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**SHADOW FINANCIAL REGULATORY COMMITTEE**



Statement No. 245

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Statement of the Shadow Financial Regulatory Committee on

**Subprime Mortgage Lending Remedies and Concerns**

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Softening home prices are subjecting some mortgage lenders, mortgage borrowers, and holders of mortgage-backed securities to increasing stress. The stress is particularly intense for a narrow subset of subprime loans whose contracts feature teaser interest rates and/or zero or nearly zero downpayments. Subprime borrowers are characterized by a low credit score or weaknesses in documentation. Monthly payments on teaser-rate loans jump from temporarily low initial payments to much higher levels after one or two years have passed.

A small proportion of these so-called "exploding-obligation" subprime mortgages were underwritten in ways that qualified borrowers for loans that they could not be expected to handle once contract rates reset unless their incomes increased substantially or housing prices rose to create additional equity. The worst of these loans were based on inadequately tested income information supplied by overeager or fraudulent borrowers.

Subprime lending can benefit society by enabling families with low incomes or few assets to become homeowners. Originations of subprime mortgages have accounted for a rising share of total mortgages originated. In 2006 subprime loans were less than 15 percent of outstanding mortgage finance, and the share of zero-downpayment teaser-rate loans between only one and two percent.

The Shadow Financial Regulatory Committee would like to correct the perception that this narrow category of subprime lending is responsible for the turbulence in financial and housing markets that has emerged in recent months.

The housing and mortgage-lending bubbles were fueled by many factors. While defaults on teaser-rate loans have contributed to the rise in delinquency and foreclosure rates, at the current time (although partly because of widespread negotiation) the default rate on subprime mortgages is running just less than that experienced as recently as 2000-01.

Lenders that allowed borrowers to take loans with zero or tiny downpayments should not be surprised that many borrowers treat such mortgages as if they were rental contracts and are prepared to vacate their properties if monthly payments rise. Zero-downpayment borrowers effectively negotiated a below-market rent for the period they were in the home. Nonetheless, the prospect of widespread foreclosures in the future has sparked demands for federal assistance and regulatory reform.

Proposals for addressing this problem include: offering direct or indirect federal subsidies for low-interest bridge loans to delinquent borrowers; imposing federal suitability standards or restricting particular dimensions of future adjustable-rate home-mortgage contracts; establishing a new federal regulatory regime for nonbank mortgage lenders (who have originated most subprime adjustable-rate mortgages); and designing simpler and more-accurate disclosures by lenders of the risks inherent in mortgage contracts, particularly for loans offering a lesser rate.

The Committee disagrees with calls for massive federal intervention into mortgage markets. To the extent that defaults on subprime mortgages may contribute to deterioration in local housing markets, efforts to assist borrowers in those particular areas should be treated and funded locally. These are not problems that call for federal subsidies, whether appropriated by Congress or channeled less transparently through below-market refinancings of troubled loans by Fannie Mae and Freddie Mac (as these firms' managers have proposed). It also is not sensible policy for either the states (as some have already done) or the federal government to expand 100-percent, or "zero equity", mortgage loans in an effort to increase home ownership. Some zero-equity borrowers have been gambling that home prices will continue to increase, gambles that government should not encourage, especially in light of recent declines in home prices in some parts of the country.

The Committee believes that efforts to bail out parties that make bad decisions will elicit new and stronger waves of poor lending practices and unrealistic borrowing decisions in future years. Though painful adjustments are required, market solutions to mortgage financing problems are underway. If allowed to run their course, these market solutions will, on average, penalize unwise and careless lenders more severely than they will punish conscientious but delinquent borrowers.

Subprime lenders whose underwriting standards have proven inadequate are being forced to exit the industry. Insolvent entities are being dropped by their auditors and their portfolios and viable platforms for originating and servicing mortgage loans are often snapped up by other financial institutions, although at substantial discounts from book values. Marketable securities backed by poorly documented subprime mortgages are trading at similar discounts.

Industry realignment and the loss absorption it entails are healthy forms of market discipline. Putting the mortgage-lending and mortgage-backed securities industries through these disciplines is the fairest and most efficient way to insure that subprime and other mortgage lenders upgrade and rationalize their underwriting activities in the future.

The only reform that merits attention at this time is for regulators to require vastly simplified disclosures to borrowers on their applications and on all follow-up documents that clarify how much initial interest rates can increase on teaser-rate or capped adjustable-rate loans:

- by identifying the highest interest rate and corresponding monthly payment and the earliest date on which that rate and payment might apply;

- by giving a clear statement of the percentage of the borrower's monthly income that the current and the maximum possible mortgage payment might absorb;

- by including a strongly highlighted warning just above the signature line stating that borrowers should not sign the document unless they fully understand the size and time pattern of the maximum payments they might be obligated to make.