Subprime Lending: Current Trends and Policy Issues

by Kenneth Temkin

Subprime lending, due to its growth over the past decade, is coming under more scrutiny by consumer groups, regulators and policy analysts. Many mortgage market observers are uneasy about some of the features associated with this type of lending, particularly the use by lenders of aggressive marketing techniques, and the relatively high interest rates and fees charged to borrowers receiving subprime loans.

In response to these issues, states are considering adopting laws that will prohibit certain practices. Some of these statutes will be based on the state of North Carolina's recently adopted anti-predatory lending law, which places restrictions on the points and fees lenders are allowed to charge borrowers and limits the size of allowable prepayment penalties. Subprime lenders claim that only a small proportion of companies engage in predatory lending, and the recent publicity about questionable practices provides a distorted picture of subprime lending.

It is difficult for people to judge which side in this debate is correct. Subprime lending, despite its growth, is still not well understood, and has not been systematically studied to the extent that policy makers need to inform their decisions. The purpose of this article, then, is to provide a primer on the industry in order to provide basic information about the structure of the subprime lending industry, and the factors that have led to its growth. This paper 1) defines the subprime market; 2) provides data about the size of the market; 3) analyzes who is served by the subprime market 4) identifies trends that have influenced its growth; and 5) discusses the credit terms offered to subprime borrowers.

Definition

What is subprime lending? At its most basic level, subprime lending is usually defined in terms of what it is not, rather than what it is. Simply put: it is not prime lending. Prime mortgages are originated to borrowers who meet the underwriting standards used by commercial banks, mortgage companies and thrifts. And since so many loans are sold to the secondary market, Fannie Mae's and Freddie Mac's underwriting guidelines related to downpayment requirements, front- and back-end ratios, credit history, among others, are used throughout the prime industry. Moreover, many lenders are using Fannie Mae's and Freddie Mac's automated underwriting systems, which provide an even greater level of standardization in the prime market.

In addition to a high degree of underwriting standardization, prime lenders readily provide information about interest rates and points offered to borrowers in the newspaper, through television and radio advertisements, and via the Internet. As a result, prime borrowers are able to shop around for the best deal, and have choices related to balancing

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lower interest rates with higher up-front costs. Given these two characteristics – a high level of underwriting standardization and available pricing information – most observers consider the prime mortgage market to be efficient: borrowers receive the best price possible, and their loan applications are evaluated using criteria that relate to loan payment performance.

The subprime market is very different from the prime market described above. In general, subprime borrowers do not meet prime market underwriting standards developed to screen out applicants who represent a relatively bad credit risk to the lender. In general, subprime borrowers represent higher risks because 1) they have relatively poor credit histories, 2) they have mortgages with very high loan-to-value (LTV) ratios, and 3) they are unable to document all of the information on their loan applications. Given these differences, what types of loans are made in the subprime market?

- First, subprime lenders serve "credit-impaired borrowers" who typically have a credit score below 620. Empirical evidence indicates that loans originated to borrowers with a FICO score less than 620 exhibit much higher delinquency rates. Since credit-impaired borrowers have low credit scores, these borrowers are offered loans only if they have a relatively large amount of equity in their home. This equity offsets the risks associated with lending to credit-impaired applicants. While most borrowers in the prime market have a FICO score over 620, and 61 percent have a FICO score over 720, the average credit score for credit-impaired borrowers receiving subprime loans is less than 600.
- Second, subprime lenders originate "high LTV loans." This segment of the subprime market has grown considerably since 1993. In general, these mortgages have an LTV over 100 percent, and sometimes even as high as 150 percent. Since borrowers with a high LTV mortgage tend to have higher default rates, subprime lenders typically originate high LTV mortgages to borrowers who are good credit risks. In general, lenders do not originate high LTV mortgages to a borrower with a FICO score less than 630; the average FICO score for high LTV borrowers is between 670 and 680.
- The third type of subprime lending, called "Alt A," or "low-doc," is targeted to borrowers who are good credit risks, but cannot document all of the information on a loan application. Self-employed borrowers, or those who work in industries in which tips provide a large share of income, cannot or do not want to document all of their income. Therefore, their documented income is lower than that reported on a loan application. In general, though, Alt A borrowers are good credit risks: nearly 43 percent of Alt A borrowers have a FICO score over 720, compared to 61 percent among prime borrowers.

The point here is that subprime borrowers do not necessarily have low FICO scores. High LTV loans are only originated to borrowers with good FICO scores, and Alt A borrowers look more like prime borrowers than subprime borrowers. Nonetheless, subprime borrowers are more risky: they either have lower FICO scores, higher LTV loans, or income that cannot be documented by the underwriter.

Since subprime borrowers are more risky, they pay more for mortgage finance. But, unlike prime borrowers, it is difficult for subprime borrowers to shop around for better deals because subprime lenders do not advertise their rates. In addition, the underwriting guidelines in the industry are not standard: different companies evaluate risk using their own rules. Borrowers are usually quoted monthly payments, not loan terms. Therefore, a borrower will be told: "We'll lend you 'X' dollars to use, and it will only cost you 'Y' dollars per month." The borrower may never ask what effective interest rate he or she is being charged.

In summary, subprime lending represents a segment of the mortgage market that serves borrowers who do not qualify for prime loans for any number of reasons. In fact, even industry participants use different names: home equity lending, B & C lending, or sometimes "nonconforming." Subprime lending is really a term that captures all of these, and can obscure differences across the market.

Size of the market

There are no data sets that measure subprime lending as a separate activity. The most quoted figures are those generated by HUD, which measures subprime lending activity using Home Mortgage Disclosure Act data. These measures are not perfect: HMDA data is self-reported by lenders, and does not capture information from all types of lenders. Moreover, HMDA does not contain information about the rates and terms of the loans. Nonetheless, HMDA remains the best source of information about lending, but bear in mind that the figures presented below represent estimates, not precise measures of subprime lending activity.

Caveats aside: how big is the subprime market? Big, and it's growing. In 1998, HUD identified 236 subprime lenders, up from 21 in 1993. Industry participants estimate $150 billion worth of subprime mortgages were originated in 1998, up from only $25 billion in 1993. This growth rate of 500 percent is obviously much greater than in the prime mortgage market. The number of subprime home purchase mortgages increased 762 percent between 1993 and 1998, from 24,000 to 207,000. Over the same period, the number of conventional prime loans increased only 41 percent, from 2.2 million to about 3.1 million. The same pattern is found for refinance mortgages. Subprime refinance mortgage originations increased almost 890 percent between 1993 and 1998, from 80,000 to 790,000. This increase is in sharp contrast to prime refinance volumes, which increased only 2 percent between 1993 and 1998 from 5.2 million to 5.3 million loans. Moreover, subprime refinance loans have increased in every year, despite changes in interest rates, which drive prime refinance activity.

Who originates these loans? No one company dominates the subprime market. The Money Store is the largest lender: it originated 8 percent of all subprime loans in 1998. The next nine companies: WMC mortgage, United Companies Lending; Headlands Mortgage; Ameriquest; Equicredit; New Century; First Union Home Equity Bank; and Banc One Financial Services, originated about another 27 percent of subprime loans. Overall, then, the top ten subprime lenders originated about a third of all subprime loans issued in 1998. The industry has consolidated since 1998: the Money Store is now owned by First Union.

Who is Served by these Lenders?

HUD's figures show one clear pattern: the subprime market disproportionately serves African-American and Hispanic borrowers. Among borrowers in the prime market, only 3.4 percent of home purchase loans were originated to African-American borrowers, 4.1 percent were originated to Hispanics. African-Americans, in contrast, received nearly 2 percent of subprime home-purchase loans in 1998, Hispanics received almost 8 percent of them. African-Americans and Hispanics, then, received roughly one in five subprime home-purchase loans originated in 1998, as opposed to less than one in 10 prime home-purchase loans.

This discrepancy is even greater for refinance mortgages. African-Americans received less than 3 percent of prime refinance mortgages in 1998, the Hispanic proportion was just over 3 percent. African-Americans, however, received almost 13 percent of all subprime refinance mortgages, while the proportion of subprime refinance mortgages originated to Hispanics was just over 4 percent.

Moreover, in a study of Chicago lending patterns using HMDA, analysts found that subprime loans were much more likely to be originated in predominantly minority neighborhoods. In 1998, less than 10 percent of home-purchase loans originated in Chicago neighborhoods that were more than 85 percent white were subprime; almost 30 percent of home-purchase loans in neighborhoods that were 75 percent or greater African-American were subprime. Similarly, almost 60 percent of refinance loans originated in 1998 in predominantly black neighborhoods were subprime, six times the proportion in mostly white neighborhoods.

These patterns, according to Immergluck and Wiles, authors of the Chicago study, indicate that the mortgage finance system is hypersegmented: minorities are increasingly being served by subprime lending companies that are concentrating their activities in neighborhoods with a high concentration of African-American and Hispanic residents. Alarmingly, this type of lending activity is growing at a rate far above that of the prime market.

Reasons for Subprime Market Growth

What are the factors that explain the phenomenal rate of growth in the subprime market? One major factor is that consumers are increasingly relying on subprime mortgage loans as a cheaper source of credit than unsecured debt, such as revolving credit cards. Therefore, the demand for subprime loans has increased, especially as consumers have increased their use of credit cards. At the same time, lenders realized that they can make money in this business, and have stepped-up their efforts, through new products and more aggressive marketing, to serve this need. Finally, lenders have been able to sell subprime loans to investors in the form of mortgage-backed securities, which provides the industry's liquidity.

In part, subprime lending represents the flip side of the successful changes in the prime market during the 1990s that have increased home-ownership rates for lower income and minority borrowers. Prime home-purchase mortgage originations to African-Americans increased 47 percent between 1993 and

1998, from about 72,000 loans to almost 110,000. The growth rate for Hispanics was about the same, increasing 50 percent from 87,000 loans in 1993 to 130,000 in 1998. These gains far outpaced the overall conventional prime home-purchase mortgage market, which grew only 37 percent over that time period.

Not only are there more homeowners, there are also higher levels of consumer debt, including credit cards and medical bills. The relatively high interest rates charged by credit card companies and other creditors make home equity loans appealing, even though borrowers in the subprime market pay interest rates between 200 and 600 basis points higher than prime borrowers, depending on their risk.

Subprime borrowers are usually categorized into risk classifications (or buckets) that range from A-minus (denoting a level of risk just below prime borrowers) to D, which represents a high level of risk. Borrowers rated as a D risk may have had a recent bankruptcy, or have been 30 days late on their mortgage six times in the last year. In contrast, A-minus borrowers have FICO scores between 600 and 620, and have had only one 30-day late mortgage payment in the past year. About 50 percent of borrowers in the subprime market are categorized as A-minus; currently, they receive loans at rates of 10 percent (200 basis points over prime borrowers). While this is a high rate, it compares favorably to an 18 percent credit card.

Moreover, lenders are making money, even lending to higher-risk borrowers. The premium interest rates allow lenders to cover losses associated with higher-risk borrowers, and the largest companies make money on the transaction associated with packaging the loans into mortgage backed securities, which are sold to investors. While some subprime lenders have been purchased due to weak financial performance, the remaining companies continue to earn profits. These profits, to a great extent, are based on the ability of subprime lenders to generate high volumes of loans, since such companies earn fees at origination, and also realize gains when packaging the loans into bonds. This creates an incentive for companies to take aggressive steps, through marketing, to reach as many borrowers as possible.

Do Subprime Loans Accurately Reflect Risk?

Subprime lenders argue that subprime debt serves a need: it provides a cheaper alternative to unsecured credit, and the higher prices charged to borrowers are justified by the higher risks associated with subprime lending. A key question to be answered is this: Are borrowers paying prices that represent their true level of risk? Or, are borrowers taking out loans that have costs in excess of the risks they represent, and could some receive prime loans? In a recent study, Freddie Mac analysts found that borrowers in the subprime market were more risky. However, they also calculated that subprime borrowers, on average, pay interest rates that are in excess of their risks. This provides some evidence that the subprime mortgage market is inefficient, and borrowers are not receiving the lowest possible rates. But, more work needs to be done in order to determine if the subprime market is inefficient, and which policy interventions will succeed in decreasing the costs associated with subprime loans. ▪

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