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the Value of Subprimes

By James P. Gaines

Unprecedented growth in U.S. homeownership, from 64 percent in 1995 to more than 69 percent in 2006, resulted from substantially lower mortgage interest rates and drastically relaxed, "easy credit, easy terms" mortgage lending practices (Figure 1). The widespread availability of nontraditional, higher-risk mortgage products spurred previously excluded homebuyers to enter the market despite poor credit histories, irregular employment or lack of a down payment.

High-risk mortgage instruments are estimated to make up 25 percent or more of all mortgage loans originated since 2001. An estimated 10 million to 12 million subprime loans have been originated since 2003, and at least two-thirds of those carry adjustable rates. Subprime mortgages are designed for lower-income households with low credit scores and feature higher loan-to-value ratio loans with significant prepayment penalties (Table 1).

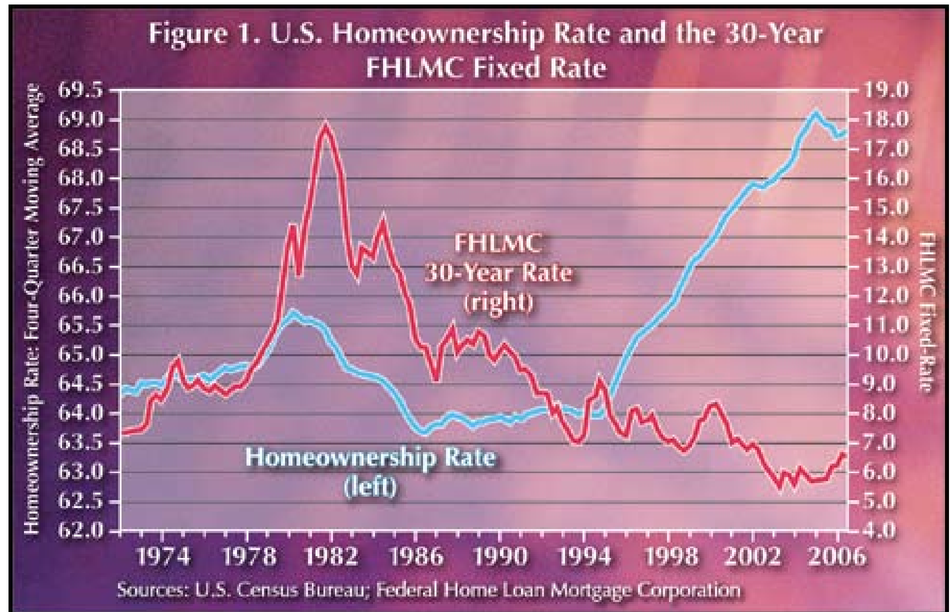
Table 1. Loan Characteristics by Type of Loan: 2005

Sector	Average Loan Amount ($K)	Average FICO Credit Score	Loan-to-Value Ratio	Percent Full Doc	Percent Prepayment Penalty
Prime Fixed	$499	742	70.6	54.7	1.7
Prime ARM	$453	732	73.9	44.3	15.4
Subprime Fixed	$128	636	81.2	70.2	76.6
Subprime ARM	$200	624	85.9	56.9	72.4

Source: Bear Stearns, Loan Performance, as published in "The Residential Mortgage Market and Its Economic Context in 2007," Mortgage Bankers Association.

Residential lending practices during the past five years ventured beyond merely aggressive into predatory and illegal. Numerous lawsuits have been filed and more are expected against companies accused of predatory lending, fraud and misrepresentation.

Some originators steered borrowers into loans that were more expensive and had a higher risk than necessary. Preclosing "good faith" cost estimates often proved to be either misleading or so complicated that borrowers could not understand them. Borrowers were sometimes told not to worry about individual costs and fees because they would be rolled into the loan.



Millions of people bought homes who might not otherwise have done so. Some were victimized by illegal practices; many were unprepared and ill-equipped for the financial responsibilities of homeownership. Some believed these alternative loans were their only chance to own a home and wanted to take the risk.

Essentially, subprime loans replaced government loans for many low-income, first-time buyers. Since 1998, FHA and VA loans have declined from 30 percent to less than 10 percent of the residential market; subprime loans have increased from less than 2 percent to more than 14 percent of the total market (Figure 2). Major home builders relied on the expanded affordability created in the market. The National Association of Home Builders (NAHB) estimates that two-thirds of the top 200 home builders had mortgage finance subsidiaries making subprime loans, and the rest had relationships with lenders in the subprime market.

By definition, subprime and other nontraditional mortgage products are high-risk loans. Adjustable rate mortgages, which have been available for decades, typically carry more risk as borrowers must pay higher mortgage payments if interest rates go up. Inevitably, market realities catch up and high-risk investments fail at considerably greater rates than moderate- or low-risk investments. Increased delinquency and foreclosure rates reflect this reality.

Foreclosure Activity

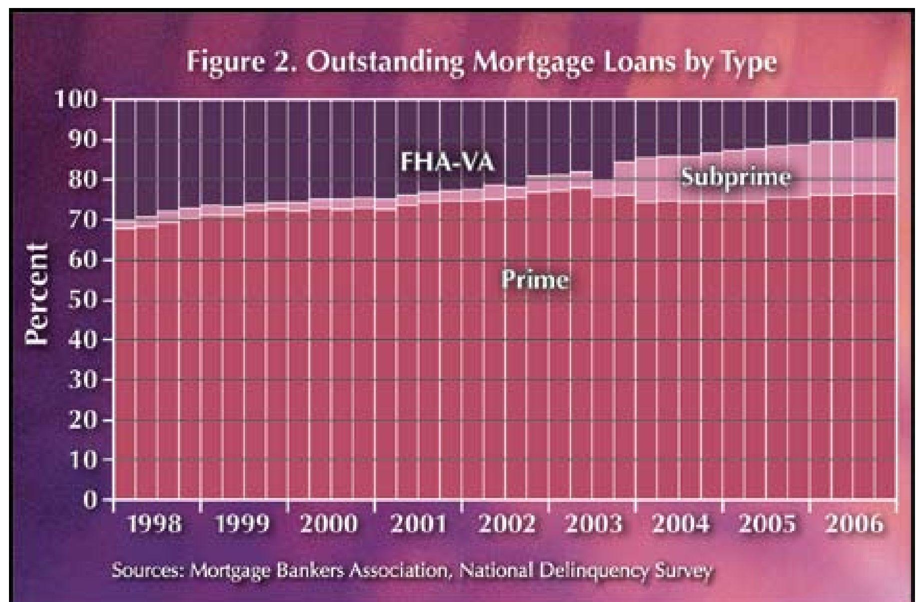
According to the Mortgage Bankers Association (MBA), by the end of 2006 the subprime mortgage foreclosure rate was nine times greater than prime loan foreclosures — 4.5 percent versus 0.5 percent. About 14.3 percent of subprime loans were between 30 and 90 days delinquent compared with 2.8 percent of all prime loans. An estimated 1.2 percent of all mortgages in the United States were in foreclosure by the end of 2006; 5.3 percent were between 30 and 90 days delinquent.

Texas' foreclosures and delinquencies ran slightly higher than the U.S. figures. An estimated 1.2 percent of all Texas mortgages were in foreclosure and 7.4 percent were 30 to 90 days delinquent. About 4.3 percent of all Texas subprime loans were in foreclosure by the end of fourth quarter 2006, approximately 8.5 times more than the 0.5 percent of prime loans.

Another 15.8 percent of all Texas subprime loans were 30 to 90 days delinquent at the end of 2006 compared with 3.4 percent of prime loans. Current foreclosure and delinquency rates at both the state and national levels are not significantly different than the respective nine-year average rate (Figures 3 and 4).

Although the MBA did not separate prime and subprime loans until 1998, the data clearly reveal the greater risk of subprime compared with prime loans. Since 1998, U.S. foreclosures on subprime loans averaged 5.7 percent compared with 0.5 percent for prime loans (Figure 3). Subprime delinquencies and defaults averaged 12.1 percent compared to 2.4 percent for prime loans.

The current national subprime foreclosure rate of 4.5 percent is less than half the peak rate reported in fourth quarter 2001 and 21 percent less than the eight-year average. Texas foreclosure and delinquency rates are running about equal to their



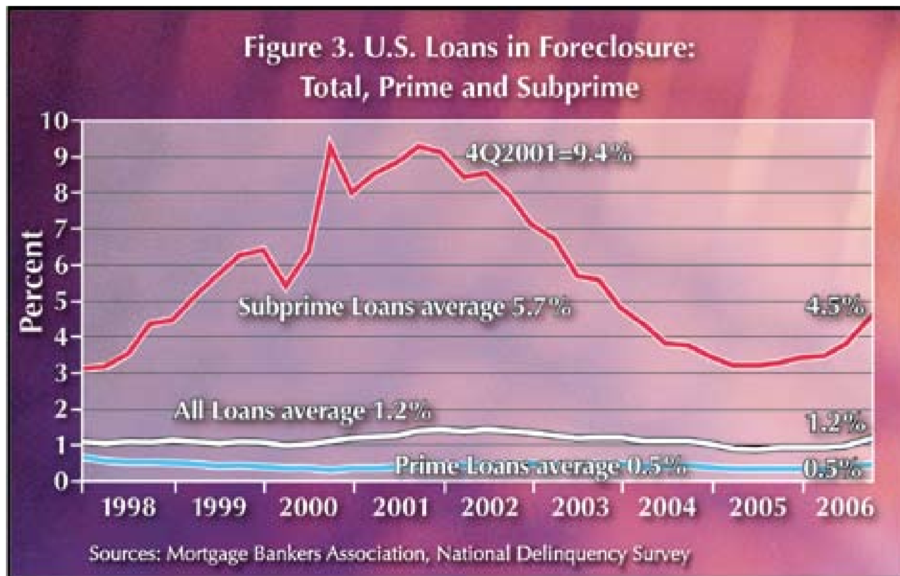
eight-year averages. The current 4.3 percent foreclosure rate is nearly 40 percent less than the peak foreclosure rate reported in fourth quarter 2002. The real difference in the peak and current foreclosure rates, though, is the substantially greater number of subprime loans today versus 2001 and 2002.

Assuming a total of 12 million subprime loans, the eight-year average level of delinquencies and foreclosures suggests that about 1.45 million loans will go into delinquency and about 684,000 into foreclosure. If the subprime foreclosure rate climbs to 10 percent or 15 percent, 1.2 million to 1.8 million loans will be vulnerable to foreclosure.

Even at these high rates, however, between 10.2 million and 11.3 million loans *would not* be foreclosed, and those homeowners would continue living in the homes they might never have been able to purchase if not for subprime loans.

Foreclosure Causes

The relatively high level of current foreclosures can be traced primarily to a few major, interrelated financial and residential market factors.



- Relaxed credit underwriting in general and, specifically, the spurt of subprime loans expanded home affordability, making home loans available to higher-risk borrowers.
- Attractive loan terms and new home-loan products allowed borrowers to buy homes with little or no down payment, often with monthly mortgage payments equal to a much higher percentage of monthly income than in the past.
- Level or falling home prices in many markets reduced or eliminated homeowners' ability to refinance or sell their properties on delinquency or default, resulting in increased foreclosure actions.
- Overextension of credit at attractive terms to nonresident investor buyers who sought short-term price increases but lacked carrying capacity over time.
- A significant portion of adjustable rate mortgages, both prime and subprime, with interest rate resets occurring this year (and next). Some loans had initial "teaser" rates as low as 1 percent, so in some cases the rate after adjustment increased by 4, 5, 6 or more percentage points.
- Spikes in other housing costs, especially property taxes and utilities, raised total monthly housing costs and stretched borrowers' capacity to make monthly mortgage payments.
- Layoffs in the auto industry dramatically affected housing markets in the upper midwest, leading to falling home values and higher foreclosure rates.

First American CoreLogic Inc., in its 2007 report, "Mortgage Payment Reset: The Issue and the Impact," analyzed the potential effects of interest rate reset changes on residential adjustable rate mortgages and concluded that 32 percent of teaser loans (those with initial interest rates significantly below the prevailing market rate), 7 percent of market-rate adjustable loans, and 12 percent of subprime loans will default because of resetting interest rates.

The study further concluded that each 1 percent rise in national prices causes 70,000 fewer loans to be lost to reset-driven foreclosure, and each 1 percent fall in national prices causes an additional 70,000 loans to enter reset-driven foreclosure.

What Should Be Done?

Despite the fact that the current subprime foreclosure rate is less than half the peak rate reported during the 2001 recession, media coverage devoted to expected foreclosure levels in 2007 and 2008 has garnered considerable attention. Responses by numerous organizations and government officials range from advocating a complete federal bailout of subprime borrowers and lenders to calls for greater aid to delinquent borrowers to lender forbearance. One state official seriously suggested a six-month moratorium on all foreclosures.

A recent NAHB survey found that among the larger home builders (companies in the *Builder* 200), current tighter mortgage lending standards, not only for subprime but also for other specialty loans and prime loans, have led to a significant decline in sales volume. The reported median sales volume impact was an estimated 10 percent decline in sales volume so far.

So, what should be done about subprime lending?

First, there is no reason to overreact and kill something that has served, and could continue to serve, a useful purpose. For at least 30 years, housing advocacy groups, organizations and government agencies at all levels called on the private sector to be more active and aggressive in fostering homeownership by, among other things, making mortgage credit available to lower-income, higher-risk buyers.

A plethora of state, local and federal housing programs and initiatives were created to increase homeownership through subsidized payments, below-market interest rates, tax credits, down payment assistance and a host of other schemes. Most of these efforts never reached the numbers of potential homeowners that the subprime market reached.

The private sector found a way to make loans to low-credit, previously unfinanceable households so that they could own homes. While this effort was spurred by profit, not altruism, the effect on homeownership throughout the country was nevertheless profound.

The fraud, predatory lending practices, purposeful misrepresentations and other illegal practices employed by unscrupulous lenders must be stopped. This may not be easy because many of the practices are hard to clearly categorize as proper or improper, much less legal versus illegal.

It is imperative that the residential mortgage market operate efficiently and with clear, defined limits. The penalty for exceeding or disregarding the limits should be severe. The market itself has the means to do this as well as or better than regulatory or legal enactments. It can curtail the money flow to those who do not conduct business properly to avoid potential significant financial losses.

Capital providers must believe in the price-risk relationship relied on in the securitized mortgage pools. Activity during the past several months suggests that this is exactly what is happening in the market.

The Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA) have earmarked billions of dollars in new financing to help subprime borrowers. Guidelines for federally regulated financial institutions to make nontraditional loans were issued jointly by the major government oversight agencies and organizations late last year.

A new standard being advanced is for lenders to make "suitable" loans to homebuyers, meaning that borrowers have a reasonable expectation of paying back loans without undue financial hardship. This standard may place lenders in a more fiduciary relationship with homebuyers, requiring them to inform borrowers about the terms, conditions and risks of the loans.

Almost all government housing assistance efforts mandate borrower education, but the effectiveness of these programs is questionable. Better education for homebuyers is essential. Many homebuyers have little or no understanding of the complexities involved in purchasing a home (mortgage debt financing, interest rates, mortgage terms and the consequences of interest rate resets, for example). Many are intimidated by the process. Foreign-born buyers may have difficulty with the language, especially the "legalese" in mortgage contracts and other closing documents, and may also have no similar experience in their cultural heritage to equate to the homebuying process.

Given time, and with better-informed homebuyers, the market will correct the excesses and illegal practices under so much scrutiny today. That should open the door for new programs to expand homeownership to millions of people in the future.

Dr. Gaines (jpgaines@tamu.edu) *is a research economist with the Real Estate Center at Texas A&M University.*

THE TAKEAWAY

Subprime loans are high-risk loans and consequently have much higher delinquency and foreclosure rates. But they are useful to buyers with low, bad or no credit, many of whom would not be able to purchase a home without them. Much of the negative media attention related to subprimes has focused on predatory lending and other illegal practices, which must be stopped.

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Texas A&M University
2115 TAMU
College Station, TX 77843-2115

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