

Subprime Lending: Misunderstood and Maligned

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Abstract

Subprime mortgages have probably been one of the most maligned financial innovations in history. However, much of the criticism is simply wrong. Although thought of as mainly a vehicle for lending to poor minority groups, subprime was actually used mainly by the middle class. It is the fact that subprime also enabled significant numbers of people previously excluded from the prime mortgage market to obtain loans that led to the misrepresentation of subprime as a low-income-only product.

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I. Introduction

Subprime mortgages have probably been one of the most maligned financial innovations in history. The mortgages arose in the mid-1990s because of the existence of a viable market—borrowers with poor credit or in unique financial circumstances—that was either not served or underserved by traditional lenders. However, due to the collapse of the mortgage industry in the financial crisis of 2007–10, much of the blame fell upon subprime mortgages.

The subprime mortgage industry provided a convenient scapegoat for the crisis. One group of critics argued that the industry had in many cases fraudulently encouraged borrowers to overextend themselves. Others contended that many of the borrowers were too high risk, had poor credit, and should not have been granted a mortgage. Still others blamed the government, asserting that lenders were pressured by the regulators under the Community Reinvestment Act to lend to poor-credit borrowers. All critics cited the borrowing terms of the mortgages as perhaps being predatory.

However, much of the criticism of subprime mortgages is simply wrong. Although thought of as mainly a vehicle for lending to poor minority groups, subprime, as shown later, was actually a product used

mainly by the middle class. It is the fact that subprime also enabled significant numbers of people previously excluded from the prime mortgage market to obtain loans that led to the misrepresentation of subprime as a low-income-only product.

The irony of the rise and fall of the subprime mortgage industry is that there had been considerable discussion in national politics about the differential in homeownership between whites and minorities. Subprime emerged as the market's answer to that differential. During its adoption, that differential narrowed. Yet because of the blame levied upon subprime as a major cause of the financial collapse in the United States, subprime mortgages were effectively regulated out of existence.

A valid question is whether this condemnation is justified. In this article, which I wrote as an educational white paper in 2006, I give the reasons why subprime should not be vilified and should be reconsidered as a viable way of increasing homeownership. Although this is an unpopular view, the homeownership differential that existed before subprime has increased. Historically, government subsidies and programs have not resulted in a narrowing of the differential. Yet a market solution did narrow the differential. Perhaps it is time to reevaluate the role of the subprime mortgage as a tool of public policy.

II. A Brief History

The emergence of a new financial industry is not new in American history. Savings and loan associations evolved from British building societies in order to finance homeownership for people of moderate means when the clientele of banks were either the wealthy or commercial borrowers. Credit unions migrated to the US from Canada in order to provide savings and borrowing vehicles for industrial workers whose incomes were below those of bank clientele.

Similar to the birth of new institutions to meet unserved demands, the subprime mortgage industry was pioneered by nontraditional firms. Lenders were mainly nondepository institutions, mortgage banking companies, finance companies, and real estate investment trusts, and they were later joined by depository institutions such as banks.

The advent of the subprime mortgage industry is directly linked to the 1996 congressional amendments to the Fair Credit Reporting Act of 1971 and the preemption of state laws related to "preserving a voluntary, market driven credit reporting system" (Staten 2004, p. i). This led directly to the application of the voluntary credit reporting system, which allowed the collection, dissemination, and evaluation of

credit histories of borrowers by lenders. The consequence of this was the rapid growth and dissemination of credit availability in the United States.

Importantly, the majority of this growth was among low-income populations of borrowers, including single-family households and women who were underserved by traditional lenders. For example, as Staten (2004) points out, “The proportion of households in the lowest fifth of the income distribution who had access to consumer credit jumped by nearly 70 percent over the period. By contrast, growth in the highest and second highest income quintiles averaged less than 5 percent” (p. iii). Moreover, the “benefits of credit reporting are especially great for minorities. Between 1989 and 1998, home ownership rates rose more sharply for African-Americans, Hispanics, and lower-income families than for other groups, but only a small part of these gains were attributable to improvements in their incomes or economic circumstances.” Calomiris (2001) refers to this dissemination of credit as the “democratization of finance” (p. 1). Innovation among mortgage lenders in terms of risk measurement and the ability to develop and tailor new products for specific population segments accounted for much of the gains, all of which depend upon a robust credit reporting system (Staten 2004, p. iv).

In 1994, nonprime mortgage originations were \$34 billion, or 5 percent of the overall mortgage origination market. By 2004, nonprime originations were \$325 billion, or 18 percent of all originations (see Wallace, Elliehausen, and Staten 2005, p. 3). As noted above, the impact on minority populations was dramatic. Between 1993 and 2000, conventional mortgages for low-income borrowers doubled. The number of conventional mortgages increased by 122 percent to black borrowers and 147 percent to Hispanic borrowers. Relative to the white population, these minority groups had lower median income, less wealth, and poorer credit histories. Thus, the advent of the subprime lending industry had the impact of dramatically increasing minority homeownership and opening the doors to affordable credit to the underserved.

III. Who Was Served by the Industry?

There is a common perception that the customers served by the subprime lenders were mainly poor, minorities, and the elderly. Indeed, many of those who contend this also contend that these groups were “targeted” by subprime lenders who then engaged in “predatory” lending practices.

However, the common perception is wrong. In analyzing 2002 Home Mortgage Disclosure Act data and 2000 US Census data, SMR Research Corporation (cited in Theologides 2005, p. 5) found that the population of subprime customers mirrored that of the population at large. Additionally a study by the Financial Services Roundtable found of subprime borrowers that “a majority of these borrowers are married, have annual household incomes between \$25,000 and \$65,000, and are between the ages of 30 to 54. Their racial and ethnic demographics resemble that of the U.S. population as a whole” (cited in Samuels 2004, p. 11). Staten (2004, p. 6), using the Federal Reserve’s 2001 Survey of Consumer Finances, shows that “nearly all subprime borrowers are in moderate income and relatively young age groups.” He further notes that although some subprime borrowers have low incomes, that percentage is not substantially different from the mortgage market as a whole. He concludes that “subprime mortgages are primarily a middle-class product” (p. 6).”

For specific lenders, the data are more revealing. New Century Financial Corporation, founded in 1996, the nation’s second-largest subprime mortgage lender, reported that instead of its borrowers being primarily poor, minorities, or elderly, instead they were middle class, nonpoor, and nonelderly (Theologides 2004, p. 7). Fifty-two percent of its borrowers were white, 20 percent were Hispanic, 16 percent were black, and 4 percent were Asian. New Century’s average borrower had an annual family income of \$72,000 and was under fifty years of age. Less than 7.5 percent of its borrowers were over sixty years old. The average first-mortgage loan size was \$170,857, and 93.5 percent were homeowners. The average second-mortgage loan size was \$46,165. The average FICO score was 606. The average loan-to-value ratio was 76.11 percent, and the average debt-to-income ratio was 39.25 percent (pp. 7–9).

Countrywide Financial Corporation, mainly a prime lender, entered the subprime market in 1996. Although subprime loans represented only 5 percent of the total loans originated by Countrywide, it is interesting to compare the two populations to see if its subprime borrowers had different demographic characteristics than its prime borrowers. Concerning Countrywide, Samuels (2004, pp. 9–10) reports the following:

1. The average age of both the subprime and prime borrowers was 43. Six percent of the subprime borrowers were over the age of 60 while 10 percent of the prime borrowers were over 60.

2. The FICO score of subprime borrowers was 608. The FICO score of prime borrowers was 715. Around 20 percent of the subprime customers had FICO scores over 660, but were classified as subprime due to other factors—collateral, loan-to-value or documentation.
3. The average amount borrowed was \$179,000 for subprime with one fourth of the loans being greater than \$300,000.
4. Loan-to-value ratios were 82% for subprime and 80% for prime customers with 17% of the subprime loans with [loan-to-value ratios] greater than 95%.
5. The average income of subprime borrowers was \$69,000 and \$74,000 for prime customers. Less than 3% of the subprime borrowers had incomes below \$25,000.

Thus, there were very few significant demographic differences between the populations of subprime borrowers and prime borrowers. What were the differences in the two sets of borrowers? Those differences were typically one or more of the following:

1. *Income documentation.* Prime lenders generally had fairly stringent income documentation requirements in order to conform to Fannie Mae and Freddie Mac guidelines. Subprime lenders made a significant proportion of their loans on a “stated income” basis (called no-doc loans). This was important to borrowers who could not verify their income. New Century reported that over 40 percent of its loans were no-doc loans. New Century and other subprime lenders evaluated the risk of non-repayment by looking at credit in conjunction with prior mortgage history, rental payment history, other consumer-debt repayment history, and other payments on nontraditional credit sources. New Century also required a notarized statement regarding income (Theologides 2004, p. 11).
2. *Loan amount.* The average New Century loan in California and New York was *above* the Fannie Mae and Freddie Mac maximums.
3. *Credit criteria.* Eighty-one percent of New Century borrowers had credit scores below 660.
4. *Limited down payment or cash reserves.*
5. *More cash-out.* Fannie Mae and Freddie Mac generally did not allow a borrower to exceed a 90 percent loan-to-value ratio on a cash-out refinance loan. Subprime lenders did not have this limitation.

Another often-heard contention is that many, if not most, subprime borrowers would qualify for a prime mortgage but are

steered into the subprime market. Indeed, Butts (2004) states that “huge numbers of homeowners with good credit, particularly people of color, are being steered towards subprime loans” (p. 6). This is an important contention. Freddie Mac estimated that if subprime borrowers were integrated into the prime market, there would be net savings of \$5.7 billion, with savings of \$42 per month for black borrowers, \$21 per month for Hispanics, and \$14 per month for white borrowers. Thus, this was the cost to consumers of subprime borrowing. A past chairman of Fannie Mae, Franklin Raines, stated that the average subprime borrower borrowing at prime rates would save \$200,000 over the life of a thirty-year loan (p. 6). Freddie Mac estimated that 10 to 35 percent of subprime borrowers would qualify for prime loans (Fishbein 2003, p. 7). Fannie Mae stated that half of subprime borrowers could qualify for prime loans (p. 8).

However, the above statistics must be scrutinized carefully. As Fed governor Edward M. Gramlich (2004, p. 1) notes, a good credit history—as indicated by FICO score—does not guarantee prime borrower status. Indeed, Gramlich notes that half of the subprime mortgage borrowers had FICO scores above the subprime threshold. The question is, why were these borrowers not in the prime rather than the subprime market? The answer can be found in the characteristics given above and others. They include low or no loan documentation, loan amounts different from Fannie Mae / Freddie Mac guidelines, high loan-to-value ratios, high debt-to-income ratios, greater cash-outs, change in employment status, change in marital status, and medical emergencies.

If the statements by Butts, Freddie Mac, and Fannie Mae relied mainly on the use of FICO scores as the basis of the contention that subprime borrowers were prime borrowers steered into the subprime product, then they were in error. Theologides (2004, p. 12) reports that New Century subjected its entire population of 2003 loans (164,414 loans) to the Fannie Mae guidelines and found that 96.5 percent would not qualify for a Fannie Mae–approved loan. He also notes that of the 3.5 percent that might qualify, 58.61 percent were white. Many advocacy groups would have you believe that the vast majority of that 3.5 percent must have been minority borrowers, which is not the case.

Lastly, and perhaps most importantly, the subprime borrower was not relegated to being subprime forever. Many of the circumstances that migrated a borrower into subprime status (which should be interpreted as not conforming to Fannie Mae / Freddie Mac guidelines) were

temporary. Once those circumstances were resolved, the borrower's status could change. The subprime market allowed a borrower to reestablish credit and to gain prime status. Indeed, Countrywide reported that 45 percent of its subprime refinance customers graduate into prime products, which is "compelling evidence that nonprime loans did indeed provide a 'second chance' for families who have experienced adverse life events" (Samuels 2004, p. 13).

IV. How the Subprime Mortgage Market Worked

Loan rates in the subprime mortgage market were higher than those for prime loans. The reason is higher risk to the lender as well as higher costs. Higher loan-to-value ratios, poorer credit, greater debt-to-income ratios, and little or no documentation of income imply a greater risk to the lender and a higher interest rate to the borrower. Moreover, as Pennington-Cross (2002) notes, after the loan is originated, it costs more to service it in the subprime market than in the prime market. He notes that the cost of servicing can be four times higher for subprime loans (p. 31).

Many if not most of the loans in this market were nonconforming—that is, they did not conform to Fannie Mae/Freddie Mac guidelines and could not be sold to those agencies. This meant that the risk had to be absorbed by the private market instead. That the private market could absorb the risk is a testament to the risk evaluation process made possible by increases in the technology of credit reporting. As noted before, specialized lenders arose to meet this unmet market demand. Now it was possible for other, more traditional lenders to operate in this market because the costs of risk assessment had dropped appreciably.

The advent of additional lenders meant more competition. More competition meant that the rates to borrowers were lower than they would have been in the absence of competition (see Staten and Cate 2003, pp. v, vii). Theologides (2004, p. 6) notes that the spread between subprime mortgage rates and prime mortgage rates narrowed with the increased competition. In the 1990s, the average spread was 2.5 percent. In 2003, the spread fell to a range between 1.75 and 2.0 percent.

What is striking is that despite the increase in credit availability to nonprime customers due to improved risk evaluation techniques, the loan denial rates in the subprime market were significantly *higher* than the denial rates in the prime market (Canner and Passmore, 1999, p. 715). Indeed, Theologides (2004, p. 7) states that in 2002, the denial rate in the subprime mortgage market was 52 percent as compared

to 13.2 percent for prime lenders. These statistics show that the subprime market did not provide carte blanche easy access to subprime applicants. Those that were rejected had to avail themselves of other sources, such as borrowing from family members or borrowing in other markets such as pawnshops or payday lenders.

V. Predatory Lending

Concern about predatory lending practices has led thirty-seven states and the District of Columbia to enact some form of legislation addressing the problem. The debate about the effects of such legislation is beyond the scope of this paper. However, there is considerable disagreement as to its effectiveness and whether it has an adverse impact on those served by subprime lenders (see Quercia, Stegman, and Davis, 2005; Lampe 2001).

Often predatory lending has been linked to subprime lending. Indeed, with the rapid increase in mortgage availability to previously underserved populations comes increased opportunities for abuse. Predatory lending is such an abuse.

What is “predatory lending”? Carr and Kolluri (2001) state that “predatory loans are characterized by excessively high interest rates or fees, and abusive or unnecessary provisions that do not benefit the borrower, including balloon payments or single-premium credit life insurance, large prepayment penalties and underwriting that ignores a borrower’s repayment ability.”

Freddie Mac lists the following predatory lending practices:

1. Making a loan to an individual without regard to the individual’s ability to repay.
2. Repeatedly refinancing (“loan flipping”) a loan within a short period of time and charging high points and fees with each refinance.
3. Packing a loan with single premium credit insurance products and not adequately disclosing the inclusion, cost or any additional fees associated with the insurance.
4. Charging excessive rates and fees to a borrower who qualifies for lower rates and/or fees offered by the lender.
5. Balloon payments
6. Excessive prepayment penalties

Each of the above characteristics is subject to interpretation. For example, how excessive is “excessive”? Also, there are valid reasons for many provisions in subprime mortgage contracts such as balloon

payments and prepayment penalties. Indeed, limiting the use of these provisions could lead to a reduction in credit availability. Nonetheless, it remains the responsibility of the lenders to provide mortgage contracts that can be repaid in a timely fashion at the lowest cost and interest rates to the consumers.

Several lenders have been subject to regulatory scrutiny regarding some of their practices. The most significant recent case is that of Ameriquest Mortgage Company, the largest subprime lender in the nation. Ameriquest was charged by the attorneys general of several states and settled, without an admission of guilt, with forty-nine states and the District of Columbia—Ameriquest did not do business in Virginia. The settlement was for \$295 million in restitution to consumers and \$30 million in legal fees. The allegations included fraudulently inflated appraisals, fabricated borrower income, misrepresented loan terms, rushed closings, hiding interest terms until late in the lending process, and use of high-pressure sales tactics. Under the terms of the settlement, Ameriquest agreed to affirmatively redress these issues.

VI. Delinquency and Foreclosure

Many observers have pointed out that the higher incidence of foreclosure in the subprime market was a result of predatory lending practices (see Fishbein 2003, p. 8). Nevertheless, given the greater credit risks involved in subprime lending, higher rates of delinquency and foreclosure are to be expected. Gramlich (2004, p. 4) points out that rates of serious delinquency, defined as mortgage payments either ninety days delinquent or in foreclosure, were 1 percent in the prime market and 7 percent in the subprime market. However, note that this means that 93 percent of the loans in the subprime market were not in this category.

Calomiris (2001, p. 3) notes that the probability of default for the highest risk class of subprime borrowers was 23 percent, which is about a thousand times greater than the fault risk of the lowest risk class of prime mortgage borrowers. Because of this increased risk, lenders were compensated with higher interest rates to account for the additional risk premium. Research shows that loan pricing in the subprime market was consistently related to borrower risk (see Staten 2004, p. 10).

If one looks at certain writings, one will conclude that the incidence of foreclosure is mainly the result of predatory abuses rather than other circumstances (see Butts 2004; Smith 2004). Indeed, Bunce

et al. (2000) state that “there is a growing body of anecdotal evidence that a subset of these subprime mortgage lenders engages in lending practices that strip borrowers’ home equity and place them at increased risk of foreclosure” (p. 237).

Again, despite claims to the contrary, the problem is that it is not possible to draw generalized conclusions from anecdotal evidence. If one finds one or several instances of abuse, this does not imply that such abuse is the norm even within the same lender. It certainly does not imply that such abuse is overarching. Moreover, even many statistical studies are misleading in that they examine foreclosure incidence but do not account for the factors that determine foreclosure. As has been noted (see Wallace, Elliehausen, and Staten 2005), the lack of a comprehensive database of subprime loans limits the empirical research that can be done in this area. Even Home Mortgage Disclosure Act data, which are often employed by academics and others, have well-documented inadequacies, namely lacking risk characteristics of borrowers (see Avery and Canner 2005).

Most studies do not document the causes of foreclosure. Two exceptions are a study of foreclosure in Chicago (Smith 2004) and a study of data from nonagency publicly placed securitized loans (Denis and Pennington-Cross 2005). Anecdotal evidence provided by Theologides (2004) about New Century loans shows that New Century’s foreclosure rate was around 5 percent and that “when a foreclosure occurs, we find it most frequently is not due to some improper lending practice, but is due to an unexpected and adverse change in the borrower’s personal circumstances” (p. 23). Lastly, there is no evidence that the pursuit of foreclosure is a profitable business practice. Rather, Theologides states that “foreclosures are our wors[t] nightmare” in that New Century “loses an average of around \$40,000 whenever it is forced to foreclose on a loan” (p. 6).

Two studies have addressed the issue of foreclosures and practices deemed predatory and have reached different conclusions. Quercia, Stegman, and Davis (2005) classify prepayment penalties and balloon payments as predatory loan terms and find that the inclusion of these terms in subprime mortgages increases the odds of foreclosure. Quercia, Stegman, and Davis do not make the argument as others have that lenders deliberately include these terms to lead to foreclosure in order to repossess the property. Rather, they cite a study by Pennington-Cross (2002) that finds that lender losses from subprime foreclosures are five to six times greater than for prime loans. Indeed,

as Capone and Metz (2003, p. 1) note, “With few exceptions, loans that default will not be profitable.”

The other study that directly considers the impact of prepayment penalties and balloon payments is Rose (2006). Rose finds the impact of these terms varies by whether the loan is a refinance or first mortgage and by whether the loan is fixed rate or variable rate. Rose (2006) notes that in his results (and those of Quercia, Stegman, and Davis), when balloon payments are associated with higher probabilities of foreclosure, the foreclosures occur *before* the balloon payments are due. This implies that the balloon payments are not themselves the source of foreclosure; it is due to some other characteristic of the loan or of the borrower.

Lastly, there are other factors that contribute to foreclosure that have not been adequately addressed in the literature. First, many borrowers have inadequate financial education and are not ready for homeownership. Several lending programs for low-income households require financial education as a condition for getting a home loan. There has been little research on the effectiveness of such programs. Second, many homes in the “affordable” price range are often substandard (wiring, plumbing), which creates affordability-of-repair issues. There is anecdotal evidence that in certain instances, the inability to adequately repair a home will lead to delinquency and foreclosure. Third, a precipitous increase in utility bills can have a major adverse impact on many households. One often hears stories—again anecdotal—that significant increases in heating bills trigger delinquencies and may lead to foreclosures.

VII. Mortgage Servicing and Default

A large proportion of the mortgages originated are sold. Most subprime mortgages were not held in the portfolios of the originators but were sold to investors as whole loans or securitized as asset-backed securities (see Pennington-Cross, p. 31). The vast majority of these loans were then outsourced to a third-party servicer, which collected payments for the holder of the mortgage. Mortgage servicers also often manage escrow accounts, paying property taxes and insurance for the borrowers. The servicer also is responsible for monitoring the loan and seeking to collect when the loan is in default.

Given the higher incidence of default among subprime borrowers as opposed to prime mortgage borrowers, the role of servicers has been subject to scrutiny. Pennington-Cross (2002) states that servicing delinquent loans was more labor intensive in the subprime than the

prime market. A study by Kogler (1997) cited by Pennington-Cross estimates that this servicing cost was four times higher for subprime loans than for prime loans. This higher servicing cost was another factor that would motivate the outsourcing of these loans to specialized servicers who have lower transactions costs and enjoy economies of scale.

The role of servicers in the subprime market has been the subject of some controversy generated in part by the \$40 million Fairbanks settlement. Fairbanks Capital Corporation, a subprime mortgage servicer, was accused of assessing late fees when payments were made on time, using force-placed insurance when the borrower already had insurance, foreclosing on property illegally, and other charges (see Andrews and Jones 2025).

The charges against Fairbanks and other servicers led to the use of the term “predatory mortgage servicing,” and some subprime mortgage servicers were accused of being predatory. However, research reveals a contrasting story. Capozza and Thomson (2006, p. 13) find that although subprime mortgages had higher rates of default than do prime mortgages and were twice as likely to become “real estate owned,” they took about four times longer to reach foreclosure, suggesting greater forbearance by lenders for subprime borrowers. Ambrose and Capone (1996) look at default rates and foreclosures by race and find that although minority borrowers had higher rates of default than white borrowers, they remained in default longer. Ambrose and Capone conclude that lenders were more lenient toward minority borrowers in foreclosure processing. As Ambrose and Capone state, “If lenders are discriminating against minority borrowers after a loan is made, higher foreclosure rates and shorter forbearance times for minority borrowers would be expected. The absence of these outcomes leads us to rule out statistical discrimination at the default stage” (p. 94).

VIII. Conclusions

From the above, we conclude the following.

First, despite what is commonly assumed, borrowers in the subprime market were not dissimilar to borrowers in the prime mortgage market. That is, these borrowers were primarily white, middle income, and not elderly. Indeed, the profile of a subprime borrower is one who is in the age cohort that is most likely to borrow to finance a home and finance a college education.

Second, the movement toward universal credit scoring and credit reporting along with technological advances allowed credit to be extended to those segments of the population underserved by prime lenders. Although these segments include low-income borrowers, they also include the self-employed and borrowers with blemished credit records, borrowers with income that is not easily verified, and other borrowers who may have high credit scores or high income but whose loan terms do not meet Fannie Mae or Freddie Mac guidelines.

Third, despite the increased service to underserved populations, this does not mean that the subprime market is less likely to reject applicants than the prime market. In fact, the opposite is the case. Subprime rejections were significantly higher than rejections for prime loans.

Fourth, although there were well-documented abuses, such as those arising from the Ameriquest settlement, there is no evidence that this incidence was widespread among the majority of subprime loans.

Fifth, higher rates of delinquency and foreclosure were natural consequences of lending in some segments of the subprime market. However, these losses were manageable to the lenders or else such lending would have ceased. Again, there is no empirical evidence that such foreclosures were profitable to the lenders. Indeed, there is evidence that the opposite was the case.

Sixth, subprime mortgage servicing was significantly more costly than prime mortgage servicing. There is evidence that mortgage servicers and lenders practiced greater forbearance in the subprime market than in the prime market. Although subprime loans had higher default rates, it took these loans longer to move into foreclosure. With regard to race, lenders practiced greater forbearance for minorities than for white borrowers. This runs contrary to the allegations that were often made in the popular press.

Finally, a word of caution. The goal here has been to highlight that a careful, nonbiased analysis of the subprime industry is warranted. Oftentimes, arguments on both sides of the issue do not rely on statistical data from which meaningful conclusions can be drawn. In a related area of research, discrimination in mortgage lending, many of the same problems occur. In this area, where there are enough data points, reliance on lender-specific data has often revealed more useful results than more generalized studies.

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