By Steven Holland

The Emergence of 'Neo-Prime' Lending

In October, the third annual Mortgage Lending Industry Emerging Markets & Diversity Conference was held in Arlington, Virginia. The conference, sponsored by Compliance Technologies, Genworth Financial and the Mortgage Bankers Association (MBA), is held to "promote the link between racial and ethnic diversity in the work force, and racial and ethnic diversity in lending," according to Maurice Jourdain-Earl, Compliance Technologies' managing director.

Because of all the events surrounding the current subprime meltdown, this year's conference focused heavily on where the industry should go from here. Since last December, it is estimated that more than 150 mortgage lenders have shuttered their operations, most due to their inability to continue offering subprime loans. Consequently, many attendees voiced their concerns about the impact subprime lending has had on emerging-markets communities.

Emerging markets—commonly known as lending to minority, first-time, immigrant and low-to-moderate-income homebuyers—unquestionably have been affected by the subprime mortgage fallout. What is less clear is whether the overall impact has been a net gain or a net loss for emerging markets.

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Subprime lending—the bad

It seems easier to make the argument that subprime lending, overall, has been a net loss for emerging markets.

Earlier this year, an advocacy group called the Center for Responsible Lending (CRL), Durham, North Carolina, came to just that conclusion, stating that subprime lending has been a "net drain" on American homeownership and on minority homeownership in particular. In April, several civil-rights organizations—including the Leadership Conference on Civil Rights, the NAACP, the National Fair Housing Alliance, the National Council of La Raza and the Center for Responsible Lending—called for a six-month moratorium on subprime home foreclosures.

Even the Fed, in its September *2006 HMDA Data* report about the most recently released Home Mortgage Disclosure Act (HMDA) data, stated that after accounting for factors such as income, credit and loan-to-value (LTV) ratios, minorities were still far more likely to receive more costly subprime loans than the general market. However, the Fed report also stated that "many factors routinely used by lenders to underwrite and price loans—including loan-to-value ratios and measures of borrower credit history (for example, a credit history score)—are not included in the HMDA data and, consequently, cannot be included in an analysis of pricing differences that relies on the HMDA data alone."

The topic generating the most discussion and concerns at the mortgage industry diversity conference was the subject of foreclosure and mortgage delinquency. With the number and percentage of foreclosures and delinquent loans spiking this year, many felt it was severely hurting emerging-markets communities. Several representatives of mortgage lenders detailed their foreclosure-prevention programs and strategies to stem the growing tide of foreclosures.

The question that seems to be avoided by the public, by the media and even by the industry is: What, if any, good did subprime lending bring to emerging markets? Two years ago, much of the discussion in the industry was rosy and upbeat about the rise in the overall homeownership rate, and the growth in ethnic homeownership in particular.

"Risk-based pricing," a core principle in subprime lending, seemed to be opening the door for more emerging-markets consumers to participate in the American dream of homeownership. Somehow between then and now, that door to homeownership seems to have closed.

Subprime lending—the good

It is less than candid to discuss the pain subprime lending created in emerging markets without at least discussing the benefits subprime lending brought to emerging markets.

Subprime lending benefited emerging-markets consumers in several ways, which is why subprime lending dominated lending in emerging markets. For many emerging-markets homebuyers, the choice that subprime lending offered was a "fast yes" compared with a "slow no" that prime or conventional lending offered.

Subprime lending allowed many emerging-markets consumers to participate in the record home-appreciation rates the U.S. housing market was experiencing between 2004 and 2006. Throw in historically low interest rates, historically relaxed underwriting standards and historically strong industry competition, and subprime lending opened the door to homeownership in ways no governmental regulations or programs have ever done.

Then private secondary market forces came in, packaging and spreading the risks as thinly as possible. If, by an accident of nature, the housing market were to slow down, no one class or type of investor would have to shoulder the losses alone.

When it came time to repaying the piper, subprime loans could simply be refinanced with new subprime loans, and so on and so on. As long as home prices stayed strong, subprime lending blew the door wide open to homeownership—the No. 1 wealth-building tool in America and especially in emerging markets.

Subprime lending—the ugly

But home prices began to weaken in the second quarter of 2006. No longer could they be counted on to cover the credit risks of relaxed subprime underwriting.

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Favorite subprime loan terms, hybrid 2/28 and 3/27 adjustable-rate mortgages (ARMs), started to adjust or reset for many borrowers, including those in emerging markets. With new and higher mortgage payments, many borrowers sought to refinance in order to lower their payments.

Refinancing these customers became increasingly difficult, because the first time around they were qualified with lower teaser rates and now they had to be qualified with higher market rates and with higher-than-expected LTVs.

Few lenders provided pre- or post-purchase homebuyer education, so very few borrowers had worked on their finances during the two- to three-year period of low payments that they'd had to prepare for the rate adjustments.

Investors, sensing they may have overplayed their positions, stopped buying subprime loan products, such as no-documentation loans, stated-income loans, low-down-payment loans and other loans with multiple layers of risk. Now, mortgage lending is back to pre-2004 underwriting.

Where do we go from here?

To rebound from the subprime implosion, much work has to be done. The first thing is to bury the term "subprime." The prefix "sub-" is defined as "to act as a substitute; less than completely or normally; below or beneath." "Sub" is negative in tone, and in the mortgage industry. And especially in emerging markets, where consumer confidence is already an issue, the term has no place.

Next, we need to replace the term, along with revisiting "risk-based" underwriting and lending. One term that could replace "subprime" is "neo-prime." The prefix "neo-" is defined as "new and different," and is exactly the approach the mortgage market and emerging markets need to take.

New and different underwriting guidelines are needed in emerging-markets lending. Emerging markets need mortgages with new product features—products with prime pricing and prime underwriting, products with near-prime pricing and near-prime underwriting, products with built-in pre- and post-purchase education programs, and products with marketing communications support for mortgage originators and mortgage brokers.

A key reason for the subprime implosion was its irrational reliance on non-stop rising home prices. Underwriting took a back seat to home-price appreciation. That mistake must never be repeated.

Yet, underwriting still needs to evolve and become more up-to-date with true credit risks and with the cultural nuances of emerging markets. Examples of this neo-prime underwriting are:

- Not automatically associating no credit with bad credit;
- Viewing multiple/seasonal jobs as income diversification or job versatility instead of job instability;
- Using documented payments to family members, school tuition payments and ongoing child-care payments for credit history purposes;
- Allowing more flexibility in the documentation of income and assets; and
- Allowing higher debt-to-income (DTI) ratios for those with demonstrated histories of paying higher rents.

Neo-prime underwriting does not ignore credits risks. It just seeks to re-identify and re-assess consumer behaviors that best indicate the likelihood of timely repayment.

Neo-prime lending acknowledges that the mortgage industry must move beyond changing the rules of the game—the underwriting—to changing how the game is played by loan originators, mortgage brokers and consumers.

Loan originators and mortgage brokers need more training and coaching on serving and marketing the right products to the right people. Consumers need more training on how to better position their finances to get the most cost-effective loan for them.

The future of the mortgage industry is bright. The industry has been cleansed of the excesses of subprime lending and is now ready to plant a new crop—neo-prime lending. Leading this change should be the market segment known to have the greatest growth potential: the emerging markets.

The Mortgage Lending Industry Emerging Markets & Diversity Conference shed much light on new approaches to mortgage lending—neo-prime lending. Let's hope the rest of the industry follows its lead.

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