



Subprime lending – some reflections

‘Subprime lending’, a mood setting phrase of our times, has slipped into everyday language over the last year joining ‘credit crunch’. It has brought down some of the biggest names in investment banking, conjuring up images of poor unsophisticated American families encouraged to take out loans they could never afford. But, this is only part of the story as subprime lending has served a valuable purpose for many over the last 15 years. Whilst the US has seen extremes, in the UK, residential first mortgages have been regulated since October 2004 by the Financial Services Authority (FSA) and the Office of Fair Trading (OFT) issued guidelines for other secured personal borrowing in 1997.

‘Non-conforming’ and ‘non-status’, alternative terms for this type of business, better describe what the industry does. The OFT defines non-status borrowers as ‘those with impaired or low credit ratings and who would find it difficult generally to obtain finance from traditional sources on normal terms and conditions’.

Growth in UK subprime borrowing resulted from three factors;

- the housing slump of the early 1990’s with high levels of arrears and repossession,
- ever increasing housing demand from population growth and changes to demographics and,
- developments in the funding markets.

The housing slump created a generation of homeowners with borrowing problems (75,500 (0.77% of all mortgages) homes were repossessed in 1991 and at its worst at the end of 1992 352,000 homeowners (3.55%) were in serious arrears). In addition there were arrears and defaults on other personal debt.

Housing demand has reflected demographic changes including more single person households. It is also now more likely that borrowers have had financial problems due to relationship breakdown or over-indebtedness. Greater job mobility has also affected housing demand creating more contract type workers who move around. The buy-to-let sector has grown as many investors have been attracted by the apparent inexorable rise in house values and because of stock market volatility/under performance and discrediting of other investments.

Allied to demand changes was increased availability of funding. Securitisation allowed individual higher risk loans to be grouped and re-cut to create a range of marketable investments which were syndicated to professional investors.

Subprime lending assumes that all lending can be priced using an assessment of risk and the reward needed to compensate for that risk. Lenders therefore felt able to consider a range of risks from modest missed payments in the past to serious debt problems such as recent discharge of bankruptcy. However the reward was impacted by competition in both the prime and sub-prime markets with the drive for volume overtaking the correct pricing of the risk taken.

In most cases lending risk has two main factors:

- the likelihood of the borrower repaying the loan (personal covenant) and,
- the amount and quality of any security.

In subprime lending a borrower will not have the best personal covenant and therefore the security has greater significance. However, sometimes, the property forming security for the loan has unusual physical or legal features.

Subprime lending is generally short lived and leading to these outcomes:

- an improved credit record allowing the borrower to move to cheaper finance or,
- re-financing allowing the borrower to roll up any current or recent debt problems into a larger loan as the result of increased house prices.

(Loan default is clearly not in anybody's interests.)

The market has contracted since September 2007 for several reasons; firstly the price of borrowing increased significantly and quickly (subprime lending tends to be priced using market rates, typically 3 month LIBOR) reducing refinance opportunities for borrowers, this in turn slowed the early redemption of existing loans meaning that lenders who remained in the market suffered greater strain on their funding lines and at the same time existing funding lines came under pricing and credit pressure and the market effectively closed for new funding. Remortgage opportunities will also be affected by reductions in house prices. Loans have therefore been on lenders' books for much longer than before the credit crunch

– hence the recent incentives for moving your mortgage.

So subprime lenders were hit by a liquidity problem but the slowdown in volume also affected profits as many subprime lenders charge fees on new loans and exit fees in the first years of a loan. In addition there is the effect of increased actual and potential losses due to default – where losses would be affected by the fact that nearly all subprime business is sourced from intermediaries. At the same time the distributors (subprime brokers) suffered a severe reduction in sales income due to lower demand from new and refinancing customers.

So what of the future? Undoubtedly the need for subprime borrowing remains but many of the volume players have left the market (Moneyfacts recently reported a 2/3 reduction in the number of subprime lenders). The brokers who specialised in subprime lending are thinning out as revenues have been slashed. Funding will still be scarce, pricing will increase but the specialists mainly at the deeper end of the market and who have got long experience will thrive.

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