Lenders feeling pain as more homeowners default in U.S.

'Sky may be falling'

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WASHINGTON - HSBC Holdings PLC, the world's third-largest bank, said yesterday it will be hurt by its exposure to controversial mortgages that helped spark the U.S. housing boom, but which are now coming up for renewal.

The London-based bank is expected to be the first in a long list of major residential mortgage lenders in the United States forced to take a hit from the increasing number of defaults by homeowners who cannot afford to pay sharply higher interest rates.

About US$2-trillion in the popular adjustable-rate mortgages (ARMs) used to finance the housing boom come due in the next two years. That represents about one-third of the US$6-trillion U.S. mortgage market.

Analysts said other lenders such as Citibank Corp. and Bank of America should soon be telling markets they are in the same boat as HSBC.

"We think the sky may be falling," said Mark Fitzgibbon, director of research at New York investment firm Sandler O'Neill & Partners LP. "Credit quality has been deteriorating for two quarters and we think the pace of deterioration will accelerate this quarter."

At least one Canadian bank with U.S. operations said it does not have a large exposure to these types of controversial mortgages. A spokesman for TD Banknorth Inc., which operates in the U.S. Northeast, said only 11% of its loan portfolio is residential, while more than 60% is commercial. It is owned by Toronto-Dominion Bank.

HSBC underestimated borrowers' ability to repay mortgage loans in the U.S., Douglas Flint, its finance director, said yesterday in a conference call with analysts.

In the United States, loan delinquencies and writedowns increased from the first part of the year because of more bankruptcies and a weaker housing market, he added. HSBC did not put any number to those delinquencies, but said the hit is expected to be felt in the bank's fourth quarter.

However, much of it is linked to its US$14.8-billion purchase in 2003 of Household International Inc., now called HSBC Finance Corp. Widely seen as a lender for high-risk borrowers, HSBC Finance generated 31% of HSBC's North American profit but 65% of its non-performing loans.

Economists have warned that ARMs, the popular finance vehicle used four years ago to finance the housing boom, would come back to haunt homeowners with interest rates up sharply from the time they took out the mortgage.

One-third of U.S. homes were financed with the unusual mortgages, which offered teaser interest rates as low as 1% for between two and five years. But after that the rate would be based mostly on prevailing rates.

U.S. short-term rates have risen by 4.25 percentage points since 2004, while oil prices have more than doubled over three years, putting huge stress on homeowners' wallets.

Benjamin Tal, a senior economist at CIBC World Markets in Toronto, said many of the adjustable mortgages were offered to people with bad credit and who had little or no downpayment. The refinancings have led to higher mortgages and now an increasing number of defaults.

Mr. Tal said he had expected to see the earnings of major mortgage lenders, which were quick to lend the money, get hit as the number of defaults began to increase.

"It's payback time," he said.

Stock markets have widely anticipated the downturn. The Philadelphia KBW bank index was up only 1% this quarter, compared with the 5% increase in the Standard & Poor's 500 index.

Non-conventional lenders are also getting hit by defaults and bankruptcies linked to the housing downturn.

H&R Block's Option One unit, which the tax preparer is trying to sell, posted a US$39-million fiscal second-quarter pre-tax loss, compared with a year-earlier profit of US$48.8-million.

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