

From a book on the subprime mortgage crisis. Target audience was male with high school or perhaps some junior college education and either a subprime mortgage or a mountain of credit card debt. The challenge was to clearly explain the ideas, many of which were math-based, to readers that don't have a lot of experience with numbers or financial terms.

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 reason people borrow money is to purchase a home. It may come as a surprise considering the current mess the industry is in but subprime mortgages account for just thirteen percent of all mortgages. In this section, we're going to have a look at eight different factors that make 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 thirteen 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. Having even a 5% down payment can significantly reduce the 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, credit score is not the only determining factor. Because other factors (like down payment and income to debt 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, Freddie Mac and Fannie Mae estimated that fifteen to fifty percents of the subprime loans they purchased went to borrowers whose credit scores indicated that they qualified for prime loans. The likely

reason for this is a high income to debt 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 at a more favourable interest rate. 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 unlikely to be refinanced. Subprime borrowers also commonly gamble with their equity by getting a cash-out refinancing, which means they borrow against equity they have already accrued to make capital improvements to their property with the hopes of increasing its value when it comes time to sell. In simpler terms, a homeowner who has paid \$50,000 out his \$150,000 mortgage decides to refinance at a more favourable 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.

Assets

Originally, subprime lending was a way for homeowners to buy a second home or vacation property. So, in its original form subprime lenders 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 chattel (household possessions).

Income To Debt Ratio

This is perhaps the single most important factor in determining a borrower's prime or subprime status. In terms of Income and Debt Ratio, debt refers to the amount of fixed monthly expenses. This includes credit card payments, car payments and any other 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 thirty-eight percent.

Subprime borrowers almost always have an income to debt ratio of more than

thirty-eight percent. Lenders that specialize in subprime mortgages generally have a maximum ratio of fifty percent. This problem 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.

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, aside from a car or RV, 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 the truth is that three times out of four, a subprime borrower will be Hispanic or African-American. In 1999, it was reported that fifty percent of subprime mortgage refinances originated in predominately African-American census tracts, areas that accounted for only ten percent of prime refinance. Cleveland has become the touchstone city of the subprime crisis. The city is primarily working class with an ethnicity split of fifty-one percent African-American, forty-one percent white and seven percent Hispanic. In 2005, nearly sixty percent of loans taken out by African-Americans in Cleveland were classified as high-cost.

The percentage of high-cost loans taken out by the white people, was thirty-four. 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 colour, 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. 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 crisis 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. These practices and their effects on entire neighbourhoods will be detailed more fully in Section III

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 forty percent of home sales in 2006, twice the national average. Nearly half of these homes were bought with subprime mortgages.

TRENDS IN SUBPRIME HISTORY

Loan Grade

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 fifty percent in 1995 to roughly eighty-four percent in 2003, meaning subprime lenders became increasingly risk-averse 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 900 points and changes as a consumer's credit status gets better or worse. The average credit

score declined each year throughout the 1990s but since 2000, credit scores shown a trend towards improving. In fact, as of 2004, the gap between the average subprime and conventional credit score was just eighteen points. (651 vs. 669).

In 1995, the percentage of subprime loans given to borrowers with a FICO score of 500 or less was approximately seventy 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. It's a case of the bigger the better and borrowers who are able to provide a significant initial 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, has gone 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 two 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 7% 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% of the original amount borrowed!

The difference between loan grades, approx 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 (approx four percent) for the privilege. To see what a difference this makes, let's have a look at three common scenarios. I've purposely kept all the variables the same except for the ones that change with each scenario to illustrate what a big difference they make.

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 slightly higher rate of interest (10.5%), they can even get a loan for \$150,000 to help cover closing and moving costs as well as buying new furniture. If they go through with this mortgage, the total cost of their house over 30 years will be \$494,000.

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%. 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 qualify easily for the \$110,000 they need to buy their house. What's more, they are able to secure a very favorable interest rate of 7%. At

then 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.

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 and encouraging loan flipping or constant refinancing.

The human imagination knows no limit when it comes to coming up with ways to profit. One of the more outrageous predatory practices reported recently was the city building inspector falsifying documents to say that a home needed repairs. A few days later, conveniently, a mortgage broker would come buy offering a cash-out refinance of the mortgage to help pay for the repairs 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 and encouraging loan flipping or constant refinancing.