Sub-prime mortgage market

IThe mortgage loan market has seen considerable changes in the last two decades. One of the major changes has been an emergence of the sub-prime mortgage loan market.

Prior to this, the mortgage use to take place almost entirely in the prime market consisting of reputable loan providers and borrowers having a credit history which put them at low risk of defaults (GAO, 2004)The sub-prime market consists of borrowers with poor or no credit histories and do not meet the credit standards of the borrowers in the prime market. The major lenders in this market are of the predatory type. According to a report of the United States General Accounting office (2004), this market has seen a dramatic rise in the recent years from $ 34 billion in 1994 to $ 213 billion in 2002. In their book Retsinas and Balsky (2005) cite that Cutts and Van Order in 2005 found that the sub-prime mortgage was 10 % of the overall single-family residential mortgage market. This paper makes a study of the sub-prime mortgage and the various issues associated with it.

The term sub-prime, also known as non-prime in the world of mortgage market covers a wide range of mortgage products and practices. Sub-prime mortgage in simplest terms represents the type of mortgage lending where the cost of credit is higher than what is offered in by the prime and Federal Housing Administration FHA lending specialists. In many of the cases, it is seen that the higher cost means that he low credit value of the approved applicants comes out to be low, as measured by their credit resources (Retsinas & Balsky, 2005). Prior to the emergence of this market, the lenders had strict procedures and models for evaluating the credit value of the potential borrowers. There were strict and rigid standards of evaluation, and

the sub-prime borrowers were denied access to credit at any price. The present trend is shifting towards a more risk-based lending scenario.

Instead of the rejection of applications based on credit records, the lenders now evaluate the credit record of the borrower give credit quality rating. Lenders evaluate the past loan payment behavior and make credit scoring metrics. The lenders then divide them into risk categories, and give the pricings according to these categories.. The pricing becomes higher and more complex as the risk becomes higher. Hence, the sub-prime loans are also given based on the past credit behavior (Retsinas & Balsky, 2005).

While the general belief is that sub-prime lending is limited to people with bad credit records, according to Rockwell (2005), there are many other buyers who obtain sub-prime mortgages because of the following situations: Can’t (or would rather not have to) meet the income and asset documentation requirements of prime lendersHave good credit but carry more debt than what the prime lenders allowWant to purchase non-standard properties that the prime lenders don’t regard as acceptable collateralNeed large loan for buying very expensive housesAs is mentioned earlier, the sub-prime loans require a higher rate of interest than the and higher processing fee than the ordinary mortgage loans. In the period 1998-2001 it was seen that the sub-primer borrowers paid 3. 7% more than the prime borrower. That is to say if the prime borrower paid an interest of 7% per annum, the corresponding rate for a sub-primer borrower was 10. 7%. However, the sub-prime lenders also include a pre-payment penalty charge he requires to avoid investing at a much lower interest rate.

The rejection rate is also higher in case of sub-prime lending (Martin, 2003). The market of sub-prime lending is not well-understood or documented. The market has many lenders whose name is not well-known. Sub-prime lending usually consists of refinancing as opposed to new-purchase mortgages.

This may however be an erroneous conclusion because the information on sub-prime lending is limited to select samples of loans (Arnot & McMillen, 2006)Many prime market loan companies may have internal sub-prime divisions for catering to the situations involving bad credit record of borrowers. There are also lenders who cater exclusively to sub-prime lending. Borrowers may also get sub-prime loans from a mortgage broker. As is seen above, the sub-prime lenders generally place more restrictions on the loan. Dulworth and Goodwin (2004) give some such restrictions in their book as below: Payment Penalty: Usually one to three yearsHigher interest rate: Up to 5 % higher than the regular Prime ratesHigher Organization fee: Between two and four pointsLimited loan programs Usually shorter-term loansHowever Dulworth and Goodwin (2004) point-out that sub-prime lenders are also more lenient towards the credit record of the borrowers and offer: Higher allowable debt-to-income ratios: As high as 50-55%Higher LTV i.

e. Loan-to value ratio: Up to 100% financingLower FICO scores are acceptable: As low as 500Smaller reserves requirement: Requiring smaller than normal post-closing assetsDespite the lenient conditions of the sub-prime borrowers, not the entire population is eligible for such mortgage loans. For instance, borrowers having a FICO score less than 500 or facing bankruptcy might still not be able to secure a loan in this market. An option

in this case is the hard money loan which means taken on property regardless of the credit records.

The sub-prime lenders also assume that the borrower will not be in the sub-prime category and will increase his credit rating and hence long term loans are usually not a norm in this segment (Dulworth & Goodwin, 2004)The restrictive features of money repayment is for counterbalancing the some of the extra risks involved in lending the loans, they also cause trouble to the borrowers/ While it is seen that majority of the sub-prime lenders are legitimate, there are many who profit by deliberating making loans on burdensome terms to borrowers who are likely to have difficulty in paying them. The market of sub-prime lending is governed by a special set of government laws who decide various caps like the maximum amounts of points that can be charged (Rockwell, 2005)SummaryThe paper describes the various features of sub-prime mortgages. This mortgage market segment has gown explosively in the last few years. The market scene is profitable to both lenders who get every attractive price for the loans, and the borrowers who have credit rating which do not make them eligible for getting mortgage loans in the prime market. This market however still tends to become predatory, but there are government laws taking care to protect the borrowers from being exploited.