

# CRS Report for Congress

## Subprime Mortgages: Primer on Current Lending and Foreclosure Issues

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# Subprime Mortgages: Primer on Current Lending and Foreclosure Issues

## Summary

Subprime mortgages are loans extended to borrowers with weak credit profiles. Subprime mortgages entail higher risk of delinquency and default. Recent increases in subprime borrower foreclosures and lender bankruptcies have prompted concerns that some lenders' underwriting guidelines are too loose and that some borrowers may not have fully understood the risks of the mortgage products they chose. Regulatory agencies are revisiting the guidance they provide lenders and are reevaluating required disclosures to consumers. In addition, Congress is holding hearings on the subject and may consider consumer protection legislation.

Subprime foreclosures have reached the highs of the 2000-2001 recession but delinquency rates are not the same across mortgage features. The adjustable interest rate (ARM) feature is currently associated with higher delinquency rates than comparable fixed rate loans. However, the delinquency rate of loans with the negative amortization (NegAm) feature has remained below 1%, the range normally associated with less risky loans. NegAm is a loan that allows a monthly payment less than the current interest on the loan with the remaining interest added to the principal, thus increasing the loan balance.

Financial regulators issued a guidance for alternative mortgage products in October 2006 and issued a proposed statement for subprime lending in March 2007. The guidances require that consumers be given plain-language explanations of the risks of their mortgages. Borrowers must be qualified for mortgage loans based on the ability to repay the loan, not based on speculation about future increases in the value of the real estate collateral. The proposed guidance also seeks to limit payment shock and prepayment penalties. Policymakers are faced with the challenge of balancing the benefits of access to credit against the costs of potential foreclosures.

This report will be updated in the event of significant regulatory or legislative change.

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# Subprime Mortgages: Primer on Current Lending and Foreclosure Issues

## Background

Subprime mortgage lending can benefit consumers by allowing greater access to credit, and thus homeownership, but can also impose costs on consumers through defaults and foreclosures. Subprime refers to people who have no credit history, have a blemished credit record, and/or have a weak debt-service-to-income ratio. A generation ago, subprime loan applicants were generally denied credit and neither enjoyed homeownership nor risked default. Policymakers evaluating subprime lending issues will be called on to consider the benefits of increased access to credit markets which can lead to homeownership as well as the costs of increased debt burdens and potential foreclosure. To that end, this report describes the subprime market, presents delinquency and foreclosure data, and summarizes banking agency guidance on subprime lending.

The rise of risk-based pricing encouraged growth of the subprime market during the mid-1990s.<sup>1</sup> For example, the number of subprime refinance loans increased nearly tenfold between 1993 and 1998.<sup>2</sup> Subprime loans increased from an estimated 5% of the mortgage market in 1994 to as much as 20% in 2005.<sup>3</sup> After retreating during the recession of 1999-2001, subprime lending expanded rapidly during 2002-2005. In 2006, the housing market slowed and there was a rise in late mortgage

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<sup>1</sup> Risk-based pricing refers to assessing a borrower's risk and then charging higher-risk borrowers a higher interest rate rather than simply refusing to qualify them for a loan. In contrast, pool-based pricing accepts a range of borrowers into a pool which is charged the same rate based on the average credit quality of the pool. Borrowers outside the pool are simply denied credit.

<sup>2</sup> "Unequal Burden in New York: Income and Racial Disparities in Subprime Lending," Department of Housing and Urban Development (HUD), May 2000, p.1. The study cites the Home Mortgage Disclosure Act (HMDA) database as reporting 80,000 subprime loans in 1993 and 790,000 in 1998.

<sup>3</sup> Robert Avery et al., "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin, September, 2006 (rev.), p. A125. There is no single accepted source for subprime market share. The Federal Reserve collects loan information through the Home Mortgage Disclosure Act (HMDA), which does not currently require lenders to report a borrower's credit score and only requires interest rate information if the rate is more than 3% above a comparable Treasury rate. The proportion of loans that exceed HMDA's 3% threshold, and are thus considered high cost, is sensitive to changes in the proportion of loans that are adjustable rate and to the difference between short-term and long-term interest rates. Alternatively, the Department of Housing and Urban Development maintains a list of lenders who specialize in loans to consumers with weaker credit. The market share of these lenders can vary significantly over time. Private financial consultants with access to more detailed lender loan information provide a third set of estimates.

payments and foreclosures. The rise in delinquencies and foreclosures continues to be more severe in the subprime market than the prime market but both rates are growing. Several prominent subprime lenders are experiencing financial difficulties, including the recent bankruptcy of Ownit and investigations into New Century. Potential negative consequences for consumers, banks, and financial markets have drawn renewed attention to government policies related to subprime lending.

Government policies play a role at each stage of the mortgage lending process. When a borrower takes out a mortgage loan, the Truth in Lending Act (TILA) and the Home Ownership Equity Protection Act (HOEPA) provide rules for disclosure and limitations on the terms of certain high cost loans. When lenders originate loans, the regulatory agencies of the Federal Financial Institutions Examinations Council (FFIEC) supervise their portfolios to ensure safe and sound banking practices.<sup>4</sup> When lenders sell some of their loans to secondary markets through the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight (OFHEO) supervises the GSEs for safety and soundness and the Department of Housing and Urban Development (HUD) regulates the GSE's charter compliance. When investors purchase mortgage-backed securities (MBS) issued by the GSEs or their competitors, the Securities and Exchange Commission (SEC) enforces the anti-fraud provisions of the securities laws.

Government policies designed to aid lower-income consumers achieve homeownership may have contributed to the expansion of subprime lending. For example, the Community Reinvestment Act (CRA) encourages lenders to provide loans in the poorer areas of their market where subprime borrowers are more likely to reside. Similarly, increases in HUD's Affordable Housing Goals encourage the GSEs to expand their purchases of loans originated from lower-income and minority borrowers who are more likely to be subprime. Federal Housing Administration (FHA) slowness to adopt some of the nontraditional mortgage products that became popular when house prices were rising rapidly may have resulted in some FHA-eligible borrowers turning to subprime lenders.

## **The Subprime Market and Alternative Mortgages**

Generally, subprime mortgages are defined in terms of the credit bureau risk score (FICO) of the borrower.<sup>5</sup> Other credit imperfections, however, can also cause borrowers to be categorized as subprime for a particular loan. For example, the addition of the mortgage loan might increase the borrower's debt-to-income level above traditionally prudent thresholds. Generally, bank supervisors look for one or

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<sup>4</sup> The FFIEC includes the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), The Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA).

<sup>5</sup> A FICO score is an estimate of a borrowers creditworthiness provided by credit rating agencies that monitor consumer payment histories. The term comes from the company, Fair Isaacs, that originated the score and continues to provide it to lenders.

more of the following credit-risk characteristics when deciding to label a loan subprime:<sup>6</sup>

- Recent payment delinquencies (30-day or 60-day depending on recency)
- Judgment, foreclosure, repossession, or charge-off within prior two years
- Bankruptcy in the last five years
- Relatively high default probability (FICO below 660 or similar measure)
- Limited ability to cover living expenses after debts (debt-service-to-income ratio of 50% or more)

Subprime loans are disproportionately used by the elderly and members of minority groups. The elderly are more likely to own a home and to have accumulated significant equity and therefore are more likely to qualify for a refinance loan despite, perhaps, having imperfect credit. Minorities, on average, have lower incomes and therefore are often more likely to have credit blemishes. In addition, there is some evidence that minorities who could qualify for cheaper prime loans are sometimes borrowing in the more expensive subprime market.<sup>7</sup>

In recent years, subprime borrowers increasingly used alternative mortgage products that had previously been used primarily by sophisticated investors. Interest only (I-O) mortgages provide an introductory period during which monthly payments cover only the loan interest. After the introductory period, loan payments reset to a higher amount to also cover the loan's principal. Negative amortizing mortgages (NegAms) allow borrowers to pay less than current interest due and result in a higher loan balance and higher future payments. In contrast to fixed rate mortgages (FRM), which have fixed interest rates and constant monthly payments, adjustable rate mortgages (ARMs) reset the interest rate with changes in market interest rates and therefore can result in higher or lower monthly payments depending on market conditions. Because alternative mortgage products allow monthly payments to rise, some policymakers are concerned that subprime borrowers in particular may not have fully understood the risks associated with non-traditional features.

## **Growth, Foreclosures, and Risk in Subprime Mortgages**

Expansion of the subprime market may have benefited some consumers by improving access to credit and facilitating homeownership. The timing of the growth of the subprime market corresponds to growth in homeownership. The U.S.

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<sup>6</sup> "Subprime Lending (Risk Management and Internal Controls)," *Bank Holding Company (BHC) Supervision Manual*, Section 2128.08, Dec. 2002, pp1-2.

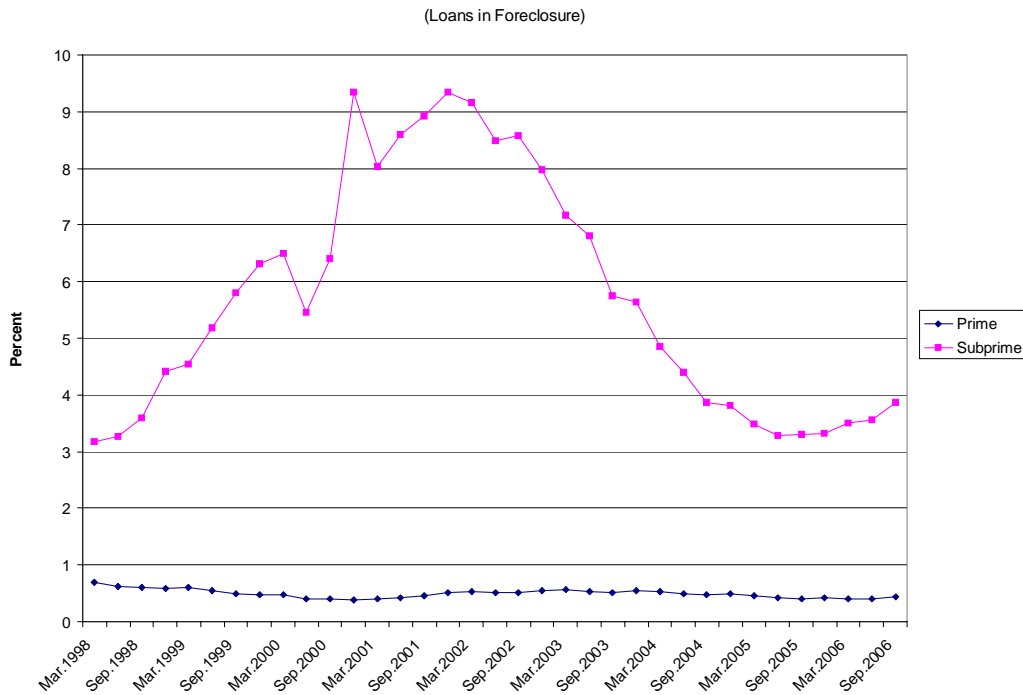
<sup>7</sup> *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, HUD, 2000.

homeownership rate increased from 64.1% in 1993 to 68.9% in 2005.<sup>8</sup> Homeownership among minority groups increased at a faster rate, from 42.4% in 1993 to 51.3% in 2005. Recall that subprime lending is more prevalent in minority communities. The homeownership gap between white-non-hispanics and all-minorities dropped from 27.8 percentage points in 1993 to 24.5 percentage points in 2005.

Expansion of the subprime market may have increased the costs associated with greater debt burdens. Subprime foreclosures increased faster than prime foreclosures during the 2000-2001 recession and are again rising faster than prime foreclosures in the current housing slowdown. **Figure 1** presents data from the Mortgage Bankers Association mortgage delinquency survey. Subprime loans in this sample are several times more likely to go into foreclosure and are far more sensitive to the credit cycle than prime loans. **Figure 1** shows that less than 1% of prime loans were in foreclosure during 1998-2006. In contrast, at least 3% of subprime loans were generally in foreclosure. During the 2000-2001 recession, subprime foreclosures reached almost 10%. In the current housing downturn, subprime foreclosures are again rising rapidly.

Although higher subprime foreclosures confirm that subprime loans are riskier than prime loans, the evidence for alternative mortgage products depends on the particular feature. **Figure 2** shows that the adjustable rate feature appears to be

**Figure 1. Prime and Subprime Loans in Foreclosure, 1998-2006**

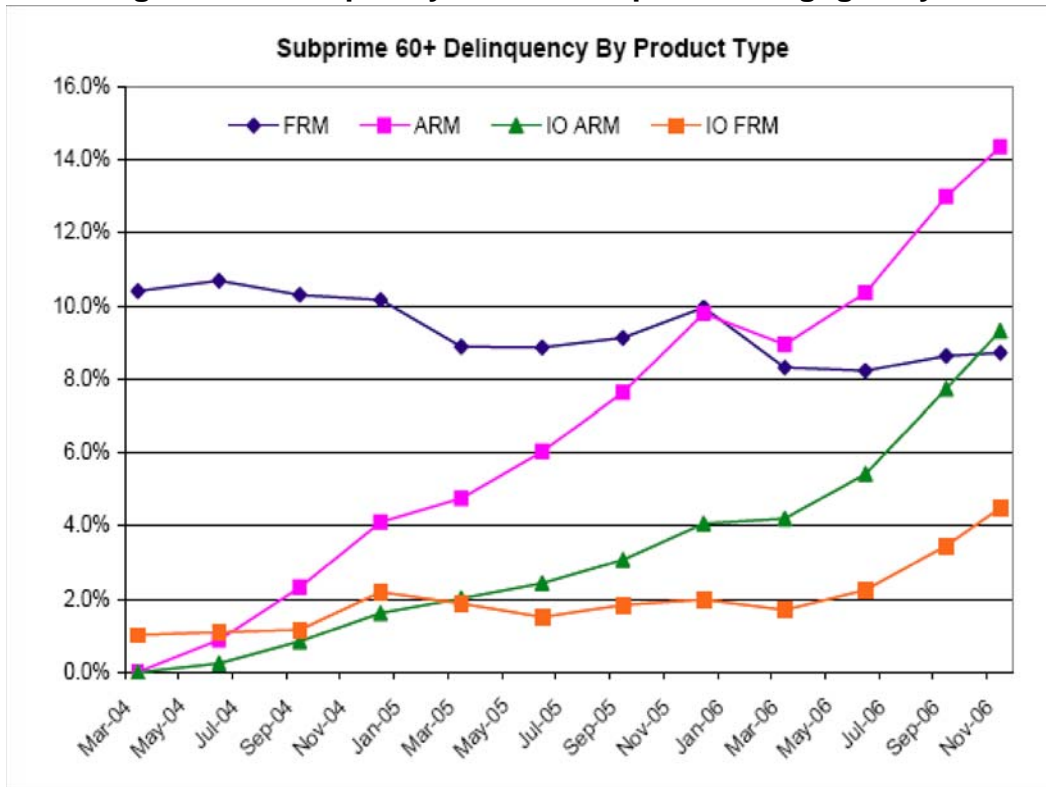


**Source:** Mortgage Bankers Association Delinquency Survey

<sup>8</sup> U.S. Department of Commerce, Bureau of the Census. The year 1993 is chosen as the beginning point both because Census data reflect a changed weighting procedure in that year and because the subprime market grew rapidly during 1993-1998.

under significant stress for both interest-only loans and fully amortizing loans.<sup>9</sup> Loan Performance, a financial consulting firm, has found that among subprime loans, adjustable rate products appear to have increased their delinquency rate faster than fixed rate products since 2005.<sup>10</sup> During the period Loan Performance studied, the 60-day delinquency rate for subprime fixed rate mortgages remained close to 9%, but the 60-day delinquency rate for subprime adjustable rate mortgages rose from under 2% during the summer of 2004 to over 14% in November 2006.

**Figure 2. Delinquency Rate of Subprime Mortgages by Feature**



The 60-day delinquency rate for negative amortizing (NegAm) loans is rising but remains relatively low. NegAm loans give the borrower the option of paying less than the interest owed in any month and therefore can increase the loan balance. In the sample analyzed by Loan Performance, most NegAm ARMs originated during 2004-2006 have increased their balance but the delinquency rate for these products has not risen as fast as subprime delinquency rates. The 60-day delinquency rate for all NegAm ARMs originated in 2006 remained below 1%, but the 60-day delinquency rate for subprime ARMs originated in 2006 exceeds 8%.<sup>11</sup>

<sup>9</sup> A fully amortizing loan pays off the loan balance using the traditional method of constant monthly payments. An interest-only loan has an introductory period of lower payments during which the monthly payments do not pay down the loan balance.

<sup>10</sup> Loan Performance calculations cited in *Economic Commentary*, Fannie Mae, February 20, 2007, p.2. A 60-day delinquent loan is not yet a loan in foreclosure. Loan Performance's definition of subprime does not necessarily match the Mortgage Bankers Association survey.

<sup>11</sup> Loan Performance calculations cited in *Economic Commentary*, Fannie Mae, February 20, (continued...)



## Stress on Subprime Lenders

In addition to rising foreclosures among subprime borrowers, the slowdown in the housing market has also challenged subprime lenders. Many subprime lenders raise funds by selling their loans to investors in the secondary market and using the proceeds to make new loans. These lenders can suffer significant hardship if investors downgrade the value of subprime debt. For example, Ownit Mortgage declared bankruptcy in December 2006, reportedly after it lost financing from Merrill Lynch and other investors.<sup>12</sup> New Century is under investigation for accounting and other improprieties connected to its subprime business. Several other lenders have shut their doors or restricted their subprime lending.

Stress on subprime financing is not confined to just a few lenders. A key indicator of investor estimation of the risk associated with funding loans through secondary markets, the ABX index, declined suddenly and significantly for subprime loans in February 2007 (see **Figure 3**). The ABX index is based on the cost of hedging purchases of mortgage loans that are packaged into securities and sold to investors in the secondary market.<sup>13</sup> According to Markit, an independent provider of data for derivatives trades, the price that investors were willing to pay for the BBB- rated portion of the index (part of the subprime market) fell from just over 97% on January 19, 2007, to under 70% by February 26, 2007.<sup>14</sup> The decline in the ABX index reflects the reduced willingness of investors to accept the risks associated with subprime loans. As a result, funds for additional subprime loans are decreasing.

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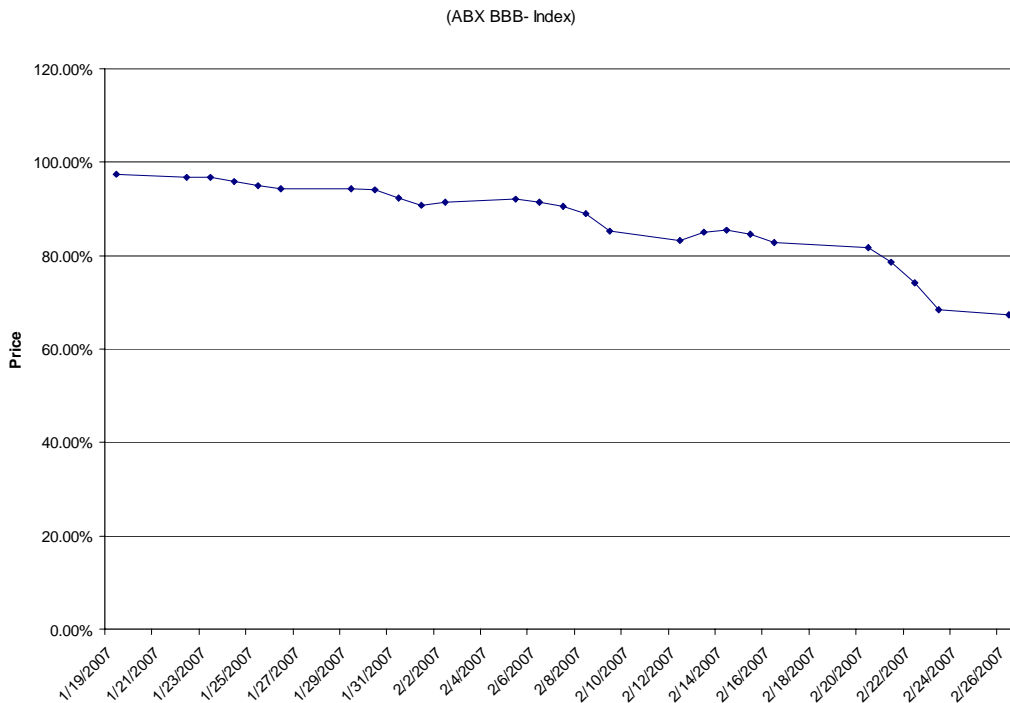
<sup>11</sup> (...continued)

2007, p.2. Not all subprime loans are NegAm loans and not all NegAm loans are subprime loans.

<sup>12</sup> Julie Creswell and Vikas Bajaj, "A Mortgage Crisis Begins to Spiral and Casualties Mount," *New York Times*, Mar. 5, 2007, p. C1.

<sup>13</sup> Investors can use insurance and other financial instruments to reduce their exposure to the risk that their investment will go sour. A traditional hedge occurs when someone simultaneously invests in two instruments that move in opposite directions so that if one goes bad, the other partially compensates. The ABX index is one measure of the price investors are willing to pay to hedge mortgage backed securities.

<sup>14</sup> Data provided by Markit Group, Limited. The company receives daily data contributions from over 70 firms dealing in related securities. See [<http://www.Markit.com>]. A decline in the index percentage represents an increase in the cost to hedge the investment.

**Figure 3. ABX Index of BBB- Rated Mortgage Derivatives**

**Source:** Markit Group Limited

The safety and soundness of subprime lenders has been a concern for many policymakers because some believe that disruptions in financial markets could have wider effects on the economy. For example, some believe that banking disruptions can make the business cycle more volatile. Federal responses to the Savings and Loan Crisis in the 1980s may have been due in part to concerns for the larger economy. The Federal Reserve itself was created because of a congressional commission to study banking issues in the Panic of 1907. While disruptions in the current subprime market do not rise to the level of historic banking panics, financial regulatory agencies have made public their intention to closely watch the subprime sector. The FFIEC agencies have issued new inter-agency guidance “to address emerging issues and questions relating to certain subprime mortgage lending practices.”<sup>15</sup>

## Banking Agency Guidance

Financial regulators have recognized the increased risks of subprime lending. Rising subprime foreclosures during 2000 prompted the OCC to tighten oversight of subprime lending programs in January 2001. “Institutions with significant subprime lending activities will be subject to closer scrutiny to ensure that their programs have

<sup>15</sup> “Proposed Statement on Subprime Mortgage Lending,” Federal Register, Vol 72, No. 45, Mar. 8, 2007, p. 10533.

appropriate risk management controls and capital support.”<sup>16</sup> The guidance covered capital maintenance, standards for individual loan review by examiners, documentation requirements for delinquent subprime accounts, and policies to curb potentially abusive lending practices.

Since 2001, as mortgage markets have continued to evolve, and housing markets have expanded, subprime lending has drawn renewed attention. In October 2006, the lending regulators of the FFIEC issued guidance for alternative mortgage products. The guidance reiterated that lenders must qualify loans based on the borrower’s ability to repay the loan balance, not based on the value of the loan collateral in sale or foreclosure. The October 2006 guidance also reminded lenders of Truth in Lending Act requirements to explain payment terms in plain language in order to curb abusive lending practices.

With subprime delinquencies and foreclosures mounting again, the FFIEC has issued a new interagency guidance for comment. The proposed guidance “reiterates many of the principles addressed in existing guidance relative to prudent risk management practices and consumer protection laws.”<sup>17</sup> Concerning risk management, the proposed guidance states that predatory lending typically involves at least one of (1) lending on collateral value rather than borrower ability to repay, (2) inducing repeated refinances to charge high points and fees, or (3) using deceptive marketing to conceal the true nature of the mortgage obligation. Concerning consumer protection, the proposed guidance states that mortgage product descriptions and advertisements should provide clear, detailed information on the costs, terms, features, and risks of the loan to the borrower, including any payment shock or prepayment penalty.

In the proposed guidance, the FFIEC asks for comments concerning restrictions on planned refinances because “the structural evolution of subprime mortgage lending in recent years has introduced some products that are intended at their outset to be temporary credit accommodations in anticipation of early sale or refinancing, rather than longer-term amortizing accounts.”<sup>18</sup> Commentors are asked to address the following:

- Do planned subprime refinances always present inappropriate risks that should be discouraged? If not, under what circumstances are they appropriate?
- Will the proposed guidance restrict existing subprime borrowers’ attempts to refinance and avoid payment shock?
- Should restrictions on planned refinances apply beyond subprime markets?

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<sup>16</sup> “Subprime Lending: Expanded Guidance for Subprime Lending Programs,” OCC 2001-6, Jan. 31, 2001. This bulletin supplements OCC Bulletin 1999-15, “Subprime Lending, Risks and Rewards.”

<sup>17</sup> “Proposed Statement on Subprime Mortgage Lending,” Federal Register, Vol 72, No. 45, Mar. 8, 2007, p. 10533.

<sup>18</sup> “Proposed Statement on Subprime Mortgage Lending,” Federal Register, Vol 72, No. 45, Mar. 8, 2007, p. 10533.

- Should prepayment penalties be restricted to the introductory period?

## Policy Considerations

Subprime loans, which are extended to borrowers with weaker credit conditions, have higher delinquency and foreclosure rates. Policies that facilitate subprime lending have to balance the benefits of homeownership against the risks of increased debt. More complex mortgage products may facilitate homeownership under some conditions but may be more difficult for consumers to understand.<sup>19</sup> Restrictions on mortgage products may insulate credit-impaired borrowers from default risk but may make it more difficult for these potential borrowers to own a home. Federal and state authorities also protect consumers through anti-predatory lending initiatives.<sup>20</sup> The recent rise in subprime delinquencies illustrates the trade-off between encouraging greater access to credit markets and risking increased defaults and foreclosures.

Policymakers decide the role of government agencies and government sponsored enterprises (GSEs) in the subprime sector.<sup>21</sup> Some argue that greater GSE presence in the subprime market could help reduce instability in that market by helping to standardize underwriting procedures. Raising the GSEs' housing goals may direct their programs to lower-income households but may increase the flow of funds to risky mortgages.<sup>22</sup> Reforming the loan programs of the Federal Housing Administration (FHA) could provide lower-income borrowers with an alternative to subprime lenders but may be less flexible in changing market conditions.<sup>23</sup> FHA makes it easier for borrowers to obtain loans by insuring the loan payments. On the other hand, some argue that granting FHA greater flexibility could increase the amount of risky mortgages.

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<sup>19</sup> CRS Report RL33775, *Alternative Mortgages: Risks to Consumers and Lenders in the Current Housing Cycle*, by Edward Vincent Murphy.

<sup>20</sup> CRS Report RL32784, *Predatory Lending: A Comparison of State Laws to the Federal Home Ownership and Equity Protection Act*, by Kamilah M. Holder, Kate M. Manuel.

<sup>21</sup> CRS Report RS22336, *GSE Reform: A New Affordable Housing Fund*, by N. Eric Weiss.

<sup>22</sup> The GSE housing goals refer to the percentage of housing units financed by the GSEs' loan purchases that must be for low income groups and underserved areas. The housing goals are set by HUD.

<sup>23</sup> CRS Report RS20530, *FHA Loan Insurance Program: An Overview*, by Bruce E. Foote, Meredith Peterson.