Risky Borrowers or Risky Mortgages?

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Research and analysis on the transformative power of capital

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Should the "risky" households – most of them low-income - be blamed for the housing crisis?

- If yes, then a seemingly logical solution: make sure that the lender and brokers avoid lending to families of modest means and modest credit scores.
- Once we exclude these "undesirable" families, with the help by the bailout plan for big banks, the housing market will eventually recover.

This study tries to provide a piece of evidence:

- What would be the default risk if subprime borrowers had received prime-term products?
- Many of these borrowers holding subprime loans qualify for a prime mortgage (Freddie Mac 2005); subprime borrowers may have received prime products.

Serving LMI/minority borrowers…

- **Traditionally:**
  - **FHA**
- **Starting in the 1990s:**
  - **Community reinvestment type products** are mostly FRM originated by lenders. More regulation, existence of reputation risk, and lenders' knowledge of the community allows them use with flexible but carefully underwritten standards. Limited due to liquidity concerns.
- **Starting in the late 1990s:**
  - **Subprime loans** are products characterized by risky underwriting —reliance on rapid appreciation, low doc or no-doc, low-down or no-down, high debt ratios, originated by brokers.
- **Starting in the late 2000s:**
  - **FHA loans** has gained market share after the inset of the current crisis (~30% of originations in 2008?)

Performance of Community Lending is Close to Prime FRM
Subprime Products have the Worse Performance

(Updated to June 2008)

Sub ARM

Sub FRM

Prime_ARM

FHA

Community Lending
Prime FRM

Source: Mortgage Bankers Association and Self-Help. 90+day delinquencies include loans in different foreclosure stages.

Community Reinvestment Loans

- Community Advantage Program (CAP)
  - Partnership between Ford Foundation, Self-Help, Fannie Mae
  - Started in 1998, over 50,000 loans
  - Secondary market outlet for CRA-type loans
- This is a group that resembles the typical subprime borrower
  - Low- to moderate- income
  - Weak credit history and/or low down-payments
- Prime-term mortgages
  - Most 30-year prime-level fixed-rate mortgages
  - Lender originated, no prepayment penalties; no balloon

Subprime Data

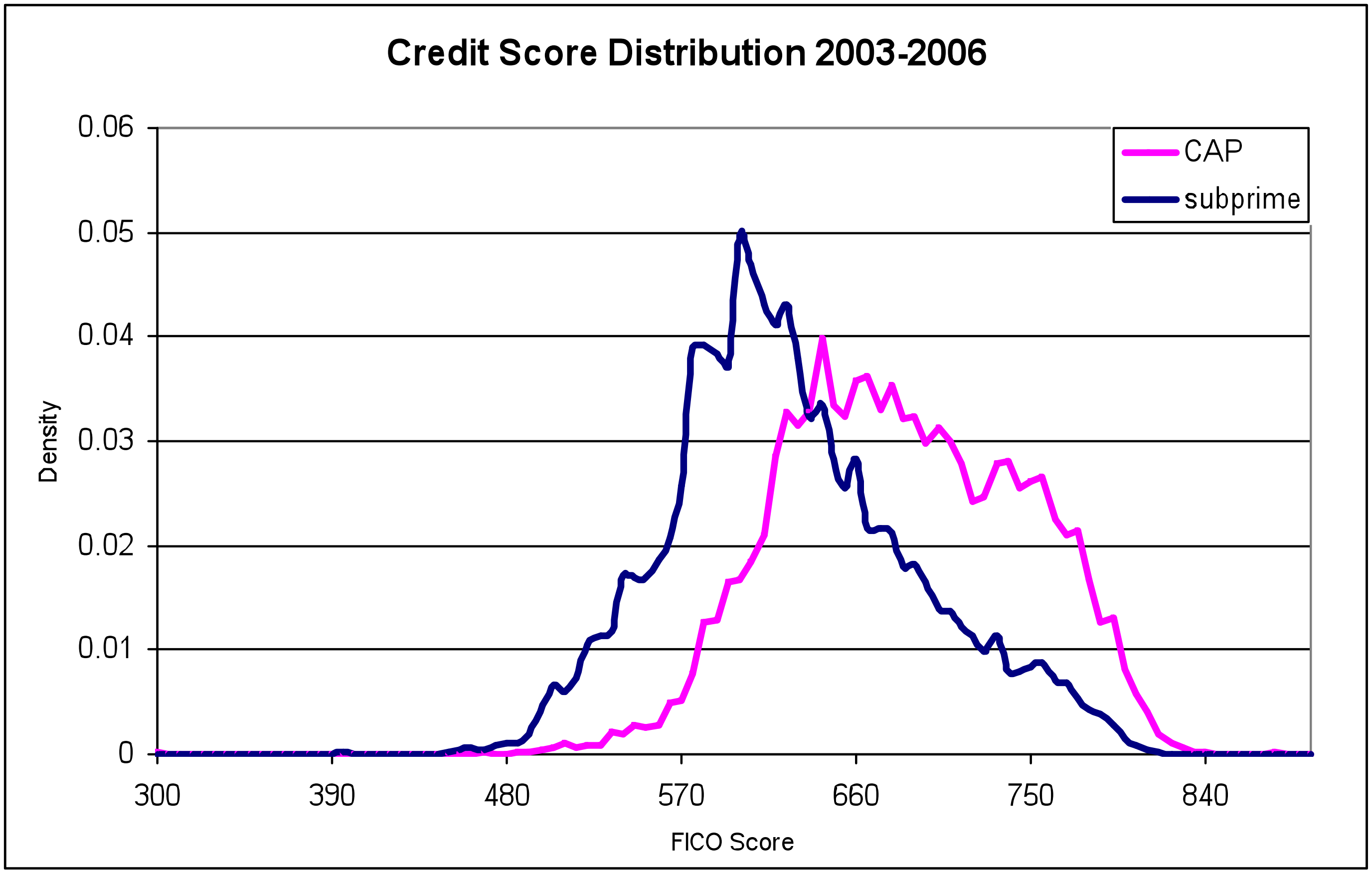
McDash Analytics

- Loan level info about 15 residential mortgage servicers;
- Tracking over 20 million active loans on a monthly basis
- Good coverage on conventional prime loans and FHA market
- Modest coverage in the subprime market

Definition of subprime loans

- B&C loans
- High-cost ARMs (arm margin greater than 300 basis points)

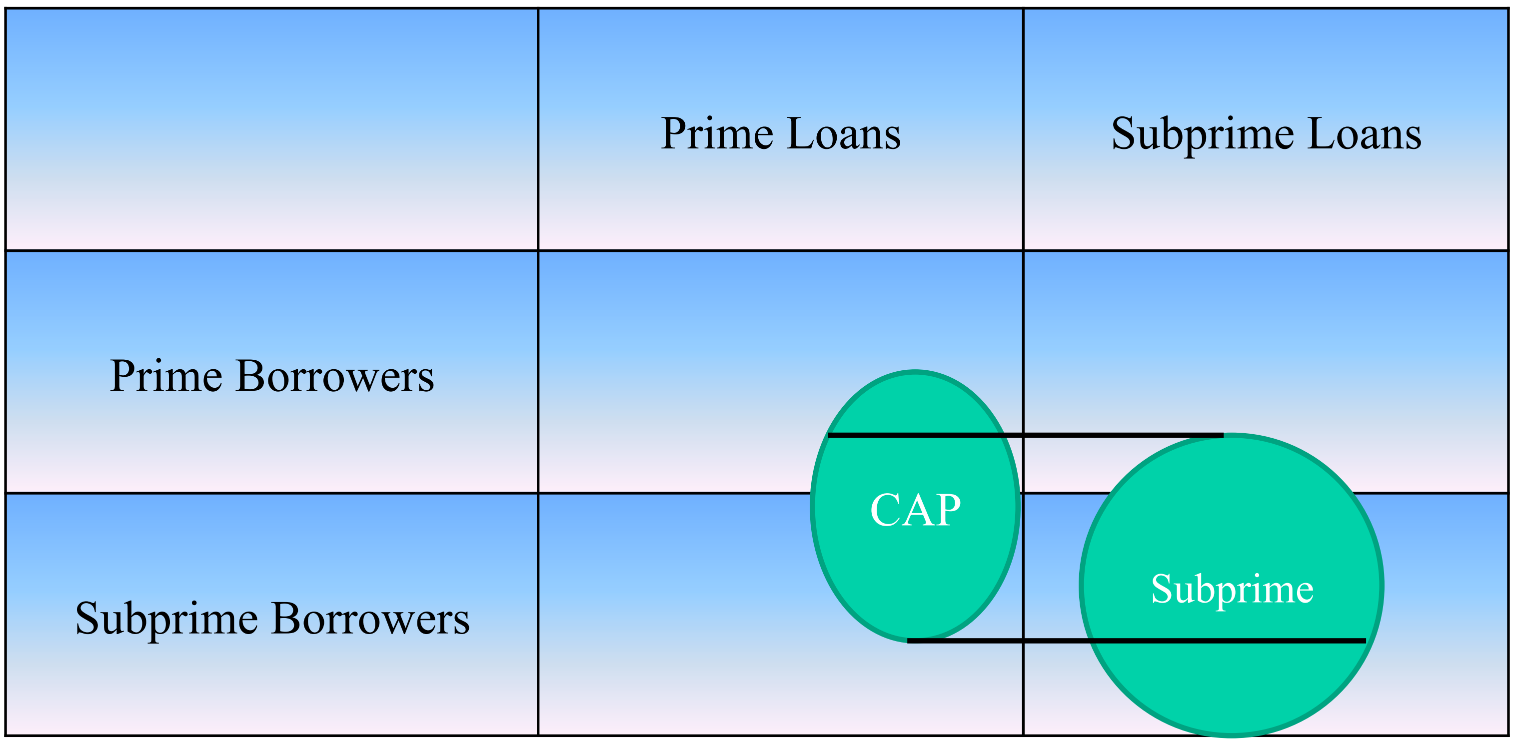
To make it comparable: we limit our sample to subprime loans: first-lien; purchase money, 30-year, owner-occupied, full/alternative documentation; and in zip codes with CAP activities.


Credit Score Distribution 2003-2006
CAP
subprime
Density
0.06
0.05
0.04
0.03
0.02
0.01
0
300
390
480
570
660
750
840
FICO Score

Explanatory variables to predict propensity of taking out subprime

- **Underwriting variables:** FICO score; DTI; LTV.
- **Loan amount**
- **Local credit risk:** average FICO score in the zip code.
- **Financial knowledge/literacy:** educational distribution in the zip code
- **Market competition:** the sum of squared market shares of lenders in a zip code: HHI index.
- **Demographics** Share of minority is included to consider the local.
- Quarterly calendar dummy variables.

Propensity Score Match: focusing on borrowers with similar risk characteristics but holding different products: CAP or subprime



Predicted Serious Delinquency 24 months after Origination Community Lending (CAP) and Subprime loans

Note: Estimation is based on a borrower with a FICO score between 580-620 with the mean value of other regressors. Controlling variables include borrower DTI, FICO_score, home equity, loan age, loan size, area credit risk, area unemployment rate, and interest rate environment.

Why Subprime Loans Have Much Higher Default Risk?

	Broker	ARM	PPP
CAP	0	0	0
Sub_FRM*	0	0	0
Sub_FRM_PPP*	0	0	1
Sub_ARM	0	1	0
Sub_ARM_PPP	0	1	1
Sub_BRO_FRM	1	0	0
Sub_BRO_FRM_PPP	1	0	1
Sub_BRO_ARM	1	1	0
Sub_BRO_ARM_PPP	1	1	1

Predicted Serious Delinquency 24 months after Origination
Community Lending (CAP) and Retail Subprime loans

Note: Estimation is based on a borrower with a FICO score between 580-620 with the mean value of other regressors. *sub_arm* represents retail originated subprime ARMs without prepayment penalties; *sub_arm&ppp* represents retail originated subprime ARMs with prepayment penalties.

Predicted Serious Delinquency 24 Months After Origination
Community Lending (CAP) and Broker Originated Subprime Loans

Note: Estimation is based on a borrower with a FICO score between 580-620 with the mean value of other regressors. *sub_bro&ppp* and *sub_bro* represent broker-originated subprime FRMs with and without prepayment penalties respectively; *sub_bro&arm&ppp* and *sub_bro&arm* represent broker-originated subprimeARMs with and without prepayment penalties respectively.

Summary

• For borrowers with similar characteristics, the estimated default risk is much lower with a prime-term CAP loan than with a subprime mortgage. Given an opportunity to access fair mortgages, most families who foreclosed under the burden of reckless loan products would still be in their homes.

• Variable interest rates, repayment penalties, and broker origniation channel help explain why subprime loans are more likely to fail than the CRA type prime-term mortgages.

• Loan products and origination channels are the problem, not the borrowers. Lender and brokers should not be promoting instruments that are high-risk and they know it.

Implications

• Done right, done responsibly, low-income homeownership can be a viable and sustainable asset building tool. We should respond to the mortgage crisis not by closing the door to homeownership but by ensuring that all families have access to fair and responsible financial services.

• We should pursue a plan to stabilize borrowers with the same urgency that has been applied to the financial system. Such an effort should include default counseling and new mechanisms to restructure mortgages into sustainable loans that keep borrowers in their homes.

•Predatory lending practices should be prohibited that made subprime mortgages destined to fail.