BackSpace

By Bill Conroy

Subprime-loan resurgence tests the nation's risk tolerance

Today, some eight years after the housing bubble burst, subprime mortgages — which cater to borrowers with below-average credit — are making a comeback.

Some contend this trend poses a grave risk to the stability of the housing market. Others argue that today's subprime mortgages are a different animal, with far better underwriting than the subprime loans that fueled the housing-market collapse in 2007.

Determining who is right and wrong on that score is no easy task, because data exists to support both sides of the argument. What may matter more, however, is determining the level of risk the nation is willing to accept in the effort to expand homeownership opportunities for more Americans.

Subprime purchase and refinance home loans to borrowers with credit scores below 620 have been trending upward since 2012, according a recent report from Equifax Inc. In first-half 2015, the report shows, subprime originations made up 4.5 percent of all first-mortgage originations, and they were 32 percent higher compared with first-half 2014.

"We have had a tremendous year in mortgage originations in 2015, so a rising tide is lifting all boats," says Amy Crews Cutts, chief economist for Equifax. Crews Cutts says these subprime mortgages are underwritten carefully, and their risk profile is "very different today."

In 2008, Crews Cutts says, "more than 10 percent of first-mortgage originations went to borrowers with credit scores below 620," which is more than double the current level.

Government backing

The resurgence of subprime lending should create pause for concern in the area of government-backed loans, however. At least that's the argument advanced by Edward Pinto, codirector of the conservative American Enterprise Institute's International Center on Housing Risk. Pinto contends that the Federal Housing Administration (FHA) could well be at the center of an avalanche of defaults in the event of a major downturn in housing prices.

"A growing percentage of FHA loans are to borrowers with credit scores below 620, and these are very risky loans," he says. "They are low-downpayment loans often involving high debt-to-income ratios, and they have a high default risk."

Subprime purchase loans — specifically those involving borrower credit scores below 620 — represented 3.71 percent of all FHA-backed purchase loans originated in 2014, Pinto says. In first-half 2015, that figure increased to 4.6 percent. Using a 620 credit-score bar

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for subprime loans understates the potential problem, according to Pinto, because he says the standard cut-off for a subprime loan is typically higher — a credit score below 660.

A report published earlier this year by the Federal Reserve Bank of Cleveland points out that the FHA increased lending significantly as the financial crisis shook the country — with FHA-backed loans peaking at nearly 44 percent of mortgage originations in November 2009.

The Fed report says even though the FHA in 2010 stopped originating "deep subprime" loans — those involving credit scores below 600 — they still represent 6.2 percent of all outstanding FHA loans, and subprime loans overall represent nearly 31 percent of the agency's portfolio.

"The default rate of all FHA loans combined is still higher than it was before the onset of the subprime boom in 2003," the Fed report states.

A big part of the risk with FHA's subprime portfolio is a legacy problem, the report concludes, and "if the FHA continues to facilitate lending to more creditworthy borrowers, the performance of the overall FHA market is poised to improve in the future."

Laurie Goodman, director of the Housing Finance Policy Center at the liberal Urban Institute, says there is no question that subprime-mortgage lending is "trending up." She stresses that the riskiness of today's subprime loans, however, is much lower than even in the early 2000s, "prior to the run-up to the housing crisis."

Goodman points to the Urban Institute's Credit Availability Index, which is a measure of the share of mortgages originated that are likely to go sour. The index shows that default risk in the "government channel," which includes FHA-backed loans, hit nearly 22 percent in the early 2000s. As of second-quarter 2015, the index score stood at 10 percent, less than half the prebubble level. The index scores for the overall mortgage market mirror that same pattern.

"We have loosened a little bit, but not nearly to the point we were at in 2001, which is even before the run-up to the financial crisis," Goodman says. "We still have much more room to prudently expand the credit box…. As a society, we should have a greater willingness to underwrite loans that have some probability of default, because homeownership is the major way that people build wealth in this country."

Outside the box

Another sign of the resurgence in subprime lending is reflected in the willingness of some investment companies active in the secondary market to again embrace these higher-risk loans. For example, this past October, New York investment company Seer Capital Management LP agreed to purchase as much as $100 million worth of future commercial and residential real estate loans from Maryland-based ACC Mortgage Inc., which is a niche lender specializing in high-downpayment subprime mortgages.

Robert Senko, president of ACC Mortgage, says his company requires a minimum of 20 percent down on a subprime loan. "If you have skin in the game, and you have the ability to repay, we can get you a loan," he says.

Senko agrees that, in general, the underwriting and oversight of subprime loans in today's market is far more rigorous than in past years. He says loan risk expands when lending becomes "too commoditized, with no human element and interpretation."

"We apply credit scores, but we also look at the big picture, because a credit score is not always indicative of the success or failure of an individual," Senko says. "Part of the due diligence should involve getting to know the character of the borrower, rather than just seeing if they fit in a box." ■

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