

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Volume 18, No. 61

1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

By James A. Bianco (847) 304-1511

August 29, 2007

Why Subprime Is Not The Problem In The Capital Markets

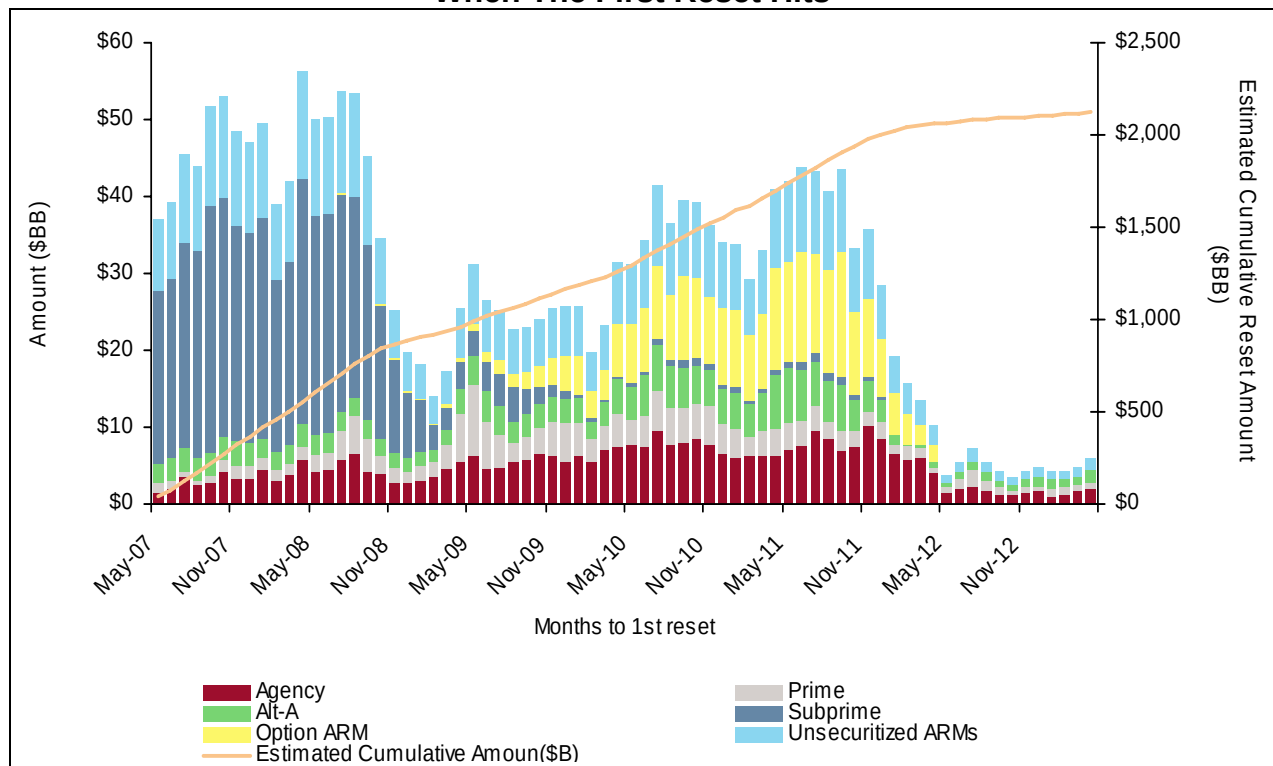
It seemed unlikely, if not absurd, that the American economy and credit system could be shaken because a few people with poor credit fell behind on their mortgages. Why should that slow consumer spending? Why should it affect companies that made mortgage loans only to people with good credit? Why should it bring a halt to the leveraged buyout boom? – The New York Times, [August 17, 2007](#)

The quote above is from the ever-observant Floyd Norris of *The New York Times*. He correctly points to something we have been struggling with as well – is the subprime problem being overblown? In this *Commentary* we will look at the size and the scope of this mortgage problem, ultimately concluding it is not as big as most fear. **This is separate from the much larger issue whether the difficulties in pricing securities derived from subprime mortgages have contributed to credit market turmoil and balance sheet impairment.**

Resets

The chart below, courtesy of Credit Suisse, shows when an adjustable-rate mortgage will first reset (gold line). \$2.2 trillion will reset in the next 10 years with almost half this amount, or \$1 trillion, coming between now and November 2008. Most of these resets will be subprime (dark blue bars) between now and next year. The peak for subprime resets is May 2008.

When The First Reset Hits



The above chart has everyone concerned since it shows a large number of resets in the near future. It even has Congress and most of the presidential candidates actively debating what kind of bailout these mortgage holders should receive.

While the chart above does look menacing, let's break it down.

Originated Mortgages

The table to the right shows the total number of mortgages and gross values originated between 2004 and 2006. It breaks them down by initial interest rate. This is the key period of originations that has everyone concerned about some sort of breakdown. Mortgages originated before 2004 have enough of an equity cushion thanks to home price appreciation through 2005 that they do not present a concern for the marketplace.

Some stats:

- A total of 25.9 million mortgages were originated with a gross value of \$5.377 trillion. The average mortgage was \$207,000.
- A total of 8.4 million **adjustable-rate** mortgages were originated with a gross value of \$2.3 trillion over this critical three year period. This is 32% of all mortgages or 42% of all gross value originated. The average adjustable-rate mortgage was \$272,000.
- A total of 17.6 million **fixed-rate** mortgages were originated with a gross value of \$3.1 trillion over this critical three year period. This is 68% of all mortgages and 58% of all gross value originated. The average fixed-rate mortgage was \$177,000.
- Any initial interest rate of **less than 5.50%** on an adjustable-rate mortgage, the level of three-month libor before turbulence hit the credit markets, is a good working definition of a "teaser rate." The table specifically highlights those adjustable-rate mortgages with this teaser rate definition (*italics*). A total of 3.2 million mortgages representing 39% of all adjustable-rate mortgages with a gross value of \$1.05 trillion or 46% of all gross value qualify.

All First Mortgages Originated Between 2004 and 2006

Initial Interest Rate	No. of Loans	% of Adj.	Balance in Bln	% of Adj.
<i>Below 2.0%</i>	1,123,595	13.4%	\$ 431	18.9%
<i>From 2.0% to 3.0%</i>	132,427	1.6%	\$ 41	1.8%
<i>From 3.0% to 4.0%</i>	174,651	2.1%	\$ 49	2.1%
<i>From 4.0% to 4.5%</i>	293,195	3.5%	\$ 88	3.9%
<i>From 4.5% to 5.0%</i>	607,090	7.3%	\$ 176	7.7%
<i>From 5.0% to 5.5%</i>	897,065	10.7%	\$ 269	11.8%
Teaser Rates	3,228,023	38.6%	\$ 1,055	46.3%
From 5.5% to 6.0%	1,056,880	12.6%	\$ 317	13.9%
From 6.0% to 6.5%	932,623	11.1%	\$ 273	12.0%
From 6.5% to 7.0%	896,898	10.7%	\$ 225	9.9%
From 7.0% to 7.5%	553,895	6.6%	\$ 118	5.2%
From 7.5% to 8.0%	589,086	7.0%	\$ 114	5.0%
From 8.0% to 8.5%	345,431	4.1%	\$ 61	2.7%
From 8.5% to 9.0%	335,176	4.0%	\$ 54	2.4%
From 9.0% to 9.5%	164,074	2.0%	\$ 24	1.1%
From 9.5% to 10%	139,373	1.7%	\$ 20	0.9%
From 10% to 10.5%	57,543	0.7%	\$ 7	0.3%
From 10.5% to 11%	42,834	0.5%	\$ 5	0.2%
From 11% to 11.5%	17,761	0.2%	\$ 2	0.1%
From 11.5% to 12%	12,926	0.2%	\$ 1	0.1%
Subtotal	5,144,500	61.4%	\$ 1,222	53.7%
Total Adjustable	8,372,523		\$ 2,276	
<i>Percent Adjustable</i>	32.3%		42.3%	
Total Fixed	17,562,609		\$ 3,101	
<i>Percent Fixed</i>	67.7%		57.7%	
All Mortgages	25,935,132		\$ 5,377	

Data Source: www.loanperformance.com

The impending reset of \$1 trillion dollars of teaser-rate mortgages is alarming. Approximately \$431 billion of these will be resetting from rates of 2.0% or less. These mortgagors are going to see to see crushing resets when they hit.

A note about this data: The database focused on properties with active first mortgages; loans that had been originated but were later completely satisfied through payoff, refinance or sale **were removed from the database**. Each loan was studied in the LoanPerformance database according to its current balance as of December 2006; both principal reductions and accumulated negative amortization (where that occurred) were included in this loan analysis.

Mortgages *Already* Reset

Before panicking, consider the table below:

- A total of 3.9 million of the adjustable-rate mortgages originated between 2004 and 2006 **have already** reset (specifically through the end of 2007). This represents 47% of all adjustable-rate mortgages. Their gross value is \$1.05 trillion, or 46%, of all adjustable-rate mortgages.
- Among the adjustable-rate mortgages qualifying under our teaser rate definition (less than 5.50% as explained above), 1.9 million **have already** reset. This represents 58% of all adjustable-rate mortgages. Their gross value is \$651 billion, or 62%, of all adjustable-rate mortgages.
- Among the adjustable-rate mortgages with an initial interest rate of less than 3.0%, over 99% **have already** reset.

**All First Mortgages That Have Reset
Through The End of 2007 (in Four Months)**

Initial Interest Rate	No. of Loans	% of All Adj.	Balance in Bln	% of All Adj.
Below 2.0%	1,121,963	99.9%	\$ 430	99.8%
From 2.0% to 3.0%	131,709	99.5%	\$ 41	98.7%
From 3.0% to 4.0%	153,638	88.0%	\$ 43	88.0%
From 4.0% to 4.5%	155,273	53.0%	\$ 47	52.9%
From 4.5% to 5.0%	163,042	26.9%	\$ 47	26.8%
From 5.0% to 5.5%	146,541	16.3%	\$ 43	15.9%
Teaser Rates	1,872,166	58.0%	\$ 651	61.7%
From 5.5% to 6.0%	203,846	19.3%	\$ 56	17.8%
From 6.0% to 6.5%	263,302	28.2%	\$ 66	24.0%
From 6.5% to 7.0%	402,865	44.9%	\$ 87	38.8%
From 7.0% to 7.5%	315,869	57.0%	\$ 61	51.6%
From 7.5% to 8.0%	336,794	57.2%	\$ 58	50.8%
From 8.0% to 8.5%	190,635	55.2%	\$ 29	48.0%
From 8.5% to 9.0%	165,530	49.4%	\$ 23	41.8%
From 9.0% to 9.5%	72,818	44.4%	\$ 9	36.3%
From 9.5% to 10%	55,047	39.5%	\$ 6	32.1%
From 10% to 10.5%	20,596	35.8%	\$ 2	28.7%
From 10.5% to 11%	14,079	32.9%	\$ 1	27.0%
From 11% to 11.5%	5,243	29.5%	\$ 0	24.2%
From 11.5% to 12%	3,889	30.1%	\$ 0	26.2%
Subtotal	2,050,513	39.9%	\$ 399	32.7%
Total Reset	3,922,679	46.9%	\$ 1,050	46.1%

Data Source: www.loanperformance.com

Conclusion

Let us be blunt; the mortgage reset fears are overblown. Virtually all of the super-low teaser rates have reset already. Only a few thousand remain. Of the resets left, their composition or amount should **not** pose a problem for the capital markets or the economy. Floyd Norris was correct.

Why then are the capital markets having so many problems? The commonly heard answer is

Mortgages Left To Be Reset

The final table below shows the mortgages that **will be reset** in 2008 and beyond:

- A total of 3.1 million adjustable-rate mortgages **will be reset** in 2008 and beyond. This represents 53% of all adjustable-rate mortgages originated between 2004 and 2006. The gross value is \$1.3 trillion, or 54%, of all adjustable-rate mortgages.
- Among the adjustable-rate mortgages qualifying under our teaser rate definition (less than 5.50% as explained above), 1.4 million **will reset** in 2008 and beyond. This represents 42% of all teaser rate adjustable mortgages originated between 2004 and 2006. Their gross value is \$404 billion, or 38%, of all adjustable-rate mortgages.
- Among those with an initial interest rate of less than 3.0%, only 235,000 mortgages with a gross value of \$1.1 billion **will reset** in 2008 and beyond. Teaser rates this low are only offered for a short time with a reset soon after closing.

**All First Mortgages That Will Reset
In 2008 and Beyond**

Initial Interest Rate	No. of Loans	% of All Adj.	Balance in Bln	% of All Adj.
Below 2.0%	1,632	0.1%	\$ 1	0.2%
From 2.0% to 3.0%	718	0.5%	\$ 1	1.3%
From 3.0% to 4.0%	21,013	12.0%	\$ 6	12.0%
From 4.0% to 4.5%	137,922	47.0%	\$ 42	47.1%
From 4.5% to 5.0%	444,048	73.1%	\$ 129	73.2%
From 5.0% to 5.5%	750,524	83.7%	\$ 226	84.1%
Teaser Rates	1,355,857	42.0%	\$ 404	38.3%
From 5.5% to 6.0%	853,034	80.7%	\$ 261	82.2%
From 6.0% to 6.5%	669,321	71.8%	\$ 208	76.0%
From 6.5% to 7.0%	494,033	55.1%	\$ 138	61.2%
From 7.0% to 7.5%	238,026	43.0%	\$ 57	48.4%
From 7.5% to 8.0%	252,292	42.8%	\$ 56	49.2%
From 8.0% to 8.5%	154,796	44.8%	\$ 32	52.0%
From 8.5% to 9.0%	169,646	50.6%	\$ 32	58.2%
From 9.0% to 9.5%	91,256	55.6%	\$ 15	63.7%
From 9.5% to 10%	84,326	60.5%	\$ 13	67.9%
From 10% to 10.5%	36,947	64.2%	\$ 5	71.3%
From 10.5% to 11%	28,755	67.1%	\$ 4	73.0%
From 11% to 11.5%	12,518	70.5%	\$ 1	75.8%
From 11.5% to 12%	9,037	69.9%	\$ 1	73.8%
Subtotal	3,093,987	60.1%	\$ 823	67.3%
Total Left To Reset	4,449,844	53.1%	\$ 1,227	53.9%

Data Source: www.loanperformance.com

“subprime” which often means “mortgage resets”. They indeed started the problem, but the capital markets have moved onto other issues – specifically confidence in valuing complex securities and potential damage to consumer spending from lower household wealth levels. The term “subprime” has devolved into an explanatory icon for these larger and more complex issues to be addressed in an upcoming Commentary.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511

Fax (847) 304-1749

e-mail: research@biancoresearch.com
<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599

James A. Bianco jbianco@biancoresearch.com

Strategist/Analyst (847) 304-1511

Howard L. Simons hsimons@biancoresearch.com

Greg Blaha gblaha@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.

Director of Sales & Marketing (800) 625-1860

Fritz Handler fritz.handler@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com
<http://www.arborresearch.com>

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602

Daniel Lustig dan.lustig@arborresearch.com

Phone (866) 877-0266 Fax (312) 269-1681

New York Sales Office

The Chrysler Building, 405 Lexington Ave
New York, NY 10174

Edward T. McElwreath ed.mcelwreath@arborresearch.com

Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office

4 Broadgate, 2nd Floor, Room 57

London England EC2M 2QY

Phone 44-207-965-4784 Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com

Ben Gibson ben.gibson@arborresearch.com

European Sales

James L. Perry james.perry@arborresearch.com

Phone (847) 756-3510 Fax (847) 304-1595

Rich Kleinbauer rich.kleinbauer@arborresearch.com

Phone (41) 22 363-9229

Far East Sales

Robert Reynolds robert.reynolds@arborresearch.com

Phone (847) 756-3680 Fax (435) 647-3073