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SUBPRIME LENDING

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ABSTRACT

Subprime loans are those given to people and businesses who have a history of being unable or unwilling to repay their debts. These loans generally come with high interest rates, weak collateral, and less advantageous conditions for the borrower because they are more likely to default on the loan.

The population of India appears to be a profitable market for subprime lenders, with many having solo trade licences or freelance employment, preferring cash transactions to pay fewer taxes, and not keeping necessary paperwork. While several big financial organisations such as Citi, Bandhan, and Yes Bank have entered the Indian market between 2010 and 2018, the prolonged recession has hampered their growth.

This study examines the rise of subprime lending in India and its impact on the country's socio economic development. We can detect this by looking at the history of subprime lending and its impact on national economies.

According to our study, India has a large number of prospective subprime loan customers, and if India does not take the required actions to safeguard its economy from the rising default rates of these types of loans, which are attributable to COV 19 and the continuous lockdown, the country might face a catastrophe similar to that which occurred in the United States in 2008.

RESEARCH METHODOLOGY

While there are a variety of research methodologies that may be utilised to get insight into the position in which minor sports find themselves, Because of the large quantity of data accessible and the state-by-state lockout, I chose to conduct secondary research.

Secondary research is a methodical, analytical inquiry in which I depend on information already accessible on the issue. Because I'll be using data from the internet, I've made careful to only utilise data from reputable sources and media outlets.

This study methodology is not only cost- and time-effective, but it also assures the data's validity by obtaining data from reputable sources. Using this kind of study also helps me to identify any knowledge gaps that might be utilised to launch a more systematic investigation.

LITERATURE REVIEW

- Federal Reserve History: the article looks into the history of banking systems across the globe and how the Subprime mortgage crisis affected the strongest economy.

- The first twenty years of the European Central Bank: monetary policy: The article provides a comprehensive view of the ECB's monetary policy over these two decades.
- Subprime Mortgage Crisis, Its Timeline and Effect: The paper provides a chronological history of Subprime lending and how it feeds the demand for mortgage-backed securities sold through the secondary market.

- Corporate Finance Institute- Credit Analysis Process: The paper looks into credit analysis process refers to evaluating a borrower's loan application to determine the financial health of an entity and its ability to generate sufficient cash flows to service the debt

- The Risk of Subprime Mortgages by a New Name:the paper looks into why Subprime lending has been directly connected to the Great Recession

- The Subprime Mortgage Crisis: Causes and Lessons Learned: Highlights some of the most prominent factors that contributed to the greatest economic pullback since the Great Depression of the 1930s.

ANALYSIS

WHAT IS SUBPRIME MORTGAGE

A subprime loan is a type of mortgage given to persons with poor credit scores—640 or less, and usually under 600—who may no longer be able to qualify for regular mortgages due to their poor credit history. Any subprime loan has a significant number of risks. Rather than the loan itself, the word subprime relates to the borrowers and their financial position. Debtors with subprime credit are considerably more likely to default than those with higher credit ratings. Subprime mortgages have higher interest rates than prime loans because subprime borrowers pose a greater risk to lenders. Subprime mortgage interest rates are determined by a number of unique criteria, including the borrower's down payment, credit score, past-due invoices, and credit report delinquencies.

TYPES OF SUBPRIME MORTGAGE

1. Fixed-Interest Mortgages

Another type of subprime loan is a fixed-rate loan with a duration of 40 or 50 years, as opposed to the standard 30-year term. Although a longer mortgage duration reduces the borrower's monthly payments, it is considerably more likely to be followed by a lower interest rate. Fixed-interest mortgage interest rates can vary significantly from one lender to the next.

2. Adjustable-Rate Mortgages

An adjustable-rate loan starts with a set interest rate and later, at some point of the existence of the loan, switches to a floating rate. One common instance is the 2/28 ARM. The 2/28 ARM is a 30-12 months loan with a fixed interest rate for 2 years before being adjusted. Another typical version of the ARM loan, the 3/27 ARM, has a fixed interest fee for 3 years before it will become variable. In these styles of loans, the floating rate is decided based on an index plus a margin. A normally used index is ICE LIBOR. With ARMs, the borrower's month-to-month bills are usually lower during the preliminary term. However, while their mortgages reset to the higher, variable fee, loan bills usually increase significantly. Of course, the interest rate could decrease over time, depending on the index and monetary conditions, which, in turn, could reduce the payment amount. ARMs played a big role in the crisis. When home prices started to drop, many house owners understood that their homes were not well worth the amount of the purchase price. This, coupled with the rise in interest rates led to a massive amount of default. This led to a drastic growth in the range of subprime mortgage foreclosures in August of 2006 and the bursting of the housing bubble that ensued the following year.

3. Interest-Only Mortgages

The third type of subprime mortgage is an interest-only mortgage. For the initial term of the loan, which is typically five, seven, or 10 years, principal payments are postponed so the borrower only pays interest. He can choose to make payments toward the principal, but these payments are not required. When this term ends, the borrower begins paying off the principal, or he can choose to refinance the mortgage. This can be a smart option for a borrower if his income tends to fluctuate from year to year, or if he would like to buy a home and is expecting his income to rise within a few years.

4. Dignity Mortgages

The dignity loan is a brand new sort of subprime loan, wherein the borrower makes a down payment of approximately 10% and concurs to pay a higher rate of interest for a fixed period, normally for 5 years. If he makes the month-to-month payments on time, after 5 years, the amount that has been paid toward interest is going in the direction of reducing the balance on the mortgage, and the interest rate is lowered to the prime rate.

The borrowers of subprime loans have certain characteristics in common. These are as follows:

- They usually would have a lower income
- Their credit score would be below 600
- They may have debt-to-income ratio equal to or greater than 0.5
- They would have a poor credit history
- Their credit cards or loan payments would be delayed
- They might have declared bankruptcy once in the past 60 months
- They would have a foreclosure in the past 24 months
- They can also be a new business, retiree or self-employed

STAGES IN THE CREDIT ANALYSIS PROCESS

The credit score evaluation system is a prolonged one, lasting from some weeks to months. It starts from the information-collection stage up to the decision-making stage while the lender decides whether or not to approve the mortgage application and, if approved, how much credit to extend to the borrower.

The following are the key stages in the credit analysis process:

1. Information collection

The first stage in the credit score evaluation method is to accumulate data about the applicant's credit score history. Specifically, the lender is interested in the past repayment report of the customer, organisational reputation, monetary solvency, as well as their transaction records with the financial institution and different monetary institutions. The lender may also assess the ability of the borrower to generate additional cash flows for the entity by looking at how effectively it utilised past credit scores to grow its core business activities. The lender additionally collects data about the purpose of the loan and its feasibility. The lender is interested in understanding if the venture to be funded is feasible and its ability to generate enough cash flows. The credit analyst assigned to the borrower is needed to determine the adequacy of the loan amount to implement the venture to completion and the existence of a good plan to undertake the project successfully. The bank additionally collects data about the collateral of the mortgage, which acts as security for the loan in the event that the borrower defaults on its debt obligations. Usually, lenders prefer getting the mortgage repaid from the proceeds of the venture that is being funded, and only use the security as a fallback on the occasion that the borrower defaults.

2. Information analysis

The facts collected in the first stage are analysed to determine if the information is accurate and truthful. Personal and company documents, such as the passport, corporate charter, trade licences, corporate resolutions, agreements with clients and suppliers, and different legal documents are scrutinised to determine if they're accurate and genuine. The credit analyst additionally evaluates the monetary statements, which include the earnings statement, balance sheet, cash flow statement, and other related documents to evaluate the monetary capacity of the borrower. The bank additionally considers the experience and qualifications of the borrower in the venture to decide their competence in enforcing the venture successfully. Another aspect that the lender considers is the effectiveness of the venture. The lender analyzes the purpose and future possibilities of the venture being funded. The lender is interested in understanding if the venture is possibly sufficient to provide good enough cash flows to service the debt and pay the operating expenses of the business. A profitable venture will without problems stable credit facilities from the lender. On the downside, if a venture is dealing with stiff competition from different entities or is on a decline, the financial institution can be reluctant to increase credit because of the high possibility of incurring losses on the occasion of default. However, if the financial institution is satisfied that the borrower's level of risk is acceptable, it can extend credit at a high-interest rate to compensate for the high risk of default.

3. Approval (or rejection) of the loan application

The final stage in the credit score evaluation method is the decision-making stage. After acquiring and reading the precise financial information from the borrower, the lender decides on whether or not the assessed level of risk is suitable or not. If the credit analyst assigned to the specific borrower is satisfied that the assessed level of risk is acceptable and that the lender will not face any challenge servicing the credit, they'll put up a recommendation file to the credit committee on the findings of the assessment and the final decision. However, if the credit analyst unearths that the borrower's level of risk is simply too excessive for the lender to accommodate, they may be required to write down a report to the credit committee detailing the findings on the borrower's creditworthiness. The committee or other appropriate approval body reserves the final decision on whether or not to approve or reject the loan.

BENEFITS AND LIMITATIONS OF SUBPRIME

Benefits of a Subprime Loan

Borrowers with low or poor credit scores can qualify for subprime loans that include many types of loans, such as mortgages and personal loans. A subprime loan can be used to consolidate debt, making payments easier to manage. If borrowers make timely payments on subprime loans, their credit scores might improve. Subprime loans provide opportunities to borrowers to buy homes and other goods that they would not have been able to fund otherwise.

Limitations of a Subprime Loan

Subprime loans charge higher interest rates to compensate for the higher credit risk.

Higher rates of interest than conventional loans can lead to higher monthly interest payments. Uninformed borrowers are often charged high interest rates and other fees by predatory lenders.

COMPARISON

WHY INDIA IS THE PERFECT MARKET FOR SUBPRIME LOANS

India is one of the largest loan-taking countries around the world in 2020 due to the pandemic and the lockdown. Due to covid many people lost their jobs and necessities were also in a dire situation in India so many people opted to take loans but as they were not qualified for the basic loans given by the government they took subprime loans from local lenders. Many of the Indian population nowadays are freelancers and startups who often need funds but don't have any collateral so often they tend to go for the subprime loans rather than the normal loans and have high interest on them.

WHY PEOPLE TEND TO GO FOR SUBPRIME IN INDIA

Most freelancers do not have any collateral and do not have proper paperwork for a normal loan so they tend to go for subprime from local vendors with high-interest rates as they know banks won't give them proper loans.

Most of the startups have proper paperwork but don't have any good collateral so they tend to take subprime from the banks with higher interest rates as banks or borrowers have a lot of risk going up to 37% of defaults on startup loans.

Another prominent reason for people opting for subprime on high-interest rates in India is that most people deal in only cash and taking loans from banks is simply not possible for them so they take subprimes to form local lenders with high-interest rate rather than opting for any other type of loan.

GROWING INDIA ECONOMY AND ITS EFFECT ON SUBPRIMES

As more and more people are getting educated in India and due to its population of around 1.37 billion more and more people wants to be rich and most of the Indian population doesn't have a strong financial background so they do not have the collateral necessary for a normal loan and they also don't have a good credit score as they do not have a steady income so they tend to go with subprime loans with banks or local vendors as they seem fit according to their situation.

HISTORY OF SUBPRIME LENDING

When did it begin?

On 15 September 2008, Lehman Brothers [a Wall Street investment bank] filed for bankruptcy. This is generally considered to be the day the economic crisis began in earnest. The then-president George W Bush announced that there would be no bail-out. “Lehmans, one of the oldest, richest, most powerful investment banks in the world, was not too big to fail,” says the Telegraph.

What caused the 2008 financial crash?

The 2008 financial crash had long roots but it wasn’t until September 2008 that its effects became apparent to the world.

The immediate trigger was a combination of speculative activity in the financial markets, focusing particularly on property transactions – especially in the USA and western Europe – and the availability of cheap credit, says Scott Newton, emeritus professor of modern British and international history at the University of Cardiff.

“There was borrowing on a huge scale to finance what appeared to be a one-way bet on rising property prices. But the boom was ultimately unsustainable because, from around 2005, the gap between incomes and debt began to widen. This was caused by rising energy prices on global markets, leading to an increase in the rate of global inflation.

Lenders To Blame

Most of the blame is on the mortgage originators or the lenders. That's because they were responsible for creating these problems. After all, the lenders were the ones who advanced loans to people with poor credit and a high risk of default.7 Here's why that happened.

When the central banks flooded the markets with capital liquidity, it not only lowered interest rates, it also broadly depressed risk premiums as investors looked for riskier opportunities to bolster their investment returns. At the same time, lenders found themselves with ample capital to lend and, like investors, an increased willingness to undertake additional risk to increase their own investment returns.

The Bottom Line

There may have been a mix of factors and participants that precipitated the subprime mess, but it was ultimately human behavior and greed that drove the demand, supply, and investor appetite for these types of loans. Hindsight is always 20/20, and it is now obvious there was a lack of wisdom on the part of many. However, there are countless examples of markets lacking wisdom. It seems to be a fact of life that investors will always extrapolate current conditions too far into the future.

CONCLUSION

So after my research I would like to conclude that there are a lot of loopholes and faults in the present banking system all over the world and there is no one step one can take to prevent what happened in 2008 and what happened when covid 19 virus hit the world's economy due to the lockdowns. The impact of covid on banking industry is a lot the default rate in india has rose up to 32% from 24% most people were not able to pay their monthly or yearly instalments on india which also led to -6.8% depreciation in india's GDP in 2020 3 quarter.the crisis in 2008 was caused due to the greedy banks wanting to earn money and the bankers who approved the loans just fee and didn't see the person's credit history one major problem was also the government of united states who did not do anything until the fall happened and the people who knew made a huge profit out of this situation. seeing india through that eyes of a economist today we can safely say that we are way secure as many people in india still don't believe in taking loans and the default ratio is also quiet low compared to what the situation was in us when the crisis happened but this doesn't mean that the crisis could not happen in india if we do not take safe steps india banks should have economy shutdown in 10 15 years ahead of this newsletter.But taking precautions and making our banking system synchronised with the government will help in avoiding such crisis. although india is the right market for subprime loans as most people don't have good credit scores because of their family background and because many people in india are getting educated and have a lot of new business ideas which need funding and due to their low income they need to take loans and have to go with subprime market.so overall india is a large market for these subprime loans and the indian government and rbi should maintain a proper record for such loans and their default rate otherwise there will be an crisis in india just like united states

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