Sub-prime loans natural evolution of easier cash

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Never have I received more e-mails or telephone calls about what has been going on in the sub-prime mortgage market in the United States than in the past month or so. Let me try to put things in simple English.

First, what is sub-prime mortgage lending? Simply, it is the lending to borrowers who do not qualify for loans from traditional mortgage lenders, typically banks. In the US, the use of consumer credit bureaus is quite advanced and transparent.

The use of consumer credit data determines the amount of loans available to a borrower and the risk-adjusted level of interest rate. The most commonly used credit scoring system is called Fico (Fair Isaac Corp).

A Fico score is a number typically between 300 and 850 which is based on a statistical analysis of a person's credit files. This represents a person's creditworthiness - the likelihood that a person will pay his or her bills. Using Fico, a borrower with a score below 620 would be considered higher risk.

The US sub-prime mortgage market is not a new phenomenon. Since the mid-1990s, sub-prime lending has increased in popularity and its growth represents a natural evolution of credit markets.

This evolutionary process was encouraged by various government actions, in particular, incentives to make loans to low and moderate-income borrowers or areas.

While I do not believe that the sub-prime mortgage market will mirror the US savings and loans crisis in the late 1980s, the knock-on impact on the overall US economy cannot be understated. The housing market has been one of the primary drivers of consumer spending in the past decade. Any property market slowdown (prices or new home starts) will inevitably have an adverse impact.

From all the recent negative events reported on the US sub-prime mortgage market, there are two important issues to keep in mind. First, in the past four years, almost one in five mortgages or US$2 trillion are sub-prime.

Recent data shows that almost 15 per cent of all sub-prime mortgages are more than 90 days overdue.

Second, existing homeowners (prime and sub-prime borrowers) during this same period borrowed almost the same amount in home equity loans. These borrowers monetised (took cash out) unrealised gains in their property. Ultimately, this double combination of sub-prime lending and home equity borrowing will undoubtedly have a significant impact on the US economy.

In Hong Kong, not until the late 1990s was there really any sub-prime borrowing.

Only after the credit card crisis resulting in thousands of borrowers filing for personal bankruptcies (banks wrote off more than HK$8 billion in credit card debt in 2002 and, in the same year, there were more than 25,000 personal bankruptcy orders) did Hong Kong now have a group of sub-prime borrowers.

In late 2003, authorised institutions were required to share data on all unsecured consumer finance accounts (mainly credit cards and unsecured personal loans) with TransUnion. However, banks continue to be reluctant to share the largest consumer database record - residential mortgages.

To provide a comprehensive consumer credit score, banks should be required to provide all their residential mortgage data. In this way, Hong Kong lenders would have a complete credit picture of every borrower and be able to make proper lending decisions.

As mortgage lending competition intensifies, it would not be surprising that banks turn to sub-prime lending in Hong Kong as there are more than 100,000 sub-prime borrowers, and still growing each year.

However, without the robustness and transparency of the US consumer credit bureaus, will Hong Kong lenders have learned from the recent US experience or will they lend with incomplete consumer credit information?

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