

Pre-Crisis Subprime Trends

Subprime has been developing as an industry for over twenty years and during that time it has naturally changed its focus. In this section, we'll look at various aspects of the subprime industry to see just how fluctuation in each area can snowball into a big change overall.

Loan Grades

Lenders have divided borrowers into six categories (A+, A, A-, B, C & D) according to the level of risk associated with the loan. Factors such as the loan to value ratio, debt to income ratio, down payment available and credit history determine what category a borrower fits into. The A+ and A categories are considered prime borrowers and they qualify for the best interest rates. The remaining categories are taken care of by subprime loans. Lenders are understandably risk-averse and have always favored the categories that have the least chance of going wrong.

It is a common misconception that the subprime mortgage crisis is largely due to loans being extended to borrowers with extremely poor credit. While those that qualify for subprime mortgages don't have the best credit, there are many, many other factors that contributed to the present crisis. In fact, loans made to A- borrowers, the least risky subprime category, increased from slightly over 50 percent in 1995 to roughly 84 percent in 2003, meaning subprime lenders became increasingly risk adverse over time.

Credit Scores

The Fair Isaac Corporation, better known as FICO is responsible for measuring consumer credit worthiness. A FICO score ranges from 300 to 850 points and changes as a consumer's credit status gets better or worse. According to a 2006 report in the Federal Reserve of St Louis Review, the average credit score declined each year throughout the 1990s but since 2000, credit scores have shown a trend towards improving. In fact, as of 2004, the gap between the average subprime and conventional credit score was just 18 points. (651 vs. 669).

In 1995, the percentage of subprime loans given to borrowers with a FICO score of 500 or less was approximately 70 percent. A decade later, this figure had shrunk to approximately seventeen percent. The fastest growing segment was borrowers with a score between 600 and 700.

Down Payment

Lenders generally require a down payment to minimize their risk. Who wouldn't? Let's be honest here. Would you just give someone \$200,000 if they hadn't bothered to make any investment of their own? It's a case of the bigger the better and borrowers who are able to provide a significant initial down payment are rewarded with a lower overall interest rate for the life of the mortgage. During the early days of subprime lending, in the 1990s, companies tended towards lower and lower down payments. Like FICO scores, after 2000 the amount borrowers were paying down on their mortgages has increased each year thus reducing the risk to the lender.

It seems logical that a high credit score and high down payment would go hand in hand. While this is true at the highest level (FICO 800+), there is otherwise very little correlation between these two factors. This is mostly due to the fact that lenders require a larger down payment from borrowers in lower loan grades in order to compensate for the higher risk of default.

Interest Rates

The prime interest rate, set by the Federal Reserve Bank, went down nearly three percentage points between 1995 and 2003. Subprime lenders have followed this trend and reduced interest rates from ten percent to seven over the same time period. There is a spread of three percent between borrowers with the highest and lowest FICO scores. This may not seem like much but can easily turn into hundreds of thousands of dollars depending on the term and amount of the loan. For example, a 30-year fixed rate mortgage of \$200,000 taken out at a rate of seven percent costs just over \$479,000 when the interest paid is added on. The same loan taken out at ten percent ends up costing just under \$632,000, a difference of \$153,000 or 77 percent of the original amount borrowed!

The difference between loan grades (approximately three percent) is much more substantial, proving that there is more to loan qualification than credit history. Borrowers who are granted loans greater than the value of the property they are purchasing pay a substantial premium (roughly four percent) for the privilege. To see what a difference this makes, let's have a look at three common scenarios. In order to show how much of a difference this interest premium makes, I have kept all other details the same.

Scenario 1

John and Marta are newly married and dying to get out of their dingy apartment and into a proper house, with a yard, garage, room for guests and, sometime soon, little

ones. They find a great little starter home on the market for \$129,900 but are concerned that their lack of down payment will be a problem when securing the mortgage.

Their broker assures them that it's not and for a slightly higher rate of interest (10.5 percent), they can even get a loan for \$138,000 to help cover closing and moving costs. If they go through with this mortgage, the total cost of their house over 30 years will be \$454,442.38.

Scenario 2

John and Marta are newly married and dying to get out of their dingy apartment and into a proper house with a yard, garage, room for guests and, sometime soon, little ones. They have a look at the housing market but decide to stay in their apartment and save up for a down payment. After a year, they have managed to save \$10,000 and have found a great little starter home listed at \$132,900.

Their broker tells them that they qualify for a mortgage of \$125,000 at a rate of 8.5 percent. At the end of their 30-year term, they will have paid \$346,000 for their house.

Scenario 3

John and Marta are newly married and dying to get out of their dingy apartment and into a proper house with a yard, garage, room for guests and, sometime soon, little ones. They have a look at the housing market but decide to stay in their apartment and save up for a down payment. After two years, they have managed to save \$25,000 and have found a great little home listed at \$135,900.

Because of their substantial down payment and good credit score, John and Marta easily qualify for the \$110,000 they need to buy their house with a very favorable interest rate of 7 percent. At the end of their 30-year fixed term mortgage, they will have paid \$275,000 for their house, just under half as much as they would have paid had they bought immediately.

Each family has their own set of circumstances which will dictate how long they are able to save for a down payment but I felt it was important to show you how much of a difference interest rates can make over the life of your mortgage.

Predatory Lending

We'll talk about this in more detail further on in the book, but it is important to mention the ugly side of subprime here, since it is part of the story. Predatory lending refers to the practice of purposefully seeking out borrowers who lack the financial knowledge to make an informed decision about their mortgage with the hopes of securing a commission or profiting from extra fees.

Opponents of subprime claim that the whole practice is predatory since it is aimed at people who don't have a solid credit history. Common predatory lending practices include:

- prohibitively high prepayment penalties
- aggressive recruitment
- not responsibly outlining a prospective borrower's financial situation
- offering extremely low rates in the first two year to tease borrowers into taking on the loan
- encouraging loan flipping or constant refinancing.

The human imagination knows no limit when it comes to coming up with ways to profit from others. One of the more outrageous predatory practices reported recently in the Globe and Mail was a Cleveland building inspector falsifying documents to say that a home needed repairs. A few days later, conveniently, a mortgage broker would come by offering a cash-out refinance of the mortgage to help pay for the repairs.

Most scams are not this overt but it does illustrate the need to really research your mortgage broker and make sure you trust their knowledge. You wouldn't marry someone you talked on the phone to for twenty minutes would you? Then don't choose your mortgage broker that way. All I'm saying is that there aren't many other relationships in life that require you to pay \$10,000-\$20,000 and end in you being legally bound for 30, 40 or 50 years, so be careful.

Profile: The Subprime Borrower

Subprime loans are used to buy a car, pay for living expenses, remodel a currently owned residence or pay down a high interest credit card. By in large, however, the reasons people borrow money is to purchase a home or refinance their existing mortgage. It may come as a surprise considering the current mess the industry is in but according to a fact sheet published in November 2007 by the Center For Responsible Lending, **subprime mortgages account for just 14 percent of all outstanding home loans.** In this section, we're going to have a look at eight factors that make up a borrower's overall mortgage eligibility. While every person and situation is different, it is possible to put

together a general profile of the average subprime borrower to better acquaint you with just who exactly makes up that 14 percent.

Down Payment

Generally speaking, the typical subprime borrower does not have a substantial down payment saved. This, combined with less-than-exemplary credit rating, is a major reason why they do not qualify for a prime loan in the first place. Loan To Value Ratio (LTV) is a key part of determining what interest rate the borrower is qualified for. Mortgages for one hundred percent or more of the home's purchase price are possible but attract a premium of up to four percent interest on top of the already inflated subprime rates. Borrowers who have saved even a 5 percent down payment can access loans at a reduced interest rate.

Credit Profile

Most potential borrowers think their credit score is what determines their loan eligibility. While it does allow the lender to quickly get an idea of the risk involved, your credit score is not the only determining factor. Because other factors (like down payment and debt to income ratio) are taken into consideration, there is no fixed cutoff point to determine whether a borrower qualifies for a prime or subprime loan. As a general guideline, most subprime borrowers have a credit score of 620 or lower. In 2005, it was estimated that 15 to 50 percent of subprime loans went to borrowers whose credit scores indicated that they qualified for prime loans. Most likely, the reason these borrowers were not able to access a prime loan is their high debt to income ratio due to a large amount of consumer debt.

Equity

There are two distinctly different types of subprime borrowers: those that are buying a home for the first time and those that are refinancing existing mortgages for a more favorable interest rate and/or cash-out. Those that are buying for the first time, have no equity, since they have not yet purchased anything. Borrowers who are refinancing generally have at least some equity although likely not a lot, since a loan near the end of its term is less likely to be refinanced.

Subprime borrowers also commonly gamble with their equity by getting a cash-out refinance, which means they borrow against equity they have already accrued. Basically, it's like using your house as a credit card. In simpler terms, a homeowner who has paid \$50,000 out of his \$150,000 mortgage decides to refinance at a more favorable interest rate

with an additional \$20,000 in cash to put in a new kitchen. Doing this reduces his equity to \$30,000, meaning if he were to sell the house immediately, he would only clear \$30,000 from the \$150,000 sale price. Most people refinance to make capital improvements to their property with the hopes of increasing its value when it comes time to sell but this practice can be a slippery slope. Many people get into trouble when they make refinancing a habit because they get used to having more money than their income allows.

Assets

Originally, subprime lending was a way for homeowners to buy a second home or vacation property, so in its original form subprime borrowers usually had quite healthy asset portfolios. Over the past ten years, as subprime lending has migrated to the lower income portion of the real estate market, borrowers have tended to have very few assets aside from a car and household possessions.

Debt to income Ratio

This is an important factor in determining a borrower's prime or subprime status. In context, debt refers to the amount of fixed monthly expenses. This includes credit card payments, car payments and any other binding financial commitments. The reason this ratio is so important is that banks will generally not authorize a mortgage payment that pushes the total amount of monthly debt (including the mortgage payment) over 38 percent.

Subprime borrowers almost always have an debt to income ratio of more than 38 percent. Lenders that specialize in subprime mortgages allow a much higher ratio, sometimes as high as 60 percent. A high debt to income ratio isn't restricted to borrowers at the lower end of the income scale because it is based on percentage rather than a fixed amount of money. In 2005 credit constrained borrowers with substantial wealth were most likely to finance the purchase of a home by using a subprime mortgage

Type of Property

This is the most difficult of the categories to generalize and really, all that needs to be said is that subprime borrowers don't live in gated communities, condos or mansions on the hilltop. Typically, they live in working class neighbourhoods made up of small, post-war single-family homes or, in more urban areas, row houses and multifamily dwellings. Borrowers with larger homes are usually those who have refinanced an existing mortgage to either get cash out or a lower interest rate. As we discussed in the Assets section, a subprime borrower's house is almost always the only real, non-depreciating asset they have.

Ethnicity

This is a factor that most people would rather not talk about, but according to a 2008 article in the *Globe and Mail*, the truth is that three times out of four, a subprime borrower will be Hispanic or African-American. Cleveland has become the touchstone city of the mortgage market collapse. The city is primarily working class with an ethnicity split of 51 percent African-American, 41 percent white and seven percent Hispanic. In 2005, nearly 60 percent of loans taken out by African-Americans in Cleveland were classified as high-cost. The percentage of white people who got high-cost loans, was 34

This correlation holds true even after outside factors such as income, size of loan and property location are taken into consideration. What this means, in real terms, is that if you had two groups of one hundred people equal in every way aside from skin color, 60 members of the African-American group would have taken out high-cost loan while only 34 members of the white group would have done the same.

While subprime borrowers tend to be in a lower income bracket than their prime counterparts, studies have shown that even high-income African-American and Hispanic families were more likely to have taken out a high-cost loan than their white counterparts. This discrepancy is not just in Cleveland. Studies have shown similar trends in New York, Washington DC, Philadelphia, Baltimore and Boston.

This trend became a huge issue when the mortgage market collapse finally became unavoidable in 2006. Stories of predatory lending, brokers targeting known minority neighbourhoods and brokers working in collusion with corrupt building inspectors started to appear in newspapers. Of course, it must be pointed out that there are many other explanations for these figures aside from out and out racism, most of which have to do with discrepancies in education and differences in social customs in various subcultures. This is such a complex issue that it really needs its own book (not to mention a PhD thesis) to do it justice.

Gender

Single women, often with children, are one of the fastest growing groups of homeowners in recent years. In Baltimore, this demographic group accounted for 40 percent of home sales in 2006, twice the national average. Nearly half of these homes were bought with subprime mortgages.