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SUBPRIME LENDING:

Lessons for the Microfinance Industry

Introduction

With the collapse of the subprime credit market, investors and other players are asking if the same forces that drove this market also extend to commercial microfinance.

Will the legitimate drive to maximize profits result in neglect (or abuse) of the interests of the borrowers, as it did in the subprime market? Will "overabundant" funding lead to irrational growth? Or will the interests of all stakeholders remain in balance as the commercial microfinance market evolves? This paper explores the development of the subprime market, the rise of predatory lending and recommendations for investors and others in the microfinance industry.

About the Author

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About MicroVest

MicroVest Capital Management, LLC is a global microfinance intermediary based in Bethesda, Maryland. As the first private microfinance investment fund in the United States, MicroVest's goal is to link capital markets to the entrepreneurial poor by expanding the capacity of profitable MFIs throughout the world. See www.microvestfund.com for more information.

Subprime Loans And Predatory Lending

Subprime Loans, Benefiting Society

Through the 1970's and most of the 1980's, only borrowers with substantial assets and strong credit histories had access to home mortgage loans. The 1980's brought deregulation of the mortgage market and tax reform, making higher cost loans (accompanied by tax savings) not only legal for lenders but also attractive to borrowers.[1]

Lenders developed the subprime loan product in an effort to extend financial services to a broader market. As envisioned, customers with less-than-perfect credit would qualify for subprime loans. The loans would carry higher interest rates than prime loans to compensate for increased credit risk. But the borrowers would become homeowners, following a traditional route into the middle class; and neighborhoods would become more stable, benefiting society as a whole.

The subprime residential mortgage market was a success (reaching USD 332 billion in 2003, up from USD 65 billion in 1995[2]). Lenders bundled their inventories of subprime loans into pools for sale on the secondary market, relying heavily on borrower's credit history to measure risk and to price pools. Investors derived comfort that their risk was mitigated by diversification within these large pools (across geographic regions, property types, interest rates etc).

Yields were very attractive, and the secondary market flourished (58.7% of the subprime loans originated in 2003 were sold into securitizations, up from 28.4% in 1995[3]).

Impact of Competition

Lenders flocked to the lucrative subprime market and the increased competition drove down yields. They designed new products to attract additional residential mortgage clients. Entrepreneurs with irregular income flows but good credit histories and assets now qualified for low- or no-income- verification loans. Upwardly mobile borrowers stretching to buy that new home now qualified for interest-only loans. While these were valid products, they required careful marketing and underwriting in order to maintain an acceptable borrower risk profile in this financially vulnerable market.

Wall Street structured more complex subprime securitizations, compensating for the increased risk with investor protections in the form of excess spread, subordinate bond classes, reserve funds and bond insurance. Investors were comfortable with the relatively low default rates and the constantly appreciating collateral. However continued strong performance was uncertain, as the loan products and deal structures were new and relatively untested. Furthermore, everyone knew the real estate bubble could not last forever.

Specialized loan servicing firms managed the underlying mortgage loans. This industry also flourished, although it was challenged by both increasing delinquency rates and narrowing profit margins. A successful business strategy involved consolidation into ever-larger companies and adoption of more sophisticated technology. Now servicers could reduce costs by minimizing human intervention in the processing of delinquent loans. At the same time they could efficiently assess borrowers an array of processing and late fees.

> “ Subprime lending is not synonymous with predatory lending. Many subprime lenders and servicers ran sustainable, profitable businesses addressing the needs of a previously-underserved client base. ”

Predatory Lending

Subprime lending is not synonymous with predatory lending. Many subprime lenders and servicers ran sustainable, profitable businesses addressing the needs of a previously-underserved client base. In addition, predatory lending can and does occur outside of the subprime market.

But with an ample supply of funding from the secondary market and with high demand for home ownership, many subprime lenders targeted an ever-larger share of the home loan market. The industry grew rapidly and unsustainably, without the opportunity for adequate staff training or infrastructure development. Sophisticated technology increased the distance between lenders and their clients. In many instances, the result was a culture tolerating, perhaps even engendering, abusive policies toward borrowers.

Predatory lending became an industry buzzword, and a regulatory target. While there is no universally-accepted definition of predatory lending, the following is a useful guideline:

Any of a number of fraudulent, deceptive or unfavorable lending practices. Many of these practices are illegal, while others are legal but not in the best interest of the borrowers.[4]

Predatory lending is frequently associated with the following:

- Poor analysis of borrower's ability to repay,
- Aggressive marketing of high-risk, high-interest loans,
- Promotion of complicated loan products not easily understood by borrowers,
- Collection of undisclosed charges and expensive fees and
- Payment of illegal kickbacks.

In 2006 and 2007 the market began to feel the pinch of predatory lending (especially in the financially-vulnerable subprime market) and the trend toward relaxed underwriting standards. Investors noticed increasing loan defaults, particularly in the vintage 2005 and 2006 loan pools. Many of the defaulting loans were underwritten with no income verification[5] and had reached their first payment adjustment date with borrowers now unable to afford the required monthly payments.

Today, borrowers who took on these high-risk loans are losing their homes through foreclosure; lenders are acquiring properties worth a fraction of the amount owed to them; loan servicers cannot manage the sheer volume of defaults and investors have seen the depreciation of their portfolios.

The subprime lending market was a viable business model, with the potential to benefit society by extending financial services to the broader community. Had the emphasis been on sustainable growth, balancing the interests of all stakeholders (borrowers, lenders, other third party businesses and investors), the outcome may have been different.

Commercial Microfinance - Avoiding The Pitfalls

Commercial Microfinance

Commercial microfinance is not synonymous with subprime lending.[6] Notably, microfinance loans do not rely on the value of underlying collateral and thus are not at risk from real estate bubbles. However, microfinance is a nascent, high-growth industry with several commonalities with the early stages of the subprime lending industry.

Characteristics Microfinance Shares with the Subprime Market

- *Expansion of financial services to the underserved* – to provide business opportunities for investors and access to funding for clients
- *Influx of available funding to the markets* – to enable rapid growth of business, in some cases from over-anxious, inexperienced lenders[7]
- *Prevalence of high interest rates* – to offset the increased risk in subprime markets and to cover operating expenses in microfinance markets
- *Appearance of innovative new products* – to facilitate market penetration, broadly adopted in spite of limited data on effectiveness
- *Increased reliance on technology* – to facilitate rapid growth, while distancing borrowers from lenders

"...microfinance is a nascent, high-growth industry with several commonalities with the early stages of the subprime lending industry."

Recommendations for Investors and Others

Microfinance investors, lenders and borrowers must exercise caution if commercial microfinance is to grow in a profitable and sustainable manner. All parties should recognize when microfinance institutions become careless as they seek to deploy available funding.

Investors should insist on thorough due diligence of microfinance institutions. The wrong answers to the following questions may suggest a trend toward predatory lending:

- *Compare average yield to net income.* Is the interest rate higher than average for the region? If so, why? Are operating expenses reasonable? Are returns to investors higher than average? The interests of borrowers and investors should be in balance.
- *Examine a sample of delinquent loans (across different loan products).* How was borrower's ability to pay / indebtedness determined and documented? What steps were taken to collect on delinquent loans? What fees, if any, were charged? How were disputes handled? The process from underwriting through default management should make sense to the ordinary person.
- *Review the new loan products offered.* Do borrowers have multiple loans? Are underwriting standards appropriate? Are delinquency rates satisfactory for these new products? Each product should be suitable from a business perspective, for the particular microfinance institution.
- *Request a schedule of fees (charged at underwriting and on collections).* Are fees higher than industry / regional average? Are fees reasonable? Are fees clearly disclosed on loan applications? Fees charged should not be excessive; borrowers should understand the terms of their loans.
- *Evaluate character.* Is the stated mission of the organization reflected in the on-site culture? Are senior management, board members and staff members forthright and responsive to questions? Is compensation adequate and considered "fair"? The most effective lenders respect both their staff and their clients.

Overall, investors and microfinance institutions should monitor these issues as part of their standard business practices. Lenders should remain close enough to the borrowers to understand their interests and thereby to grow their own businesses successfully.

Commercial microfinance stands at the threshold of the capital markets. The availability of abundant funding is fueling rapid growth. Now is the time to learn from the mistakes made in the subprime market where overabundant funding and irrational growth led to disaster for all stakeholders.

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[1] The Depository Institutions Deregulation and Monetary Control Act (DIDMCA), adopted in 1980, permitted lenders to charge high rates and fees to borrowers; the Alternative Mortgage Transaction Parity Act (AMTPA) of 1982 permitted the use of variable interest rates and balloon payments; the Tax Reform Act of 1986 (TRA) prohibited the deduction of interest on consumer loans, while permitting the deduction of interest for a primary residence and one additional home ("The Evolution of the Subprime Mortgage Market" by Souphala Chomsisengphet and Anthony Pennington-Cross, Federal Reserve Bank of St. Louis Review, January/February 2006, page 38).

[2] "Evolution of the Subprime Mortgage Market", page 37.

[3] "Evolution of the Subprime Mortgage Market", page 38.

[4] http://www.investorwords.com/5728/predatory_lending.html

[5] Dubbed "Liar Loans" by the New York Times.

[6] Although K. McKee stated that "In some respects, microfinance is the sub-prime market in most developing and emerging countries", "Meditations on the U.S. Sub-Prime Crisis, Kate McKee, The Microfinance Gateway, March 2008.

[7] "...The entry of private investors is the most notable change in the microfinance investment marketplace. New players arrive on the scene every month. Forty specialized microfinance investment firms have been established in the past three years alone...", Xavier Reille and Sarah Forster, Foreign Capital Investment in Microfinance, Balancing Social and Financial Returns, CGAP Focus Note, No. 44, February 2008, page 1.

About MicroCapital
MicroCapital publishes the MicroCapital Monitor and other products offering specialized news and information on international microfinance. As microfinance is an emerging global industry with a legacy of charity, objective news with a business orientation is scarce. MicroCapital seeks to provide candid information on microfinance as an emerging investment class. MicroCapital is owned and operated by Prisma MicroFinance, Inc.

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