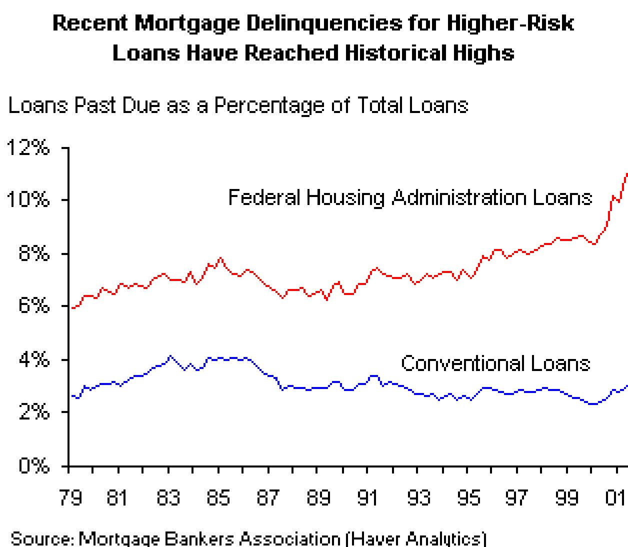
Subprime Mortgage Lending Faces the Test of a Slowing Economy

February 7, 2002

Entry by FDIC-insured institutions into subprime lending as a targeted line of business was largely a phenomenon of the 1990s. These lending programs are now being tested by recession, in most cases for the first time. Even before the recession began, there was already evidence that some subprime credit card borrowers had begun to show signs of rising stress.[1] However, it remains to be seen how entry into subprime mortgage lending might alter the performance of traditionally lower-risk single-family residential lending. So far, it appears that the incidence of significant repayment difficulties among subprime mortgage borrowers is increasing.

Subprime mortgages are not separately reported on Bank and Thrift Call Reports, making it difficult to monitor from off-site the performance of these portfolios. However, loans insured by the ***Federal Housing Administration*** (FHA) tend to exhibit characteristics similar to those of subprime loans because these loans are often extended to borrowers with more limited financial resources.[2] The delinquency rate on FHA-insured mortgages rose 2.3 percentage points to 11.4 percent in the year ending September 2001 (Chart 1). In contrast, the national delinquency rate on conventional mortgages (reported by the ***Mortgage Bankers Association***) rose by only 0.6 percentage points over the same period.



The effect of a slowing economy is also evident in a vintage analysis of subprime loan pools. As Chart 2 illustrates, loans originated in 2000 are exhibiting higher delinquency rates than earlier vintages at a comparable point in the life cycle. This higher delinquency rate may reflect not only the onset of recession but also looser underwriting standards during 2000 relative to prior years. The recent refinancing boom may be amplifying the sharp rise in delinquencies in subprime loans originated in 2000,

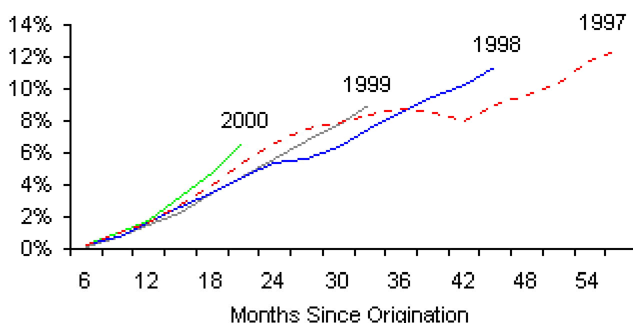
because the worst-performing loans are likely to remain in the origination pool, while the best-performing loans have been refinanced at a lower mortgage rate.[3]

The FDIC estimates that fewer than one percent of all insured institutions have significant subprime residential mortgage exposures.[4] However, a much larger number of institutions have some limited involvement in subprime mortgage lending. A survey by the ***Minneapolis Federal Reserve Bank*** found that 29 percent of banks in the Minneapolis District offered loans to low-credit-quality consumer borrowers in 1999.[5] While the larger universe of insured institutions may be adversely affected if subprime mortgage indicators continue to deteriorate, those institutions with less-diversified loan portfolios are likely to be more affected.

Chart 2

The 2000 Book of Subprime Mortgages Has Fared Poorly In Comparison With Prior Vintages

Seriously Delinquent Subprime Loans as a Percentage of the Dollar Volume of Subprime Loans Outstanding



*Note: Seriously delinquent loans are defined as loans at least 90 days delinquent or in foreclosure.

Source: Loan Performance (Mortgage Information Corporation)

The outlook for subprime mortgage performance in 2002 and beyond depends not only on the economic outlook but also on the prospects for consumers who are more exposed to economic adversity. Current trends do not suggest any near-term improvement in the performance of subprime mortgages.

More information on this topic and other housing-related lending issues will be available in the first quarter 2002 edition of the FDIC's ***Regional Outlook***, forthcoming in March.

1. "Emerging Risks in an Aging Economic Expansion," ***Regional Outlook***, Fourth Quarter 2000.
http://www.fdic.gov/bank/analytical/regional/ro20004q/na/Infocus1.html

2. For more information about the FHA, see the U.S. Department of Housing and Urban Development.
http://www.hud.gov/offices/hsg/hsgabout.cfm

3. "Another Look at the 2000 Book," *The Market Pulse*, Mortgage Information Corporation, Winter 2001.

4. Significant subprime residential mortgage exposure is defined as holding total direct and indirect interest in subprime residential mortgages greater than 25 percent of tier-1 capital.

5. Ron Feldman and Jason Schmidt, "Why All Concerns About Subprime Lending Are Not Created Equal," *Fedgazette*, Minneapolis Federal Reserve, July 1999.

Chart 1: Recent Mortgage Delinquencies for Higher-Risk Loans Have Reached Historical Highs

Data Source: Mortgage Bankers Association (Haver Analytics)

Vertical Axis: Loans Past Due as a Percentage of Total Loans (scale = 0 to 12 percent)

Horizontal Axis: This is a time series showing quarterly data from the first quarter of 1979 to the third quarter of 2001

This line graph shows the percentage of delinquent FHA-insured and conventional mortgages between 1979 and 2001. The share of delinquent FHA-insured mortgages approximated 6 percent in 1979, then trended steadily upward until 1985, when it briefly peaked at nearly 8 percent. It moderated for a few years, but then trended upward throughout the 1990s, rising sharply in 2000 and 2001, when it ultimately reached over 11 percent during the third quarter of 2001. In contrast, only 2.7 percent of conventional mortgages were delinquent in 1979. That figure rose to approximately 4 percent between 1983 and 1987, then declined slightly to between 2.8 and 3.2 percent until 1991 when it peaked briefly at 3.4 percent. It then moderated again through much of the 1990s to between 2.5 and 3 percent, and then turned upward in 2000 and 2001, rising to 3.1 percent as of third quarter 2001. Over the nearly 23-year period, the FHA-insured mortgage delinquency ratio was at least twice as high as the conventional mortgage delinquency ratio. However, throughout 2000 and 2001, the delinquency ratio for FHA-insured loans grew even faster than the ratio for conventional loans. By the third quarter of 2001, the FHA delinquency ratio was nearly four times higher than that of conventional mortgages.

Chart 1: Publicly Traded Companies Are Filing for Bankruptcy in Record Numbers While Overall Business Bankruptcy Filings Have Declined

Data Sources: Administrative Office of the U.S. Courts (Haver Analytics); BankruptcyData.com

Left Scale: Number of Business Bankruptcy Filings (scale = 0 to 100,000)
Right Scale: Number of Bankruptcy Filings by Publicly Traded Companies (scale = 0 to 300)

Note: The number of business bankruptcies in 2001 is an annualized figure based on quarterly filings through the third quarter. The number of filings by publicly traded companies in 2001 reflects totals through year-end.

The time series shows annual data from 1980 to 2001 on the horizontal axis.

The vertical bars represent the number of business bankruptcy filings (left scale). This data series peaked in 1987 at 88,278 filings. After 1987, this series declined until the 1990-91 recession, after which it peaked once again in 1992 at 72,650 filings. After 1992, the number of business bankruptcies generally declined, reaching a cyclical low of 36,910 filings in 2000. Based on annualized data through the third quarter of 2001, business bankruptcies should tick slightly upward again in 2001, reaching 39,829 filings.

The line represents the number of bankruptcy filings by publicly traded companies (right scale). From 1980 to 1997, this data series experienced the same general trend as overall business bankruptcies. However, after 1997, this data series began to spike sharply upward, running counter to the downward trend in overall bankruptcy filings. In 2001, this series hit an all-time high of 257 filings, 46 percent higher than the prior year's record number of filings.

Chart 2: The 2000 Book of Subprime Mortgages Has Fared Poorly In Comparison With Prior Vintages

Data Source: Loan Performance (Mortgage Information Corporation)

Vertical Axis: Seriously Delinquent Subprime Loans as a Percentage of the Dollar Volume of Subprime Loans Outstanding (scale = 0 to 14%)

Horizontal Axis: This is a time series showing the number of months since origination of the loan pools (scale = 6 to 57 months since origination, in 3-month increments)

This line graph compares the percentage of seriously delinquent subprime mortgages originated during 1997, 1998, 1999, and 2000 from 6 to 57 months after origination. For all vintage years, the delinquency ratio trended slightly upward during the first year after origination, but was less than 2 percent after the first 12 months of seasoning. Performance following the first year of seasoning differs substantially among the various vintage years. For instance, following the first 21 months of seasoning, subprime mortgages underwritten during 2000 had a delinquency ratio of 6.6 percent, whereas similarly-seasoned subprime mortgages underwritten in 1997, 1998, and 1999 had delinquency ratios of only 5.4, 4.5, and 4.5 percent, respectively. As of the third quarter of 2001, the 1997 vintage had reached a peak delinquency rate of 12.5 percent after 57 months of seasoning, the 1998 vintage an 11.3 percent delinquency rate after 45 months, and the 1999 vintage a 9.0 percent delinquency rate after 33 months.

Chart 2: C&I Loan Loss Rates Are Rising Faster at Larger Banks than at Smaller Banks

Data Source: FDIC Bank Call Reports (Research Information System); adapted from the FDIC Quarterly Banking Profile

Left Scale: Four Quarter Moving Average C&I Charge-off Rate (scale = 0 to 2.5 percent)

Note: C&I = commercial and industrial

The time series shows quarterly data from 1992 to the third quarter of 2001 on the horizontal axis.

The dotted line represents small commercial banks, or 7,748 commercial banks with less than $1 billion in assets. This line shows a decline in the charge-off rate from 1.9 percent in 1992 to 0.6 percent in 1994. After 1994, the line remains relatively flat, rising to 0.74 percent in the third quarter of 2001.

The solid line represents large commercial banks, or 401 commercial banks with greater than $1 billion in assets. This line follows the same general trend as the dotted line for small banks until the mid-1990s, falling from a 1.9 percent charge-off rate in 1992 to a low of 0.1 percent in 1995. This line remains relatively flat until the second quarter of 1997, when it begins to rise. In the second quarter of 2000, the solid line for large bank C&I charge-offs surpasses the line for small banks, finally rising to 1.2 percent in the third quarter of 2001.