WILLCOX SAVAGE

The good, the bad and the oh so ugly

Stephen W. Brewer
Willcox Savage

© *Inside Business*/June 11, 2007

Problems in the subprime lending market have roiled the usually placid waters of the U.S. residential mortgage lending industry.

In an era dominated by increasing automation, more and more mortgage products, and promises of ever shorter times for loan approval and loan closing, subprime lending woes have shaken consumer and investor confidence in the residential mortgage lending process.

The assumption that almost any American could find the house of his or her dreams and a mortgage to make that dream a reality has been challenged by the turmoil in the subprime lending market during the last six months.

The good

So-called subprime loans are loans that are made to borrowers with weaker credit who typically have credit scores of 620 or less on a scale of 300-850.

Other factors that may push a borrower toward a subprime mortgage product are low or no down payments and high debt to income ratios. These weaknesses result in the lender charging the borrower a higher interest rate on the loan to compensate for increased risk.

Notwithstanding such higher interest rates, however, the evolution of the subprime lending market and the development of subprime loan products have enabled lenders to make mortgage loans available to a broader segment of the American population and to provide financing for home purchases that would not have been possible in the past. Subprime mortgages have enabled federally insured lenders to meet congressionally mandated community reinvestment goals and objectives and have expanded the segments of the community that such lenders are able to serve.

When properly structured and administered, subprime lending programs can provide a valuable tool for borrowers trying to pursue the American dream of home ownership.

The bad

If subprime mortgages provide an opportunity for home ownership to borrowers who otherwise would have difficulty entering the market, what is the catch? The typical subprime mortgage is structured as an adjustable rate mortgage with a low initial interest rate that increases in subsequent years until it reaches current market interest rates. As the interest rate adjusts upward, monthly payments increase and the financial burden of the mortgage becomes more pronounced.

Unscrupulous mortgage lending practices in some corners of the industry and overly aggressive marketing of subprime lending products in general have led to an increasing wave of mortgage foreclosures and loss of home ownership. According to the Mortgage Bankers Association, during the fourth quarter of 2006, foreclosures were at the highest level since that group began keeping records.

All too frequently, the focus during the mortgage loan application process is on the amount of the initial monthly loan payment, with little or no thought given to the higher monthly payments that will inevitably result when the mortgage interest rate adjusts.

Increased monthly payments lead, in some cases, to mortgage default, which in turn leads to mortgage foreclosure. The prospect of foreclosure has in turn led to the development of an entirely new American enterprise – the foreclosure rescue company – and attendant problems with “con” artists operating in this line of work, who “promise” to save the struggling borrower from foreclosure but who often fail to make good on that promise.

The borrower who happily embraced the dream of home-ownership finds those dreams dashed by higher payments and, in some cases, the nightmare of foreclosure and loss of home-ownership.

The ugly

For the individual borrower, foreclosure is an unnerving and tragic experience. For the mortgage lending industry, increasing foreclosures in the subprime mortgage market have led to the bankruptcy or shutdown of several major subprime lenders and to substantial charges against reserves for loan losses by many other lenders in the subprime market.

While fears that the meltdown in the subprime lending market may lead to decreased sales of new homes and possibly a general economic recession are probably exaggerated, there is no doubt that increasing mortgage loan delinquencies and foreclosures in the subprime mortgage lending market have exacted a heavy toll.

Lenders at all levels in the subprime lending industry are reassessing their willingness to make subprime loans, and not surprisingly, federal and state regulators are taking a new look at the entire process.

Calls for reform, including tighter loan underwriting, fewer and less exotic loan products, more detailed truth-in-lending disclosure forms, and more comprehensive regulation of mortgage loan brokers are certain to continue, and the result may be even more extensive government regulation of the mortgage lending industry.

In recent comments at a homeownership summit in Washington, D.C., HUD Secretary Alphonso Jackson stated that subprime loans remain an important alternative for borrowers who cannot qualify for conventional financing, provided that such loans are made in a “legal, fiscally responsible and ethical” way.

Good subprime lending practices provide a gateway to the American dream of homeownership; bad subprime lending practices prey upon unsuspecting borrowers who often do not have the economic sophistication needed to protect themselves. The ugly mess in which subprime lenders find themselves now needs to be resolved as quickly as possible to restore confidence in the mortgage lending industry.

Stephen W. Brewer is an attorney at Willcox & Savage PC whose practice focuses on commercial real estate matters. He can be reached at 628-5595 or via e-mail at sbrewer@wilsav.com.