



Credit Market Analysis

16 March 2007

www.lloydstsb.com/corporatemarkets

Why the negative impact of the US subprime mortgage market may be exaggerated

US mortgage delinquency rates at 4yr highs...

The media has become transfixed with the US subprime mortgage market recently, where mortgages are extended to borrowers with higher credit risk, i.e. with low credit scores. This market has grown rapidly in recent years, as unemployment has fallen and credit lending standards have eased.

However, according to data from the Mortgage Bankers Association, the subprime mortgage delinquency rate, where loans are past due, has increased to a 4-year high of 13.33% in the final quarter of 2006, compared with 12.56% in Q3 and 11.63% a year earlier. The rise was particularly marked in subprime adjustable-rate mortgages (ARMs), which are more sensitive to interest rate rises. Remember too that interest rates have been raised seventeen times from a low of 1% in mid-2004 to 5.25% presently.

However, there are several reasons why the rise in subprime delinquency rates will not necessarily spread directly to a broader slowdown in consumer spending and therefore US economic growth (see below). The greater risk, in our view, is the possibility of contagion effects, resulting in tighter bank lending standards, even to consumers with good credit histories, and in the spillover effect to other asset classes.

...but the direct impact on the US economy should be limited

So why should the rise in subprime delinquency rates not necessarily spread directly to a broader slowdown in consumer spending?

Firstly, the subprime mortgage market represents only a small proportion of the total market, about 10%. Moreover, delinquency rates for prime mortgages remained low at 2.57% in Q4 and have risen much less than subprime mortgages in recent years. Chart a on the next page illustrates the total mortgage delinquency rates since 1972 and chart b shows the split between prime and subprime delinquency rates since 1998.

Secondly, given historically low interest rates and continued jobs growth, particularly in the buoyant service sector, households should continue to service their debts comfortably. Chart c shows

Table 1: Key financial market interest rates

	latest 15 Mar 2007	1w ago	1m ago	3m ago
UK				
BoE repo rate	5.25	5.25	5.25	5.00
1m libor	5.42	5.43	5.40	5.25
3m libor	5.53	5.53	5.54	5.30
6m libor	5.62	5.63	5.63	5.40
2y swap	5.57	5.59	5.65	5.48
5y swap	5.41	5.42	5.50	5.33
2y govt	5.26	5.27	5.33	5.16
10y govt	4.79	4.78	4.86	4.68
High-grade spread (bps)	80	78	76	79
High-yield spread (bps)	237	237	187	204
Eurozone				
ECB refi rate	3.75	3.75	3.50	3.50
1m libor	3.86	3.84	3.64	3.66
3m libor	3.90	3.88	3.83	3.69
6m libor	4.00	3.97	3.95	3.80
2y swap	4.13	4.10	4.16	4.03
5y swap	4.10	4.08	4.18	4.00
2y govt	3.90	3.91	3.93	3.80
10y govt	3.91	3.93	4.04	3.80
High-grade spread (bps)	48	47	46	50
High-yield spread (bps)	236	233	204	229
US				
US fed funds	5.25	5.25	5.25	5.25
1m libor	5.32	5.32	5.32	5.35
3m libor	5.35	5.34	5.36	5.37
6m libor	5.31	5.29	5.39	5.38
2y swap	4.98	4.97	5.19	5.07
5y swap	4.93	4.93	5.11	4.98
2y govt	4.58	4.56	4.83	4.72
10y govt	4.54	4.51	4.71	4.59
High-grade spread (bps)	92	91	87	92
High-yield spread (bps)	288	285	259	298
Emerging market				
Global EM spread (bps)	191	194	174	187

source: Bloomberg, ML indices

Table 2: Interest rate and spread forecasts

	latest 15 Mar 2007	End Q2 2007	End Q3 2007	End Q4 2007	5-year avg.
US					
US fed funds target	5.25	5.25	5.25	5.25	2.50
2y govt yield	4.58	5.00	5.10	5.00	3.06
10y govt yield	4.54	4.95	5.05	5.20	4.38
High-grade spread (bps)	92	99	106	116	130
High-yield spread (bps)	288	307	329	363	570
UK					
BoE repo rate	5.25	5.50	5.50	5.50	4.25
2y govt yield	5.26	5.60	5.60	5.55	4.40
10y govt yield	4.79	5.15	5.15	5.15	4.63
Eurozone					
ECB refi rate	3.75	4.00	4.00	4.00	2.50
2y govt yield	3.90	4.10	4.25	4.40	2.88
10y govt yield	3.91	4.25	4.55	4.65	4.01

Client support

Economic Research Team
Trevor Williams

0207 158 1748

trevor.williams@lloydstsb.co.uk

Nichola James

0207 158 1741

nichola.james@lloydstsb.co.uk

Jeavon Lolay

0207 158 1742

jeavon.lolay@lloydstsb.co.uk

Kenneth Broux

0207 158 1750

kenneth.broux@lloydstsb.co.uk

Hann-Ju Ho

0207 158 1745

hann-ju.ho@lloydstsb.co.uk

Rabia Bhopal

0207 158 1747

rabia.bhopal@lloydstsb.co.uk

Stuart Frost

0207 158 1744

stuart.frost@lloydstsb.co.uk

Nikesh Sawjani

0207 158 1749

nikesh.sawjani@lloydstsb.co.uk

Distribution

Sarah Pedder, 0207 158 1746

Information Manager

Hugh Geen, 0207 158 1740

Customer sales

Andrew Willett

0207 158 1616

andrew.willett@lloydstsb.co.uk

John Haines

0207 158 1675

john.haines@lloydstsb.co.uk

Jeremy Hodges

0207 050 6006

jeremy.hodges@lloydstsb.co.uk

LloydsTSB Corporate
Markets,
Economic Research,
10 Gresham Street,
London EC2V 7AE

Switchboard:
020 7050 6045

that employment has risen by an average of 156,000 in the past three months, in line with trend growth, boosted by a buoyant service sector.

Thirdly, the massive rise in housing wealth in recent years should provide ample cushion against modest declines in house prices. According to S&P/Case&Shiller data, house prices have fallen in nine of the twenty metropolitan areas they cover (see chart d). However, there is no firm evidence to suggest that subprime delinquency rates in these areas are particularly high.

Chart e on the next page plots metropolitan areas with above-average subprime delinquency rates (data taken from First American LoanPerformance, as reported by Reuters on 14 March 2007) versus their respective latest annual house price inflation, according to official OFHEO data. Despite former Fed Chairman Greenspan's comments yesterday linking house prices and subprime mortgage problems, there seems to be little evidence of a strong negative correlation between house prices and subprime delinquency rates. Indeed, the relationship appears to be positive to neutral. At the aggregate level, we expect house prices to stabilise this year and begin to recover in 2008.

Overall, while previous episodes of higher mortgage delinquencies (prime and subprime) have tended to coincide with a downside in economic activity, we believe that consumers will be more resilient this time, because employment growth in the service sector is expected to remain strong.

Main risk: spillover effects via tighter credit conditions and a general rise in risk aversion

A key risk for the household sector is if the problems in subprime mortgage loans, mostly originated outside the banking sector, spill over into a tightening of mortgage lending standards by banks in the prime market. The concern, specifically, is that risk aversion leads to an overtightening of general credit supply to the household sector (and one can extend this to the supply of credit to the business sector).

Indeed, the latest Fed Q4 senior loans survey revealed that a net 16% of banks reported tightening credit standards on residential mortgage loans, which was the highest level since the early 1990s, see chart f. However, total mortgage delinquency rates have remained below the previous peak in 2001.

Aside from the impact on liquidity from bank lending standards, the other key risk is a reduction of liquidity in the financial markets resulting from a general rise in risk aversion, essentially a contagion effect. This means that, as risk aversion rises, the use of the abundant levels of liquidity in the financial markets seen in recent years will fall back, resulting in lower equity prices, wider

Chart a: Total mortgage delinquency rate has moved higher

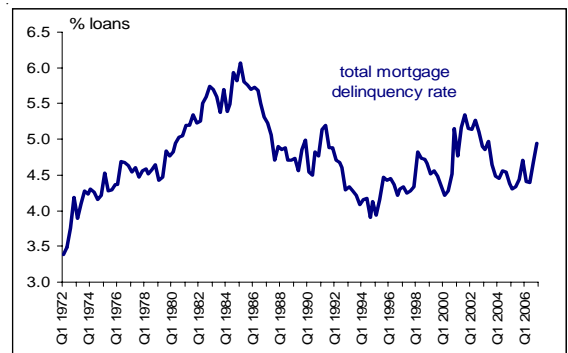


Chart b: Subprime delinquency rate has risen more quickly

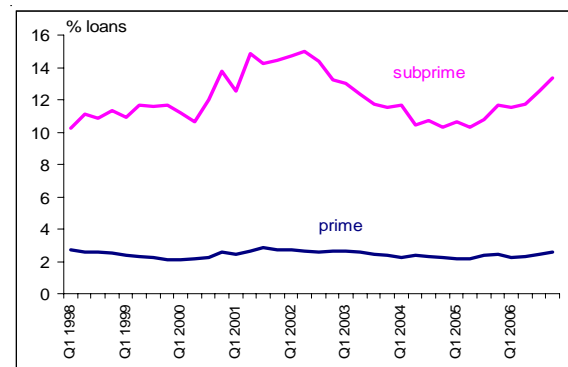


Chart c: US employment growth still strong, maintaining households' ability to service their debts

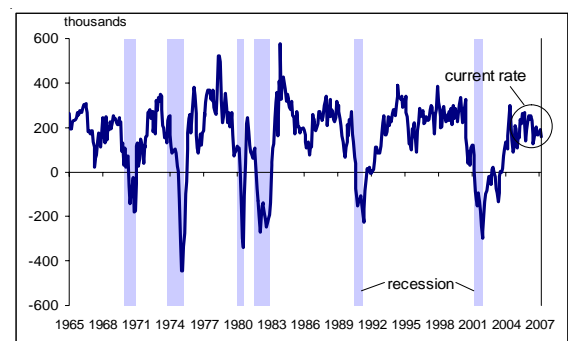
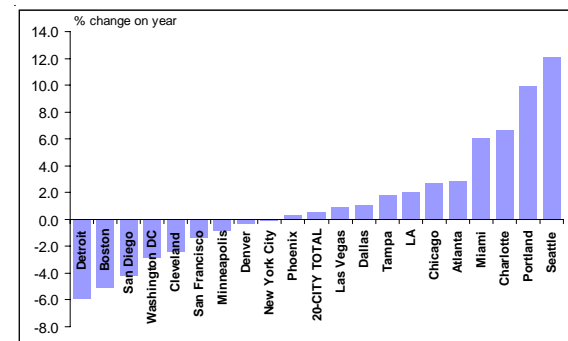


Chart d: House prices falling in some metropolitan areas (S&P/Case/Shiller data)



corporate spreads versus treasuries and possibly higher corporate default rates. We have already seen some evidence of this recently, see chart g.

However, we believe that the tightening of credit standards are precautionary, in case the quality of loans deteriorate significantly. With economic fundamentals remaining broadly strong for the household sector, we do not expect a broader 'credit crunch' to develop. Further, we could see delinquency rates stabilise towards the end of the year. Moreover, despite the risk of contagion, the financial markets have also responded effectively in recent months by reducing treasury yields and therefore mortgage rates, thus ensuring a sufficient supply of liquidity in the system and providing support to the housing market.

In summary

Overall, we believe that talk of higher subprime mortgage delinquency rates leading directly to weaker household consumption growth and overall economic growth in the US are exaggerated. The subprime market is a very small part of the total mortgage markets, consumers' balance sheets remain solid and households should be able to weather temporary falls in house prices, given the build-up of housing wealth in recent years. Further, metropolitan areas which have seen lower house prices recently do not appear to be the same areas which have high subprime delinquency rates.

Instead, the greater risk is the contagion effects of higher subprime delinquency rates into other asset classes not directly related. Such a general repricing of risk could lead to higher corporate spreads and default rates, which we have already factored in to our macroeconomic forecasts. Further, banks have already reported tighter credit lending standards for traditional (mainly prime) mortgages and the risk is that they overtighten lending standards, leading to a credit crunch.

However, we expect the prime market to remain strong and delinquency rates may peak later this year. This potentially could lead to some interesting trading opportunities, as these trends become clearer over the course of the year ahead.

Hann-Ju Ho, Senior Economist

Chart e: But no strong negative correlation between house prices and areas with above-average subprime delinquency rates

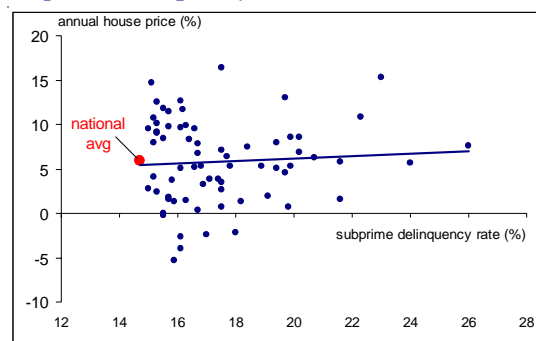


Chart f: Tighter bank lending standards could be a greater risk for the wider economy

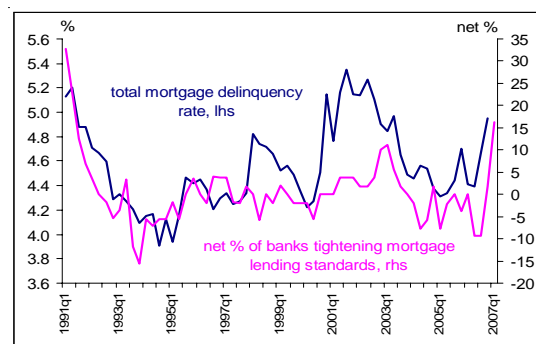
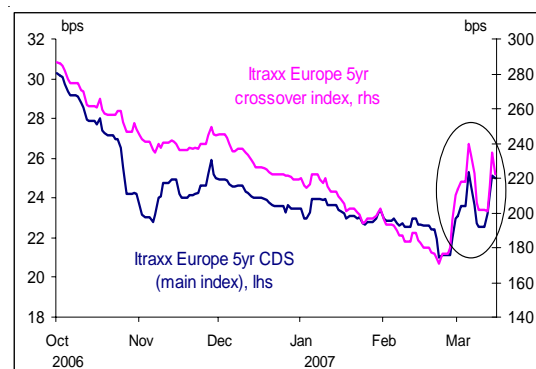


Chart g: Credit default swaps have risen in response to a rise in general market risk aversion



* All data and charts are sourced to Lloyds TSB Corporate Markets Economic Research, Merrill Lynch, iTraxx, Reuters, Mortgage Bankers Association and Bloomberg.

Any documentation, reports, correspondence or other material or information in whatever form be it electronic, textual or otherwise is based on sources believed to be reliable, however neither the Bank nor its directors, officers or employees warrant accuracy, completeness or otherwise, or accept responsibility for any error, omission or other inaccuracy, or for any consequences arising from any reliance upon such information. The facts and data contained are not, and should under no circumstances be treated as an offer or solicitation to offer, to buy or sell any product, nor are they intended to be a substitute for commercial judgement or professional or legal advice, and you should not act in reliance upon any of the facts and data contained, without first obtaining professional advice relevant to your circumstances. Expressions of opinion may be subject to change without notice. Although warrants and/or derivative instruments can be utilised for the management of investment risk, some of these products are unsuitable for many investors. The facts and data contained are therefore not intended for the use of private customers (as defined by the FSA Handbook) of Lloyds TSB Bank plc. Lloyds TSB Bank plc is authorised and regulated by the Financial Services Authority and is a signatory to the Banking Codes, and represents only the Scottish Widows and Lloyds TSB Marketing Group for life assurance, pension and investment business.