



After the Subprime Lending Bust

By Alex J. Pollock

The great house price inflation of the past several years has topped out, and the unsustainable expansion of subprime mortgage credit which accompanied it has shifted distinctly into reverse. As many people have pointed out, the market itself is correcting sharply and rapidly, if belatedly. The subprime boom is over; the bust is here. Former enthusiasm has been replaced by large financial losses, the bankruptcy of subprime lenders, layoffs, accelerating foreclosures, fear, a liquidity squeeze, and, of course, recriminations, some well-deserved. What was recently seen as “creative” and “innovative” democratization of credit is now viewed as misguided and culpable bungling—or worse.

All these elements of the current subprime mortgage lending bust display the classic patterns of recurring credit overexpansions. Such credit celebrations are based on optimism and a euphoric belief in the ever-rising price of some asset class—in this case, houses and condominiums—providing a surefire way for both lenders and borrowers to make money. These booms are inevitably followed by a hangover of defaults, failures, dispossession of unwise or unlucky borrowers, revelations of fraud and scandals, and late-cycle regulatory and political reactions.

In the general pattern, nothing changes. You would think we would learn, but we do not. As the great student of financial behavior, Walter Bagehot, observed in 1873:

The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of

a greater prosperity. . . . Every great crisis reveals the excessive speculations of many houses which no one before suspected.

We had a period of remarkably rising house prices. This stimulated the sanguine and ardent subprime lenders—and it also stimulated the sanguine and ardent subprime borrowers. If the price of the asset is always rising, the risk of the loan seems less, and it appears that more leverage is always better. Booms are usually accompanied by a plausible theory about how we are in a “new era”; the subprime mortgage boom was no different.

It is essential to remember that the boom gets going because many people experience financial success. This so-far successful speculation is extrapolated. Subprime lenders were experiencing large profits and high stock prices. Subprime borrowers could get loans and buy houses they would otherwise be unable to and could benefit greatly from house price appreciation. A borrower who took out a 100 percent loan-to-value, adjustable rate mortgage (ARM) with a teaser rate to buy a house which subsequently appreciated 30 percent now had built substantial equity and the ability to refinance on more favorable terms. This was a successful outcome as a result of taking risk. But

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then somebody ends up buying at the top on a highly leveraged basis.

It is first success, and then observing other people's success, which builds up the optimism, which creates the boom, which then sets up the bust.

Home Ownership and Risk

The American home ownership rate has moved up to 69 percent. This is widely praised and is on balance a good thing. Some commentators have wondered whether this was not pushed too high, since home ownership is not for everybody. It is hard to say what the ideal home ownership ratio is.

The current American ratio is not particularly high on an international basis. According to an International Union for Housing Finance analysis, the United States, Britain, and Australia—all with 69 percent home ownership—rank tenth, eleventh, and twelfth among all advanced economies. A number of countries maintain ratios greater than 75 percent. Conversely, Switzerland, a prosperous and pleasant country, has home ownership of only about 35 percent.

We can say that the mortgage market is constantly experimenting with how much risk there should be, how that risk is distributed, and how that trades off with success or failure. The subprime mortgage market obviously overshot on risk creation and is now paying the price. But if lenders and investors are free to take on credit risk, and if borrowers are free to take on risk in order to have the chance to own a house, credit cycles are inevitable as these experiments proceed.

In general, it seems that if you want the long-term growth, innovation, and economic well-being for ordinary people that only market experimentation can create, then you will have the boom and bust cycles that come along with market experimentation. I do not believe they can be avoided, except in hindsight.

Consider another notable experiment with mortgage lending: the creation of the long-term, fixed-rate, amortizing mortgage loan. There is no doubt this form of mortgage loan is highly attractive to borrowers. Introduced in the 1930s in response to the complete collapse of the mortgage market, it has been very successful in many ways.

But in the structure set up in the 1930s to deliver this form of housing finance—namely the savings and loan industries—the long-term fixed-rate mortgage was the basic cause of another complete and very expensive

collapse: the savings and loan bust of the 1980s, which many of us remember vividly.

In economics, nothing is ever free. In order to preserve the fixed-rate mortgage no longer provided by savings and loans in the 1980s, it was necessary to depend on vastly expanded securitization. Securitization typically breaks the link between the originator of the mortgage loan and the bearer of the credit risk. This usually results in riskier lending.

The financing engine of the subprime mortgage boom was securitization. This structure has greatly suffered, as is now clear, from just this break in credit decisions from credit risk bearing.

In an ideal mortgage finance system, the loan originator should always maintain a significant credit risk position in the loan, which creates a superior alignment of incentives; this is always my advice to developing countries as they consider housing finance ideas. The subprime mortgage financing system is very far from this ideal.

Mortgage Risk

Mortgage finance has some very reliable systematic risk factors, and the subprime mortgage boom had all these risk factors operating together:

- Subprime loans have higher defaults and losses than prime loans
- Adjustable rate loans of all kinds have higher defaults and losses than fixed-rate loans
- High loan-to-value (LTV) loans have greater defaults and losses than low LTV loans
- Periods of very rapid house price inflation result in greater defaults and losses than those of steady house price movements

Current statistics reflect these risks. Subprime ARMs have 50 percent higher serious delinquencies than subprime fixed-rate loans (9 percent vs. 6 percent), subprime ARMs have six times the serious delinquencies of prime ARMs (9 percent vs. 1.45 percent), and prime ARMs have twice the serious delinquencies of prime fixed-rate loans (1.45 percent vs. 0.7 percent).

The foreclosure rate on subprime mortgages of over 4 percent is below its recent peak of over 9 percent in 2000, but it is rising quickly. The subprime market is

now eight times larger than it was in 2000, having grown from about \$150 billion to \$1.3 trillion, so its economic and political impacts are much greater.

The foreclosure rate for the oil patch mortgage loan bust of the 1980s peaked at 14.9 percent for Arkansas, Louisiana, Mississippi, and Oklahoma—an extreme experience used for stress tests by the bond-rating agencies. If subprime mortgage foreclosures should approach this level nationwide, one analyst estimates losses to lenders of \$100–\$150 billion and the loss of their homes by 1.5 million people.

It was not that subprime mortgage lenders did not understand these fundamental factors; it was that the risk reality outstripped the expectations of the models. As an old friend of mine says, “The model works until it doesn’t.” Perversely, the more everyone believes the model and the more everyone uses the same model, the more likely it is to induce changes in the market that make it cease to work.

Fraud

A risk difficult to model is fraud. Booms tend to induce fraud, misrepresentation, and scandals. To quote Bagehot again, “The good times of too high price almost always engender much fraud.” And to quote the great economic historian Charles Kindleberger: “The propensity to swindle grows parallel with the propensity to speculate during a boom. The implosion of an asset price bubble always leads to the discovery of fraud and swindles.”

The subprime mortgage boom is true to its type in this respect also. Of course, the fact that fraud and misrepresentation always occur does not mean they should be excused or tolerated. Integrity in describing the terms of a loan is essential.

As a sign of the times, *National Mortgage News* has introduced a new weekly “Fraud and Compliance Report,” responding to what it calls “the explosion of mortgage fraud.” Note, however, that it is often the *lenders* who are being defrauded.

Consider in this context the spread of “stated income” loans. The disastrous previous experience with this bad idea, then called “no doc” or “low doc” loans,

seems to have been unfortunately forgotten. Such loans are an obvious temptation, or even invitation, to exaggeration of income in order to obtain the mortgage loan—hence the now-familiar name of “Liars’ Loans.”

Of late, subprime borrowers with defaulted loans have sometimes been referred to as “victims.” In my view, however, anyone who lied about his income to get a loan hardly qualifies as a victim. Perhaps the lie seemed a small thing compared to getting to buy the house whose price will always keep on rising.

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What Should Be Done Now?

Late in the credit cycle, when losses are rising, credit is tightening, liquidity is disappearing, and asset prices are already falling, regulators face a dilemma. The former mistakes and scandals are already clear, and regulators should respond somehow, but how can they take action that is not pro-cyclical and will not make the current problems worse?

In my view, the “Proposed Statement on Subprime Mortgage Lending” of the combined financial institution regulators is, in general, a sober and sensible attempt to balance these pressures. The credit and disclosure principles regulators expound seem to me prudent and basic banking which is rightly combined—in their Request for Comment—with concern about the risk of pro-cyclical negative market effects because of the late-cycle timing.

How to achieve the final balance appears still open. As always, there is the further risk of a difference between carefully balanced words in a policy statement and their application by potentially overzealous field staff.

The proposed disclosure principles seem sound and fundamental overall. A good lender wants the borrower to understand what the loan agreement is. In particular, it is essential to disclose simply and clearly any prepayment penalties and the pattern of interest rate changes, if any, to which the loan is subject. I will say more about disclosure below.

I find it interesting that the proposed statement does not address down payment or LTV issues, since an equity stake in the house is an essential credit factor, and savings an essential economic factor. As one mortgage banker said recently, “Lenders will have to tell some borrowers to save

for a down payment.” Imagine that! Perhaps mortgage finance needs to rediscover saving as a principle.

There has been recent discussion in Congress and elsewhere of the possibility of some kind of fund to refinance defaulted subprime mortgages. The Federal Housing Administration is often mentioned in this context, although it is a credit insurer, not a mortgage investor.

Also, its delinquency rate is at the same level as the subprime sector, which suggests that loosening its credit standards further may not be the best idea. And we should certainly not be bailing out subprime lenders and investors; they should be on their own.

In considering this issue, I have been able to find one historical precedent: the Home Owners’ Loan Corporation (HOLC), created by the Home Owners’ Loan Act of 1933. In the midst of the housing finance system collapse of that time, the act was to “protect the small home owner from foreclosure and relieve him of part of the burden of excessive interest and principal payments.” Giving its bonds in exchange for defaulted mortgage loans, it provided refinancing for about 20 percent of U.S. mortgages. HOLC ended up itself foreclosing on about 20 percent of its own loans. Upon liquidation in 1951, it returned a small surplus to the U.S. Treasury.

The One-Page Disclosure

When considering borrowers in financial trouble—whether from unwise borrowing, not having understood their risks, having been fooled, or even having been induced into loans by misrepresentation—there is a natural desire to try to protect them.

The superior strategy is to equip borrowers to protect themselves by providing short, simple, and clear disclosures of mortgage loan terms. Most of us have experienced being overwhelmed and befuddled by the huge stack of documents full of confusing language in small print presented to us at a mortgage closing. These documents are the result of legal and compliance requirements, including regulatory attempts to insure disclosure.

I would like to see the design of a *one-page* form which states the essentials of the loan, and would be given to every mortgage borrower a week before the closing. The one-page Pollock Prototype and a two-page explanation of terms are

included with this *On the Issues*. A good lender wants an informed and understanding borrower. Just as you get a prospectus for an investment, you should also get a one-page form like this before you enter a mortgage loan agreement.

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experienced being
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stack of documents full
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in small print presented
to us at a mortgage
closing.

THE POLLOCK PROTOTYPE

Borrower: _____ Property address: _____

Lender: _____

Amount of loan: \$ _____, which is _____% of the property's appraised value.

Your loan is for _____ years. Its final maturity date is _____.

The type of loan you have: _____

Your beginning interest rate is _____%. This rate is good for _____ months/years. The rate and your payment can go higher on _____ and each _____ months after that.

Today's estimate of how high the rate will go, called the fully-indexed rate, is _____%.

The maximum possible rate on your loan is _____%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF \$ _____.

Your beginning rate = a monthly loan payment of \$ _____ = _____% of your income.

-including taxes and insurance, this is about \$ _____ = _____% of your income.

The fully-indexed rate = a monthly loan payment of \$ _____ = _____% of your income.

-including taxes and insurance, this is about \$ _____ = _____% of your income.*

*This is called your fully-indexed housing expense ratio.

Special factors you must be aware of:

-A prepayment fee of \$ _____ must be paid if _____.

-A "balloon payment" of \$ _____ to pay off your loan will be due on _____.

-You do/do not have a "payment option" loan. If you do, make sure you really understand what this means. Start with the definition on p. 3.

Total "points" plus estimated other costs and fees due at closing are \$ _____.

FOR QUESTIONS CONTACT: Name: _____

Phone: _____ E-mail: _____

**See definitions of underlined terms and guidelines on pages 2-3.
DO NOT SIGN THIS IF YOU DO NOT UNDERSTAND IT!**

Borrower Date

Authorized Signer of Lender Date

Borrower Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraiser estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed-rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. In a 2/28 hybrid, it will be the same for two years and then go up a lot, and change frequently after that.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. It is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate will go up by a lot. You need to know.

The *fully-indexed rate* is an essential indicator of what will happen to your interest rate and your monthly payments. It is today's estimate of how high the interest rate on an adjustable rate mortgage will go. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if your formula is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is $5\% + 3\% = 8\%$. This will *always* be higher than your beginning rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down,

you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser rate" for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pretax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct.

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A "*balloon payment*" means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining

loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A “*payment option*” loan means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. The very low payments in early years create the risk of very large increases in your monthly payment later. Payment option loans are typically advertised using only the very low beginning or “teaser” required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? (4) What is the fully-indexed rate?

“*Points*” are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points

mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don’t be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it*. You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you do not pay. Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign.