

Georgetown U. Credit Research Center Seminar

Pricing of Subprime Mortgages: An Empirical and Conceptual Overview

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Key Points

- Pricing of subprime mortgages reflects important features of this market
 - High credit losses
 - Heterogeneity of borrower credit characteristics (Nichols, Pennington-Cross, and Yezer 2003)
 - High prepayment speeds
 - Information production
 - Systematic risk

Key Points

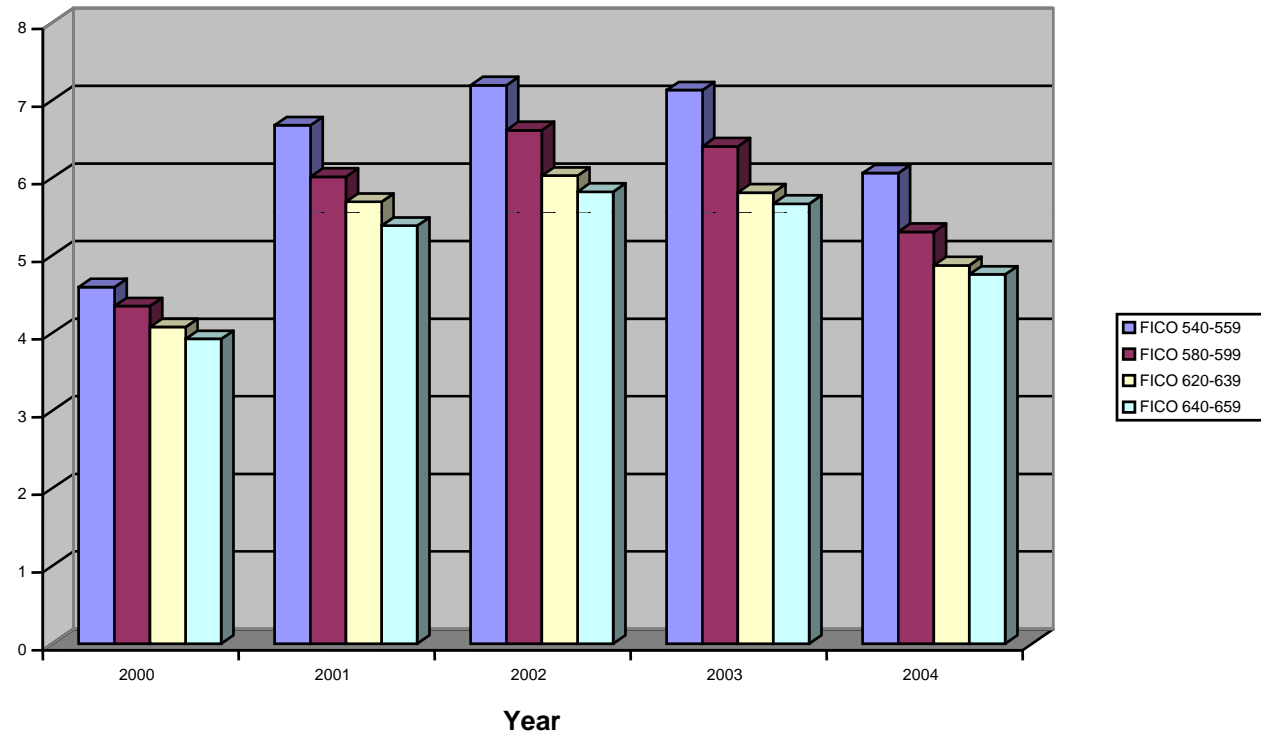
- The market has evolved over time
 - Increasing prepayment speeds despite widespread use of prepayment penalties
 - Increased share of ARM
 - Elimination of balloon mortgages and introduction of interest-only

Key Points

- Some important questions are a subject of continuing debate
 - Do borrowers pay higher prices or make unwise borrowing decisions due to lack of sophistication?
 - Are some lender practices predatory or discriminatory?
 - Are some lenders making unwise pricing and lending decisions involving adverse selection?

Recent Pricing Patterns

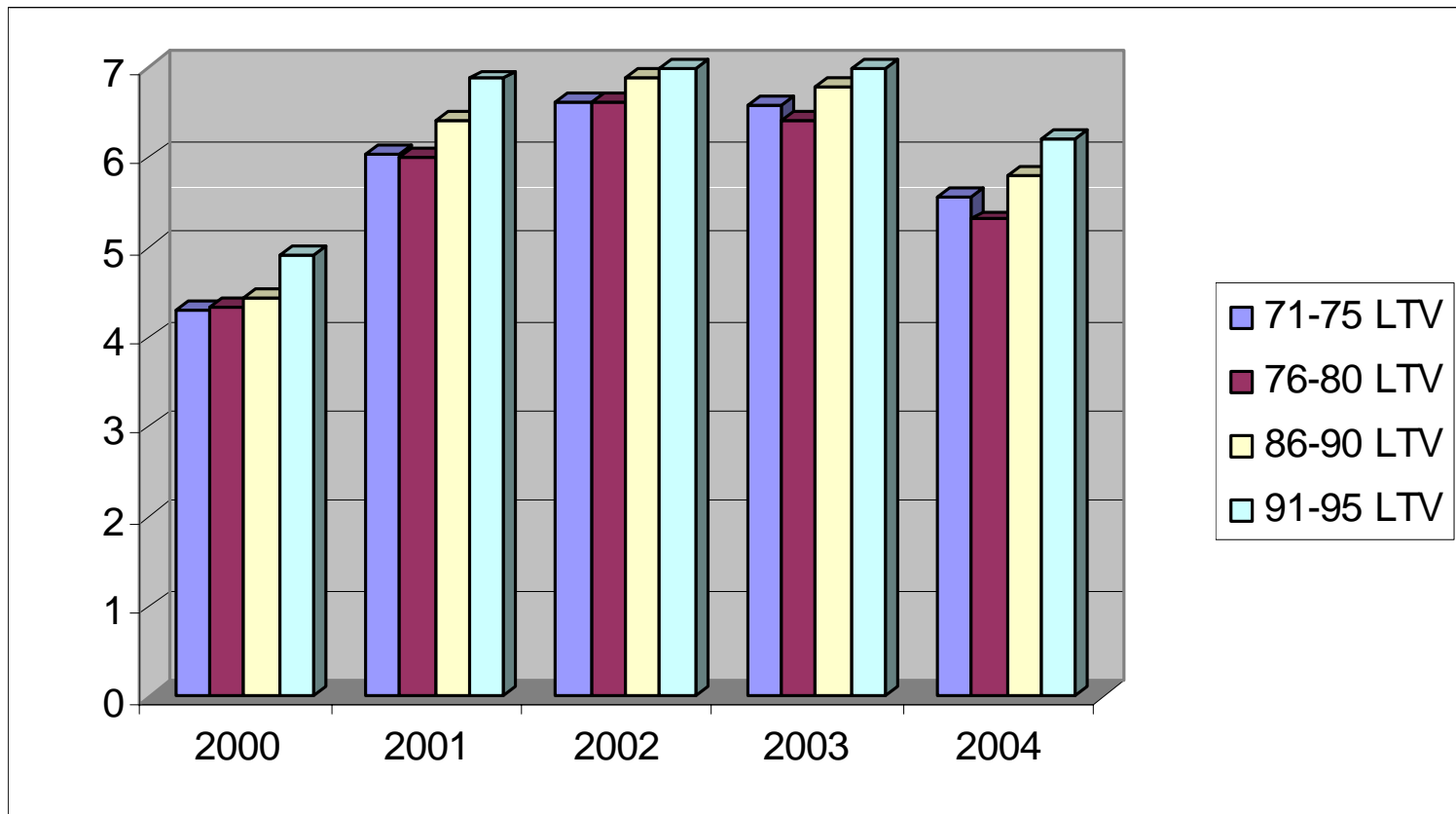
ARM spread over 1-year t-bill (80 LTV)



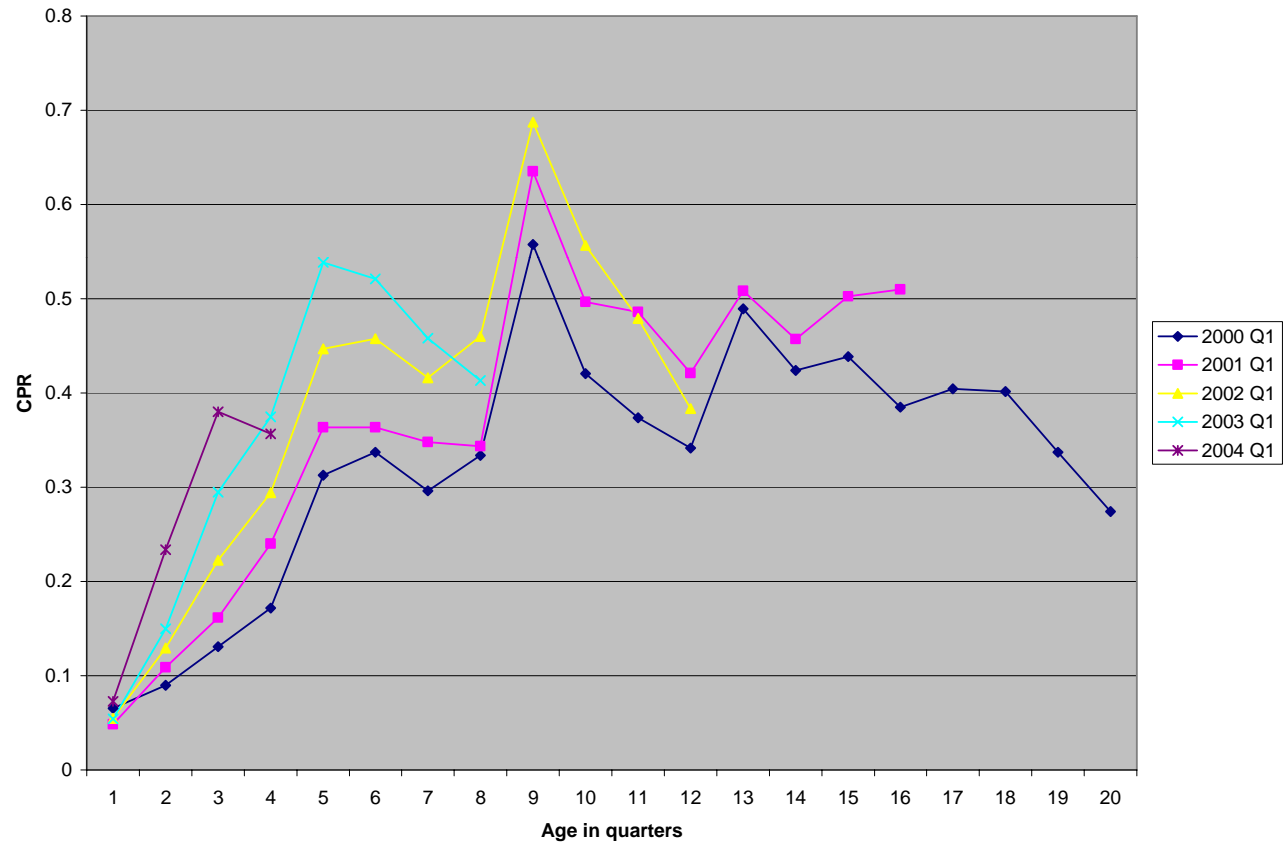
Source: LoanPerformance subprime securities database

Recent Pricing Patterns

ARM spread over 1-year t-bill (580-599 FICO)



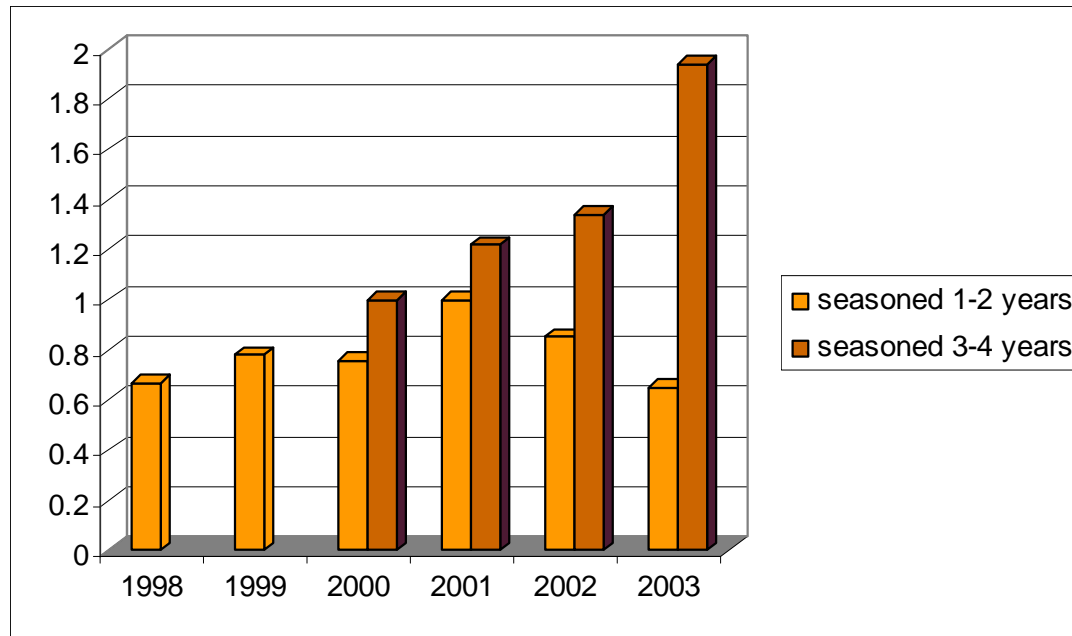
Recent Prepayment Patterns



Source: LoanPerformance subprime securities database

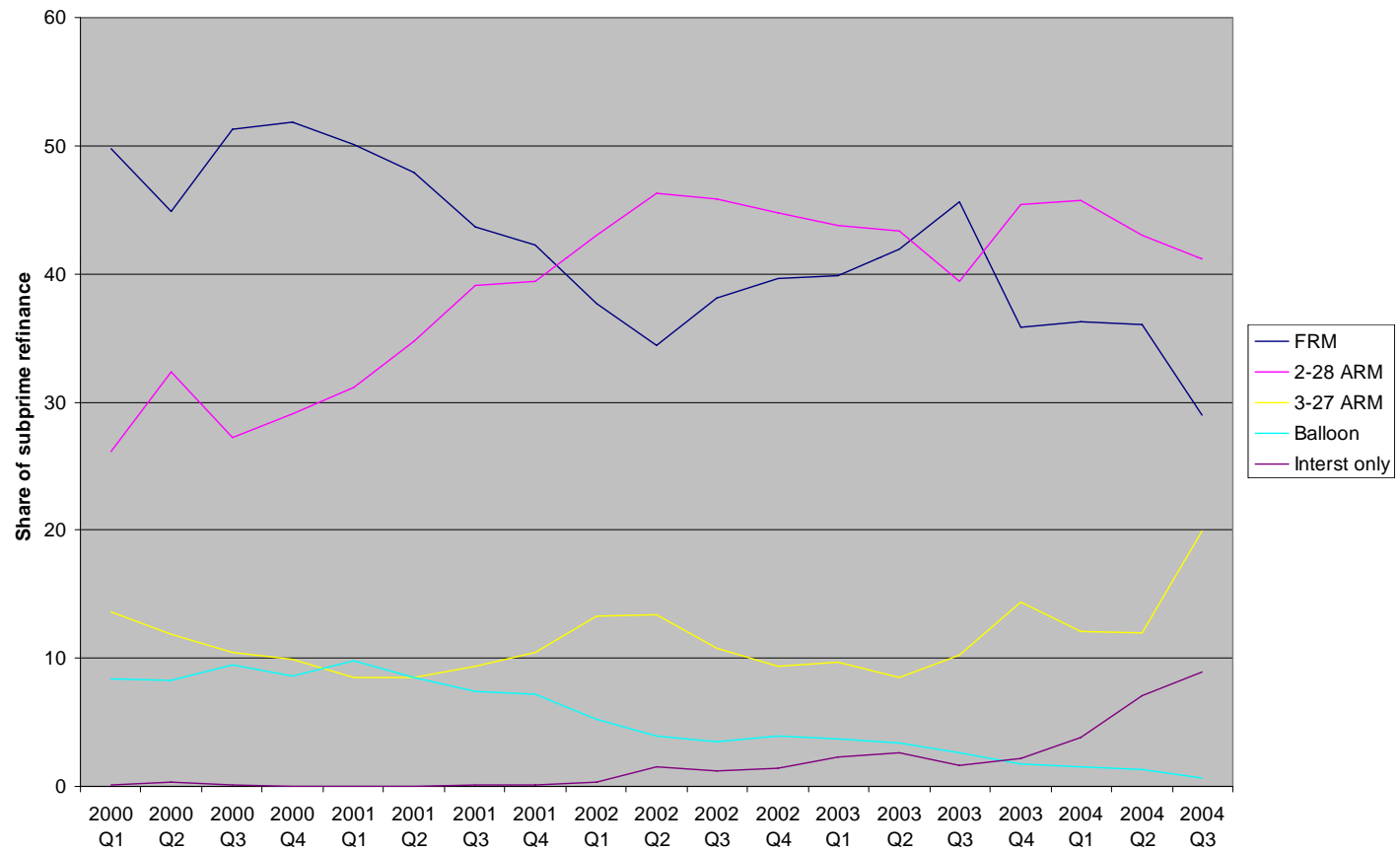
Recent Delinquency Patterns

Average annual % of balances 90-days delinquent for B or C rated loans seasoned 1-2 and 3-4 years*



Source: LoanPerformance subprime securities database

Evolving Product Mix



Source: LoanPerformance subprime securities database

Continuing Debate

- Do borrowers pay higher prices or make unwise borrowing decisions due to lack of sophistication? (Courchane 2004, Calem, Hershaff, and Wachter 2004)
- Are some lender practices predatory or discriminatory? (Farris and Richardson 2004)
- Are some lenders making unwise pricing and lending decisions involving adverse selection?
- Due to complex set of factors affecting pricing, these questions are difficult to answer definitively