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Special Report:

Hurricane Katrina and Mortgage Credit: Some Early Results

The most recent estimates of damage from Hurricane Katrina top $100 billion, with thousands of people left homeless in its aftermath. From the early reporting, it appears a large proportion of the survivors may also have been left with debt secured by homes that are damaged beyond repair.

Given the important role that the capital markets play in intermediating mortgage risk, lenders, mortgage servicers, and investors in securitized mortgage pools are also potentially impacted by this catastrophe. All face a long process of determining recovery values and seeking reimbursement from insurance companies and federal agencies. In this article, we discuss a range of topics surrounding this catastrophe including insurance, servicing, the effect on borrowers, and finally, the exposure of each of the non-agency mortgage sectors.

Flood or Hurricane?

The Federal Emergency Management Agency (FEMA) defines a hurricane as a tropical storm with winds that have reached a constant speed of 74 miles per hour or more. The National Flood Insurance Program (NFIP) defines a flood as an excess of water (or mud) on land that is normally dry.

While a significant number of homes in Alabama, Louisiana, and Mississippi may have been damaged by wind and rain, many homes were affected by flooding. Indeed, in many instances, the damage was probably caused by a combination of factors. Because the line between the two is so unclear, it is likely to be a point of contention for months to come between the interested parties.

Insurance

The reason this debate is likely to be contentious is that standard home insurance for hazards does not cover flood damage, but it does cover hurricane damage, such as that caused by wind and rain. The root cause of the damage is therefore of more than just academic significance. It is important to note that some manufactured housing policies do cover flood damage, such as those written in all states by State Farm and in eight states by Allstate (the eight include Florida but do not include Alabama, Louisiana, or Mississippi).

Flood insurance is offered supplementally by NFIP. This is because most insurers will not underwrite flood coverage because of the potentially catastrophic nature of flooding. Private carriers who offer flood insurance do so as the servicer and seller of the policies, with the liability retained by NFIP.

The purchase of flood insurance is mandatory for all Federal or federally-backed financial assistance for the acquisition and/or construction of buildings in high-risk flood areas (Flood Zone "A" as defined by NFIP). However, in the Non-Agency mortgage world, the onus is on the servicer to impose flood insurance requirements. Some servicers require flood insurance for those homes that are located in "A" zones and/or "V" zones (coastal areas), but others have no such requirement and thus could be exposed to more severe losses.

Mortgage Servicing

Mortgage servicers have found themselves caught in the middle of this problem due to the delicate balance between the rights of both borrowers and investors.

Freddie Mac has instructed their servicers to suspend all automatic payments (in the form of automatic clearinghouse (ACH) payments or monthly debits from a borrower's checking account) from homeowners. Servicers must also suspend all collection activities and refrain from reporting to credit agencies any missed or late payments through November. Servicers will also have the option of extending this period or offering borrowers reduced payments for up to nine additional months, dependent on an evaluation of the homeowner's situation by the servicer before the December payment date. Additionally, they have given the servicers the option of whether or not to advance interest during this period. Individual servicers' decisions of whether to advance will not affect investors of FHLMC MBS because of Freddie Mac's guarantee of principal and interest on their participation certificates.

Most servicers of Non-Agency mortgage deals have also adopted a 90-day forbearance policy for their borrowers. However, in these cases, whether or not principal is advanced will affect the servicers' liquidity and future losses, as well as the cash flow available to investors. Servicers will most likely continue to advance during the forbearance period, because they are technically obligated to do so unless and until the loan is deemed uncollectible. Given the haziness of the situation at the present time, a definitive determination of uncollectibility is clearly out of the question.

MBS Exposure

The Jumbo and Alt-A sectors have relatively low concentrations in the disaster zone (below 0.5%), with the majority of the properties that may have sustained damage falling in the subprime sector. However, even in this segment, only 1.16% of the outstanding amount is within the affected counties. **In this report and in the accompanying Special Report Appendix, we define the affected counties as those eligible by FEMA for both public and individual assistance.**

Figure 1 shows the total outstanding balance in the affected counties, Figure 2 shows the total number of loans in the affected counties, and Figure 3 shows the percentage of the total outstanding balance in the affected counties.

Figure 1. Exposure to Affected Counties in Millions of Dollars; by Sector and Vintage

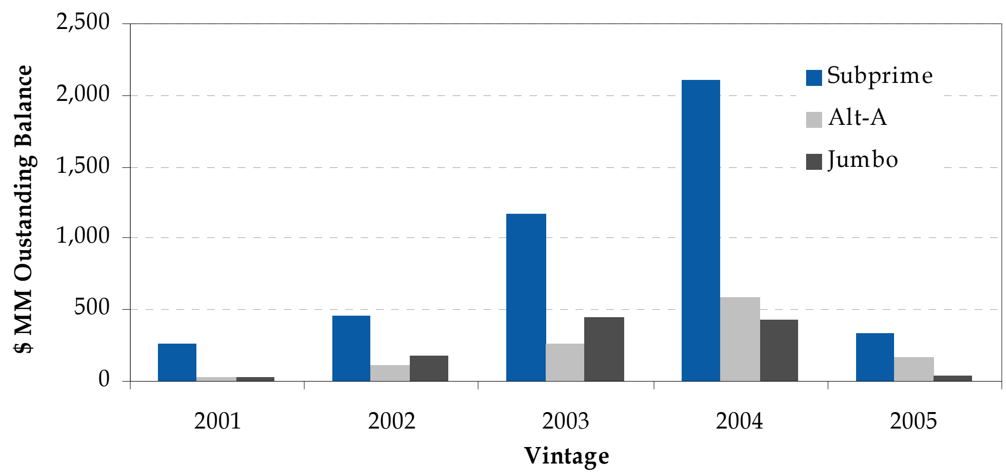


Figure 2. Exposure to Affected Counties by Number of Loans; by Sector and Vintage

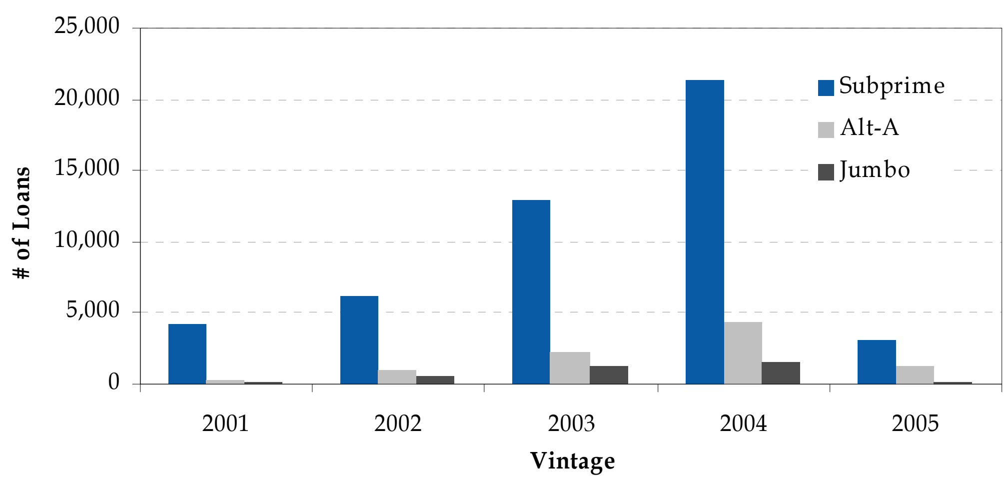
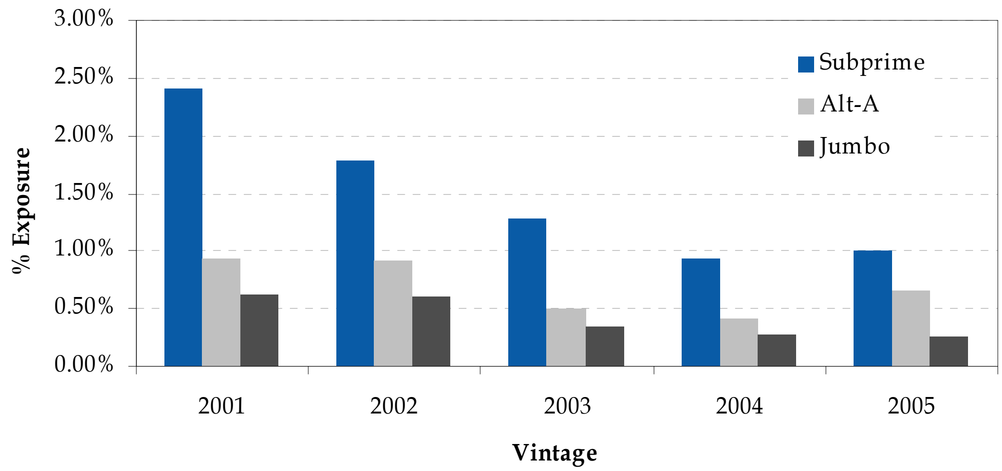


Figure 3. Exposure to Affected Counties as a % of Total Balance; by Sector and Vintage



In addition to the sector analysis, we analyzed approximately 3,000 deals in the Jumbo, Alt-A, and Subprime sectors to determine each deal's exposure to these counties. Please see the online appendix (link at the end of this article) for the exposure in millions of dollars and as a percentage of the current balance for each deal.

Rating Agencies

Thus far, the rating agencies have not issued an official statement on how they will treat the rating of existing mortgage-related transactions based on their exposure to hurricane and flood damage. Deals generally require a representation with respect to each mortgage loan from the seller that the property is in good repair as of the closing date. A breach of a representation will require the seller to repurchase the related mortgage loan.

The Mortgage Pipeline

The recent events will no doubt have an effect on mortgage purchases which have not yet settled. Although buyback provisions have always allowed mortgage buyers to require the seller to repurchase loans for which the underlying property was found to have had material damage as of the closing date, deal documents will no doubt be more closely scrutinized in the wake of serious losses being incurred due to Katrina. Additionally, many whole loan buyers have imposed requirements that a new inspection certification be submitted within 30 days on any forward-settle loan transactions. Expect a slight hiccup in the pipeline while issuers, lenders, and servicers struggle to keep up with the additional administrative demands that they now face.

Summary

In summary, while the consequences of Katrina in terms of lives lost and untold human suffering cannot be minimized, the overall impact on the mortgage sector in terms of its immediate impact is not likely to be very significant. Our estimates assume complete and total loss under the presumption that no one has flood insurance in the affected areas. The reality is likely to be much more benign.

Among all the segments, subprime loans appear to be the most impacted but even here, the affected proportions are relatively small. A bigger challenge for servicers is likely to be the ongoing task of maintaining the performance of the mortgage pools for loans where the properties are still standing. The negative impact on the local economy in areas contiguous to the flood zone is likely to pose a significant burden for borrowers in these areas and will require a careful and considerate collection effort on the part of servicers. In addition, the process of claims management is also likely to pose a significant logistical burden to ensure that insurance proceeds are collected and disbursed to the trusts in a timely fashion.

The Special Report Appendix can be found at the link below. The Appendix shows deal-level exposure to the counties deemed eligible by FEMA for both public and individual assistance.
http://www.bearstearns.com/bscportal/pdfs/appendices/2005/special_report_appendix_091205.pdf

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