

Jumbos: BIG LOANS, Big Problems

High-balance loans aren't immune from credit problems, especially if the borrower falls into the subprime category. And the problem could get worse before it gets better.

BY ALTON GARY SIMPSON

THE FALLOUT FROM THE IMPLOSION OF THE SUBPRIME MARKET segment is being felt across the financial landscape of the mortgage industry, even reaching the heights of the jumbo and super-jumbo market niches. According to Moody's Investors Service's U.S. Jumbo Mortgage Credit Indexes: April 2007 Reporting Period, March 2007 marked the first time since May of last year that the delinquency rate declined from the prior reporting period.

"We're not even at the halfway point for what's in store for us as lenders, as brokers and secondary market players," said Michael Covino, president of wholesale super-jumbo luxury mortgage lender Luxmac Covino & Co., Tarrytown, N.Y. "I don't want to be the bearer of bad news, but the mortgage marketplace is not in a recession. It's in a depression. If you didn't prepare for this and if you are not prepared for the fallout, whether you are a broker or a banker, you are probably going to exit the business."

Jumbo and super-jumbo loans are for borrowers in need of mortgages in excess of the conforming loan limits set for Fannie Mae and Freddie Mac by the Office of Federal Housing Enterprise Oversight. The average interest rates on these loans are typically greater than normal for conforming mortgages, and vary depending on property type and mortgage amount. The current conforming loan limit is \$417,000, except in designated high-cost areas such as Alaska, Hawaii, Guam and the U.S. Virgin Islands, where the limit is \$625,000.

Although the definitions of what constitutes a jumbo or super-jumbo loan can vary depending on locale and broker/lender, generally speaking, jumbo loans cover the range between the conforming loan limits and \$650,000, with super-jumbo loans covering everything in excess of that. However, because of the skyrocketing price appreciation of the past six years, many homebuyers in high-priced markets, such as the New York and Los Angeles metropolitan areas, have been forced into the jumbo market segment.

A lot of the subprime lending of the past few years was in the jumbo price category noted Mr. Covino, who added that as recently as six years ago subprime lenders restricted themselves to

mortgage lender that focuses on the jumbo segment of the adjustable-rate mortgage market. He noted the toxic combination of lenders looking to increase their spreads, borrowers failing to take responsibility for their own financial situations, federal and state governments encouraging lenders to lend to disadvantage borrowers and investment classes such as hedge funds, investment funds, insurance companies and foreign banks searching for higher-yielding investments that inflated the subprime credit bubble.

According to Mr. Badal, "If you look at the overall mortgage business and look at how the ARM segment has declined dramatically, the biggest reason for that decline is the contraction of the subprime business in that market. It's the same thing with whatever subprime has touched. It is causing a decrease whether it is in housing starts, resale houses or mortgage applications."

As defaults and foreclosure rates on subprime loans began climbing and lenders began going under, underwriting guidelines became more restrictive and credit liquidity began drying up across the board. "What we're seeing is a flight to quality," said Mr. Badal. "There's pressure created both internally by com-

the super-jumbos. If that results in an overreaction on the part of the credit markets, then you will see a substantial slide in values, because once liquidity leaves a sector it tends to put more pressure on the downward trend for value." He estimates that as much as a third of recent jumbo and super-jumbo loans relied on alternative documentation. He also noted that the present turmoil in the industry is based on information that is more than 90 days old, alluding to the indications from Moody's and others that there is more unpleasant news in the offing.

"Last year wasn't a banner year and certainly volume is off this year as well," said Bill McNamee, president of the Illinois Association of Mortgage Brokers. "The jumbo market is still lower than usual. There are still people who are looking to refinance, but purchases are less than normal. The lack of appreciation, especially in the jumbo market is having its impact."

He noted that tighter underwriting guidelines combined with the lack of price appreciation is like a one-two punch for distressed borrowers looking to refinance their homes. "You find out fairly quickly whether you can help somebody," he said.

According to Michele Raab-Francis, president and founder of Safe Harbor Capital Group in Bellport, N.Y., "The criteria for approval are becoming more stringent. You're seeing a real sweeping change in underwriting guidelines for any level of financing." She said that credit score requirements have been raised to the next tier for approval, more equity requirements and liquid funds post-closing as bankers look to mitigate the risk. "We're bringing in the belt notch by five or six holes," she said, adding that this is true for both jumbo and super-jumbo loans.

Ms. Francis, who brokers many loans in the high-end luxury market in the Hamptons, stated that she hasn't seen any significant slowdown in luxury home sales in the over-\$2 million price range. "You've got a real solid buyer in that price range," agreed Ms. Francis. "From a financial aspect, all the criteria are met there."



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*Michele Raab-Francis
Safe Harbor Capital Group*

loans under \$250,000. "Within the last six years, subprime lenders started to go to \$2 million," he said. "What they did was bring a lax underwriting standard to a jumbo market that had never before had that type of liquidity."

"The whole subprime fiasco was like a perfect storm," said Joseph Badal, senior executive vice president and chief lending officer, Thornburg Mortgage Inc., a Santa Fe, N.M.-based residential

panies themselves, by regulators, by congressional action and so forth. So all of a sudden companies are more concerned with credit quality. More and more people are focused on appropriate pricing and appropriate underwriting."

Mr. Covino added, "The collapse of subprime draws attention to the lax underwriting standards and that bleeds over to alt-A, drawing more attention to the underwriting criteria used to underwrite

Mr. Badal added that borrowers on the prime side of jumbo loans almost by definition aren't as affected by economic exigencies as the average borrower. They tend to have a higher net worth and are usually more financially sophisticated. However, Ms. Francis noted that she is seeing more negotiation for homes in the \$650,000-\$2 million price range. "It's that profile of a borrower who is not on steady ground," she noted. "It's not a robust sale in that price range that I'm seeing. If a builder is out there on spec, it's taking them a longer amount of time to sell that house. A lot of builders are probably more inclined to engage someone in contract before moving forward

mention the ancillary effects that a general housing downturn would have on the overall U.S. economy.

Mr. Covino, who has more than 27 years of experience in the mortgage finance industry under his belt, has seen at least three or four of these market cycles. He pointed out that he witnessed the tremendous devaluation of high-end homes in the 1987-88 market, specifically in California and other parts of the country, which was a direct result of a credit squeeze when the S&Ls failed. "If liquidity dries up for super-jumbo loans, if they're not as readily available as they once were," he warned, "you could see a very quick depreciation of prices."



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*Michael Covino
Luxmac Covino & Co.*

in this particular market."

Mr. Covino said that the historical markets with high-end housing — the bedroom communities of the major metropolitan areas — are remaining somewhat stable. "But, these new communities that have popped up with multimillion-dollar houses aren't central to any major center of industry," he said. "You're seeing a bit of pressure on that." He also said that the weaker markets are starting to show stagnant price appreciation and in some instances, price depreciation of as much as 15% to 20%.

"Traditionally, the super-jumbo market has remained resilient in times like that. The values are late to slide and early to recover, especially in the key prime markets," stated Mr. Covino, adding the caveat, "It really is all up to where rates go. If rates continue to stay where they are, I think that next year we'll fare far worse than we are." He said if that's the case, we would see marked declines in home values, originations and in housing starts, not to

Mr. Covino emphasized that the market is cyclical, citing the New York area during the down market of 1986-87, when on average homes lost 33% of their value. Within three years, not only had these homes regained their value, but they were actually up by 12%. "It took four years for the cycle to work its way through," he noted. "It's all about rates. It's all about liquidity in the marketplace. It's about ease of credit."

Mr. Covino noted that the tightening underwriting guidelines had changed the rules for everyone in this sector. "I think that the key here is for both regulators and secondary market people to understand that the lending decision, especially on super-jumbos, is an individual decision. It's not a FICO score driven decision. It's not solely an asset driven decision. It's not solely a collateral decision. It's more a combination of all those factors, which makes for a prudent lending decision," he said.

Rather than the rush to origination if a person had an OK FICO score and six

months of reserves, which Mr. Covino said was commonplace during the past few years, he said that originators will have to look at the story behind the borrower. He said that the kind of questions that originators and lenders have to ask when evaluating a prospect must include:

Who is this individual, their career path and length of time in chosen field of endeavor?

Where are they in their life cycle?

How do they manage their affairs and have they handled high debt before?

What sector of the economy are they involved in and what's the likelihood of that sector's continued success?

Does this individual have a track record of success?

What's the likelihood they will be successful in the future?

"The appreciating market covered up a lot of mistakes." He noted that if you made a loan to a person who wasn't qualified, but they were receiving 20% appreciation on their property, then that person could probably sell that property at a profit before trouble hit home.

"You make that same lending decision today and he loses 15% a year for the next two years, and can't carry the property," noted Mr. Covino. "Some lender takes a hit for a million dollars. That's only going to happen a couple of times before someone says, 'Wait a second, there's something more than a FICO score and liquid reserves that have to go into this equation.'

"You're going to see people looking towards the character of the individual and the experience of that individual before they go ahead and lend them several million dollars."

To further prove his point, he cited the example of builders during the 1980s, noting that before the S&L crisis, they were good bet. "Nobody wanted to make a builder a loan from 1989-1993," said Mr. Covino. "Those guys had a hard time getting mortgage loans on their own primary residences because liquidity to their sector dried up. If they had FICO back then, you would have seen a great FICO and great earnings for the previous years, but their business ended overnight." **B**