



**Home Buying as a High Stakes Bet:
Risk-Based Mortgage Lending for Home Purchase**

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Overview

A decade ago if you wanted to buy a home, but failed to meet the standard credit or income requirements for a mortgage, you had few alternatives. In essence, the mortgage market was closed off to you if you appeared to be above a specific level of risk. At the same time, however, you could have successfully found a loan for a car, or a credit card, so long as you were willing to pay an increased interest rate. Access to credit in the mortgage market was rationed to a relatively rigid risk standard, but offered along a continuum of interest rates in other credit markets. Not surprisingly, over the last decade, mortgage markets have begun to relax the practice of rationing loans by risk, and instead offer loans at a variety of risk levels.

One long-standing form of making mortgages available at higher costs to otherwise unqualified loan applicants is the use of mortgage insurance for borrowers with small downpayments. New types of mortgage loans for higher-risk borrowers emerged, however, beginning in the early 1990s. Initially designed for existing homeowners with poor credit looking to borrow against the equity in their home, risk-based mortgages eventually migrated to loans for the actual purchase of a home.

This new type of loan product presents opportunities, and challenges, for consumers in the marketplace. Homebuyers using higher-risk loans are taking a calculated risk—a bet on their future ability to manage their debt, their income and credit, and on trends in house prices in their neighborhood. Typically this bet pays off—homeowners are better off than if they did not buy a home with the risk-based price loan. But the costs of losing this bet are high—loss of a home, potential bankruptcy and foreclosure.

Practitioners, advocates and policy makers designing and implementing programs to support wealth-building for working families need to understand how risk-based pricing is changing mortgage markets. With appropriate support, the odds can be tilted in favor of homebuyers betting on higher-cost loans. Supported by clear information, insurance against adverse life events and coaching to clear up credit problems, high-risk borrowers can successfully partake in the American dream of homeownership.

How Home Purchases Evolved Into Using Risk-based Priced Mortgages

In the 1920s, most homes were purchased with cash or a combination of a large downpayment (up to one-half of the home's value) and a short term loan secured by the property. In the 1930s, the emergence of FHA (Federal Housing Administration) mortgage insurance permitted borrowers to make smaller downpayments. In exchange for a premium collected from borrowers, FHA largely guaranteed lenders against loan losses, and helped fuel an expansion of lending for homeownership through the 1970s. By the 1980s mortgages routinely had fixed-interest rates for as long as 30 years and downpayment requirements were reduced to ten percent or less of the home value due in part to FHA and primate mortgage insurance.

In the 1980s investors on Wall Street created investment securities based on wide variety of income streams, ranging from the royalties on David Bowie's music sales, to uncollected credit card debt. Investors in securities pay a lump sum upfront for a flow of income in the future. Importantly, investors also take on the risk of disruptions to this income flow, assuming the potential returns on the investment are high enough. The greater the potential returns, the more risk investors are willing to take.

Traditionally mortgage lenders made loans from capital provided by deposits or savings accounts. In the 1990s a new group of lenders emerged entirely capitalized by investors using mortgage backed securities. These lenders realized making long-term mortgages based on short-term deposits is less efficient than funding a loan portfolio with securities. Also, by using more flexible capital from Wall Street, lenders could provide loans to new categories of higher-risk borrowers, as long as the income streams associated with the mortgage backed securities containing these loans provided sufficient returns to investors.¹ This emerging industry was originally called "home equity lending," because it provided loans to existing homeowners seeking to borrow against their home's equity. Because investors and lenders compared the risk quality of loans in this market to loans in the more traditional market, they became known as "subprime," meaning below the credit quality of the prime market. Some financial experts suggest these loans are defined by what they are not—they are not up to the underwriting standards of the prime market. For this reason the term "nonprime" is also used.

In the late 1990s, the subprime industry underwent a maturation and consolidation process; as some firms folded, others expanded rapidly. Other subprime firms were purchased by major prime lenders. Today the top ten largest subprime lenders represent 60 percent of the entire subprime market. While institutions initially specialized in either prime or subprime

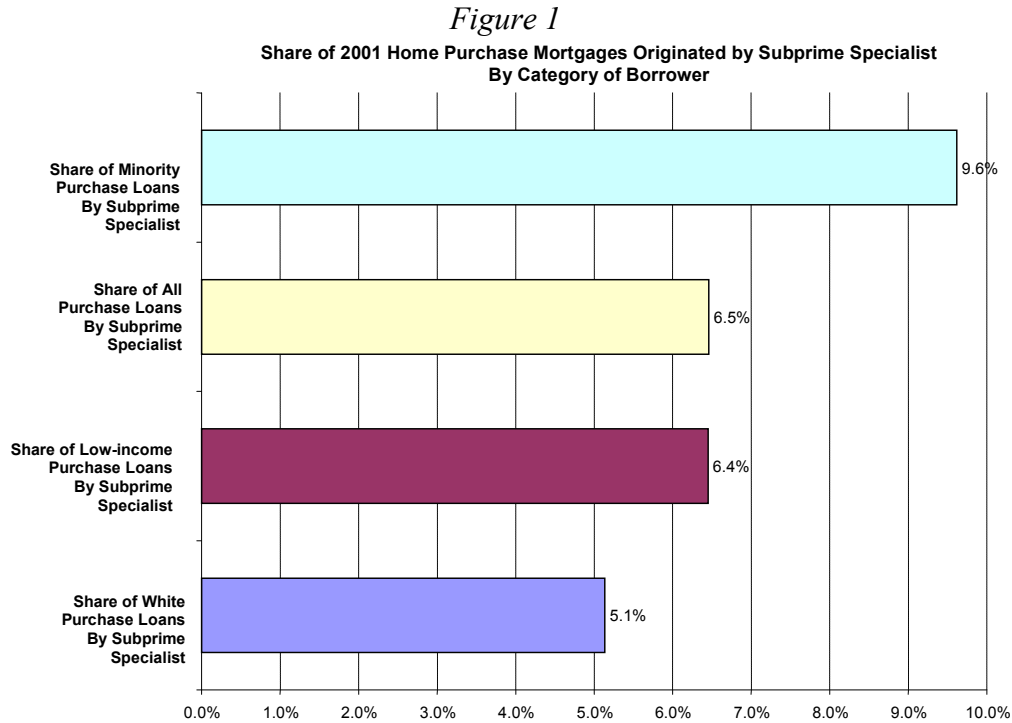
¹ It is important to note pools of loans are "sliced and diced". While a pool of loans may be relatively risky and therefore require increased return to investors overall, each pool is subdivided into tranches, which are slices of income streams from loans with corresponding risks. Any one investor in even a high risk pool may own a low-risk tranche with low returns.

lending, increasingly subprime loans are made by traditionally prime institutions, while prime loans are made by subprime lenders. Since institutions no longer specialize in one type of loan anymore, it is difficult to determine what share of risk-based loans are made by different kinds of institutions. However, one indicator of how the market has changed is in 1994 all of the ten institutions with the largest volume of subprime loans were independent firms, as of 2004 half were owned and operated by traditional banking institutions.

Ideally, lenders price the risk of the borrower for each loan. In practice this matching is conducted by mortgage brokers for the majority (57 percent in 2004, according to National Mortgage News) of loan applicants overall, and a larger portion in the subprime market. Brokers usually offer a broad spectrum of loan products, and typically can find a loan for even a high-risk applicant.

It is important to note that the vast majority of subprime loans are for refinance or home equity. Only seven out of 100 subprime loans are used for the purchase of a home. About a quarter of a million homebuyers purchased a home in 2001 using a loan from a subprime lender, which is 6.5 percent of all home purchase mortgages (2001 is the latest date for which government figures are available). While a small share of overall lending, this market serves a larger share of minority borrowers. Figure 1 shows the share of all home purchases using loans from a “subprime specialist” (based on HUD’s definition) by each borrower characteristic in 2001. The share of minority borrowers using a subprime loan was greater than the share of all borrowers using a subprime loan. Low-income borrowers, however, were not more likely to use subprime loans.

Minority borrowers may be more likely to use a subprime mortgage because the average minority borrower has a lower level of savings and more credit problems than an average non-minority borrower. Another explanation is related to systematic biases in the mortgage market which may drive minority loan applicants into loans from subprime lenders. While difficult to measure, some borrowers qualifying for prime loans, may only shop for loans in the subprime market. Qualitative research conducted by lenders, as well as surveys of consumers, suggest minority loan applicants may also be so averse to being rejected for a loan, that any accepted mortgage application is viewed positively (Apgar, 2004). Of course, the highest risk loans are also the most likely to be rejected, which may compound consumer’s desperation and contribute to reduced efforts to search for a loan. Finally, some consumer advocates have suggested less knowledgeable borrowers are misled by unethical mortgage brokers or direct lenders to believe the only loan options available are high cost loans, despite the fact borrowers can qualify for a lower cost product. In short, minority use of higher cost loans is in part explained by legitimate economic factors which contribute to risk, but there remains an unexplained portion which may be related to social factors, industry practices and discrimination.



Source: 2001 Home Mortgage Disclosure Act Data with HUD Subprime Specialist List

Why Risk-Based Pricing Benefits Home Buyers

Imagine an automobile market where only one type of car is produced and sold through only one exclusive type of car dealer. People who cannot qualify to buy this car, due to their inability to pay, or due to limited access to the car dealer, are excluded from the market. But, if a new class of cars and dealers is created, the market becomes more inclusive. Consumers are better off because a market niche has opened up to meet their demand. Before risk-based pricing, mortgages were essentially rationed by rigid guidelines enforced by bank loan officers. If borrowers were close to meeting certain criteria, they might be offered a slightly higher cost loan with mortgage insurance. If they could not qualify for that loan, they were denied access to credit. The market has widened its reach to include more types of borrowers, including those left out previously. Consumers are better off because they are able to access credit and then pursue their personal goals with the proceeds of a loan, which might include buying a home or using equity from an existing home for non-housing related goods and services.

How Are Risks Priced in the Subprime Mortgage Market?

Figure 2 is a simple graphic illustration of the risk factors which lenders must consider when approving a loan. Risk areas include: (1) willingness to pay, as measured through credit records, (2) the value of the collateral, and (3) the quality of the information contained in the loan file. Each of these factors represents an added risk and results in higher interest rates and loan fees to offset that risk.

1) Credit Risks

Any lender considering a loan must judge if the loan applicant will actually make loan repayments as promised, or if the loan will default. In the past, lenders reviewed a borrower's credit history by checking on outstanding loans and analyzing a borrower's use of credit. This information was often not available in a standard form, nor was it uniformly reliable. As a result, lenders would not approve loans without sufficient information. But the development of credit scores has allowed lenders to measure the risk of borrowers along a continuum from very low probability of defaulting to a very high probability. Today, in addition to a credit score, lenders also review the mortgage payment history of existing homeowners. While a homeowner's credit score may be good, lenders will single out missed mortgage payments as an added risk factor. Increased interest rates, fees, and stricter loan terms are required as credit risks increase.

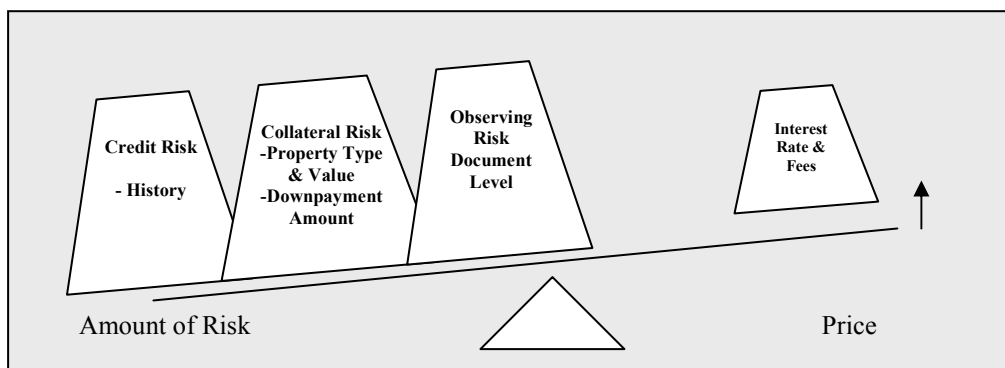
2) Collateral Risks

Another risk for mortgage lenders is not based on the borrower's credit, but whether the underlying collateral will hold its value if the loan does default and the lender must sell the property. Typically, this is measured by the amount of the loan relative to the value of the property being financed. Lenders create ratios of the loan to value, with values near or in excess of 100 percent being most risky. Loans with no downpayment represents greater collateral risks. Properties that do not conform to industry standards, such as unusually small or large homes, or homes in unusual locations, present an added risk to lenders because they are not assured the property can be sold off in a foreclosure. Small loans for low-cost homes, such as those below \$50,000, are one example of loans for which lenders will require increased interest rates and fees to compensate for added risks.

3) Documentation

Because most lenders plan on selling loans to investors through secondary markets, each loan file must contain a standard set of information including the borrower's income, debts, credit record and the property being used as collateral. When borrowers cannot provide documentation to verify such information, lenders are faced with an added risk. While it is possible this loan will perform well, in the absence of any data, the lender cannot predict which undocumented loans will perform well. Lack of documentation again requires increased rates and fees to compensate for added risks.

Figure 2: Balancing Risk and Price in Mortgage Origination



These three risk areas are each measured along a continuum, from low-risk to high-risk. The amount of compensation required is proportional to the risk level. For example, a slight blemish on a credit record will only require a small interest rate premium. Also, risk factors can mitigate each other. A borrower with outstanding credit can use their credit rating as a compensating factor for a high loan-to-value ratio on a loan. In addition, borrowers with moderately low credit scores may qualify for a prime market loan if other risk factors are low. Loans with high risk factors across all three risk areas require much higher interest rates and more restrictive terms. In the extreme, some borrowers are so risky lenders will not approve a loan at any interest rate.

The result of risk-based pricing along these three risk factors is that it is difficult to characterize all subprime loans as being high cost. Some loans are very high cost, others are priced closely to loans in the prime market. There are huge variations in loans, depending on the purpose (purchase, refinance, home equity), terms, penalties, or other clauses. Some lenders actually publish pricing tables with each of these factors listed, and the corresponding interest rate required. These price tables are not published for consumers however. Because pricing depends on so many variables, even if they were widely available, it would be hard for the average consumer to decipher. As a result, borrowers outside of the prime market are hamstrung because they cannot easily compare loan offers to a market-wide benchmark.

Figure 3 shows one categorization of subprime loans by risk ratings, from A to C. The top level, A, corresponds to the prime market. These loans are priced similar to the interest rates in the prime market. The next level down, Alt-A, is by far the largest portion of the subprime market. These are loans which fail to meet prime market standards in relatively minor ways, such as one risk factor with an elevated level of risk. In fact, much of this market segment consists of loans without the level of documentation required in the prime markets.

Pricing for Alt-A loans is usually within 1 percentage point of the prime market—a relatively small increase. The next category, A- (“A minus”), consists of borrowers with poor credit, or a combination of moderate risk factors. Combined the A, Alt-A and A- categories are 71 percent of the subprime mortgage market. These loans are priced within three percentage points of the prevailing interest rate in the prime market. The higher risk categories, B and C, are relatively rare, but priced much higher than any of the A segment. The category of CC and below are very high-risk borrowers, such as those emerging from bankruptcy. These loans may be priced six points or more above prime rates.

Figure 3:
Subprime Market Share

Borrower Credit Segment	Share of Subprime Market	APR Interest Rate Differential	Serious Delinquency rate (90 days +)
A	6%	1.1	1.4%
Alt A	41%	3.0	5.9%
A-	24%	3.3	10.2%
B	11%	4.5	10.8%
C	8%	5.7	21.0%
D	11%	6.6	23.6%

Source: Crews Cutts Van Order 2004, Table 1
(A-B segments are 80% LTV; C is 75%; D is 65% LTV.)

Why Would a Borrower Use a Subprime Mortgage to Purchase a Home?

Carefully used, a subprime loan can help a homebuyer purchase a home and build assets. But even an A- risk level loan has a 1 in 10 chance of becoming 90 days or more past due. Loans at a C risk level have a one in five chance. While the majority of borrowers will not run into trouble, many will, and some will not be able to catch up after falling behind. Some borrowers may be stuck in a subprime loan because they lacked information when they applied for loans, or were duped by an unethical mortgage salesperson. Others may have been victims of fraud or forgery, or participants in appraisal scams. Yet in spite of the risks, over 250,000 borrowers used subprime loans to purchase a home in 2001. What would drive a borrower to a subprime loan to purchase a home?

1.) Application Flexibility: Low Documentation

Subprime loans are popular among the self-employed and people without steady incomes who cannot provide information acceptable to a prime lender. Approximately one quarter of all subprime mortgage loans are originated with reduced documentation requirements, what lenders call “low-doc” or “no-doc.” There are three main types of mortgages with limited documentation, (1) stated income loans, (2) no-ratio loans, and (3) NINA loans.

Stated-income mortgages are designed for people who work but either cannot or do not want to show work-related W-2 forms and federal tax returns. Small business owners, contractors, the self-employed and workers paid in commissions may not be able to show their ability to repay a loan based on income documented in past years. (Note this is a separate issue from income tax unreported in an effort to evade taxes.) Stated income loans do require thorough documentation of assets and creditworthiness, and typically offer interest rates within a point of conventional loans for the same credit score and loan terms.

The second form of low-doc loans are no-ratio loans. These mortgages do not have loan to income ratios at all because there is no income listed in the loan application record. The loan is underwritten based entirely on the assets of the borrower. These loans are useful for

people who live off their investments, such as retirees, recent widows or divorcees. The most aggressive types of low-doc loans are nicknamed NINA loans--No Income/No Assets. Lenders make NINA loans based entirely on the loan applicants assertion they have enough income to make loan payments, but no documentation or verification is required. These borrowers typically must have near perfect credit and put down large downpayments. These loan applicants trade off the time and effort of collecting documentation required for a loan application for a much higher interest rate, often 3 points or more over prime mortgage interest rates. While privacy concerns may motivate some borrowers (for example a celebrity or someone in the midst of law suit), more often these loans are driven by borrowers' need for a quick and easy loan approval.

Everything consumers buy has some search cost. Typically the more a consumer shops around, the more choices with lower prices that are discovered. In theory, the value of the time and effort spent searching is offset by the lower price obtained. And, of course, each person has a different level of willingness to shop around (bargain hunters versus speed shoppers). Some borrowers who might qualify for a mortgage in the prime market will chose a subprime loan because it requires fewer forms and is faster to approve. If the consumer values speed and low search and application costs, he or she may be willing to accept the increased costs for the loan itself. The fact that low-doc loans cater to this market is economically efficient, assuming borrowers know and understand the cost.

2.) Getting Back on Track: Credit Cure

Another reason to purchase a home with a subprime mortgage is if a loan applicant has had credit problems, but is now moving into a more stable credit payment pattern. Borrowers may have hit a rough patch, which created a temporary blemish on their credit record. Consumers typically take 1 to 2 years to work through repayment problems to the point where their credit records are "cured" and eligible for prime credit again. While a potential homebuyer could stay in their current home or apartment for this period and then apply for a prime loan, some may not want to wait. Instead, they could buy a home immediately, even with their poor credit, and then refinance a high cost loan in a few years when their credit has improved. For example, someone who lost a job, experienced a divorce, or had a health emergency may have a negatively impacted credit report but still want to buy a home. If a borrower is confident that in two years they can clean up their credit and refinance into a lower-cost loan, they can enjoy two years in a home while fixing their credit. If a borrower makes 24 payments at a 4 percent increased rate on a \$100,000 mortgage, it would add \$6,500 in interest payments, plus the cost of refinancing. That breaks out to \$270 per month, an amount which might be a reasonable trade for the consumer. If the alternative is renting or owning a house with less space or amenities at a similar cost, it can be advantageous for a consumer to purchase a home using a subprime loan.

The risk for borrowers using this strategy is that they may fail to keep up with loan payments and further harm their credit rating, or even default and lose the home altogether.

The other risk is the borrower failing to refinance when his or her credit cures, either due to inattention, or prepayment penalties and prohibitions imposed by the lender. According to one analysis, 40 percent of subprime borrowers are able to transition to prime markets within two years.² It is unknown how many of the remaining 60 percent of borrowers would have qualified to refinance into prime loans. It is also unclear if the highest risk borrowers are as capable of moving up market. There may be some for whom refinancing does not make sense, such as those borrowers planning to move and sell the home. Borrowers missing payments, of course, will still only qualify for a subprime loan, although some may refinance into a lower-cost subprime loan if their credit improves modestly.

3.) Seizing a Home in Rapidly Appreciating Markets

In some housing markets house prices are appreciating at many times the rate of inflation, as much as 15 to 20 percent annually. In these markets, a renter who may be considering delaying the purchase of a home for two years in order to cure credit problems could face a 30 to 40 percent increased hurdle in terms of house price. For example, if a renter could buy a house today for \$100,000, but expects house prices to increase 10 percent per year, in two years, the same house will cost \$122,000. If a borrower makes 24 payments at a 4 percent increased rate on a \$100,000 loan, that adds \$6,500 to interest cost for those two years. The borrower would be better off to buy the home today compared to waiting and paying an additional \$22,000 for the house in two years. The consumer is better off with the subprime loan assuming they can manage their debt and then refinance when their credit cures. In addition to the risk of default and the risk of not refinancing, borrowers may be trapped in a loan if house prices fall. Although nonprime loans often have sizable downpayments, the home could be worth less than the mortgage, placing the borrower in more debt than they can recoup if they sold the home.

Risks for Consumers

Figure 4 summarizes the three strategies consumers might logically employ in choosing a subprime loan to buy a home. In all three cases, a subprime loan could actually lead to greater asset building by the borrower than delaying a purchase and using a prime loan after their credit improves. But the consumer's best laid plans may not pan out. Subprime borrowers face other risks which can derail their ability to transition back into the prime market. A job loss, health care crisis, work-related injury or disability all are unexpected life events which can harm a borrower's ability to repay a loan. More research is needed regarding the distribution of credit scores by insurance coverage, but it is likely health, life and disability insurance is less prevalent in this market segment.³ It is also possible the chance of becoming unemployed, undergoing a divorce, or experiencing a health crisis may be higher for this population, exacerbating this problem. Consumer risk management tactics are therefore critical to success. A borrower who takes out a high-cost loan has to be

² Courchane et al, 2004

³ Many studies document the use of insurance or occurrences of trigger events by race or income, but not by credit status.

focused on their personal finances to make the transition back to prime markets. Borrowers also are well served by accumulating a cash reserve to provide a financial cushion during an unexpected setback. To the extent consumers are not good judges of the risk and costs involved in these loans, they may benefit from education, counseling, or third party reviews of their loan terms.

Figure 4: Subprime Strategies, Benefits and Risks

Strategy	Benefit	Risk
Flexible Application Documentation	Reduced application time/costs	Ability to repay; Refinance timing
Credit Cure	Improved housing options	Refinance timing & costs
Seizing a Home in Hot Markets	Getting a home at today's cost	Value loss; ability to repay

Problems in the Marketplace

In addition to issues related to adverse life events and lack of insurance coverage among consumers in the credit-blemished market, the tactics of lenders using risk-based pricing may also contribute to problems in this market. First, there is a lack of transparency in pricing and terms in any non-prime loan market. There is no commonly accepted pricing schedule, the equivalent of a “blue book” guide price. Because subprime loans are priced by credit score, prepayment terms, documentation level, loan to value ratio and mortgage payment history, the number of variables makes comparisons across loans confusing. It is difficult for a consumer to know if a loan offer is in fact a good deal. Second, risk-based loans provide enormous latitude for mortgage sales professionals to use push marketing and pressure tactics. Consumers faced with a limited menu of options may end up making poor choices because they are stuck in a market channel frequented by mortgage brokers specializing in credit blemished borrowers. Loan applicants may be in a rush, feeling desperate because they have credit problems and do not want to lose an offer on a home. This can result in limited shopping and over-reliance on loan brokers. Third, when delinquencies do occur in this market, borrowers require intensive interventions. In the prime market, borrowers typically have resources to work out their problems and repay a loan if they miss a payment. Lenders and loan servicers in the prime market do not need to aggressively work with borrowers after missing a payment. But a borrower with a tight budget and a history of money management problems, might be better served by immediate and intensive interventions, including options for delayed loan re-payment. The willingness of lenders to be flexible with subprime borrowers in times of distress is widely varied, although most major loan servicers are developing specially adapted systems and standards for this market.

Subprime loans, and the lenders originating them, have been widely criticized by consumer advocates. Subprime lending is an unfamiliar market for borrowers. It is not regulated in the same way as prime mortgage lending. Subprime loans also have a high degree of variation from loan to loan in their use, terms and pricing. As a result, the market has developed in fits and starts, in some cases allowing egregious abuses of borrowers to occur through fraud and sloppy lending practices. Many of the original lenders in the subprime market have been the focus of intense scrutiny by advocates; others have been sanctioned. Some firms have so mis-managed the risks of lending that they have gone out of business. Others firms have been purchased by mainstream prime lending institutions, attracted by the high returns of these loans. The poor image and performance of institutions in the subprime market has tarnished the fundamental tool employed in this market, risk-based mortgage pricing.

One practice often attacked is the use of prepayment penalties. These provisions can require a borrower to pay a fee (ranging from a percentage of the loan balance to a number of months of interest payments) if they refinance a loan within a period ranging from two to five years. From the perspective of the lender, a prepayment penalty ensures that the loan will generate a minimum amount of revenue. Because subprime borrowers are more costly to underwrite initially and more likely to refinance as their credit cures, subprime loans are more likely to use prepayment penalties. Loans with prepayment penalties are worth more in the secondary market, and, therefore, borrowers should receive a lower interest rate for a loan with a penalty than one without a penalty. Because it often takes two years to improve credit enough to qualify for a lower cost loan, most subprime borrowers are not harmed in stable or increasing interest rate environments by shorter term prepayment penalties. In fact, for some borrowers these penalties may be a discouragement to refinancing other debt into their mortgage. As long as consumers have a choice, and understand their options, prepayment penalties can offer a lower interest rate if they do not plan to refinance in the time period specified. But many borrowers do not understand the terms of their loan. They sign mortgage contracts with long penalty terms but only become aware of them when they try to refinance. As a result, many consumer advocates believe these provisions should be banned entirely. Such a legal shift is unlikely, however, and the responsibility remains on the consumer to carefully understand the terms of their loan.

It is difficult to assess the value of subprime purchase lending in the aggregate. Of the 250,000 borrowers using subprime home purchase loans in 2001, some paid a slight premium for minor credit problems, such as in the A- market, but others paid a large premium. Assuming all 250,000 paid an average of four percentage points over prime rates for \$150,000 home (the median in 2001), the added cost of these interest payments from 2001 through 2003 was \$11,600 per borrower, or \$2.9 billion in aggregate. If these borrowers had delayed purchasing a home until 2004, when median home values increased to \$183,000, they would have to borrow an additional \$33,000, or \$8.25 billion in total. On the other hand, if 10 percent of these borrowers defaulted, that could translate into 25,000

families with worsened credit ratings, some share of whom would have lost their home in foreclosure. If these families lost an average of \$30,000 each, that would result in \$750 million in default related costs to consumers.

Implications

Not all risk-based pricing is asset reducing, even as it is used currently in the subprime mortgage market. Subprime lending can be a useful tool, if it is carefully used by borrowers. Too often subprime loans and borrowers are mischaracterized as being the most extreme form of risk-based pricing, with very high fees and high credit risks. In fact, the market is a continuum, with most subprime loans priced relatively close to prime loans. Traditionally homebuyer programs have shunned subprime loans and not targeted subprime borrowers for pre-purchase counseling. Programs, especially in rapidly rising housing markets, would be well served to re-examine at least the Alt-A and A- risk segment as services and loan products for their target population for.

Another implication regarding the emergence of risk-based pricing is an increased need for financial literacy, budgeting, education and counseling. The need for financial literacy is universal, but even more important for subprime borrowers planning to repair their credit in order to qualify for a lower cost loan. Consumers may first need help in planning for and managing risks when they initially take on subprime loans. Because these loans are often driven by a need for fast transactions, especially in tight housing markets, counseling services need to be delivered in a timely way so that sales transactions can be completed. Waiting weeks to get counseling and education will not be effective. After taking a loan, borrowers will need regular support in maintaining a planned budget, and repairing credit problems. Meeting monthly or quarterly, a borrower can work with a counselor on reducing debt and monitoring credit. When a borrower has cured their credit problem, education and counseling can help the borrower find and apply for a refinance loan at the appropriate time.

The vast majority of subprime loans are not for home purchase, but rather for refinance or home equity loans. Borrowers use these loans to pay off credit card or other debt, and then roll all of their debt into their mortgage. Because credit cards often have interest rates at over twice the interest rate of mortgage loans, this can be a smart financial strategy for borrowers if they are working to reduce their spending and pay down their debt beyond the minimum principal payment. But consumers can get stuck on a treadmill of borrowing, repeatedly consolidating loans such that they never build up any equity in their home. Like a gambler who had a lucky run, borrowers might be tempted to keep coming back to the subprime market for more credit. Used carefully, a subprime purchase or refinance loan can be a useful tool for a borrower. But like any financial instrument, risk-based mortgage loans require planning and oversight to be used successfully by borrowers.

The emergence of risk-based pricing in mortgage markets underscores how interrelated housing and household balance sheets truly are. Homes are the largest portion of the average

family's assets. Meanwhile, maintaining cash assets and the ability to manage liabilities are critical to be able to finance a home purchase. The risks that can derail homeownership, such as unemployment, divorce, and disability, also devastate the rest of a household's assets. Asset building programs need to better understand linkages between health care, disability, employment insurance and mortgage performance. Borrowers with adequate coverage are better protected from adverse life events. Financial literacy and homebuyer education programs should ensure borrowers have health and disability insurance in place. One promising example is a recent mortgage product developed by mortgage insurer MGIC blends mortgage insurance with disability coverage. In addition, programs should create incentives for borrowers to contribute to regular saving accounts in order to build up cash reserves to bridge a crisis.

The risk of a significant house price decline has been widely debated by economists recently. Historically, rapidly appreciating markets tend to go through a correction phase where prices flatten or fall. However, the timing and magnitude of such a change is difficult even for economists to predict. Such a decline would negatively affect many homebuyers, but most at risk are borrowers with high loan to value ratios and high interest rates. If prices drop, subprime buyers will not be able to sell their home and pay off their loan, trapping them in a high cost loan or forcing them into foreclosure. Innovative programs such as the equity assurance pilot by Home Equity Headquarters in Syracuse, NY may offer an avenue to protect borrowers, but are not yet well developed. In the absence of such protection, programs promoting homeownership need to objectively acknowledge the risk of home price fluctuations. Borrowers need to understand the importance of keeping a sufficient amount of both home equity and liquid assets to weather a downturn in the housing market. Those homebuyers who plan to move within a two to three year timeline should be especially cautious. Most problematic are borrowers who experience another crisis, such as a divorce or job loss, when the housing market is in decline.

How Much Risk is Too Much?

The use of higher-cost loans by higher-risk borrowers for the purchase of a home is viewed by some consumer advocates as a disturbing trend in the marketplace. The increased default risk associated with subprime loans in general does, in fact, translate into more foreclosures. These foreclosures are especially concentrated in communities or neighborhoods with high numbers of households with credit problems, where subprime loans are more likely to be used. To the extent loans are the result of fraud or shady practices by lenders, increased scrutiny of this market is required. Often, however, predatory loan brokers are not motivated to make loans which result in foreclosure, but rather to repeatedly flip borrowers from loan to loan, each time collecting a fee. Even the most egregious practices can result in borrowers making regular payments at grossly inflated costs without defaulting. In the extreme, risk-based pricing could result in loans with an almost 100 percent probability of default. Such loans would have obviously very high interest rates, and even higher fees (since the loan is not going to provide many interest payments). While some borrowers

might benefit from the chance to buy a home and own it for a short period, it seems the costs would outweigh the benefits. The principle of consumer sovereignty suggests well-informed, rational individuals ought to be able to have a wide variety of choices. But most states and many localities set limits on the extent to which lenders can push the pricing of loans with maximum rates and fees for a given type of loan. The level and extent of these consumer protections, however, are controversial. Any regulation will protect consumers either from a fraudulent lender, or from themselves. But it might also prevent a rational consumer from obtaining a loan they feel they can manage. This tension exists in all forms of regulation, from consumer product safety to pharmaceuticals. But as risk-based pricing in mortgage lending expands, regulations will need to adapt to protect consumers, while also permitting legitimate practices.

Conclusion

Overall, the emergence of risk-based pricing for the purchase of homes presents an economically efficient development for the mortgage market. By making loans to higher-risk borrowers, at higher interest rates and fees, more families have the opportunity to buy a home and the potential to build wealth. But, these loans carry added risks for borrowers, including foreclosure, failing to improve their credit, and failing to refinance into a lower cost product in the near future. While consumer advocates have generally painted the entire subprime lending industry as predatory lenders, this market is using risk-based pricing to make loans to a new class of borrowers. Practitioners and policymakers interested in promoting homeownership and asset-building need to approach calls for the curtailment of subprime purchase lending cautiously. While the market would benefit from consistently tightened standards in lending practices, consumers would also benefit from loan programs, counseling and education targeted to their unique needs. Borrowers are making high-stakes bets when they purchase a home with a risk-based priced loan. With better support, and appropriate regulation, the growth of this market segment can complement wealth building for American homeowners.

Further Questions for Practitioners, Researchers and Policymakers:

- Can consumers be expected to understand the complexities of mortgage pricing? Are mortgages much different than other complex products, such as life insurance? Why do some consumers choose higher cost products than necessary?
- What is the role of health insurance, disability coverage and other products which help a borrower make mortgage payments when trigger events occur? How likely are these events, and how widespread is the use of coverage among low-credit households?
- What determines a borrower's ability to migrate to into lower-credit risk categories? Is there a special role for long-term financial counseling blended with a loan product for borrowers who are working to cure their credit?
- What role does having a source of liquid savings play for reducing risks of default by adding to the capacity of borrowers to make payments when a crisis occurs?
- Are community-based organizations promoting homebuyer education skilled at risk-based pricing? Do they have the capacity to scan the market and provide consumers with a pricing grid for a wide spectrum of risk levels? Could they fill the information void in the market?
- Some lenders provide a borrower's bill of rights or a checklist of standard practices. Do these have any impact on consumer decisions? How can lenders be encouraged to compete more actively on price and practices?

Further Resources:

In 2004, Federal Reserve Board Governor Edward Gramlich gave a speech called “Subprime Mortgage Lending: Benefits, Costs, and Challenges.” It provides a brief overview of the industry and related public policy issues.

<http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm>

“On The Economics Of Subprime Lending” by Amy Crews Cutts, Robert A. Van Order, and Peter M. Zorn of Freddie Mac, as well as “Subprime Borrowers: Mortgage Transitions and Outcomes,” also by Freddie Mac economists Marsha J. Courchane, Brian J. Surette, and Peter M. Zorn, for the 2002 Georgetown University Credit Research Center, Subprime Lending Symposium are academic articles drafted for a conference. These papers provide an applied economic analysis of the subprime lending, including some of the few sources of empirical data on this market. Versions of both papers were published in *The Journal of Real Estate Finance and Economics* Volume 30, Issue 2, Article 4. http://www.freddiemac.com/news/pdf/subprime_012704.pdf

“Exploring the Welfare Effects of Risk-based Pricing in the Subprime Mortgage Market” by Michael Collins, Eric Belsky, and Karl E. Case is from a conference hosted by the Joint Center for Housing Studies in 2003. This paper provides a summary of the literature regarding the economic efficiencies created by subprime lending, as well as equity issues raised by this market.

http://www.jchs.harvard.edu/publications/finance/babc/babc_04-8.pdf

“Consumer Confusion in the Mortgage Market” is by economist Susan E. Woodward of Sand Hill Econometrics. The paper details how consumers shopped for a loan, focusing on brokered loans, including typical fees paid broken out by the borrower’s education and other characteristics.

http://www.sandhillecon.com/pdf/consumer_confusion.pdf

“Credit, Capital And Communities: The Implications Of The Changing Mortgage Banking Industry For Community Based Organizations” by William Apgar, Allegra Calder and Gary Fauth was released in 2004 by the Joint Center for Housing Studies. This report provides a detailed summary of recent changes in the mortgage market, and the changing role of community based organizations.

http://www.jchs.harvard.edu/media/ccc_release_3-5-04.htm