The Nonprime Mortgage Market in the United States

By

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Introduction

One of the most important changes in the mortgage lending industry over the last thirty years was the decoupling of loan origination from loan financing. This separation of loan origination from financing of the loan was made possible by the development of a securitization market for mortgage loans. The mortgage backed securities market was developed by the so-called government-sponsored enterprises (GSEs), which are the Federal National Mortgage Association, better known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, better known as Freddie Mac and by the Government National Mortgage Association, or Ginnie Mae. Loan originators no longer need to hold a mortgage loan until maturity or sell whole loans to other financial institutions. With the development of the mortgage securities markets, lenders can sell entire pools of loans not just to other banks and thrifts, but to a diverse set of investors such as pension funds, mutual funds, life insurance companies or individuals. By bringing new investors to the market, securitization has dramatically increased funding for housing finance, lowered costs and increased access to credit across the country. The decoupling of loan origination from financing has lead to a "mortgage market that is mammoth in size."[i] Today, the size of the mortgage securities market exceeds the size of the corporate bond market.[ii] The decoupling of loan origination from loan financing has created a more efficient market with lower costs, lower margins and lower interest rates.

During the 1990s, the percent of American households that own their homes rose to 68%.[iii] Investors that finance mortgage loans include major financial institutions (often different from the originator), federal and related agencies, mortgage pools or trust and individuals. The broad funding support for mortgage loans goes well beyond the originator of the mortgage loan. To be most efficient, investors that are the source of funding for mortgage debt desire reliable risk analysis of the potential borrower, good reputations of all involved in the mortgage lending process, transparency of the process and standardization of the process, and clarity in the laws governing both.

Nonprime Mortgage Market

The nonprime (also called subprime) mortgage market has expanded rapidly over the last few years. Researchers at the Federal Reserve found that "Home-purchase lending to lower-income and minority households and to residents of lower-income and minority neighborhoods has expanded significantly in recent years and at a faster rate than lending to other borrowers."[iv] A U.S. Department of Housing and Urban Development (HUD) report documents the growth in nonprime lending and attributes this growth to a number of factors: "federal legislation preempting state restrictions on allowable rates and loan features, the Tax Reform Act of 1986, increased demand for and availability of consumer debt, and an increase in subprime securitization."[v]

When I first researched the nonprime mortgage market in 1998, there wasn't a precise definition for the characteristics of a nonprime borrower in the literature.[vi] Often, lenders were using slightly different standards. Today, there is a very active mortgage-backed securities market for nonprime loans, which has been enabled by greater standardization. Nonprime origination and financing has been decoupled, just as it has for the prime mortgage market. The nonprime mortgage market has expanded rapidly over the last five years. The origination of nonprime mortgages in 2003 was estimated at $325 billion, and is estimated to represent 10.5% of all mortgage originations.[vii]

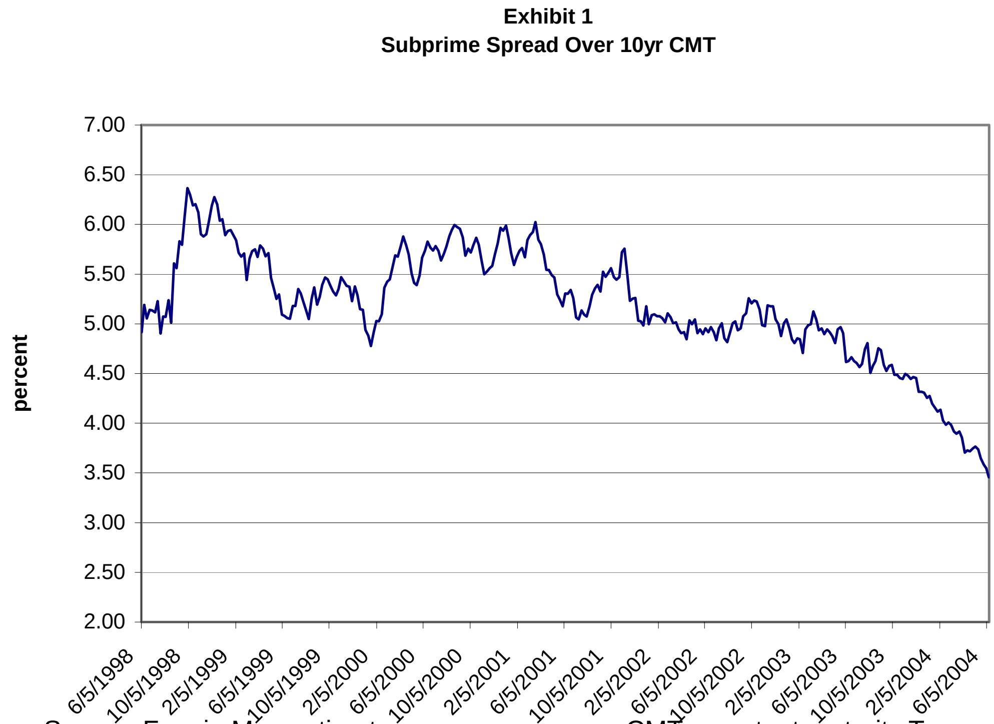
There are a lot of similarities to the growth in the nonprime mortgage market and the corporate bond market that developed in the eighties for companies with a bond rating below BBB. Prior to the development of a bond market for these companies, many of them were unable to get funds for needed capital spending. Many of these companies, that at the time were young start-ups that hadn't established a bond rating, went on to become very successful companies and have contributed greatly to the economic growth in the U.S. over the last twenty-years. Prior to the development of the high-yield market in the eighties many start-ups and other companies without well-established credit records could not borrow to expand. The high-yield bond market grew dramatically because of the growth of a secondary market for securities from companies with less than a BBB bond rating. And the growth in lending to these companies led to another source of economic growth in the U.S. during the late eighties and nineties.

Following a parallel growth pattern to corporate bonds, the nonprime bond market has grown dramatically as bond financing for mortgages has expanded. This expansion came about as more institutions and other investors became willing to invest in mortgage-backed securities that included nonprime mortgage securitizations. The fixed income bond became the predominant provider of capital to the nonprime mortgage borrowers community in the late eighties.[viii] Fixed income bond investors replaced portfolio lenders like banks and thrifts as the primary source of funds for nonprime loans. It is estimated that two-thirds of nonprime mortgage loans are now securitized in the secondary market.[ix]

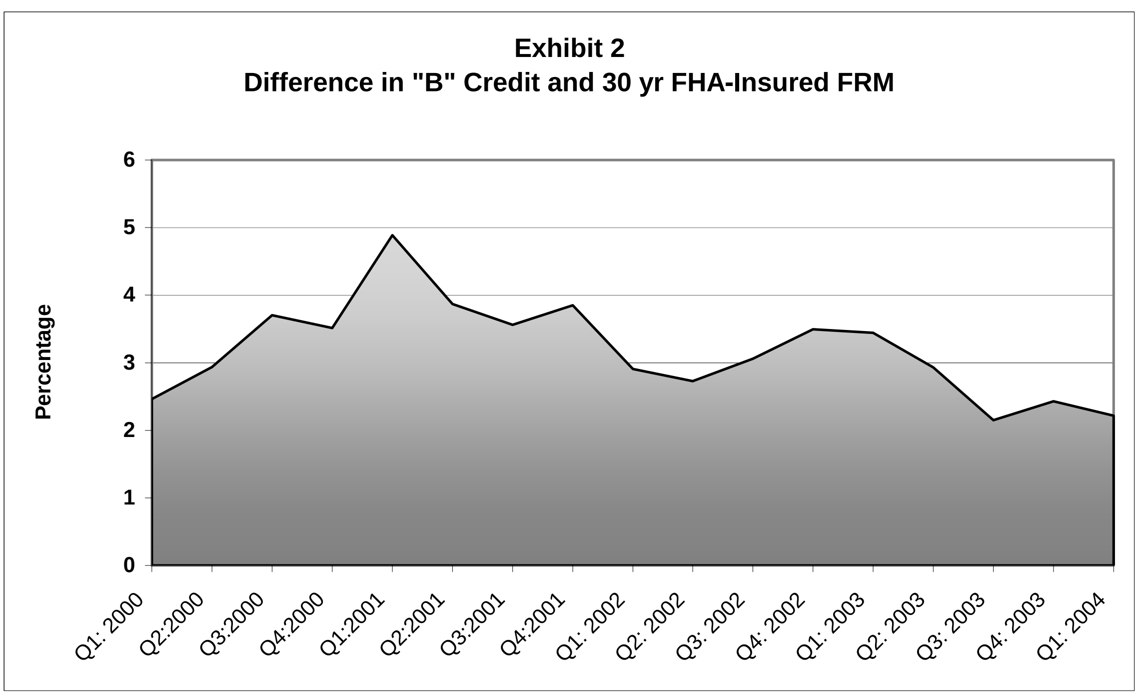
This expanding source of funds meant that many individuals with less than perfect credit records were able for the first time to buy a new home, refinance their current home loan, remodel or expand their current home, or borrow for many other productive reasons such as financing theirs, or their children's, college education. Prior to the development of the nonprime mortgage lending industry and its secondary market, many well deserving potential borrowers with a less than perfect record could not borrow. Now however, with the vast expansion of the nonprime mortgage credit, these deserving potential borrowers are able to participate in the American Dream of home ownership. I am sure that making this credit available to those without a perfect credit record has contributed to, just as lending to companies with less than a BBB bond rate in the eighties contributed to, economic growth in the U.S. as these nonprime borrowers were able to buy their first home or remodel and expand their current home or invest in their own, or their children's education, or start their own business with the capital that was provided by the nonprime loans.

Spreads

Just as high-yield interest rate spreads dropped in the eighties after the development of an active secondary market, so have nonprime interest rate spreads dropped over the last six years, especially during the last two years. Exhibit 1 shows the interest rate spreads between nonprime loans and the ten-year constant maturity Treasury (CMT) rate over the last six years. Exhibit 2 uses national data on a quarterly basis. Notice the drop in spreads over the last two years in both Exhibits. As economic theory suggests, interest rate margins for the lenders have decreased with the growing competitiveness in the markets. These decreased interest rate spreads are good news for nonprime borrowers because they represent lower interest rates to the nonprime borrower.



Source: Fannie Mae estimates CMT=constant maturity Treasury



Source: *B&C Market at a Glance* (various issues) FRM=fixed rate mortgages

Disruptions to the Nonprime Mortgage Market

Financial markets crave certainty and similarity. Often commentators will talk about the stock market dropping because of uncertainty. The same is true in the nonprime mortgage market. A law that isn't clear, or certain, may cause the liquidity of a nonprime market to drop dramatically as lenders and investors move to more certain investments, and thus drive up interest rates in the nonprime market to compensate for the uncertainty caused by the law. Investors are typically risk averse. They demand a higher return for increased risks. An investor will avoid uncompensated risk no matter if it comes from the vagueness of the law or some other market disruption. Illiquidity in financial markets is caused by the fact that investors have many choices for investments. So if an investment becomes uncertain or riskier, investors will fund other more certain and less risky investments. This will cause a disruption in the availability of financing for nonprime mortgage lending.

An example of this type of disruption was the New Jersey Home Ownership and Security Act of 2002. (This law is currently being amended). When studying this law's impacts, I found that from the first two months after its implementation as compared to the two months prior to its implementation, nonprime lending in New Jersey dropped by more than two-thirds. When I compared the drop in New Jersey to the seasonal drop in Pennsylvania for the same time periods, I found that the drop in New Jersey significantly higher than the small seasonal drop in Pennsylvania. The drop in New Jersey that seemed to be primarily due to the change in the law was approximately 60 percent.[x] Other examples of state laws that, at least, initially disrupted the markets were the anti-predatory laws in Georgia and New Mexico. There are two things to keep in mind when looking a different state or cities laws that affect nonprime mortgages. The first impact to look at is to determine what the state allows or doesn't allow and the second impact to look at is how much more difficult national lending processes and standards become with different laws in various jurisdictions. The "federal legislation preempting state restrictions on allowable rates and loan features" was the first factor that accounted for the growth in nonprime lending in the nineties that was listed in a HUD report.[xi] Any vagueness in the law will only further disrupt funding sources, as investors will be very reluctant to invest in a nonprime mortgage when there is some uncertainty about the law. Another factor of some state laws that may cause investors to avoid funding nonprime mortgages are severe penalties. Even if the law is reasonably clear, investors will invest in other markets where the penalties for an unintentional error are not as severe.

The liquidity of the nonprime mortgage market, as is true in other fixed income markets, depends upon the willingness of investors to invest. To a large extent investor willingness to invest in a financial instrument depends on the investors' confidence in the given market. Thus, investors are dependent upon the good reputation of the mortgage originator and everyone involved in the mortgage origination transaction and the securitization process. The major rating agencies, Moody's and Standard & Poor's, play an integral role in building the confidence of investors in a fixed income security. The liquidity of a market drops substantially when a rating agency is unable to reliably rate a pool of mortgages from a certain jurisdiction, as the state or municipality's anti-predatory laws make it difficult to assess credit risks of the mortgage pools. As Joanne W. Rose, Executive Managing Director of Global Structured Finance at Standard & Poor's, stated so well, that "If we can't quantify the risk, we can't rate the structure."[xii] Investors count on these credit ratings and will probably not add liquidity to mortgage debt markets if the instruments are not rated by these well-respected agencies.

A quilt pattern of state and city laws will further hinder nonprime markets by complicating lenders' and investors' ability to set up automated funding flows. Standardizing pools of nonprime mortgages enables lenders to set up automated funding processes which lower the costs of lending and thus should lead to lower interest rates for nonprime borrowers. However many of the state and city laws require nonprime lenders to set special programs for each jurisdiction, which in turn increase their costs and thus the interest rates to nonprime borrowers.

In an op-ed piece in *The New York Times,* Mr. Robert E. Litan of the Brooking Institute and Professor Charles W. Calomiris at Columbia University stated: "New laws on the pattern of some already passed at the state and local level could do great harm by discouraging lenders from making any subprime loans at all. Laws that effectively limit fees and interest in mortgage contracts are tantamount to usury ceilings, which have generally been eliminated for a good reason: They force lenders to ration credit and thus deny funds to some borrowers."[xiii]

Any disruption in the mortgage market will cause ripple effects. A drop in credit availability, for whatever reason, will not only deprive deserving borrowers credit, but will have an effect on the overall economy since these borrowers will not be able to borrow to buy a new home, remodel or expand their current homes. This reduction of credit will then have consequences for many trade workers (carpenters, electricians, plumbers, painters and other trades) who could have been hired by the borrowers to build new homes or remodel or expand their current homes. In addition, the nonprime borrower won't have the same opportunity as prime borrowers to refinance their homes at lower interest rates or use the borrowed funds for higher education expenses. This only reinforces their economic hardships and hinders any hope for progress beyond current social standings.

Well-Crafted Federal Law

A well-crafted federal law that could prevent undesirable lending practices, while at the same time preventing disruptions to nonprime lending in local markets is needed. By well crafted, I am describing a law that sets clear and objective standards to prevent certain undesirable actions like predatory lending. This well-crafted federal law should also help avoid disparity in local laws on nonprime borrowing, illiquidity in the nonprime mortgage lending market, and disruptions to automated funding flows.

National Markets

Just as is true with the prime mortgage market, the nonprime mortgage market has become national as the large institutional lenders have replaced banks and small finance companies as the primary source of funds. The nonprime mortgage market has significantly consolidated over the last ten years. The top ten nonprime lenders now represent over 65 percent of the nonprime market, according to *Inside B&C Lending*.[xiv] These lenders make nonprime loans on a national basis and their funding comes from investors from all over the United States and abroad. In contrast to the regional differences that were found in mortgage interest rates when I first got into banking in the mid-1960's, today there are almost no regional differences in mortgage interest rates. Not only are there almost no regional differences in mortgage interest rates, there are very little differences in the interest rates from one lender to another.

In my mind, the law regulating a national market should be federal. Having one national standard would enable the market to grow while at the same time preventing abusive lending practices. HUD listed four factors accounting for the growth in the nonprime markets in the 1990s and the very first reason listed was "federal legislation preempting state restrictions on allowable rates and loan features."[xv] To continue this growth of nonprime lending and allow those with less than perfect credit records to share in the American dream of home ownership, I urge Congress to enact a federal law aimed at eliminating abusive lending practices that provides clear and objective standards and that applies to all lenders.

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[i] Anthony M. Santomero and David F. Babbel, *Financial Markets, Instruments, and Institutions*, 2nd Ed., McGraw-Hill Irwin, 2001, p.277

[ii] ibid., p. 277

[iii] "Recent Changes to a Measure of US Household Debt Service," *Federal Reserve Bulletin*, October 2003, p. 421

[iv] "The Role of Special Lenders in Extending Mortgage Credit to Low-Income and Minority Homebuyers," *Federal Reserve Bulletin*, November 1999, p. 709

[v] "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March, 2002, p. vii

[vi] Richard F. DeMong, "Subprime (B&C Credit) Mortgage Loans, *Equit*y, Fall 1999, pp. 7-9

[vii] SMR Research, "Subprime Mortgage Loans, 2004"

[viii] "Analysis of The Impact of Prepayment Penalties on Residential Subprime Lending Coupons," Pentalpha Group LLC, May 12, 2004, p.3

[ix] "Statement of The Coalition for Fair and Affordable Lending ("CFAL") and New Century Financial Corporation On 'Subprime Lending: Defining the Market and Its Customers,'" Joint Hearing of the Subcommittee on Housing and Community Opportunity and Subcommittee on Financial Institutions and Consumer Credit, US House of Representatives, March 30, 2004

[x] Richard F. DeMong, "The Impact of the New Jersey Home Ownership Security Act of 2002, NHEMA (http://www.nhema.org/press.asp?bid=596), March 2004

[xi] "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March, 2002, p. vii
[xii] S&P Correct: S&P Report Addresses New Jersey State Predatory Lending Laws
[xiii] Robert E. Litan and Charles W. Calomiris, *The New York Times*, August 20, 2001
[xiv] "Top 25 B&C Lenders in 2003," *Inside B&C Lending*, February 9, 2004, p. 2
[xv] "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March, 2002, p. vii