

Subprime Mortgage Lending

September 2007

This month's newsletter covers the topic of subprime mortgage lending, with data and explanations your patrons may find useful. The subprime market has been a closely covered news topic of late. (See ["Hot Topic: Behind the U.S. Mortgage Mess,"](#) *Wall Street Journal.com*, August 11, 2007, for recent developments.)

"I continue to believe that we haven't seen the bottom in the subprime market. There will be more pain felt by people as that works through the system."

—David Viniar (*Chief Financial Officer, Goldman Sachs*), June 14, 2007

Although subprime mortgages were available as early as 1982, (via the Alternative Mortgage Transaction Parity Act), they did not gain popularity until the mid-1990s, making them a relatively new phenomenon. Simply put, subprime mortgages cost more than conventional (prime) mortgages, but they allow borrowers with "less than perfect credit" or small down payments access to homeownership. Because of their higher chance of defaulting, these borrowers would otherwise have been denied credit. As a result, homeownership has increased from an average of 64.1 percent in 1982-94 to 67.3 percent in 1995-2007. A further financial innovation, known as securitization, has allowed lenders to sell these subprime mortgages to firms that pool and sell them as bonds, also known as mortgage-backed securities (MBSs). Securitization spreads risk while providing lenders with immediate funds to provide more loans.

Since securitization reduced lenders' exposure to risk, many underwriters have loosened their standards, accepting mortgages with even higher risk. One consequence of this change is that many MBSs have lost most of their value, as is the case with two Bear Stearns funds. Currently, Standard & Poor's is evaluating the bond rating on \$7.35 billion worth of subprime loans issued in 2004-06.

Many homebuyers have benefited from subprime mortgages. But those with adjustable-rate mortgages (ARMs, a common subprime loan), which offered a lower initial interest rate in 2003 through 2005, are now seeing their first rate adjustment. The LIBOR, the index on which many mortgages are based, has risen 425 basis points, up from 1 percent in 2004. Consequently, homeowners with a \$200,000 ARM at an initial rate of 5.375 percent will now see their payments jump from \$1,120 to \$1,369 per month (assuming a 2 percent rate increase cap) and payments over \$2000 starting in the fifth year, assuming prime rates do not change. Because mortgage underwriters allowed high debt-to-income ratios or loose income documentation, even the small increase thus far has pushed the subprime loan delinquency rate up to 12 percent¹; the total number of May foreclosures is up 90 percent from a year ago.

Still, subprime loans are only a small fraction of the overall housing market and the demand for housing over the longer term will ultimately depend on the fundamentals, such as gains in jobs and incomes, and low mortgage rates. In addition, while the issues with subprime lending have affected the economy and revealed possible weaknesses in financial markets, at present the economy outside of the housing sector remains on solid footing, while the extent of the impact of subprime lending on the economy remains unclear.

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The views expressed are those of the author and do not necessarily reflect the official positions of the Federal Reserve Bank of St. Louis, the Federal Reserve System, or the Board of Governors.

¹ Loan Performance Securities database.

Recent Articles and Further Reading on Subprime Lending

[“The Subprime Mortgage Market”](#) by Ben S. Bernanke, Remarks at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition, May 17, 2007.

In this speech, Chairman Bernanke addresses most of the major questions concerning subprime loans and possible regulatory responses.

["The Evolution of the Subprime Mortgage Market"](#) by Souphala Chomsisengphet and Anthony Pennington-Cross, Federal Reserve Bank of St. Louis *Review*, January/February 2006.

This article discusses the changing nature of subprime lending and the defining of the subprime market and is heavily cited by Federal Reserve Bank of St. Louis President William Poole in his [July 20th speech](#).

["Subprime ARMS: Popular Loans, Poor Performance"](#) by Yuliya Demyanyk and Yadav Gopalan, Federal Reserve Bank of St. Louis *Bridges*, Spring 2007.

This brief article explains subprime ARMs and their effect on the U.S. mortgage market.

[“House Prices and Subprime Mortgage Delinquencies”](#) by Mark Doms, Frederick Furlong, and John Krainer. Federal Reserve Bank of San Francisco *Economic Letter*, 2007, No. 14, June 8, 2007.

Free Data Sources

Data: Terms on Conventional Home Mortgages: Adjustable-Rate Loans

Published by: Federal Housing Finance Board. News Release, Table 2

Location : <http://www.fhfb.gov/Default.aspx?Page=8>

Date: 1983 to present; **Freq:** Monthly; **Format:** News Release (PDF), downloadable (Excel);

Aggregation: Major Lenders Nationally, United States only

Data: Homeownership Rates for the U.S. and Regions

Published by: U.S. Census Bureau, Current Population Survey/Housing Vacancy Survey, Series H-111

Location : <http://www.census.gov/hhes/www/housing/hvs/historic/histt14.html>

Date: 1965 to present; **Freq:** Quarterly; **Format:** Table; **Aggregation:** U.S. and Major Regions

Data: Mortgage Comparison Calculator

Published by: Federal Reserve Board

Location: <https://www.federalreserve.gov/apps/mortcalc/>

Format: Interactive tables

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