

Dark Side of Subprime Loans

Mortgages for those with bad credit leap in popularity despite high foreclosure rate

By Kimberly Blanton, Globe Staff | August 3, 2005

Loans to homeowners with less-than-sterling credit are the fastest-growing segment of the mortgage market as lenders reach out to those unable to qualify for conventional mortgages.

So-called subprime loans have helped boost US homeownership to a record 69 percent of households. They are being tapped by borrowers in all income ranges, who struggle with poor credit ratings stemming from modest incomes or excessive credit card or other debts. In Massachusetts, subprime loans, fueled by refinancings, have grown from 1.6 percent of mortgages in 2000 to 12.3 percent today.

But the industry's growth has brought problems. Subprime lenders foreclose on properties much more frequently than do conventional lenders. About 3.5 percent of subprime mortgages and refinancing loans go into foreclosure, but a study by the University of North Carolina Kenan-Flagler Business School found that 20 percent of refinancings in 1998 through 2000 that were examined wound up in foreclosure. For conventional loans, the rate is 1.1 percent of mortgages and refinancings.

The prevalence of subprime loans contributed to a 31 percent spike in foreclosure filings in the first half of this year in the state's Land Court, as tracked by ForeclosuresMass Corp. If house prices in Greater Boston's overheated real estate market fall, these loans could accelerate a downturn as overleveraged homeowners throw their houses on the market or lenders sell foreclosed properties at fire-sale prices.

"It could potentially have a more serious impact if our economy starts to slip again," said Nicolas Retsinas, director of Harvard University's Joint Center for Housing Studies. "If people started losing jobs, and they're struggling to make due and make these payments, you could see a rapidly escalating foreclosure rate."

Subprime lenders, most recently Ameriquest Mortgage Co., have also been targeted in multistate investigations by attorneys general. To compensate for the greater likelihood customers will default, subprime loans have higher fees and interest rates than those traditional loans. But state officials and borrowers allege that some subprime lenders charge excessive fees or rates, taking advantage of the fact the borrowers have fewer options than people with good credit.

Up to 15 percent of subprime borrowers have credit scores that qualify them for traditional loans, estimates Freddie Mac, a company that invests in mortgages. Unsophisticated borrowers grappling with complex loan terms and pressure to refinance quickly can have "a vulnerable moment," said Peter Zorn, a Freddie Mac vice president. "You just got a tax bill. You don't really know you have sterling credit, or you don't understand what the costs are, because they focus on the monthly costs," he said.

With their above-market rates and growing market share, subprime lenders for most of their history have been more profitable than conventional lenders, said Sam Garcia, publisher of MortgageDaily.com, a Dallas-based industry news site. They serve a useful role, he said, providing loans to those who can pay the mortgage but could not obtain financing, due to tarnished credit.

"These people were renters," Garcia said. "They weren't potential mortgage borrowers, and they are now." Traditional lenders typically offer lower rates than competitors to snare customers. In contrast, subprime lenders base rates on credit scores, so what is a "fair" rate can be difficult to gauge. Subprime borrowers' credit scores typically fall below 620, on a scale of 350 to 850.

To compensate for taking on these riskier customers, a subprime lender might charge one customer 7.5 percent for a 30-year fixed loan, while charging a customer with a lower score 8.5 percent. Conventional mortgage rates are currently 5.7 percent. Laurie Coulombe, who refinanced her loan with 1-800 East/West Mortgage Co., believes the interest rate on her subprime loan was too high. After emerging from bankruptcy protection in 2003, she still had divorce-related debts. In July 2004, she refinanced her Fairhaven home near the sea with East/West. Now facing foreclosure, she is selling it and moving her family to an apartment.

David Bernotas, chief executive of Peabody-based East/West, said he cannot discuss a customer's loans but said people with bankruptcy in their credit history pay higher rates. It "affects scores for up to 10 years," he said. A part-time insurance saleswoman who earned \$20,000 last year, she paid \$10,000 in closing costs, including three "points." One point paid by a borrower effectively buys a half-point rate reduction. For a year, her rate was 8.875 percent and monthly payments were \$1,700. The variable rate rose to 10 percent last month, and payments increased to \$2,000, she said. The ceiling rate on the loan is 14.875 percent, she said.

"They should've made her a loan at something closer to the market rate," said Boston attorney Gary Klein, a mortgage specialist advising Coulombe. Klein said her effective interest rate, known as the annual percentage rate, is 13 percent. Federal law requires lenders to tell customers their APR, which rolls closing costs and points into the rate calculation. Significant collateral also backed her \$188,000 refinancing, which made it "virtually risk free" to East/West, he said. Coulombe estimated her house has at least \$60,000 in equity; her parents, who cosigned the East/West refinancing, also put up their \$400,000-plus house as collateral.

Subprime loans are among the newly popular mortgage products, such as interest-only loans, for people with strained budgets, including first-time buyers. Homeowners increasingly use them to refinance and consolidate household debts when their credit scores fall in the wake of bankruptcy, high medical bills, or other setbacks, said Kathleen Schreck, a mortgage banker and chair of the Massachusetts Mortgage Bankers Association.

"There are people who do get into financial trouble," Schreck said, "and subprime loans help them obtain a mortgage to get out of it. It often works." The industry's rich profits have sagged recently, due to a drop-off in refinancings from record 2003 volume and growing competition from traditional lenders invading the market. Wells Fargo, for example, operates a subprime unit, and HSBC in 2003 merged with Household International, a subprime lender.

But Paul Collier, director of litigation for the Harvard clinical program at the Hale and Dorr Legal Services Center in Jamaica Plain, said his office receives frequent complaints from subprime customers. Subprime lending once primarily targeted low-income people, including minority borrowers. "It has," he said, "reached the middle class."

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