

# Scratch-and-Dent Supply To Grow as Prices Shrink

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By Kate Berry

One consequence of American Home Mortgage Investment Corp.'s shutdown and the other tumultuous events of last week is that billions of dollars more in inventory is about to hit the "scratch and dent" market for distressed loans.

But unlike a few months ago, when there were plenty of bids from bargain hunters, it may be even harder to liquidate loans that are unacceptable to the regular secondary market - and a broader swath of products fit that description now.

Hedge funds and private-equity firms, the most visible scratch-and-dent buyers this year, have moved to the sidelines because of the deep uncertainty in the mortgage market.

"Pricing is in free fall," said Laird Minor, a managing director at Nautilus Capital LLC, a Mauldin, S.C. broker of scratch-and-dent loans.

"There are still investors out there, but they are picking and choosing very carefully the loans they want to buy."

Mike MacDonald, a senior vice president in charge of the loan portfolio sales group at KBW Inc.'s Keefe, Bruyette & Woods Inc., said certain types of loan products "have completely fallen out of favor" in the past week, including alternative-A ones.

"The definition of scratch and dent is broadening by the day," he said. "The subprime problem has crept up to better-quality loans like alt-A, because the financing and outlets for all types of nonconforming loans are drying up."

Hedge funds that bought distressed loans earlier this year with the intent of securitizing them when the market rebounded are "having problems because of the deterioration in the value of the securities," Mr. MacDonald said. Warehouse lenders, which typically advance 75% to 95% of the face amount of the loans to mortgage banking firms, are trying to find some outlet.

"These loans can be securitized at some price, but the pricing that existed a month ago would not be appropriate pricing for securitization today," Mr. MacDonald said. "I think it's going to continue to create stress on a lot of lenders, and it obviously affects independent lenders, and some could go out of business."

Mr. Minor said American Home has \$1 billion of inventory that is expected to be "dumped on the market" by warehouse lenders and bankruptcy trustees, which will further depress prices.

(The Melville, N.Y., lender said Thursday night that it had stopped taking applications and would fire most of its employees, but at press time it had said nothing about filing for

bankruptcy protection, and had not returned several phone and e-mail messages placed Thursday and Friday.)

Certain types of loans - particularly pay-option adjustable-rate mortgages - are simply not being bought, because Wall Street firms are no longer securitizing them, Mr. Minor said.

Investor interest in option ARMs had been a problem for American Home as far back as the first quarter, when it held over about \$1 billion worth of hybrid option ARMs for sale in April because of the "weak market," as Stephen A. Hozie, the company's chief financial officer, put it during an April 30 earnings call.

Option ARMs accounted for about 30% of American Home's roughly \$17 billion of originations in the first quarter, the most recent period for which it reported results.

C-Bass LLC, one of the biggest buyers of scratch-and-dent loans, is itself facing liquidity issues.

Last week the New York company said that it had met \$260 million of margin calls in the first three weeks of July, almost as much as in the entire first half, and its two main shareholders, MGIC Investment Corp. and Radian Group Inc., said they may have to write down their investments completely.

The scratch-and-dent market covers a wide spectrum of mortgages, from performing loans with underwriting glitches to loans that have defaulted.

In the past week pricing for performing first-lien mortgages has dropped by 4 or 5 cents on the dollar, and the loans are trading in the mid-80s, compared with face value a year ago.

"Right now most of the players think the sky is falling, and everyone is in full-blown panic mode," Mr. Minor said.

"It's going to continue to get worse for a while, and eventually the market will hit some equilibrium and the returns will attract new money."

Some property investors are stepping in to buy nonperforming first-lien mortgages in specific geographic areas where they can repossess the homes and sell the underlying real estate for a profit when the market turns, he said.

Scratch-and-dent buyers also are starting to shun loan products in certain ZIP codes, particularly in California and Florida, where foreclosures are skyrocketing.

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