

It's Not Just Subprime!

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Abstract

Many writers have been quick to blame the high rate of foreclosures on subprime mortgages on what they call greedy, predatory lenders who exploited poor, unsophisticated, and uneducated borrowers. The problem with this interpretation is that it cannot explain the behavior of foreclosure rates on prime mortgages. Examining the foreclosure rates on fixed- and adjustable-rate loans offers a better interpretation.

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The problems with subprime mortgages are well-known, with many defaults and repercussions for businesses and investors alike. Many writers have been quick to blame what they call greedy, predatory lenders who exploited poor, unsophisticated and uneducated borrowers (for examples, see Lillich, 2001, and PICO National Network, 2009). This is unsurprising because lenders have been accused of many similar sins in the past. For example, the furor following the publication of Munnell et al. (1996), which has been widely interpreted as evidence of racial discrimination, is well known. Yet other interpretations of the data exist, with Horne (1997) being a prominent example. Black et al. (2003) report that minorities pay larger overages or yield spreads than whites, but attribute the result to differences in the pools of borrowers rather than to racial discrimination. Block et al. (2008) argue that racial discrimination is unprofitable and that increasing competition is the preferred

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approach to eliminating discrimination. The point is that the underlying economic reason for any disparities is important if regulators and lawmakers are to formulate and enact appropriate policy to remedy any alleged problem. My paper argues that although the “Greedy, Predatory Lender” story for subprime problems makes for good copy and even better scapegoats, it isn’t consistent with the data. At the very least, there must be much more to the story.

Figure 1 gives the percentage of subprime foreclosures started from 1998–2007. The increasing pace of foreclosures beginning in 2006 is clear in hindsight, more than doubling since then. However, many would be surprised to learn from Figure 1 that the foreclosure rates from 2000–2001 were actually worse than more recent data before late 2007. In fact, through the middle of 2007, the subprime foreclosure rate was behaving just like the subprime foreclosure rate would be expected to behave, with periods of relatively low and stable foreclosure rates punctuated by periods of relatively high and volatile foreclosure rates. Still, it is easy to see why some have argued that subprime borrowers are unsophisticated or poor or uneducated and that greedy lenders exploited them. Such groups are often invoked in appeals to generate sympathy, and lenders, after all, are easy political targets.

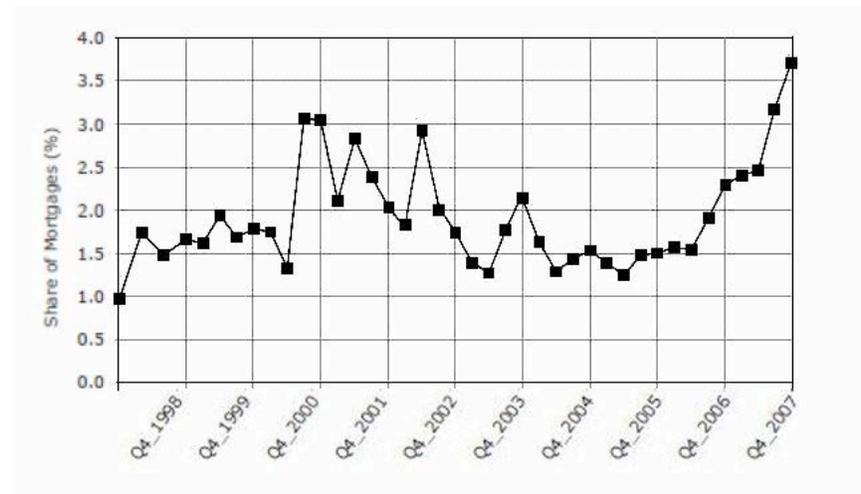


Figure 1. Subprime foreclosures started from 1998 through 2007.

The problem with this interpretation is that the Greedy, Predatory Lender explanation cannot explain the foreclosure rate for *prime* mortgages (Liebowitz, 2009). Figure 2 gives the same

information as Figure 1 but for prime mortgages instead of subprime mortgages. Granted, the number of prime foreclosures is always lower than it is for subprime foreclosures (the vertical axis stops at 0.5 percent for prime mortgages rather than at 4.0 percent for subprime), but a lower likelihood of default is, after all, what distinguishes prime mortgages from subprime. The key insight from Figure 2 is that the spike in prime foreclosures occurs at about the same time as it does for subprime mortgages and is proportionally *larger* than in subprime mortgages. The subprime foreclosure rate at the end of 2007 is only about 20 percent higher than the pre-2006 peak, whereas the prime foreclosure rate is almost double the pre-2006 peak!

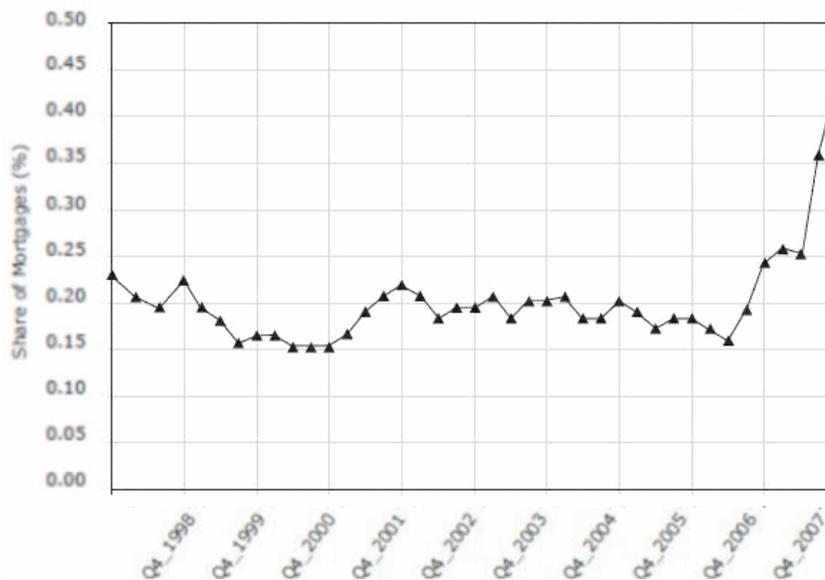


Figure 2. Prime foreclosures started from 1998 through 2007.

Figure 2 shows that the Greedy, Predatory Lender explanation of the mortgage problem is at best incomplete. Even if its proponents argue that subprime borrowers are unsophisticated or poor or uneducated and that greedy lenders exploited them, they must concoct another explanation for the even more extreme behavior of prime mortgages. I find it highly improbable that advocates of the Greedy, Predatory Lender explanation would be willing to argue that greedy lenders also exploited the sophisticated, the rich, and the

highly educated borrowers, many of whom had purchased homes in the past.

What would be a better explanation? Figure 3 and Figure 4 provide clues. Figure 3 shows that foreclosures on subprime adjustable-rate loans (ARMs) have skyrocketed while foreclosures on subprime fixed-rate loans remain low and only hint at the beginnings of the higher foreclosure rates on all subprime mortgages that appear in 2008. In fact, subprime foreclosure rates on fixed-rate loans in 2007 are among the lowest since 1998. Figure 4 shows that the pattern is similar for prime mortgages. The foreclosure rate for ARMs has increased by a factor of five since mid-2006 while the rate for fixed-rate loans barely begins to foreshadow the higher foreclosure rates that appeared in 2008.

The point is not that ARMs are bad. Many countries, including Canada, almost exclusively offer ARMs. ARMs are useful in the same way that ropes are useful. Used properly, a rope is a wonderful tool. But you can also hang yourself with one. ARMs are problematic in two cases. The first case is when lenders and borrowers cooperate so that the borrower can qualify for a bigger loan than he can realistically afford, and the second case is when speculators use ARMs to finance purchases that would not otherwise make economic sense. Figure 5 compares fixed and adjustable rates at closing. ARM rates are never as high as fixed rates, and the spread ranges from about 40 basis points to more than 2 percent. This lower initial rate is partly due to the borrower taking the interest-rate risk and partly because the lender can increase the rate later to compensate for the



Figure 3. Fixed and adjustable subprime foreclosures started from 1998 through 2007.

lower "teaser" rate. Because lenders use the initial mortgage payment to qualify borrowers, this lower initial rate means that the lender and borrower can cooperate to qualify the borrower for a bigger loan. For example, in many cases a person who barely qualified for a \$200,000 fixed-rate loan in early 2004 could have qualified for a \$250,000 loan using an ARM.

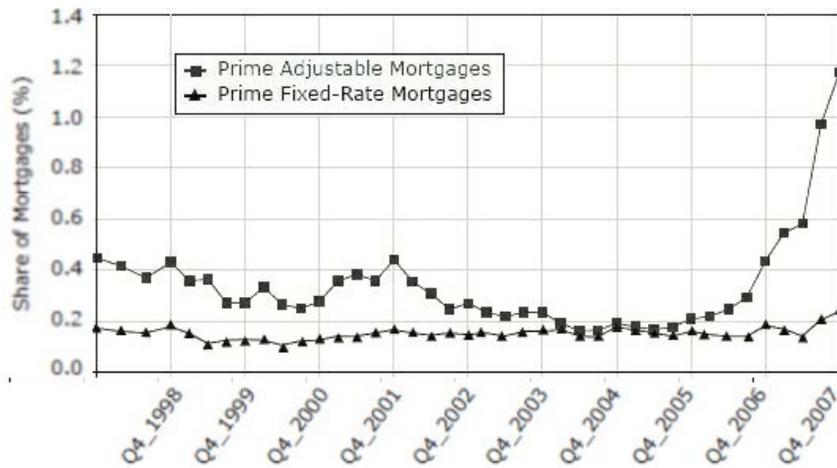


Figure 4. Fixed and adjustable prime foreclosures started from 1998 through 2007.

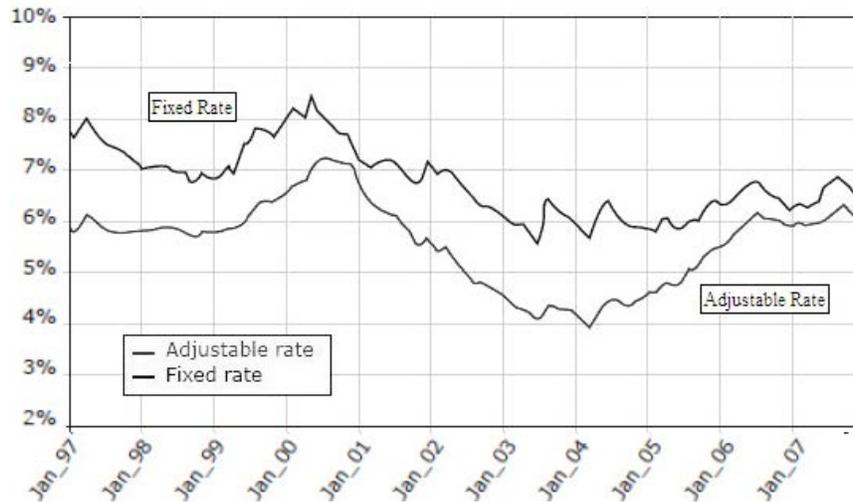


Figure 5. Fixed and adjustable mortgage rates.

Cooperating to obtain a larger loan might make sense if the borrower has good reason to expect his income or wealth to increase soon. Perhaps he is about to complete medical school, for example, or reach the age specified in the terms of the family's trust agreement that allows him access to the trust's funds. In such cases the lender may reasonably expect the borrower to be able to cover the costs of the more expensive home. Absent a good reason to expect better financial prospects, however, borrowing too much is rarely a good idea.

ARMs are also problematic if speculators use ARMs to finance purchases that would not otherwise make economic sense. For a given mortgage, ARMs have smaller monthly payments. Choosing an ARM makes perfect sense for borrowers who expect to repay within a few years, such as a corporate manager whose job requires him to relocate every few years. But ARMs also make perfect sense for investors and speculators who buy homes with the intention of reselling them within a year or so. Figure 4 and Figure 5 may result simply from speculators rationally choosing ARMs instead of fixed-rate loans. When housing prices crashed, these speculators were unable to recover their investment in their speculative purchases. Unlike the Greedy, Predatory Lender hypothesis, this explanation works for both prime and subprime borrowers.

Are there enough speculators to make a difference? The National Association of Realtors (2007) says that 28 percent of all home purchases in 2005 and 22 percent of all home purchases in 2006 were for investment reasons, which includes speculative purposes. In addition, Agarwal and Ho (2007) report that the stock of outstanding subprime mortgages was about 15 percent of all mortgages at the end of 2006 (about 20 percent including Alt-A mortgages). About half of the outstanding subprime mortgages at the end of 2006 were ARMs compared to just 18.2 percent for prime mortgages. These numbers are big enough to explain Figure 3 and Figure 4 under reasonable assumptions about the proportion of speculators who choose ARMs and default rates on speculative mortgages.

To recap, the lower initial rates make ARMs good deals for people who intend to sell the house within a few years. As many as a quarter of all home purchases in 2005 and 2006 were speculative. Finally, foreclosure rates on fixed-rate mortgages were essentially flat through 2007, but have spiked dramatically on ARMs, both subprime and prime. The Greedy, Predatory Lender interpretation might

explain the spike in subprime mortgages, but it can't explain the spike in prime foreclosures. A better story realizes that the lower initial rate on ARMs encourages two classes of borrowers to choose ARMs. The first class comprises borrowers who *cooperate* with lenders to use ARMs to obtain larger loans than they could otherwise get, and the second class comprises borrowers for investment purposes and speculators. When rates rose or borrowers faced some other financial hardship, such as job loss or a steep decrease in housing prices, the borrowers either had no financial cushion or else rationally chose to walk away from mortgages that were larger than the value of the house.

No, it's not just a subprime mortgage problem. Prime mortgages show the same spike in foreclosures, and the Greedy, Predatory Lender interpretation cannot explain this. The difference between foreclosure rates on fixed- and adjustable-rate mortgages for both prime and subprime borrowers are key to understanding the mortgage problem. Borrowers and lenders should rarely use an ARM to qualify for a bigger mortgage than the borrower could otherwise afford, and using a benign tool such as an ARM for risky intent such as speculation holds peril. Finally, the implication for policymakers is clear: Before enacting policy around faulty reasoning and scapegoating, policymakers must consider alternative explanations of the data.

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