

TO LOAN OR NOT TO LOAN: A SUBPRIME DILEMMA[©]

(Middletown, December 2006) Owning a home is part of the American dream. Having a home creates ties to the community, provides stability, and promotes civic pride. This desire for home ownership is so much a part of the American culture that governments promote this ownership by providing significant tax incentives. Mary Taggart is Senior Vice President for Mortgage Lending at a medium sized bank, Citywide State, operating in the Midwest. Mary prides herself in her role of helping her customers realize this American dream. She wants to help extend the opportunity of home ownership to her customers who previously would not qualify for a home loan from Citywide by convincing the bank management to enter into the subprime home lending market.

Citywide has been a fairly conservative banking institution, concentrating on commercial lending to local business and low risk home loans. The home loans extended by Citywide are to prime borrowers. These borrowers have reasonably well established credit and borrow in loans conforming to Fannie Mae or Freddie Mac criteria. Such loans can be packaged and sold through these government-sponsored agencies. The risk to the bank is low, many of the loans are sold to other institutions and pension funds while the bank earns fees for processing the payments. Prime borrowers generally had credit scores of 640 or higher.

In managing the loan business for her bank, Mary sees her job as dealing with two significant problems. Prior to extending a loan she must deal with adverse selection. Once the loan is extended she needs to provide sufficient incentives to reduce the moral hazard problem. Adverse selection results from asymmetric information. The potential borrower knows more about their likely behavior and financial condition than the bank. If the bank establishes a lending criteria that is significantly more lenient than its competitors, the borrowers selected are more likely to be higher risk and less likely to maintain their payments. Once the loan is extended the borrowers might expose the bank to unanticipated risk by failing to maintain the property. Mary sees this moral hazard problem being reduced by requiring a minimum down payment of 10 percent of the property's value. Since the first party to incur a loss, should the property value decline, is the homeowner, they have an incentive to maintain the value. The adverse selection problem is managed by screening the applicants. A potential borrower's credit score has proven to be a useful screening device.

Mary has been frustrated by having a screening rule that only permits loans to highly qualified borrowers. Since her bank only issues prime mortgage loans, she must turn away business from borrowers with 640 or lower credit scores. She has watched her competitors enter the less than prime (subprime) market with a high degree of success and seen many of the subprime borrowers succeed in making their housing payments, improve their credit scores, and achieve their dream of home ownership. Mary believed that these potential borrowers should not be denied the opportunity of home ownership just because of a few late payments, difficulty in documenting their income and, perhaps, a prior bankruptcy. If they were given the opportunity and provided financial counseling to help them manage their incomes, they would become good customers for the bank, provide an additional source of bank income, and become more productive members of the community.

The subprime market developed in the late 1990s. These loans were designed to provide potential homeowners with less than perfect credit the opportunity to get back on their feet, improve their credit rating, and ultimately refinance into a prime loan at lower rates. The initial subprime loans required a 20 percent down payment, had a fixed interest rate for the first two years that was generally 2 percent above the prime, 30-year fixed rate, and moved into an adjustable rate mortgage (ARM) after two years. Moving into the 2000s, housing prices were

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rising, equity was being built up for the homeowners and the loans were profitable. With the subprime loans improving bank profitability, banks and mortgage lending institutions moved to make their loans more attractive. The down payment requirements dropped to 10 percent. Institutions, in some cases, would issue loans for 100 percent of the property's value (no down payment). In order to provide additional loans, second loans were sometimes issued to subprime borrowers to permit them to take acquired home equity out of the house. While the latest movement towards more lenient lending criteria has Mary a little worried, she still sees the subprime market as a vehicle to help both her bank, with higher profits, and her customers, by providing them with the opportunity of home ownership.

The subprime loans Mary wishes to make would require at least a ten percent down payment, have a fixed rate for two years, include a prepayment penalty during the first two years, and become an adjustable rate mortgage (ARM) after two years. To compensate for the added risk associated with these loans, the fixed rate would be 2 percent higher than the bank's traditional prime home mortgage loans. The ten percent down would protect the bank in the case of foreclosure, and the future adjustable rate would make the loan attractive on the developing secondary market for subprime loans. The ARM is indexed relative to the 6-mo LIBOR (London Interbank Offer Rate). Mary is comfortable with these features. She believes that her borrowers would make their mortgage payment, reestablish a higher credit score and be able to refinance after two years into a lower rate prime loan.

Required

Mary has some concerns over entering this market and has hired your consulting firm to help her resolve these concerns and recommend how she should proceed in this market. Please write a report using the form recommended on the Gateway web site. (This case takes place in December 2006. While you have future events in this industry available, you need to make your case on data available prior to January 2007.)

In preparing your answer be sure to consider statistics concepts 4, 5, 6, and 8 and macroeconomics key concepts 4, 6, 7, and 9.

The available data is in the Excel spreadsheet subprimedata.xls found on the course web site. Note that the data is contained in two sheets.