

# Subprime Money trail

How subprime mortgages can end up in your investments



## 1 Home buyers

Buyers with weak, or subprime, credit typically pay annual mortgage rates that are at least 2 percentage points more than the rates that banks charge people with good credit.



## 2 Mortgage brokers

Brokers, many of them based in California, lie at the heart of the once-profitable partnership between subprime lenders and Wall Street. They handle as much as 70 percent of originations.



## 3 Subprime lenders

Lenders lure people with exotic mortgages such as no-doc loans, which don't require evidence of income or savings. A record \$805 billion of subprime mortgages were originated in 2005.



## 4 Big banks/wholesalers

Big banks buy the subprime loans. Many banks then bundle the debt and sell it to Wall Street firms. Banks such as HSBCHoldings have been hurt by the subprime bust.



## 5 Securitization/manufacture of CDOs

Wall Street banks package subprime loans into mortgage-backed securities and collateralized debt obligations. Sales of new MBSs soared to \$2.4 trillion in 2006.



## 6 Rating companies

When a bank creates a CDO, it meets with credit raters to discuss the quality of the contents, including subprime debt. They divide the CDO into pieces in order to get the desired rating for each portion.



## 7 Securities/CDOs

CDOs include a mix of bonds and securities backed by mortgages and home equity loans. In 2006, an estimated \$100 billion of subprime debt went into the \$375 billion in CDOs sold in the US.



## 8 Investors

Investors like CDOs because they offer potentially higher returns than bonds with the same rating. Banks, insurance companies and pension funds take on more risk in pursuit of yields as high as 20 percent.

# Subprime Lending and Subprime Mortgage

**Subprime lending**, also called "B-Paper," "near-prime," or "second chance" lending, is a general term that refers to the practice of making loans to borrowers who do not qualify for market interest rates because of problems with their credit history. A subprime loan is one that is offered at a rate higher than A-paper loans due to the increased risk. Subprime lending encompasses a variety of credit instruments, including subprime mortgages, subprime car loans, and subprime credit cards, among others.

Subprime lending is typically defined by the status of borrowers. A subprime loan is, by definition, a loan made to someone who could not qualify for a more favorable rate. Subprime borrowers typically have low credit scores and histories of payment delinquencies, charge-offs, or bankruptcies. Because subprime borrowers are considered at higher risk to default, subprime loans typically have less favorable terms than their traditional counterparts. These terms may include higher interest rates, regular fees, or an up-front charge.

## Subprime mortgages

As with subprime lending in general, subprime mortgages are often defined by the type of consumer to which they are made available.

Subprime mortgage loans are riskier loans in that they are made to borrowers unable to qualify under traditional, more stringent criteria due to a limited or blemished credit history. Subprime borrowers are generally defined as individuals with limited income or having credit scores below 620 on a scale that ranges from 300 to 850. Subprime mortgage loans have a much higher rate of default than prime mortgage loans and are priced based on the risk assumed by the lender.

Although most home loans do not fall into this category, subprime mortgages proliferated in the early part of the 21st Century. About 21 percent of all mortgage originations from 2004 through 2006 were subprime, up from 9 percent from 1996 through 2004, says John Lonski, chief economist for Moody's Investors Service. Subprime mortgages totaled \$600 billion in 2006, accounting for about one-fifth of the U.S. home loan market.

There are many different kinds of subprime mortgages, including:

- interest-only mortgages, which allow borrowers to pay only interest for a period of time (typically 5-10 years);
- "pick a payment" loans, for which borrowers choose their monthly payment (full payment, interest only, or a minimum payment which may be lower than the payment required to reduce the balance of the loan);
- and initial fixed rate mortgages that quickly convert to variable rates.

This last class of mortgages has grown particularly popular among subprime lenders since the 1990s. Common lending vehicles within this group include the "2-28" loan, which offers a low initial interest rate that stays fixed for two years after which the loan resets to a higher adjustable rate for the remaining life of the loan, in this case 28 years. The new interest rate is typically set at some margin over an index, for example, 5% over a 12-month LIBOR. Variations on the "2-28" loan concept include the "3-27" and the "5-25".

From the adjoining flow sheet we can see that these subprime loans are packaged into CDO's and Mortgage-backed securities. These CDO's get impacted when the low-credit borrower or subprime borrower defaults. Hence, high loan default may slowdown US economy. With the increase in interest rates and a slowdown in the property market, the world has turned upside down. Borrowers are not being able to refinance themselves, and have started defaulting on housing and other loans. Many financing company and banks have been affected and some have already filed for bankruptcy. It is already feared that Alt-A mortgages Those that fall between prime and sub-prime are also being impacted.

## Ripple Effect

It is expected that these defaults will lead to a foreclosure of loans, repossession of houses, and the subsequent sale of these repossessed houses in the US property market which has already started showing signs of slowdown.

This is expected to slow the pace of new construction which is a big growth driver.

After all, when people buy new home they also buy refrigerators, curtains, carpets and various other household utilities providing a boost to broader economy. Hence, on a macrolevel scenario consumer spending would lessen. Similar kind of trend is expected to happen elsewhere globally, although a bit extreme but possible. So the countries who are heavy exporters to these economies may also get impacted....