Subprime lending

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In finance, **subprime lending** (also referred to as **near-prime**, **non-prime**, and **second-chance lending**) means making loans to people who may have difficulty maintaining the repayment schedule, sometimes reflecting setbacks such as unemployment, divorce, medical emergencies, etc.[1] Historically, subprime borrowers were defined as having a FICO scores below 640, although "this has varied over time and circumstances."[2]

These loans are characterized by higher interest rates, poor quality collateral, and less favorable terms in order to compensate for higher credit risk.[3] Many subprime loans were packaged into mortgage-backed securities (MBS) and ultimately defaulted, contributing to the financial crisis of 2007–2008.[4]

Proponents of subprime lending maintain that the practice extends credit to people who would otherwise not have access to the credit market. Professor Harvey S. Rosen of Princeton University explained, "The main thing that innovations in the mortgage market have done over the past 30 years is to let in the excluded: the young, the discriminated-against, the people without a lot of money in the bank to use for a down payment."[5]

Contents

Defining subprime risk

The term subprime refers to the credit quality of particular borrowers, who have weakened credit histories and a greater risk of loan default than prime borrowers.[6] As people become economically active, records are created relating to their borrowing, earning and lending history. This is called a credit rating, and although covered by privacy laws the information is readily available to people with a need to know (in some countries, loan applications specifically allow the lender to access such records). Subprime borrowers have credit ratings that might include:

- limited debt experience (so the lender's assessor simply does not know, and assumes the worst), or
- no possession of property assets that could be used as security (for the lender to sell in case of default)

- excessive debt (the known income of the individual or family is unlikely to be enough to pay living expenses + interest + repayment),
- a history of late or sometimes missed payments (morose debt) so that the loan period had to be extended,
- failures to pay debts completely (default debt), and
- any legal judgments such as "orders to pay" or bankruptcy (sometimes known in Britain as county court judgments or CCJs).

Lenders' standards for determining risk categories may also consider the size of the proposed loan, and also take into account the way the loan and the repayment plan is structured, if it is a conventional repayment loan, a mortgage loan, an endowment mortgage, an interest only loan, a standard repayment loan, an amortized loan, a credit card limit or some other arrangement. The originator is also taken into consideration. Because of this, it was possible for a loan to a borrower with "prime" characteristics (e.g. high credit score, low debt) to be classified as subprime.[7]

Student loans

In some countries student loans are considered subprime, perhaps because of school drop-outs. In United States the amount of student loan debt recently surpassed credit card debt. In other countries such loans are underwritten by governments or sponsors. Many student loans are structured in special ways because of the difficulty of predicting students' future earnings. These structures may be in the form of soft loans, income-sensitive repayment loans, income-contingent repayment loans and so on. Because student loans provide repayment records for credit rating, and may also indicate their earning potential, student loan default can cause serious problems later in life as an individual wishes to make a substantial purchase on credit such as purchasing a vehicle or buying a house, since defaulters are likely to be classified as subprime, which means the loan may be refused or more difficult to arrange and certainly more expensive than for someone with a perfect repayment record.

United States

Although there is no single, standard definition, in the United States subprime loans are usually classified as those where the borrower has a FICO score below 640. The term was popularized by the media during the subprime mortgage crisis or "credit crunch" of 2007. Those loans which do not meet Fannie Mae or Freddie Mac underwriting guidelines for prime mortgages are called "non-conforming" loans. As such, they cannot be packaged into Fannie Mae or Freddie Mac MBS.[8]

A borrower with an outstanding record of repayment on time and in full will get what is called an A-paper loan. Borrowers with less-than-perfect credit 'scores' might be rated as meriting an A-minus, B-paper, C-paper or D-paper loan, with interest payments progressively increased for less reliable payers to allow the company to 'share the risk' of default equitably among all its borrowers. Between A-paper and subprime in risk is Alt-A. A-minus is related to Alt-A, with some lenders categorizing them the same, but A-minus is traditionally defined as mortgage borrowers with a FICO score of below 680 while Alt-A is traditionally defined as loans lacking full documentation.[9] The value of U.S. subprime mortgages was estimated at $1.3 trillion as of March 2007,[10] with over 7.5 million first-lien subprime mortgages outstanding.[11]

Canada

New types of "exotic" mortgages became popular in the U.S in the years leading up to the economic downturn. These mortgages often featured "teaser rates" that kept initial monthly payments artificially low, only to have them increase significantly later in the mortgage. Features such as this were never adopted by major Canadian mortgage lenders. The sub-prime market did not take hold in Canada to the extent that it did in the U.S., where the vast majority of mortgages were originated by third parties and then packaged and sold to investors who often did not understand the associated risk. Most mortgages in Canada, on the other hand, are originated and retained by institutions whose goal is to maintain a long-term relationship with the borrower. CMHC does not insure sub-prime mortgages.

Canadian banks, trust companies and credit unions tend to have a broader relationship with their customers than just a mortgage, also offering credit cards, car loans and investments. They have a financial interest in ensuring that borrowers do not take on unmanageable debt, which reinforces their motivation to prudently underwrite mortgages.

The Canadian banking system is dominated by five or six large banks that together hold the majority of domestic banking assets. The large banks are in turn diversified geographically and across product lines, while the non-traditional, or shadow, banking system is relatively limited in scope compared with that of the U.S. Oversight is facilitated by a single authority (the Office of the Superintendent of Financial Institutions, or OSFI), which has responsibility for the prudential oversight of these federally incorporated institutions. Communication with the banking community is thus reasonably straightforward. There is a strong focus on the quality of the banks' risk-management practices. While this is often attributed to a traditionally conservative business culture in Canada, an important factor here is the difficult lessons learned from previous banking problems. An example is the economic difficulties in the early 1990s, which included a significant housing downturn. Canadian banks therefore entered the recent period of financial stress with better risk-management practices, focused on limiting credit losses, than in previous episodes. This helped to limit their exposure to some potentially riskier sectors and products. For example, subprime mortgages, as they occurred in the U.S. market, remained a relatively limited phenomenon in Canada.[12]

Subprime crisis

The subprime mortgage crisis arose from 'bundling' American subprime and American regular mortgages into MBSs which were traditionally isolated from, and sold in a separate market from prime loans.[4] These 'bundles' of mixed (prime and subprime) mortgages were the basis asset-backed securities so the 'probable' rate of return looked superb (since subprime lenders pay higher premiums, and the loans were anyway secured against saleable real-estate, and so, theoretically 'could not fail'). Many mortgages had a low interest for the first year, and poorer buyers 'swapped' regularly at first, but finally such borrowers began to default in large numbers. The inflated house-price bubble burst, property valuations plummeted and the real rate of return on investment could not be estimated, and so confidence in these instruments collapsed, and all were considered to be almost worthless toxic assets, regardless of their actual composition or performance. Because of the "originate-to-distribute" model followed by many subprime mortgage originators, there was little monitoring of credit quality and little effort at remediation when these mortgages became troubled.[4]

To avoid high initial mortgage payments, many subprime borrowers took out adjustable-rate mortgages (or ARMs) that give them a lower initial interest rate. But with potential annual adjustments of 2% or more per year, these loans can end up costing much more. So a $500,000 loan at a 4% interest rate for 30 years equates to a payment of about $2,400 a month. But the same loan at 10% for 27 years (after the adjustable period ends) equates to a payment of $4,220. A 6-percentage-point increase (from 4% to 10%) in the rate caused slightly more than a 75% increase in the payment.[13] This is even more apparent when the lifetime cost of the loan is considered (though most people will want to refinance their loans periodically). The total cost of the above loan at 4% is $864,000, while the higher rate of 10% would incur a lifetime cost of $1,367,280.

See also

- Amortization (business)
- Collateral (finance)
- Endowment mortgage
- Graduated payments
- Microcredit
- Mortgage loan
- Soft loan
- Student loan default

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2. ^ Lo, Andrew W. "Reading About the Financial Crisis: A 21-Book Review" (http://www.argentumlux.org/documents/JEL_6.pdf). *Draft: January 9, 2012*. Journal of Economic Literature. Retrieved 17 November 2013. "The term “subprime” refers to the credit quality of the mortgage borrower as determined by various consumer credit-rating bureaus such as FICO, Equifax, and Experian. The highest-quality borrowers are referred to as “prime”, hence the term “prime rate” refers to the interest rate charged on loans to such low-default-risk individuals. Accordingly, “subprime” borrowers have lower credit scores and are more likely to default than prime borrowers. Historically, this group was defined as borrowers with FICO scores below 640, although this has varied over time and circumstances, making it harder to determine what “subprime” really means."
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