# Evaluation of the subprime mortgage financing

Henryk Zysko

The fall of subprime mortgage lending in the United States and its severe consequences around the world shook the founding principles of free market economy. This isn't the failure of the free market system as a whole, but rather a failure of the oversight of governing institutions and the whole system of critical thinking. The free market economy did what it had been doing best for centuries, which is finding loopholes and opportunities to make a profit. We cannot blame the investment banker or the mortgage broker for exploring the opportunities to make money. We should be looking at the government regulatory institutions whose funding principle is to regulate, oversee, constantly monitor and observe if in the spirit of drive for higher profits we do not jeopardize the fundamentals of good business practices and fundamental security and stability of the economy. However, in the spirit of keeping the economy going calling for restrains may had been seen as putting breaks on the free market system.

Subprime lending is the practice of lending mainly in the form of mortgages for the purchase or refinance of residences, to borrowers who do not meet the usual criteria for borrowing at the lowest prevailing market interest rates. Subprime lending has also been practiced by auto finance, student lending and personal finance companies. However, for the purpose of this article, we will focus on subprime mortgages. These criteria apply to the borrower's factors such as: credit score, credit history, income, down payment etc. If the borrower is delinquent in making the timely payments to the loan servicer; the bank or other financial firm, the lender can take possession of the residence acquired using the proceeds from the mortgage, in the process called foreclosure.

## Credit Risk

Y bajo este tenor triscaidecafílico, ofrecemos en este artículo 13 consejos de negocios cuyo denominador común es el lograr una excelente relación beneficio/costo en lo que respecta a nuestro capital humano, o sea, bajo costo de implementación y alto impacto en

## Credit Risk

Borrowers who fall under the subprime category by its definition present a higher risk to the lender and as such are charged higher interest rates. Credit risk arises because a borrower has the option and greater potential of defaulting on the loan he/she owes. Traditionally, lenders (who were primarily thrifts) bore the credit risk on the mortgages they issued. Over the past 60 years, a variety of financial innovations have gradually made it possible for lenders to sell the right to receive the payments on the mortgages they issue, through a process called securitization. The resulting securities are called mortgage backed securities (MBS) and collateralized debt obligations (CDO). Most American mortgages are now held by mortgage pools, the generic term for MBS and CDOs. Of the $10.6 trillion of USA residential mortgages outstanding as of midyear 2008, $6.6 trillion were held by mortgage pools and $3.4 trillion by traditional depository institutions.

## The Early Years of Subprime Lending

Subprime lending became legal in 1980 when the U.S. Federal Government deregulated the lending industry. This combined with the Affordable Housing Act, Community Reinvestment Act, and securitization of mortgages as well as changes to the taxation gave birth to the growth of subprime mortgage lending.

The focus of this piece is to add some “color” to a segment of the market that was invented and marketed in the United States but by now seems to influence many other sectors of the global economy, scandals, and created failure of major financial institutions and mistrust of the global financial markets. The growth in subprime lending represents an evolution of the credit markets toward efficiency. Two decades ago subprime borrowers would typically have been denied credit, as lenders were restricted by usury laws that prevented them from charging rates high enough to compensate them for the risk. However, the adoption of the Depository Institutions Deregulatory and Monetary Control Act in the United States in 1980 eliminated rate caps and made subprime lending more feasible for lenders.

In addition, in the United States the Tax Reform Act of 1986 eliminated interest deductions on consumer and auto loans while allowing interest deductions on mortgage debt, thus making the latter a more attractive source of financing. These legislative reforms encouraged the development of technologies enabling lenders to deliver risk-adjusted pricing rather than shut the door on higher-risk mortgage borrowers altogether.

It wasn't until the mid-1990s that subprime lending began to gain traction. Furthermore, the endorsement of the beginning of subprime securitizations by Wall Street firms and the willingness of investors to buy those securities represented an endorsement of this product segment, and provided impetus for expansion.

The major players in the industry included consumer finance companies, which generally retained the loans they originated on their balance sheets.

Traditional mortgage banks, however, did not have much penetration in the industry at the time. Instead, they remained focused on prime lending and questioned some of the business practices of the subprime securitizers, including their aggressive lending and accounting practices. However, increased competition, relaxation of credit and access to capital made the "prime" banks re-think their strategy and forfeit their lending principles in place of fast profits and chase for market growth and penetration.

As subprime securitizations continued to gain Wall Street and investor enthusiasm, the subprime securitizers gained origination market share at the expense of the consumer finance companies. Since 1994, the securitization rate of subprime loans has increased from approximately 32 percent to nearly 78 percent of total subprime originations. Subprime loans have accounted for an increasing share of total mortgage-backed securitizations. Subprime, together with its upscale cousin-alternative-A mortgages-have replaced agency (Fannie Mae and Freddie Mac) originations as the dominant source of securitization volume, and competition for nonconforming origination volume has increased.

The consumer finance companies relied mainly on their retail branch networks, which did not provide the same rapid expansion possibilities as the wholesale channel. The wholesale channel and marketing through mortgage brokers was the approach used predominantly by subprime lenders in the late 90's and throughout the most of 2000's.

## The Affects of 9/11

After the horrific days of the September 11th attack on the United States, the economy went to a still stop. People became very depressed and didn't shop, and since the American economy is based on internal consumption this affected the whole economy. Adding to the fact that the US economy was in the mid of a recession at the end of 2000 and early 2001 the economy definitely stopped. No activity. The Fed and the government in its desire to give the economy a boost began a series of interest rate cuts, tax refunds and activities to promote consumption.

Focusing on the housing sector was very obvious since construction and new home ownership affect other pieces of the economy through its chain of buying and interdependency. Credit became very cheap, low mortgage interest rates, zero auto financing, low interest student loans.

People were encouraged to go shopping as a therapy. This had two affects: on one end it jump started the economy and opened a new era of home ownership, but on the other side put people in heavy consumer debts and created new wave of home owners who should never be in the position of owning a home.

There were several key fundamental principles that were overlooked.

## Principles of Lending: The 5 C's of Credit

The fundamental principles of good lending practices were totally forgotten in that drive for profits, boosting the economy and to fill in the MBS pipeline.

**Character:** General impression made by the applicant. Lenders in their pursue of higher and higher profits began to look after markets that had no history of home ownership or character of repayment. Loans were made to people freshly discharged from Chapter 11 bankruptcy or reorganization, had extensive collection obligations and a long history of not paying their obligations. But who cares…they were given a mortgage.

**Collateral:** This is a security provided to the lender in place of money lent. In mortgage financing the collateral would be the home (real estate). However, if the loan-to-value exposure is at a 100%, then there is no security in case of a borrower's default or market downturn. The real estate can be sold but there are fixed costs of maintenance, legal and marketing of the property. In 100% financing there is a 100% guaranty that the lender will lose money if the borrower defaults during the first year of repayment.

**Capital:** Personal financial investment in the purchase. Drive to increase market share by lenders, increasing demands for Mortgage Backed Securities led to decreased lending principles regarding down payment. In the "old days", borrower needed to put down at least 5-10% of the purchase price of the real estate. However, lenders began to offer and heavily promoted through their brokerage channels the no money down mortgage programs. No money down mortgages became the key stone and the norm of mortgage financing. Why would you want to put money down on the property if the bank will loan you at 100% loan –to-value. Borrowers didn't bare any risk of losing money, all risk was on the shoulders of the lender. In Canada even cash back products gained in popularity where a borrower could borrow 100% of the value of the home plus cash back for closing costs, improvements and other household purchases, generally up to 7% of the value of the home, creating a loan-to-value of 107%.

**Credit:** This is evaluation of how the borrowers handle credit privileges. This is mostly historical evaluation of the past activities. In the drive to lend more money out went the standard practices of credit evaluation underwriting guidelines were being lowered constantly. This means 100% mortgage financing for fresh bankruptcy discharged borrowers, people with credit collection history, 30, 60 or even 90 day defaults on their consumer debt obligations such as credit cards, auto loans, student and personal loans and lines of credit. Who cares…you've got the mortgage.

**Capacity:** The last and the most critical principal is the capacity to repay the loan. "If I loan you money, I would like to see when and how are you going to pay me back". However, if you were a borrower in the United States with a decent credit of 640 FICO score or higher, you didn't have to worry about the verification of income or proof of assets, you simply could apply for the so called NINA mortgage loan. This means no income and no assets were verified. Borrower could literally be unemployed or just started a business with no history of earning any money and get a mortgage.

Second part of the mistaken strategy as it applied to the "Capacity" were Stated Income Mortgages which were nothing else than liar loans. Wholesale lenders and insurers such as Fannie Mae, Freddie Mac, PMI, AIG and many others would approve and insure loans where the income was stated, basically not provable. Originally, the stated programs were introduced for self employed people only where due to tax opportunities self employed individual could write off a substantial part of his/her income and in essence could not show the money that was earned on tax returns. However, we all knew and it was a practiced norm that self employed businessmen make more money than in fact they show. This program was justified for these types of borrowers. However, lenders went even further and began to offer this program to wage earners, (employees). These programs seemed very attractive to all sorts of borrowers who couldn't qualify based on their earned income. Example would be somebody working at a factory and earning $4,000/ months, however, in order for the borrower to qualify he / she would need to show an income of $5,000/ month. This additional $1,000 was stated if the borrower had a FICO credit score of 640 or higher. The understanding was that the $1,000 the borrower could earn if wanted on an open market or just started a small business or was working part-time somewhere and since he already had a good credit, he will be able to manage the mortgage and the property will go up in value.

The question was why the borrower couldn't qualify on its own, earning $4,000/ month? The basic answer is that the borrower was already over his head in debt and the only reason that a mortgage was approved was due to the fact that there was a potential to earn additional income and property going up in value. This approach also attracted speculators and people who were trading up houses or upgrading. This party could have gone on for as long as properties were going up in value but when the appreciation slowed down or stopped then borrowers and lenders soon realized that they couldn't manage their payments and began defaulting.

Securitization as a way of passing on the buck to somebody else. The demand for MBS – Mortgage Backed Securities created a demand for short term mortgages; the so called 2/28 and 3/27 Adjustable Rate Mortgages. The principle of these programs was that borrowers 30 year amortization mortgage will be fixed for the initial term of 2 or 3 years and then it will adjust to LIBOR or PRIME plus 3 or 4 percentage points. So initially the subprime borrower was qualified and approved on a rate of let's say 6%, after paying for 2 or 3 years the mortgage rate would adjust to 6% plus 3% or 4% points to arrive at 9% or 10%. These types of mortgages carried also a heavy prepay penalties, so the borrower could not refinance the mortgage before the term was due, unless paid 2%-3% penalty. This concept was fine for as long as properties were going up in value and could be refinanced.

Subprime mortgages were never serviced and held by the mortgage lender, they were sold to investors such as Meryl Lynch, Lehman Brothers, Deutsche Bank and hundreds of others. These investors would package the loans and issue bond securities. These securities were rated as AAA and marketed all over the world as secured investments backed by "good faith of American home owner". This faith was given a lot of credit when the value of properties was going up, badly tarnished when appreciation stopped. The best example was a town in northern Norway which invested in American MBS and CDO's, never explained what they were buying… and when the "investments" lost its value so did 50% of this town's annual budget.

However, what began to happen in the early 2007 and throughout 2008 was the tsunami of defaults. After mortgages adjusted to the high percentage of 9's% or even teens, borrowers could not afford since their monthly mortgage payments almost doubled. The programs that they were originally approved didn't exist, properties didn't appreciate as in the past or started to decline in value and borrowers were heavily in debt with not improved credit. Borrowers basically got stocked with now way out but defaulting. If this situation is multiplied by several millions then we have a chain effect starting from the borrower –to-servicer- to the investment banker who purchased the mortgages and then repackaged and sold to different investors. These investors such as pension funds, investment companies, municipalities, individuals or banks began to see major defaults, lose of return and their bonds became worthless as major defaults began to wide spread in the financial market.

## Mortgage Brokers

I want to emphasize and stress that 95% of all mortgage brokers and I was one of them were good and honest hard working professionals whose primary goal was to find the best solution for their borrowers. The role of a mortgage broker is definitely important in the rise and fall of the subprime mortgage financing. Demand from investment banks for Mortgage Backed Securities (MBS) increased the competition for subprime loans. Lenders began to introduce new "fancy" and clever products to attract more loans their way. Mortgage broker's job is to find the borrower, take an application, assess his/her credit worthiness, evaluate income to debt ratios and send the borrower to the lender that best suites borrower's criteria. However, this not always worked as planned. Since mortgage brokers are paid on commission, they would send even the border line or prime credit borrowers towards subprime lenders in order to earn the highest commission. Definitely less ethical practice than designed. Further, increased demand for MBS' attracted people that had zero or very little finance experience into this profession. Pizza delivery guys, waiters, taxi cab drivers, new immigrants or anybody with a beating heart who could sell was becoming a mortgage broker. This drive for fast money, combined with a low or nonexistent licensing requirements (depending on the state/ province) deliberately lowered reputation of a mortgage broker. Such a huge influx of people into the mortgage industry exposed lenders into markets that they would normally not go after: new immigrants, low income, single parents, bankrupts, renters, self employed or even unemployed. Basically, a segment of the population that should never have had a mortgage, because they definitely will have a problem with repayment.

Lenders on the other hand were racing each other with the idea to introduce the next and newest product. This led into introduction of such products as: Stated Income, Stated Assets, ARM (Adjustable Rate Mortgages), NINA (No Income No Asset), Option ARMs, High Ratio Mortgages where lender would provide financing to a borrower whose debt-to-income ratio was up to 55%. Not to mention that very high percentage of subprime mortgage loans was given at 100% or even 115% of Loan –To-Value. This high ratio and high loan to value products attracted borrowers who didn't have any down payment, couldn't afford it or as some would say it "had no skin in the deal". This type of borrowers would normally walk away from the house if times became more difficult or prices of real estate became more stagnant or began to decline. Borrowers in a short time frame owned a real estate that had a higher mortgage than the property was worth and lenders had a high financing exposure on the same house that was worth definitely less than when originally lent on. Multiplying this by thousands and millions of subprime mortgage holders created a financial tsunami.

As a conclusion to this evaluation, I can honestly say that besides a few incidents we cannot pin point the blame of the demise of subprime mortgage lending on certain individuals but rather on the failure of the system of oversight by governing and regulatory government institutions, corporate misdeeds, drive for profits but also to a great deal on borrowers themselves. When taking on a mortgage the borrowers in their desire to take out more money, cash out on the deal, buy a home that he / she could not afford in the first place, took on financial products that weren't to their benefit in a long run. Borrowers were blinded by short term desires; badly thought out decisions to own a home, go on vacation, buy things that they wanted now, even if the deal was not in their favor.

## Henryk Zysko

L B.Sc., M.B.A, has over 10 years of banking and finance experience. Spent the last 7 years in the Mortgage Banking Industry, both in the United States and Canada. Worked as a Loan Officer for Ashton Financial, LLC, a major mortgage brokerage firm in Milwaukee, Wisconsin. Joined Accredited Home Lenders in Chicago as an executive and later moved to Ontario, Canada to start up and manage sales operations in Eastern Canada until the company closed due to the global credit crunch. Started up TOR Mortgage Capital with two other partners in 2008 and also consulted for several major mortgage brokerage and real estate companies in Ontario, Canada.

hzysko@collectivepos.com

**Paradigm Shift** es una firma de consultoría que desarrolla soluciones integrales de negocios orientadas a ayudar a la empresa a alcanzar sus objetivos estratégicos.

Nos enfocamos en el factor más crítico de su empresa: su gente. Buscamos cambiar la forma de pensar y trabajar de su organización mediante la generación y transferencia de aprendizaje y conocimiento a todo su personal y directivos. Esto es, buscamos genrar un cambio de fondo en su organización para resolver los problemas de fondo y producir resultados duraderos.