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Mortgage Market Turmoil:
The Role of Interest-Rate Resets

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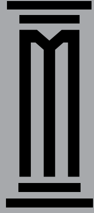

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The turmoil in the mortgage market is expected to worsen as interest rates on selected existing home mortgage loans reset upward in the months and years ahead. Loans with this feature are known as hybrids because their interest rates are fixed for a given period and then become variable, often with caps that limit the increase over a year or over the term of the loan. Such loans are at the center of ongoing debate in Washington and elsewhere because a relatively large number of people with shaky credit histories have taken out subprime hybrid mortgage loans.

Hybrids typically do not pose problems so long as home prices rise and individuals refinance their loans before the interest rates reset to a higher level. But home prices have not been rising, and people are having trouble refinancing their loans. As a result, more foreclosures are likely in the next few years.

Because hybrid loans, especially subprime hybrids, have become so controversial, it is important to assess their longer-term role in home foreclosures against other products in the mortgage market.

Figures 1 through 4 show home mortgage originations and cumulative foreclosures for prime and subprime borrowers. The numbers, covering the period January 1999 to July 2007, are based on a sample of 80 million mortgage loans from LoanPerformance. Figure 1 shows that of 71 million prime mortgage originations, nearly 84 percent were fixed-rate mortgages (mostly thirty-year, fixed-rate loans), 10 percent were adjustable rate, and fewer than 5 percent were hybrid mortgages. In contrast, figure 3 shows that of the 9.5 million subprime mortgage loan originations, 44 percent were fixed rate, 16 percent were adjustable rate, and 32 percent were hybrid mortgages.

While both prime and subprime borrowers use all three loan products, subprime borrowers rely more heavily on hybrid loans, and most of these are 2/28 and 3/27 mortgages, with short-term, fixed interest rates (two and three years, respectively), followed by variable interest rates for the remaining twenty-eight or twenty-seven years. (The 2/28 mortgages also include 2/6 and 2/1 mortgages, or mortgages that reset after six months and one year, respectively, once the two-year fixed-rate period ends; 3/27 mortgages include 3/6 and 3/1 mortgages, or mortgages that reset after six months and one year, respectively, once the three-year fixed-rate period is over.)

The cumulative foreclosure starts (and not all starts end in foreclosure) of the different mortgage products are presented in figures 2 and 4. Even though almost all the attention is focused on high and rising foreclosure rates in the subprime market, the total number of foreclosures on *prime* mortgages is slightly higher than the total number of foreclosures on subprime mortgages: 1.4 million versus 1.3 million.

Of all prime mortgage foreclosures, 74 percent occur with thirty-year, fixed-rate loans. Hybrids and adjustable-rate mortgages account for fewer than 12 percent of foreclosures. In contrast, hybrid loans account for 36 percent of all subprime foreclosures (with 2/28 and 3/27 loans accounting for most of these). Yet fixed-rate loans account for nearly as many foreclosures, at 31 percent, and adjustable-rate loan foreclosures are not far behind, at 26 percent.

Clearly, a difference exists between the types of products associated with foreclosures for prime and subprime borrowers. It is important to note, however, that more than 800,000 homes financed by subprime loans *other* than hybrid loans went into foreclosure by the end of

September 2007, according to data from LoanPerformance. Subprime mortgage foreclosures are obviously a problem, even without taking into account hybrid loans and their interest rate resets.

Without home price increases, hybrid loans will surely exacerbate the foreclosure problem if interest rates reset upward, but they are not the basic cause of it. Indeed, table 1 shows that of all the 2/28 and 3/27 subprime loans in foreclosure as of July 2007, 57 percent and 83 percent, respectively, had not yet undergone any upward reset of the interest rate.

In the first part of this decade, foreclosures were mainly a problem of the prime mortgage market. Today they are chiefly a problem in the subprime mortgage market. So far, in response to the worsening problems associated with the subprime loans, lenders have dramatically reduced the origination of such products, particularly those with reset features. However, most subprime borrowers have benefited enormously from the product diversity that has provided them access to credit and homeownership. It is important that any legislative or regulatory action not unduly curtail the availability of subprime mortgage loans.

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Figure 1: Prime Mortgage Originations
January 1999 – July 2007
Total Number = 70.8 million

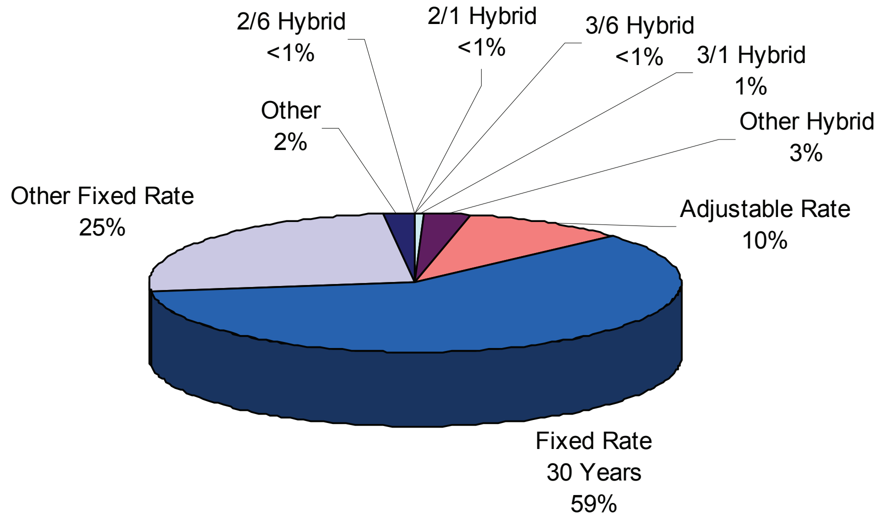

Figure 2: Cumulative Foreclosures through September 2007
on Prime Mortgages Originated from January 1999 through July 2007
Total Number = 1.4 million

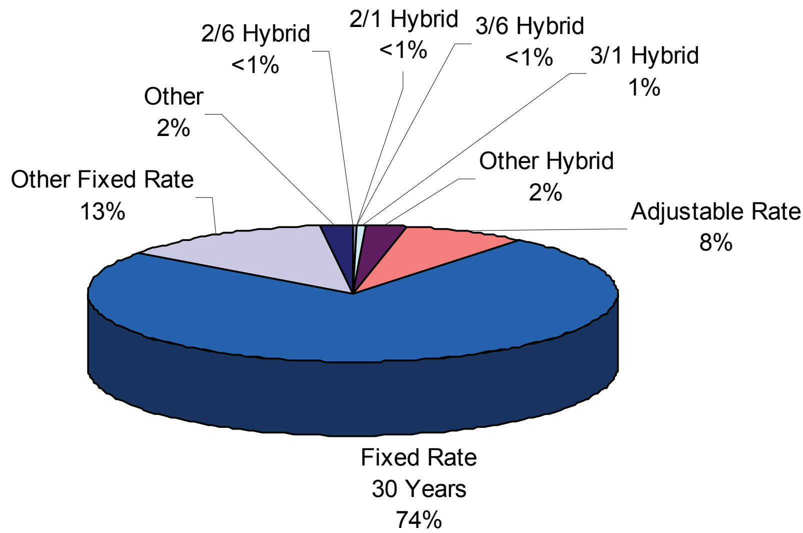

Figure 3: Subprime Mortgage Originations
January 1999 – July 2007
Total Number = 9.5 million

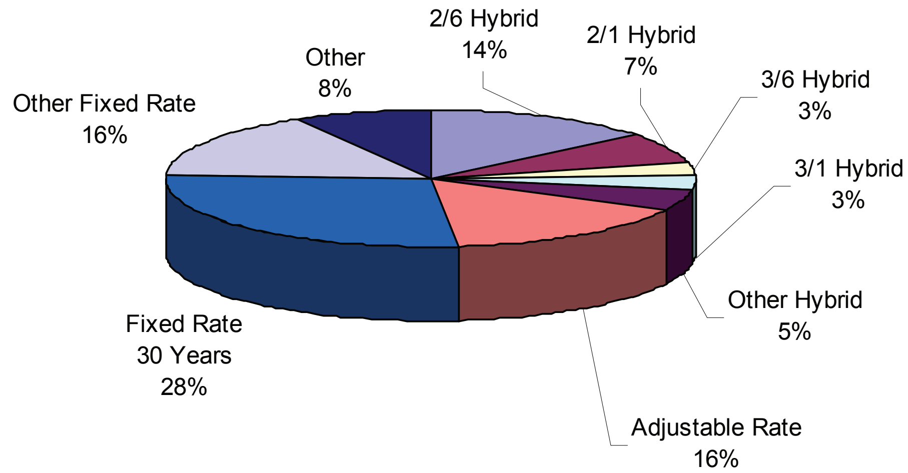

Figure 4: Cumulative Foreclosures through September 2007
on Subprime Mortgages Originated from January 1999 through July 2007
Total Number = 1.3 million

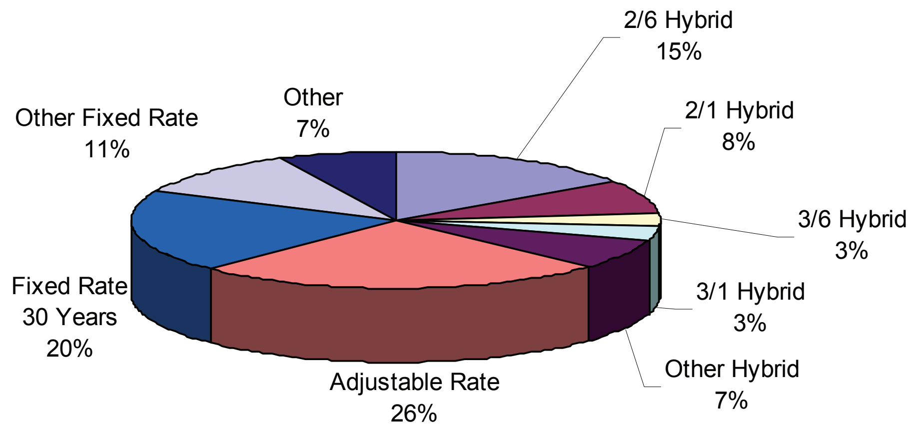

Table 1. Selected Subprime Hybrid Loans in Foreclosure, as of July 2007

	Age of Loans					
Product Type	**< 1 Year**	**< 2 Years**	**< 3 Years**	**< 5 Years**	**> = 5 Years**	**Total**
2/28 Hybrid	13.2%	44.2%	27.5%	12.0%	3.1%	100%
3/27 Hybrid	7.1%	46.1%	29.9%	12.9%	3.9%	100%