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A dark green, textured world map is centered on the page, showing the outlines of continents and some topographical features. It is set against a dark green background that transitions into a white background at the bottom.

SURPRISE: SUBPRIME MORTGAGE
PRODUCTS ARE NOT THE PROBLEM!

*James R. Barth, Tong Li,
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Rapidly rising foreclosure rates among subprime home mortgage loans have generated widespread media and regulatory interest. Some believe that the mortgage products offered to subprime borrowers are the fundamental cause of problems in this market. Based on such reasoning, they argue that many of the products offered to subprime borrowers should not have been made available.

Before addressing that issue, it is important to distinguish between prime and subprime borrowers. It is frequently assumed that FICO scores are the best determinants of a borrower's creditworthiness, and that individuals with FICO scores below a specific number (640, for example) are subprime borrowers. Yet as figure 1 illustrates, prime and subprime borrowers are not so easy to distinguish on the basis of FICO scores alone. The data, from LoanPerformance (LP), show that prime borrowers can have FICO scores below 400, while subprime borrowers can score above 820. Indeed, there is no standard industry-wide definition of the term "subprime." This means each and every lender makes its own determination.¹ In fact, if appropriate risk-based pricing is used, the distinction between prime and subprime lending becomes artificial.

Just as it is difficult to distinguish between prime and subprime borrowers on the basis of FICO scores, it is also difficult to distinguish between them on the basis of the mortgage products they use. Over the past decade, most, if not all, of the products offered to subprime borrowers have also been offered to prime borrowers. In fact, during the period January 1999 through July 2007, prime borrowers obtained thirty-one of the thirty-two types of mortgage products—fixed-rate, adjustable-rate, and hybrid mortgages, including those with balloon payments—obtained by subprime borrowers (see tables 1 and 2).

While distinct differences exist in the *extent* to which the same types of mortgage product are offered to prime and subprime borrowers, both groups have had access to a wide range of products. Stated another way, certain kinds of products have not been marketed to subprime borrowers exclusively. Furthermore, regulatory authorities have noted that "subprime lending is not synonymous with predatory lending."²

If the product per se were the problem in the subprime market, one might expect all borrowers using that product to be facing foreclosure. But this is not the case. Foreclosure rates are rising, but the rates differ widely by type of product and borrower. Most important, the foreclosure rates on all the home mortgage products still fall far short of 100 percent, which means many borrowers are benefiting from them.

To argue that the product is the source of the problem is to ignore a fundamental truth: the ability or willingness of individuals to repay loans depends on financial factors. The marketplace and a borrower's financial circumstances may deteriorate, leading to serious problems, including foreclosure. In some parts of the country, for example, real estate prices have fallen so far that houses are worth less than the amount owed on them. In addition, borrowers lose their jobs, or suffer divorce or serious illness, or otherwise face severe financial straits. It is well known that these factors, more than anything else, contribute to increases in foreclosures, regardless of the mortgage product.

Some of these products, however, have become associated with relatively high and rising foreclosure rates, especially among subprime borrowers. Tables 3 and 4 show the cumulative foreclosure

1. *Federal Register*, July 12, 2002.

2. Press release. FDIC. "Statement on Subprime Mortgage Lending," (PR-55-2007) June 29, 2007.

starts (and not all foreclosure starts complete the process) for both prime and subprime borrowers during the period January 1999 through September 2007. Both groups experience foreclosures for twenty-nine of the different mortgage products, indicating that virtually every mortgage product, whether prime or subprime, is a candidate for foreclosure. Of course, foreclosure rates on subprime mortgages are typically higher than those for prime mortgages, regardless of product type. But this undoubtedly reflects the fact that subprime borrowers are by definition riskier.

The bottom line? Product innovation is beneficial, and attempts to curtail such innovation in the mortgage market could mean no access to credit for borrowers who would not otherwise qualify for loans. Legislative or regulatory actions that are too sweeping and severe could limit the availability of mortgage products, thereby denying borrowers a wider menu from which to choose the product that best suits their needs.

One must therefore be careful in reacting to the subprime mortgage market turmoil in such a way as to curtail credit for those with limited access to traditional mortgage products. A wider range of products is meant to accommodate the wide range of borrowers with different degrees of risk, and to better match risk-and-return combinations.

Of course, new products create learning curves on the part of both lenders and borrowers. To the extent that problems arise for lenders, they will make adjustments in the products they offer. Borrowers, too, must educate themselves about which products are most suitable for their current and expected future financial status. The process by which lenders and borrowers decide on specific mortgage products is imperfect and therefore can at times create difficulties for both, resulting in re-negotiations of mortgage terms and even the curtailment, if not discontinuation, of some products, as we have seen in the current mortgage market turmoil. And regulatory authorities should be vigilant against fraudulent activity in mortgage markets.

Rising foreclosure rates are a serious issue. But as Lawrence Summers of Harvard University stated in September 2007, "... we need to ask ourselves the question, and I don't think the question has been put in a direct way and people have developed an answer; what is the optimal rate of foreclosures? How much are we prepared to accept?"³ It is not clear what foreclosure rates are optimal for different groups of borrowers from a social welfare standpoint.

James R. Barth is a Senior Fellow at the Milken Institute and Lowder Eminent Scholar in Finance at Auburn University. Tong Li is a Senior Research Analyst, Triphon Phumiwasana is a Research Economist, and Glenn Yago is Director of Capital Studies, at the Milken Institute.

3. Lawrence Summers, "Recent Financial Market Disruptions: Implications for the Economy and American Families" (panel discussion, The Brookings Institution, Washington D.C., Sept 26, 2007).

Figure 1: Distribution of Prime and Subprime Mortgage Originations by FICO Score, 2006

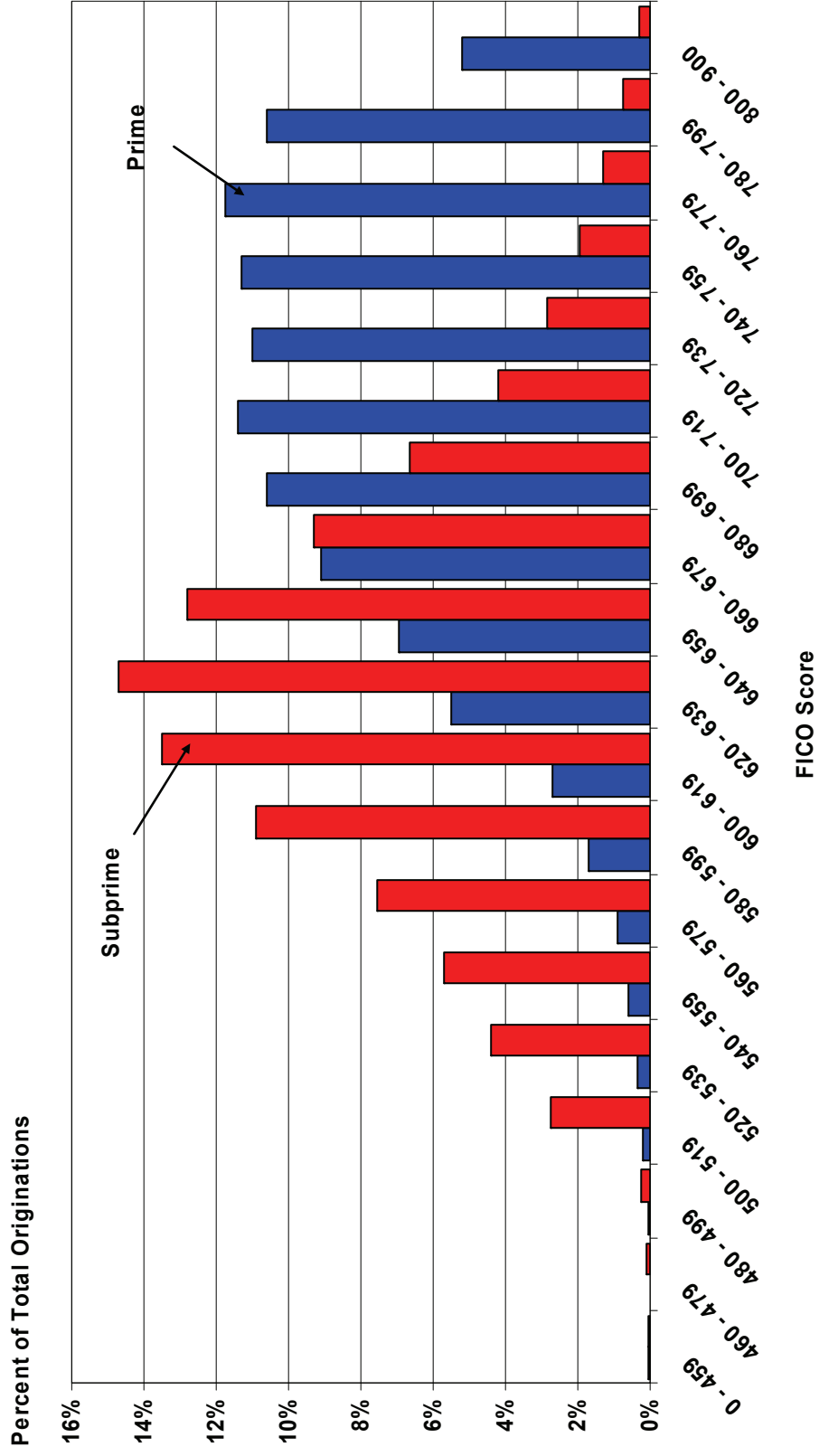


Table 1: Prime Mortgage Originations by Year of Origination and Product Type, January 1999 - July 2007

Year of Origination	Term Initial Fixed Rate Period	Hybrid												Adjustable Rate					Other ARM						
		2/6 Hybrid		2/1 Hybrid		3/6 Hybrid		3/1 Hybrid		5/6 Hybrid		7/6 Hybrid		7/1 Hybrid		10/6 Hybrid		10/1 Hybrid		15/6 Hybrid		Other Hybrid			
		1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year		6 Months	1 Year	6 Months	1 Year	6 Months	1 Year
1999	3	357	194	3,206	194	7,594	0	3,988	0	1,199	0	58,509	56,256	4,467	186,313	5,342	10,818	58	79,797	na	na	na	na	na	na
2000	251	335	1,965	3,230	11	7,449	0	10,906	0	1,064	0	48,539	109,009	3,490	131,125	3,461	11,942	3	90,712	na	na	na	na	na	na
2001	407	114	5,373	23,725	511	43,676	0	8,504	0	2,275	0	52,242	64,473	5,396	170,529	10,250	33,509	1	84,126	na	na	na	na	na	na
2002	1,336	152	4,029	87,881	1,331	109,459	0	11,625	0	2,419	0	86,484	111,610	21,267	470,054	38,523	89,385	1	133,390	na	na	na	na	na	na
2003	1,132	13	3,547	131,778	3,112	189,653	50	51,061	3	18,327	0	91,396	147,815	18,477	627,663	78,069	165,788	0	161,926	na	na	na	na	na	na
2004	2,833	787	2,369	104,022	2,393	192,580	98	44,831	16	12,790	0	77,447	294,763	70,514	649,166	88,264	178,056	0	152,338	na	na	na	na	na	na
2005	5,867	488	3,932	36,758	31,592	187,948	319	50,922	57	37,839	0	55,341	436,350	57,443	410,926	39,989	132,751	69	149,705	na	na	na	na	na	na
2006	3,359	42	2,223	15,033	34,958	170,026	407	28,355	103	17,651	0	67,935	191,414	14,154	348,558	12,990	93,526	256	208,550	na	na	na	na	na	na
January - July 2007	0	0	517	4,578	13,933	74,627	123	12,281	0	4,645	0	3,878	27,784	2,747	127,085	7,347	24,701	450	279,030	na	na	na	na	na	na
Total	15,188	2,288	24,149	410,271	87,841	983,012	997	222,453	179	98,209	0	541,771	1,439,473	197,955	3,121,409	284,235	740,476	838	1,339,564	na	na	na	na	na	na

Year of Origination	Term Initial Fixed Rate Period	Fixed Rate												Other					Grand Total									
		Fixed 10		Fixed 15		Fixed 20		Fixed 30		Fixed 40		Fixed 40 Years		Fixed 30 Years		Fixed 20 Years		Fixed 15 Years		Fixed 10 Years		Other						
		na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na		na	na	na	na	na	na			
1999	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na				
2000	56,163	833,647	164,216	3,698,673	90	77,269	1	2,415	25,640	1,202	43	32,512	44,617	5,354,568	6	1,509	7,410	468	489	24,322	45,194	3,733,598	3,733,598					
2001	15,852	244,880	60,142	2,144,634	146	765,054	13	22,686	54,363	1,962	1,018	45,893	85,623	8,578,039	167,783	2,868,283	506,547	6,517,075	84	161,862	301	80,744	11,092	11,634,375				
2002	397,964	4,252,740	782,710	8,113,636	83	291,147	1	71,727	153,291	21	15	26,036	22,608	15,801,779	146,812	1,188,737	302,979	4,180,370	348	131,541	2	36	19,274	26,822	7,931,717			
2003	67,682	709,249	241,050	4,598,216	2,124	88,559	1	1,930	6,282	0	33	23,880	57,474	7,434,776	34,216	423,685	144,223	4,459,747	20,775	46,557	0	70	1,633	104,094	6,446,752			
2004	19,244	213,281	84,071	2,833,615	33,407	26,109	0	14	213	11	84	1,010	91,494	3,886,279	983,634	12,417,770	2,574,027	42,105,448	57,495	1,830,273	23	178,127	383,754	4,613	2,089	255,304	489,018	
2005	983,634	12,417,770	2,574,027	42,105,448	57,495	1,830,273	23	178,127	383,754	4,613	2,089	255,304	489,018	70,801,883	na	na	na	na	na	na	na	na	na	na	na	na	na	
2006	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na
2007	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na
January - July 2007	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na
Total	983,634	12,417,770	2,574,027	42,105,448	57,495	1,830,273	23	178,127	383,754	4,613	2,089	255,304	489,018	70,801,883	na	na	na	na	na	na	na	na	na	na	na	na	na	na

Table 3: Prime Mortgage Cumulative Foreclosure Starts Through September 2007 by Year of Origination and Product Type, January 1999 - July 2007

Year of Origination	Term Initial Fixed Rate Period Reset Frequency	Adjustable Rate																							
		Hybrid		10/6		10/7		15/6		Other Hybrid		ARM 1		ARM 3		ARM 5		ARM 6		Other ARM					
		1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months	1 Year	6 Months		
1999	13	8	15	306	1	395	0	65	56	1,338	1,791	104	6,961	103	161	0	1,668	2,708	222	3,267	68	205	0	1,930	
2000	8	6	61	254	1	247	111	111	187	774	1,383	271	2,957	256	364	0	2,083	1,464	298	7,183	666	601	0	1,797	
2001	110	20	124	343	1	405	0	104	47	843	1,795	555	8,489	632	1,128	1	1,229	4,057	2,090	8,133	1,104	1,832	4	1,536	
2002	292	22	70	1,478	3	1,017	0	211	116	967	4,057	2,090	8,133	1,104	1,832	4	1,536	10,152	1,703	3,916	698	1,708	0	1,798	
2003	233	15	44	1,555	25	1,954	0	508	0	959	5,331	2,840	2,817	277	1,611	13	4,478	28,661	8,063	43,723	3,804	7,610	18	16,519	
2004	735	14	351	2,454	120	3,114	0	575	0	1,637	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2005	1,507	4	326	1,258	1,814	4,362	10	1,099	4	818	0	1,380	10,152	1,703	3,916	698	1,708	0	0	0	0	0	0	0	0
2006	865	0	249	423	2,636	4,078	15	726	6	174	0	1,678	5,331	2,840	2,817	277	1,611	13	4,478	28,661	8,063	43,723	3,804	7,610	
January - July 2007	0	0	3	13	165	277	0	15	11	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Total	3,763	89	1,240	8,071	4,601	15,572	25	3,415	10	1,637	0	9,568	28,661	8,063	43,723	3,804	7,610	18	16,519	0	0	0	0	0	0

Year of Origination	Term Initial Fixed Rate Period Reset Frequency	Fixed Rate														Other						Grand Total		
		Fixed 10		Fixed 15		Fixed 20		Fixed 30		Fixed 40		Other Fixed		Balloon 10		Balloon 15/30		Other Balloon						
		na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na				
1999	725	12,292	3,471	166,415	125	9,106	1	37	184	6	27	335	6,182	211,891	na	na	na	na	na	na	na	na	na	na
2000	455	6,984	2,794	128,943	138	12,550	0	15	38	1	41	413	5,387	168,603	na	na	na	na	na	na	na	na	na	na
2001	667	16,709	7,047	218,082	217	11,692	2	110	252	0	32	334	6,366	270,912	na	na	na	na	na	na	na	na	na	na
2002	750	17,777	7,794	183,573	94	10,267	1	248	419	2	14	301	3,031	240,263	na	na	na	na	na	na	na	na	na	na
2003	875	17,713	7,082	165,024	61	9,598	0	273	666	0	2	187	1,014	221,745	na	na	na	na	na	na	na	na	na	na
2004	368	6,345	3,920	90,931	33	7,353	0	90	191	0	4	58	459	136,954	na	na	na	na	na	na	na	na	na	na
2005	218	2,724	1,348	67,406	31	3,966	0	11	28	2	4	27	574	108,896	na	na	na	na	na	na	na	na	na	na
2006	49	827	389	45,168	428	1,508	0	1	5	0	43	88	1,342	78,065	na	na	na	na	na	na	na	na	na	na
January - July 2007	1	19	23	2,829	100	14	4	0	0	0	0	0	5	254	na	na	na	na	na	na	na	na	na	na
Total	4,107	81,371	33,845	1,065,542	1,127	66,040	4	785	1,783	11	167	1,743	24,375	1,437,329	na	na	na	na	na	na	na	na	na	na

