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Déjà vu

High-Risk Loans Revive Specter of '80s Debacle

By Jack C. Harris

After declining through much of the 1980s, state and national homeownership rates are once again climbing, spurred by the federal government's drive to make more loans available to first-time homebuyers. But the push to boost homeownership may carry a high price tag. The mortgage industry has greatly increased the number of low down payment loans made. And studies have shown that a loan's default risk is directly tied to its loan-to-value ratio (LTV).

The last time so many high LTV loans were made was in the mid-1980s (Chart 1), a period noted for the demise of the savings and loan industry, reform of mortgage lending regulation and slow-moving Texas housing markets. Some are now wondering if rising loan risk could lead to a similar debacle.

Chart 1. Percentage of Loan Originated with High LTV

Source: Mortgage Bankers Association of America

A few alarms are sounding, triggered by slowing in the U.S. economy and high consumer debt of all types. The *New York Times* recently reported that delinquency rates (the percentage of loans held that are at least one month behind in payments) on loans insured through the Federal Housing Administration's (FHA's) 203(b) program are already higher than during the 1980s. The rise appears to be confined to FHA loans (Chart 2), which traditionally allow more risk than conventional loans. In recent years, however, conventional loans have begun to look a lot more like FHA loans (see "FHA: Timeworn or Timeless," *Tierra Grande* July 2001).

Foreboding signals are coming from some segments of the market. Easy credit policies aimed at boosting manufactured housing sales have backfired because of high defaults and repossessions. The "subprime" mortgage market, which caters to borrowers with damaged credit, is experiencing high default rates after years of aggressive expansion.

Lending Today vs. the 1980s

Today's lending environment differs in two key ways from the mid-1980s: the impetus driving lenders to take on riskier loans and the factors used to justify additional risk. In the 1980s, lenders (mostly savings and loans) sought more risky loans to cover the rising costs of deposits. Today, there are lenders chasing high yields in the subprime market. Subprime loans are inherently more risky but are also more lucrative because interest rates are 4 to 6 percentage points higher than the market. When the economy is doing well, jobs are more secure and the incentive to make more subprime loans is strong. However, defaults are already driving lenders out of this market.

Most lenders make loans according to the dictates of loan purchasers, largely the government-sponsored entities (GSEs), Fannie Mae and Freddie Mac. Both made major commitments to expand lending to previously underserved markets in the mid-1990s by creating loan programs designed for those who could not qualify under standard underwriting requirements. Fannie Mae's Community Homebuyers program and Freddie Mac's Affordable Gold program have lower down payment requirements and allow borrowers to take on a higher burden of debt service relative to their income.

Meanwhile, community-based depository institutions (banks and thrifts) are under increasing pressure to make more loans to low-income borrowers in accordance with the Community Reinvestment Act. Armed with public information pinpointing where

and to whom loans are being made, community activists vigorously challenge the charters of lenders who fail to comply.

HOMEOWNERSHIP RATES have increased as financing has become more accessible.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) mandates that district Home Loan Banks devote a fixed percentage of their revenues to affordable housing programs. The banks award grants to local lenders for special lending programs aimed at moderate-income homebuyers.

Another reason lenders have been willing to make low down payment loans is because of their confidence in "automated underwriting" techniques. The loan committee largely has been replaced by a computerized process that evaluates a borrower's ability to handle debt. Applicants are assigned scores (called "FICO" scores) based on their financial strength and how they have handled debt in the past.

These scores do not require any information that is illegally discriminatory, such as race, sex or marital status. They enable lenders to fine-tune the underwriting process, resulting in a higher statistical probability of making sound loans. Lenders can extend loans to borrowers with lower credit ratings at higher interest rates. By being better able to spot bad credit risks, lenders feel they can offset any increase in risk exposure.

To be eligible to receive low down payment loans, borrowers must attend counseling on financial responsibility. The counseling is aimed at reducing default caused by ignorance or bad financial habits. Borrowers learn that defaulting may mean losing their homes and may impair their ability to borrow in the future.

So What's There to Worry About?

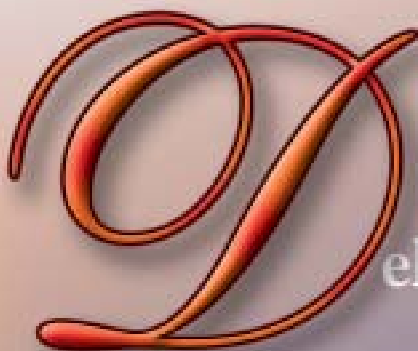
Although it would seem that lenders are better able to handle a higher level of risk in the current market, a few issues cause observers to worry.

Growing dominance of GSEs. Fannie Mae and Freddie Mac are not just large corporations; they are large corporations that have a special relationship with the federal government. Their boards of directors include government representation. They enjoy exemption from state taxation and lower-cost access to capital because investors assume they will be bailed out by the federal treasury if problems arise.

GSEs have used these advantages, along with ability to fill the void left when the savings and loan industry imploded, to dominate the home loan market. Today, the agencies hold 40 percent of all outstanding home mortgage debt.

The power of the GSEs has led to the creation of oversight organizations. Within the government, the Office of Federal Housing Enterprise Oversight oversees the agencies. FM Watch is a private watchdog group. The latter, created by mortgage bankers, sees disturbing signs not only in the move to higher-risk lending practices but in the increased purchasing of its own debt issues and moves to reduce mortgage insurance coverage.

Questions about the viability of automated underwriting. Freddie Mac and Fannie Mae encourage the use of their automated underwriting systems and their staffs feel that credit scoring accurately measures default risk. They point out that delinquencies



elinquencies on FHA loans are higher now than they were in the 1980s. Is that a sign of what's to come?

have not gotten out of hand despite a much larger proportion of low down payment loans.

Others note that the system really has not been tested under fire. All loans perform well when the economy is strong. What will happen when people start losing their jobs?

As credit scoring has become more common, so have efforts that could further compromise its effectiveness. The Department of Housing and Urban Development is probing the system for any bias that could lead to high rejection rates for minority loan applicants. Also, there is pressure to make the scoring criteria public, so that borrowers could do things to raise their scores, making the scores less reliable as predictors of borrowers' behavior.

Effect of crackdown on predatory lending. Efforts to serve new constituencies necessarily result in some new borrowers who are financially unsophisticated. Unscrupulous lenders, particularly some in the subprime market, have devised tactics to take advantage of borrower naiveté. The aim of such predatory lending (see What is Predatory Lending?) is to saddle the borrower with a high interest rate loan and high fees or induce foreclosure and confiscate the borrower's equity.

Both state and federal governments recognize that these reprehensible practices need to be stopped. The difficulty is identifying cases in which outright fraud is being perpetrated as opposed to those in which loan terms are unfavorable but appropriate for the lender's higher risk exposure. Putting an end to predatory lending with the blunt instrument of the law may severely stunt subprime lending with excessive red tape. Because subprime lending is often the only source of financing available to residents of inner cities, they may lose access to capital in these areas.

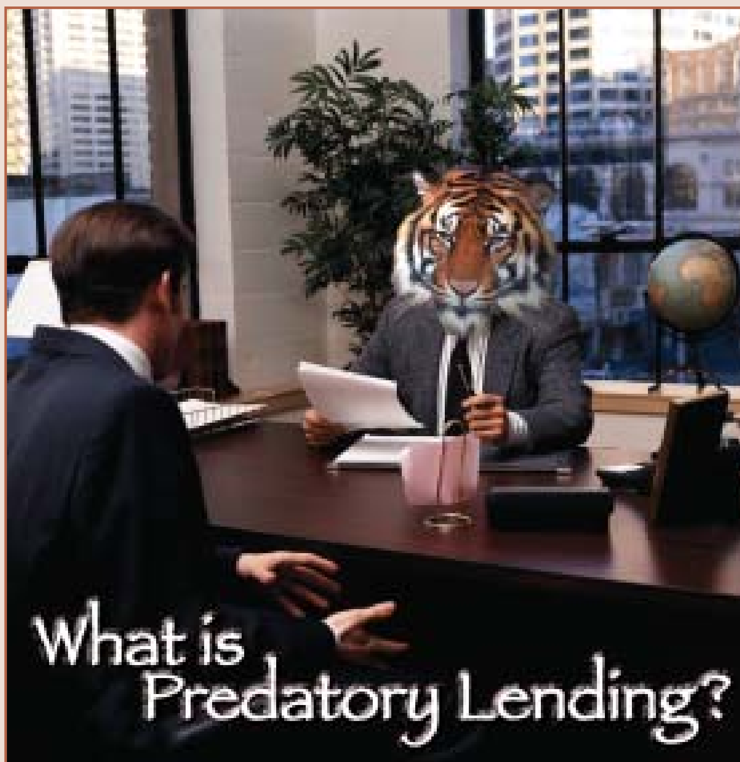
Helping Buyers Over Financial Hurdles

Expanding homeownership opportunities and broadening access to financing are worthy goals. But inducing people to take on financial burdens they can handle only under the best of economic conditions is not the way to pursue those goals.

One way to make mortgage financing more accessible is through subsidized programs that offer below-market interest rates and down payment assistance. Such programs already are available for some. Another way — liberalizing underwriting methods so that more people can qualify for loans with affordable terms — is an experiment being conducted in today's mortgage markets. Lenders are depending on scientific risk analysis and consumer education to make the strategy work.

Housing markets may soften a bit in coming years, but there is little prospect for the kind of market collapse suffered in the 1980s. As long as markets remain active, homebuyers who overcommit themselves financially need not lose their life savings and credit. And recent research shows that low-income borrowers are no more likely to default than other income groups, supporting the likelihood of the experiment's success.

Dr. Harris (j-harris@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.



Unscrupulous lenders who take advantage of borrowers with low incomes, credit problems and limited financial knowledge are referred to as "predatory lenders." Predatory lenders use various tricks to get higher than normal loan yields from borrowers. Professor Jack Guttentag of the Wharton School of Business describes three forms of predatory lending:

Equity grabs. The lender persuades the borrower to undertake a loan he or she cannot afford. When the borrower defaults, the lender confiscates the borrower's equity.

Contract knavery. The lender slips onerous, nonstandard provisions into a mortgage contract. The terms of the contract may be verbally described as more favorable than they actually are. The borrower later discovers a provision that prevents refinancing or paying off the loan without a large penalty.

Price gouging. The lender charges a much higher interest rate (often higher than the rate promised at the time of application), high fees or requires high-cost insurance on the loan. These costs are much higher than the borrower's credit rating would justify. In some cases, borrowers are given subprime loans when they qualify for better terms.

Reputable lenders could not write predatory contracts for long without losing customers. So how do predatory lenders get away with this? They exploit common beliefs and tendencies among inexperienced borrowers. Some borrowers believe they cannot get a loan from a reputable lender so they do not comparison shop for the best loan terms. The truth is that most people have difficulty understanding mortgage contracts and without counsel might agree to provisions they do not understand. Predatory lenders take advantage of this.

These scams are used mostly on borrowers seeking home equity loans and refinanced first mortgages. Laws being written to discourage predatory practices would apply to all mortgage loans.

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