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SUBPRIME LENDING

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WHEN THE AMERICAN housing bubble almost audibly popped several months ago, the arcane terms of subprime loans became front-page news. As foreclosures rise, the collapse of the subprime market has generated calls for reform from Congress to the campaign trail. Foreclosures have risen dramatically, and there is little doubt that the excesses of recent years were marked by fraud and recklessness by borrowers and lenders. But this crisis calls for sensible regulation, not demonization. The growth of subprime lending has had both benefits and costs, not only to private homeowners, but to neighborhoods and communities. Subprime lending has raised home ownership rates, especially among the lowest-income Americans, and has contributed to stronger neighborhoods and the happiness of homeowners and their families. At the same time, default rates for these riskier borrowers have risen in recent years, resulting in higher foreclosure rates and adverse neighborhood impacts. Sensible regulation of subprime lending should seek to curb abusive practices while preserving this important tool for economic mobility.

THE SUBPRIME MARKET

Despite the recent turmoil and foreclosures, overall the subprime market has increased home ownership in America. Between 1996 and 2006, the number of homeowners in this country swelled, most of whom depended on subprime mortgages to finance their purchases.[1] Although rising foreclosures have caused home ownership rates to drop, home ownership remains at record levels. The psychological and financial benefits of home ownership for these individuals and families are significant—for most low-income families, a home is the only significant source of wealth. Also, groups seeing the greatest ownership increases from subprime loans include the young, low-income households, and minorities.[2] Any policy response to the "meltdown" must carefully consider these facts. The vast majority of subprime loans do not end in foreclosure; they end with home ownership.

Subprime loans emerged after financial deregulation as a way for people with poor credit ratings to borrow money. Because people with bad credit default more frequently, banks are willing to lend to them only at higher interest rates and with a variety of other risk-based terms that are absent from prime mortgages. People can fail to qualify for prime loans for a variety of reasons, and the many different types of subprime contracts are an attempt to secure credit for these individuals while still guaranteeing the creditor a return.

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Many commentators seem to conflate all subprime loans with "predatory" loans. Though many subprime loans benefit both the borrower and the lender, there is certainly a minority that could reasonably be called predatory. In general, predatory loans have no anticipated benefit for the borrower. This might be because he has insufficient income to make the payments or because the terms of the contract are unclear or deceptive.

No one really knows how extensive predatory lending has been, but it is important to recognize which practices are *not* predatory. As discussed earlier, higher interest rates are not evidence of exploitation; they are simply a way to offer credit to riskier consumers. Many controversial provisions common in subprime loans, such as prepayment penalties and adjustable interest rates, are really just efficient risk-based pricing. Subprime borrowers are more heterogeneous than those in the prime market, and the variety of terms in subprime loans reflects this heterogeneity. In fact, the United States is almost alone in the world in offering long-term, fixed-rate mortgages with an unlimited right to prepay.[3] Adjustable-rate mortgages and bars on prepayment are much more common worldwide. Indeed, Americans pay a substantial interest rate premium in exchange for protection against interest rate fluctuations, a precaution that is justified when interest rates rise but appear unwise when they fall.

MARKET IN TURMOIL

What went wrong? In 2006 and 2007, subprime foreclosures rose dramatically from 3.5 to 5.1 percent. Foreclosures are not only undesirable because of property loss, but also because their effects are not always limited to the individual who fails to make his payments. Foreclosures can also decrease the value of the surrounding homes, and a neighborhood with a large number of foreclosures can suffer from a shrinking tax base that makes it more difficult to provide quality schools, effective policing, and other necessities. This, in turn, can lead to increased crime, vandalism, and other social ills. On the lending side, approximately 225 lenders had "imploded"—gone bankrupt and sold their assets—by February of 2008.[4]

In part, this market collapse may have been the result of broader trends in the economy. The states with the highest concentrations of delinquencies, such as Michigan and Indiana, have also struggled with the lagging American auto industry and other structural difficulties. At the same time, interest rates rose and the value of housing in many parts of the country fell. These macroeconomic trends probably had a great deal to do with the subprime turmoil, but many believe that there were fundamental problems with the market as well.

There are three basic explanations for what went wrong in the subprime market. It has been suggested that subprime loans themselves or the borrowers of such loans were unreasonably risky. As noted above, it is essentially axiomatic to say that subprime contracts and borrowers are riskier—that is why measures such as higher interest rates, balloon payments, and prepayment penalties are common for subprime loans but not prime loans—but there is little convincing evidence that they are unreasonably so. Adjustable-rate mortgages seem to perform well against the market benchmarks and the vast majority of borrowers repay their obligations in full.[5] As interest rates declined over the first part of this decade, those with adjustable rate mortgages saved millions of dollars as their interest rates automatically fell without borrowers being forced to incur the costs of refinancing. The rising interest rates of recent years are simply the other side of that risk. As Alan Greenspan noted in 2004 at the end of this period of low interest rates, "many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade" but he adds, "though this would not have been the case, of course, had interest rates trended sharply upward."[6]

It is also possible that the market was "irrationally exuberant" and simply failed to appreciate the increased risk, encouraging overinvestment. Many large investors seem to have believed that pooling subprime mortgages reduced their overall risk, an intellectual mistake to the extent that some of the risks were positively correlated. Still other risky loans were encouraged by federal regulations such as the Community Reinvestment Act, which encouraged lending to nontraditional borrowers.[7] Regardless of why the market mispriced risk in this sector, the expensive lessons learned by elite investment banks and sophisticated investors provide substantial incentives to avoid similar problems in the future—with or without new regulation. Certainly, lenders now recognize the market incentives to be more careful in the future, yet ill-considered interventions and bailouts of careless lenders risk creating a moral hazard problem that will mitigate the force of these market lessons.

As foreclosures have risen, so has public pressure to address the issue. Yet politicians should carefully ensure that proposed relief is aimed at those they seek to help and minimize the unintended consequences of interventions. Foreclosures may result from household financial distress, such as job loss, an unexpected rise in interest rates, or a natural disaster. Alternatively, foreclosure can be viewed as a type of "put option"—an "option" to give the house back to the bank rather than pay the note—that a borrower can exercise once the continuing expense of the house is no longer worth the cost.

When the underlying price of housing falls, as has happened in many areas, homeowners will begin to abandon their investments in favor of better options. This is especially true for those speculative investors who purchased homes planning to "flip" them for a short-term gain rather than for the amenities of home ownership. For similar reasons, default is more common for those loans with little or no down payment, enabling a purchase-money borrower to take a home equity loan against the initial down payment. Available data suggests that a substantial number of subprime borrowers in recent years were speculative investors who would be most likely to exercise a put option.[8] Borrower bailouts should be careful to avoid subsidizing conscious speculation.

Borrowers are also more likely to walk away from their mortgages in states with anti-deficiency or non-recourse laws, which limit a lender's remedies to foreclosure on the borrower's home and prevent creditors from bringing suit for any deficiency against the borrower. Prior research has found that states with anti-deficiency laws have higher foreclosure rates than others; in fact, many of the states with the highest foreclosure rates today are those with anti-deficiency laws that limit lender remedies, such as California, Arizona, and Colorado.[9]

Currently, it is not clear what percentage of those in foreclosure are homeowners in distress versus those rationally exercising a put option. It is also likely that rational or "ruthless" defaulters (as termed by economists) are likely overrepresented in foreclosures. A better factual understanding of the sources of foreclosure today, however, is necessary to ensure that any proposed relief assists those who most need it.

CURE THE CRISIS, MAINTAIN THE MARKET

Any subprime regulation must be careful not to restrict the legitimate loans in this market, which help millions on the road to home ownership. Legislative efforts should target predatory loans that have no possible benefit for the borrower, but because it can be difficult to discern predatory loans from legitimate subprime lending, reforming this market runs a substantial risk of having unintended consequences. As a first step, the best approach is to try to improve the conditions of competition and consumer choice for subprime loans. Those changes will help to ensure that subprime borrowers do not fall victim to deceptive terms but still allow them access to the capital they need to improve their lives.

Unfortunately, several current and proposed regulatory schemes may have exactly the opposite effect of what is intended by regulating the most obvious terms of subprime loans, such as interest rates and costs. Such regulations are prone to unintended consequences, as controls on some terms encourage lenders to substitute other, less-transparent terms of the lending contract. Empirical evidence suggests that state and local "anti-predatory lending" laws also have tended to reduce access to new loans, but there is scant evidence that they have had any impact on reducing fraud.[10] In fact, limiting access to some types of credit may have the unintended consequence of turning borrowers to other types of credit, such as payday lenders and credit cards.

The problems seen in the subprime market seldom occur in the normal mortgage market. Critics have argued that this is because subprime borrowers tend to be less educated and are simply unable to understand the terms to which they agree. According to research by the Federal Trade Commission, however, subprime borrowers are no less capable of understanding loan terms than consumers in the prime market.[11] Both subprime and prime borrowers struggle to understand complex loan terms.

The real problem is not the relative *ability* of subprime borrowers to understand complex loan terms, but rather that, for arguably legitimate economic reasons, subprime loans simply contain a greater number of complex terms. Thus, there is greater opportunity for confusion. Moreover, the greater standardization of prime mortgage loans also has the beneficial effect of making comparison shopping easier for prime borrowers by enabling them to shop on just a few terms. Subprime borrowers, by contrast, face significantly greater variety in loan terms, making comparison shopping more difficult.

Current disclosure regulations could be dramatically improved to increase consumer comprehension of lending terms. According to the Federal Trade Commission, improved disclosures would be especially valuable in improving comprehension of complex terms, thereby disproportionately benefiting subprime borrowers.[12] Moreover, before imposing new substantive or disclosure regulations, Congress should review extant regulations to ensure that the unintended consequences of such regulations do not outweigh the benefits to borrowers and to the market. In addition, many of the most egregious practices in the market were simply outright fraud, for which there are longstanding and well-established remedies.

There is plenty of blame to go around in assessing responsibility for the subprime crisis—crooked mortgage brokers, reckless lenders, and fraudulent borrowers seeking to make a quick buck. Some borrowers exploited opportunities presented by "no documentation" loans to defraud lenders, behavior to which some lenders were all too willing to turn a blind eye. Some crooked mortgage brokers exploited the ignorance and misplaced trust of vulnerable borrowers. Some consumers simply misunderstood the risk of the loans that they were incurring, especially those with low initial "teaser" rates and dramatic subsequent interest rate adjustments. But in many cases, it appears that borrowers and lenders simply underestimated the risk associated with these loans. In particular, unlike traditional prime mortgages, FICO credit scores appear to be of less value in predicting the likelihood of default in the subprime market.

Initial boom-and-bust cycles like those seen in subprime lending occur throughout American history when new consumer credit products are introduced into the market. Many of these excesses prove self-correcting through market discipline. Still others reflect traditional fraudulent behavior potentially correctable by traditional fraud remedies. Without detailed knowledge of why certain loans went bad, a drastic reshaping of the subprime mortgage market may hurt millions of homeowners given credit opportunities through the subprime market by raising interest rates and restricting access to credit. Until more is known about how to balance the costs and benefits of the subprime lending, regulators should tread cautiously in this area.

ENDNOTES

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