

## What Is Subprime Lending?

**M**ortgage loans are typically classified as either prime or subprime, depending on their credit risk—the risk that a borrower will default on the loan. Interest rates are higher on subprime mortgages, reflecting their higher credit risk. However, despite its common usage, the prime-subprime distinction is not clear-cut and there is still some confusion regarding a precise characterization of subprime lending.

Some agencies characterize subprime lending in terms of lender practices. For example, the U.S. Department of Housing and Urban Development (HUD) uses Home Mortgage Disclosure Act (HMDA) data and interviews with lenders themselves to identify lenders that specialize in subprime mortgages. This approach raises the obvious query: Why not simply look for lenders that make high-priced mortgages? One problem lies in the fact that HMDA reports did not include interest rate data prior to 2004. Moreover, HUD argues that a high average mortgage interest rate is neither a necessary nor a sufficient characteristic of subprime lending.<sup>1</sup> HUD has published a list of subprime lenders annually since 1993, with 210 lenders on the 2005 list. It notes that, in contrast to prime lenders, subprime specialists typically (i) have fewer originations, (ii) have a higher share of refinance loans as a proportion of total originations, and (iii) sell a smaller percentage of their portfolios to the government-sponsored enterprises (GSEs), i.e., Fannie Mae and Freddie Mac. Importantly, HUD notes that some prime lenders originate a significant number of subprime loans and some subprime lenders also originate prime loans.

A second approach to identifying subprime lending is to focus on borrower attributes, regardless of the lender involved. In a joint proposal to provide expanded guidance to institutions that engage in subprime lending, the federal bank and thrift supervisory agencies—the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision—specify that “subprime” refers to the credit characteristics of individual borrowers. They characterize subprime borrowers as those who display, among other characteristics, (i) a previous record of delinquency, foreclosure, or bankruptcy, (ii) a low credit score, and (iii) a debt service-to-income ratio of 50 percent or greater.

Again, this checklist includes the caveat that the “list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers.”<sup>2</sup>

Clearly, a precise characterization of subprime lending is elusive. The difficulty lies in that, unlike prime mortgages, subprime mortgages are not homogenous. Indeed, each underwriter independently evaluates the credit risk on the mortgage which, in addition to borrower-specific attributes, depends also on the terms of the loan contract. Therefore, a third (and perhaps simpler) way might be to define a prime mortgage and then classify other non-prime mortgages as “subprime” or “near-prime.” Hancock et al. (2005) make an attempt in this direction by dividing the first-lien conventional mortgage market into three broad credit risk segments based on a couple of summary characteristics. First, creditworthiness of the mortgagor is summarized by her *credit score*. Second, the terms and conditions of a mortgage contract are summarized by the *loan-to-value ratio*. Hancock et al. (2005) use these two characteristics to define three segments of the mortgage market as shown in Table 1. This definition provides a much-needed benchmark to clearly define subprime loans, and its appeal lies in its simplicity.

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<sup>1</sup> More details are available on the HUD web site: [www.huduser.org/datasets/manu.html](http://www.huduser.org/datasets/manu.html).

<sup>2</sup> For details on the supervisory guidance, see [www.federalreserve.gov/boarddocs/press/bcreg/2007/20070302/default.htm](http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070302/default.htm).

### Summary of Conventional Mortgage Market Segment Definitions

Credit score	Loan-to-value ratio		
	<80 Percent	80-90 Percent	>90 Percent
660 or higher	<b>Prime</b>	<i>Near-prime</i>	Subprime
581 to 659	<i>Near-prime</i>	<i>Near-prime</i>	Subprime
580 or lower	Subprime	Subprime	Subprime

SOURCE: Hancock, Diana; Lehnert, Andreas; Passmore, Wayne and Sherlund, Shane M. “An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitization.” Basel II White Paper No. 4, Board of Governors of the Federal Reserve System, 2005.