

Developments in mortgage lending to higher risk borrowers

There has been a growth in the number of lenders offering secured loans to people with credit problems, including those who have been bankrupt or have CCJs (County Court Judgements) against them, and for purposes such as debt consolidation. This research investigated the emergence of such 'sub-prime' lending and considered its implications for sustainable home-ownership. It found:

- Several factors caused a growth in demand for sub-prime mortgages in the mid-1990s. These include: mainstream lenders automating their credit scoring procedures; more people with previous debt repayment problems; more marginal borrowers seeking loans for home-ownership; and, in the late 1990s, soaring levels of borrowing for consolidation of debts as interest rates rose.
- The current sector has evolved since the mid-1990s, becoming increasingly diversified and segmented. Mainstream lenders have now entered the sector, largely through specialist subsidiaries.
- Sub-prime lenders clearly fill a market gap. They allow entry to owner-occupation for those who are able to repay a loan, but fail 'high street' criteria. They offer 'credit repair' - borrowers who maintain repayments can re-enter the mainstream market. Debt consolidation can provide a 'fresh start' for someone whose borrowing has become unmanageable.
- Sub-prime borrowers are higher risk overall, and face higher interest rates and charges than mainstream borrowers. They also face higher charges. There is evidence that sub-prime lenders are relatively quick to pursue repossession and impose relatively high charges to borrowers in arrears.
- This can lead to a 'downward' spiral for borrowers, through repeated remortgaging from lenders at increasingly higher rates and worse terms due to an increasingly poor credit records.
- Since October 2004, all mortgage lending has been regulated by the Financial Services Authority (FSA). However, additional loans on a property ('second charge lending') remain outwith this framework: it is here that the most unfavourable terms may continue to be offered to the most vulnerable consumers. Such borrowers are typically in very fragile financial circumstances yet face the most expensive credit.
- There is general concern at the high and rising levels of consumer debt. The researchers conclude that it is important to monitor this new and evolving lending sector, especially should the current benign economic and housing market circumstances alter.



What is 'sub-prime' lending?

The research was motivated, in part, by the evident increase in the advertising of products – including mortgages and remortgages, car loans and debt consolidation loans – specifically to people who have a poor credit record, or who are finding their existing debt difficult to manage. It might be predicted that such borrowers would be particularly vulnerable to unscrupulous practice – being in more desperate financial circumstances and having fewer options. The research found evidence of a sector increasingly characterised by hierarchy and segmentation.

In the US, such lending is known as 'sub-prime': the term is well-established and products can be marketed in this way, as consumers are familiar with their own status. In the UK, where the term is not well-known, products are marketed as being for those who have been refused credit elsewhere or who have CCJs etc. Within the industry, the terms 'sub-prime' and 'non-conforming' are used interchangeably. The sub-prime sector encompasses a range of secured lending activity, including:

- first mortgages on a property for those with poor credit records, or who need to self-certify their income, including for buying to let;
- remortgaging under similar circumstances;
- taking out a further loan on the property in addition to the initial mortgage ('second charge lending');
- borrowing to consolidate debt.

The evolution of the sub-prime sector

Since the early 1990s, a range of factors has created circumstances in which both the demand for and the supply of sub-prime lending has flourished.

- Following the 1990s recession, more people had suffered some episode that had harmed their credit rating – whether from house repossession, from falling into arrears with housing or utility payments (themselves more aggressively pursued by privatised companies), having had a CCJ or being made bankrupt.
- Reflecting broader labour market changes, more people had contract or flexible terms of employment, and income that was variable or hard to confirm.
- Mainstream lenders, who had also suffered during the housing market recession, reacted by exercising extreme prudence in their lending, particularly using mechanised and centralised credit-scoring mechanisms to select only low-risk borrowers.

The consequence was that a gap opened up; where borrowers keen to enter owner-occupation and with the willingness and ability to repay a mortgage, found that they were excluded from mainstream, high street lenders.

Starting in the late 1980s, some established US companies tried to expand their business into the UK. However, they too suffered losses in the 1990s recession. This, in addition to some bad publicity and regulatory intervention concerning the very unfavourable terms and conditions on offer in some instances, caused most to withdraw. Some of these early loans are still causing problems as borrowers finish what they thought was the full term to find (sometimes substantial), debts still outstanding.

The current UK sub-prime sector really started to evolve from the mid-1990s with the entry of specialist lenders. They saw a niche for lenders building on a more individualised approach to underwriting and pricing the risks involved in lending to sub-prime borrowers.

Since 2000, mainstream lenders have also entered the market. The very competitive mainstream mortgage market has squeezed profit margins increasingly hard, and companies were attracted by the higher margins available in the sub-prime sector. In order to manage the greater lending risk, and also to protect the reputation of an established name, some have set up specialised subsidiaries. There is no wholly reliable data on the size of the market; in 2001 sub-prime mortgage lending was estimated at £6bn (Datamonitor, 2002) and the 'sub-prime sector' at £13bn (Mintel, 2002) (while total mortgage lending in that year was valued at nearly £122bn).

A diverse sector

By definition, lending in the sub-prime sector is more risky and this is reflected in premiums charged to borrowers. Lenders' business model is also based on the assumption that recognising and managing early indications of repayment difficulty requires swift and effective practices and procedures. At the 'near prime' end, there are those who have joined the Council of Mortgage Lenders (CML) and conform to all codes of practice. Lenders across the sector vary in their willingness to lend to borrowers with ever more 'adverse' indicators of risk – in terms of recent episodes of default, the sum of debt defaulted on or number of CCJs. Lenders also judge risks in relation to patterns of remortgaging and repeated debt consolidation. They vary in their willingness to make 'second charge lending', with relatively few operating at the most adverse end. Those lending to borrowers with very adverse circumstances may have the most demanding terms and may also be the most aggressive in pursuing payment.

In contrast to the 'virtuous' progress of credit repair and rehabilitation into the mainstream credit market, there is also the potential for borrowers enter into a 'vicious' trajectory down from near mainstream to a point where those with very fragile financial circumstances and on-going difficulty with debt can still find credit, albeit on much worse terms. Evidence of the difficulties created in some such cases shows up through the work of debt advice agencies.

Intermediaries and institutions

The key lenders in this sector are not household names. Two aspects of the business model contribute to this relative invisibility.

- In the early days, even brokers were somewhat suspicious of the reputation of the sector and had no experience of dealing with sub-prime borrowers. Lenders therefore rolled out their new products through a limited number of selected brokers. Brokers and other intermediaries are still very dominant in bringing lenders business – some big lenders undertake no direct advertising in the sector, and it is argued that in any case many borrowers also prefer to secure their loan through brokers as they have already suffered rejection on the high street.
- In contrast to traditional building societies, the specialist lenders have no branch network and therefore no access to funding raised from individuals' savings. Instead, they have increasingly securitised their loan books (that is, sold portfolios of loans to institutional investors) to raise funds for further lending. This imposes an important market discipline on lenders – who have to be able to demonstrate that they have sensibly balanced risk and return in their lending activities.

The borrowers' experience

While lenders stress the functionality of and the demand for their products, most of the literature reviewed by the study was more concerned with the terms and conditions of the products.

- Loans in the sub-prime sector are more expensive than those in the mainstream sector. The interest rate charged also increases as borrowers are judged to be of greater risk.
- Available evidence suggested that other charges were also higher in the sub-prime than the mainstream market, so that there are widespread (and longer periods of) redemption penalties, Mortgage Indemnity Guarantees (MIG) required at relatively higher cost, and higher charges taken by brokers and other intermediaries.

- In contrast to some suggestions, however, the loan to value ratio on offer tends to *fall* as degree of adversity increases – which would counter charges that there is widespread 'equity lending' (i.e. where a lender is not concerned with ability to repay the loan, instead relying on eventual repossession and sale of the property to provide their profit).
- Although precise evidence is hard to find, it also seems clear that the charges consequent on delayed or erratic payment, and on any arrears that accumulate, are also high.

In summary, these factors mean that those in the sub-prime sector can pay significantly more for borrowing than those in the mainstream sector. While this might initially appear to be unfair, in that it is the more financially vulnerable who pay the most, the question is really whether such borrowers pay more than is warranted by the extra risk they present. Money advisers, in particular, express concern that people may be tempted to borrow more than they can really afford.

A greater proportion of borrowers in the sub-prime sector are in arrears than those in the mainstream sector, as might be expected (around 10-15 per cent in 2004). There is also evidence that sub-prime lenders move towards possession more quickly once arrears start to accumulate, on both first and, especially, second mortgages.

Regulating the sector

Concerns over the level and transparency of charges and over how fairly potentially vulnerable borrowers are treated have driven moves towards greater regulation across the financial services sector. In October 2004, all mortgage lending came under the regulation of the FSA and significantly all loans will be subject to the same regulation and guidance (abolishing the previous divide whereby only loans of less than £25,000 were subject to the Consumer Credit Act). It is too early to judge what the effect of these reforms will be, although many in the industry argued that even the preparation for compliance with this new regime had already improved practice and pushed out firms with poor practice.

Sub-prime lending and the sustainability of owner-occupation

As consumer debt topped £1trillion for the first time mid-2004, and in the context of general worries about the level and manageability of credit card and other debts, there is clearly cause to be concerned about people who are already in financial trouble getting deeper into debt. The issue is particularly acute when loans are secured on people's houses – the consequences of failing to repay are ultimately repossession and homelessness. There is no clear evidence, though, on the extent to which the sub-prime sector contributes to, or undermines the sustainability of owner-occupation – it can, in principle, do both:

- It provides a route into owner-occupation for those who can afford it, but are not able to borrow elsewhere. It provides a safety net, whereby those in temporary difficulty can, for instance, consolidate credit card loans and make a fresh start.
- But affordability is inevitably worse, given the higher costs and charges, so that borrowers are more vulnerable to any external changes in circumstances. And there is evidence that suggests lenders are quick to pursue possession once difficulties arise.

Conclusion

The researchers conclude that it is vital that the sector becomes more closely monitored. There are at present very significant gaps in understanding about the scale and impact of its activities. Little is known about the characteristics of sub-prime borrowers, nor how they fare in the longer term. These gaps will become much more evident if, or when, the presently benign economic conditions downturn. At this point, those already in the sub-prime sector may be pushed down the lending spectrum or out of home-ownership, while more of those presently in the prime sector will look to secure sub-prime services. What the overall impact of these changes might be cannot yet be known.

About the project

The research, carried out by a team at Heriot Watt and York Universities aimed at 'scoping' the sector, reviewing available material from existing databases and research sources and conducting a systematic literature review in the 'grey' literature – chiefly reports from within the industry and financial press. A series of expert interviews was also held, with lenders, regulators and those working in money advice agencies.

For further information

The full report, **Lending to higher risk borrowers: Sub-prime credit and sustainable home ownership** by Moira Munro, Chris Leishman, Noah Kofi Karley and Janet Ford is published by the Joseph Rowntree Foundation (ISBN 1 85935 334 7, price £12.95).

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