as it expands.

Countrywide has been cutting back on pay-option mortgages, funding just $2.7 billion in January out of a total $37 billion in new mortgages. Still, it has "significant exposure" to these risky loans, CFRA's Mr. Gast says. Countrywide declined to comment.

BankUnited acknowledges that borrowers are paying less of their monthly interest payments as interest rates have moved higher, and about 50% of the bank's loans have been made to residents of Florida, a weak real-estate market. And since BankUnited keeps about 70% of these loans in its own portfolio, if the borrowers run into problems it could hurt the company's earnings.

BankUnited shares, which fell 83 cents, or 3.2%, to $25.06 in 4 p.m. composite trading yesterday on the Nasdaq Stock Market, are trading at almost nine times its expected per-share earnings over the next year.

Under accounting rules, BankUnited counts the unpaid interest payments as revenue, however. So if a borrower pays the contractual minimum of $500 a month, rather than the $1,000 interest-only amount, the bank can count the remaining $500 as revenue. That is because it is assumed it will be repaid down the road. This revenue is a rising slice of its earnings, according to an analysis by Keefe, Bruyette & Woods.

Humberto Lopez, BankUnited's chief financial officer, says the bank focuses on borrowers with high credit scores who generally put down at least 20% of the purchase price on a home. "Our borrowers have the financial wherewithal, and they've earned the right to have options of payments," Mr. Lopez says. "We haven't seen any weakness in their ability to pay."

Deals & Deal Makers: Does Subprime Index Amplify Risk? --- ABX Bond Tracker, Depending on View, Is On Mark, Off Base ---- By Serena Ng and James R. Hagerty

The cost of insuring risky mortgage bonds as measured by a closely watched index has soared in recent weeks on fears of increasing defaults, rattling some investors while prompting a debate on whether the index is exaggerating the market's woes.

At issue is an index that tracks how much it costs to insure a group of BBB-minus-rated bonds backed by mortgages to borrowers with weak credit histories, the so-called subprime market. The index, part of the ABX family of bond indexes, is a derivative that falls in value when the cost of insurance rises, so it is seen as a proxy for the value of the underlying bonds.

The index has sunk nearly 30% since the start of this year, with most of the decline in February. That drop suggests the market believes riskier mortgage bonds stand to lose a large chunk of their value as defaults rise in the loans backing them.

"It reflects a disaster in the making in subprime, and I think it's just going to get worse," says Nouriel Roubini, chairman of economics research Web site Roubini Global Economics and a professor at New York University.

More than 20 subprime lenders have closed shop after repurchasing bad loans, as required by the terms under which they sold them. Some large lenders, including HSBC Holdings PLC and New Century Financial Corp., have reported big losses on their subprime mortgages.

"The risk the ABX is implying is way too pessimistic," argues Mark Adelson, a managing director at Nomura Securities International in New York. "There's a huge difference between the slow hissing that deflates a bubble and a bubble bursting."

The index, administered by Markit Group of London, was launched a little more than a year ago to give investors a way to bet on default trends and to hedge their risks by buying protection against a decline in the value of the underlying mortgage-backed bonds. Investors in the index can profit when they buy such protection cheaply and sell it at a higher rate. The index is one of only a few visible indicators of market sentiment for subprime mortgages, and Wall Street has become fixated with it.

The problem: "It's very, very widely followed, but more people look at the ABX than trade in it," says Peter Nolan, a bond-investment manager at Smith Breeden Associates, a fixed-income asset-management firm in Chapel Hill, N.C. When there are few buyers and sellers in a market, prices can jump around a lot, as has happened with this month's fall.

The ABX index reflects the cost of credit-default swaps -- essentially insurance policies that pay off when bonds drop in value -- on 20 subprime bonds that are selected by a group of Wall Street dealers.

In dollar terms, Wall Street firms charge investors approximately $1.6 million annually to insure the value of $10 million in BBB-minus-rated subprime bonds issued in 2006, up from $240,000 six months ago.

Critics say the ABX's 20 bond issues have performed more weakly than the overall market for subprime-mortgage securities.

Chris Flanagan, a mortgage researcher at J.P. Morgan Chase & Co., says the measure isn't perfect but is "a good reflection of long-overdue repricing of risk" of defaults.

Moody's Investors Service, a subsidiary of Moody's Corp., has lowered ratings on nine bonds from two subprime residential-mortgage-backed securities deals that were issued in 2006. It is reviewing 30 ratings on another 10 deals for possible downgrades. Together, these comprise less than 1% of the total number of subprime bonds Moody's rated last year. Fitch Ratings, a unit of Fimalac SA of Paris, and Standard & Poor's Ratings Services, a unit of McGraw-Hill Cos., have downgraded a small number of bonds.

The ABX's decline means that investors willing to sell protection against defaults can potentially reap gains if the problems in the subprime-mortgage market don't escalate.

For those with a bullish view on the housing market and U.S. borrowers' ability to pay off their mortgages, selling insurance at the current level is "probably a good bet but not necessarily a slam dunk," says Daniel Ivascyn, a portfolio manager at Pacific Investment Management Co., or Pimco, in Newport Beach, Calif. Making that bet at this time would take guts, though, he says, because lately the ABX index has been moving like "a one-way train."

Christian Stracke, an analyst at debt-research firm CreditSights in New York, says, "I think the ABX is accurately reflecting the panic being felt by some of the big mortgage players, and the hedge funds shorting it have increased the panic. But investors in the broader financial markets shouldn't be overly concerned."

Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default

Company Also to Develop Model Subprime Mortgages

MCLEAN, Va., Feb. 27 /PRNewswire-FirstCall/ -- Freddie Mac (NYSE: FRE) today announced that it will cease buying subprime mortgages that have a high likelihood of excessive payment shock and possible foreclosure. First, Freddie Mac will only buy subprime adjustable-rate mortgages (ARMs) -- and mortgage-related securities backed by these subprime loans -- that qualify borrowers at the fully-indexed and fully-amortizing rate. The goal is to protect future borrowers from the payment shock that could occur when their adjustable rate mortgages increase.

Second, the company will limit the use of low-documentation underwriting for these types of mortgages to help ensure that future borrowers have the income necessary to afford their homes. In addition, Freddie Mac will strongly recommend that mortgage lenders collect escrow accounts for borrowers' taxes and insurance payments.

In keeping with its statutory responsibility to provide stability to the mortgage market, Freddie Mac will implement the new investment requirements for mortgages originated on or after September 1, 2007, to avoid market disruptions.

To help lenders better serve borrowers with impaired credit, Freddie Mac is also developing fixed-rate and hybrid ARM products that will provide lenders with more choices to offer subprime borrowers. For example, in contrast to the payment structures of many of today's "2/28" ARMs, Freddie Mac's new hybrid ARMs will limit payment shock by offering reduced adjustable rate margins; longer fixed-rate terms; and longer reset periods. Freddie Mac will require originators to underwrite these products at the fully indexed and amortizing rate. The company plans to commit significant capital to purchasing these loans into its retained portfolio.

"Freddie Mac has long played a leading role in combating predatory lending and putting families into homes they can afford and keep," said Richard F. Syron, chairman and CEO of Freddie Mac. "The steps we are taking today will provide more protection to consumers and enhance the level of underwriting standards in the market."

Freddie Mac's new requirements cover what are commonly referred to as 2/28 and 3/27 hybrid ARMs, which currently comprise roughly three-quarters of the subprime market. Specifically, the company is requiring that borrowers applying for these products be underwritten at the fully-indexed and amortizing rate, as opposed to the initial "teaser" rate. The company also will limit the use of low-documentation products in combination with these loans. For example, the company will no longer purchase "No Income, No Asset" documentation loans and will limit "Stated Income, Stated Assets" products to borrowers whose incomes derive from hard-to-verify sources, such as the self-employed and those in the "cash economy." There will be a reasonableness standard for stated incomes.

In addition, Freddie Mac will require that loans be underwritten to include taxes and insurance and will strongly recommend that the subprime industry collect escrows for taxes and insurance, as is the norm in the prime sector. Because the maintenance of escrow accounts requires significant infrastructure and is not widely used in the subprime sector, Freddie Mac does not believe it is practical to unilaterally mandate it as a purchase requirement at this time.

"Escrowing for taxes and insurance clearly provides an added layer of consumer protection," Syron said. "It is our hope that this universal practice in prime lending today becomes the universal practice in subprime lending tomorrow."

As a secondary mortgage market investor, Freddie Mac works closely with its customers in the primary market to combat predatory lending and promote foreclosure prevention. The higher underwriting standards and model subprime products announced today build on Freddie Mac's long-term leadership in this arena. The company's previously implemented anti-predatory lending practices include:

-- refusing to do business with institutions that engage in predatory lending practices;

-- not investing in mortgages that require mandatory arbitration;

-- refusing to invest in high-rate or high-fee mortgages as defined by the Home Ownership and Equity Protection Act of 1994 (HOEPA), as well as mortgages with single-premium credit insurance or subprime mortgages with prepayment penalty terms of more than three years; and,

-- requiring that lenders provide complete credit information about borrowers to all the credit bureaus and reporting agencies.

Freddie Mac also promotes consumer education through programs such as CreditSmart(R), its award-winning financial education curriculum, Don't Borrow Trouble, an anti-predatory lending campaign, as well as its many foreclosure prevention initiatives. These programs help borrowers understand the mortgage origination process, their housing finance options, and how to avoid abusive lending practices.

Freddie Mac is a stockholder-owned company established by Congress in 1970 to support homeownership and rental housing. Freddie Mac fulfills its mission by purchasing residential mortgages and mortgage-related securities, which it finances primarily by issuing mortgage-related securities and debt instruments in the capital markets. Over the years, Freddie Mac has made home possible for more than 50 million families. **http://www.FreddieMac.com**

SOURCE Freddie Mac

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Main document changes and comments

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