Charting Your Course to Home Ownership

Understanding Subprime Lending

Subprime lending provides loans to consumers with less-than-perfect credit histories. **Not all sub-prime loans are predatory** (charge excessive interest and fees or use deceptive practices). However, many predatory lenders market their services to people who are financially distressed and are, therefore, classified as subprime. Until a few years ago, many subprime borrowers probably would not have even qualified for loans or credit cards. Today, however, they are aggressively extended credit, but at a higher cost.

Prime or Subprime?

Subprime borrowers include people from all ages, occupations, ethnic groups and income levels. Most have credit blemishes including:

- Late payments
- Judgments and wage garnishments
- Bankruptcy and foreclosures
- High debt-to-income ratio

In addition to those with credit blemishes, some subprime borrowers simply lack a credit history. They are "invisible" to lenders because there is no information in their credit file. Many subprime borrowers, can qualify for better loan terms (because they have a prime credit score), but they don't know it.

Lenders also generally use a credit tier scale to rate borrowers. Commonly used credit tier ratings are:

A—All bills paid on time

B—At least one bill paid by as much as 30 days late

C—One or more bills overdue for 30 to 90 days

D—At least one bill sent to a collection agency or written off

About 70% of borrowers have "A"(prime) credit scores and 30% are subprime with ratings of A-, B, C, or D.

Credit scores (a mathematical gauge of creditworthiness based on one's credit history) are also considered in the determination of prime and subprime borrowers. The exact threshold for an "A' (prime) borrower differs among lenders.

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Prime or Subprime—What's the cost difference?

Subprime loan rates can range from only 1-2% to over 10% higher than the cost of a conventional loan, depending upon a lender's rates and the borrower's credit history.

Over time, the difference in interest rates and monthly payments between prime and subprime loans can be thousands of dollars, especially for long loans. The difference in prime and subprime interest rates for a $100,000, 30-year, fixed rate mortgage loan in March 2008 is given in Table 1.

Credit Score	Interest Rate	Monthly Payment	Total Interest Paid
620-674 (Prime)	7.761	$717	$158182
561-619 (Subprime)	13.802	$1,169	$320,918

Table 1. (Source: **http://www.myfico.com/myfico/CreditCentral/LoanRates.asp#Calculator**)

Avoid Subprime Loans

Subprime borrowing is costly and should be avoided if possible. Try these tips to avoid subprime loans.

- **Replace subprime loans as credit improves.** After a year of making on-time payments, apply for a prime rate loan to replace a high-cost loan.
- **Check your credit report before borrowing.** Credit reports may contain errors. For example, information from people with similar names can get co-mingled. If another person's information is negative, it can cause a borrower to be incorrectly classified as subprime.
- **Check your credit score.** Some lenders will tell you your credit score on request. Otherwise, order your credit score from one or more of the three major credit reporting agencies. They may be ordered online from http://www.equifax.com, http://www.transunion.com or http://www.experian.com .
- **Try to borrow from a bank or credit union.** As many as 10-15% of persons who assume they are subprime may actually qualify for a prime rate loan. They won't know, however, unless they apply. Even if they are classified as subprime, they will pay a much lower interest rate at a bank or credit union than at a "fringe banking" company.
- **Avoid finance companies.** They generally charge higher rates for consumer loans than banks and credit unions, often more than 20 percent. Additionally, finance company loans recorded in a credit report can decrease a borrower's credit score, thereby keeping him or her classified as subprime.

Additional References:

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This material is based on work supported by the Restoring Home Ownership in Louisiana Hurricane Recovery project funded in part by USDA Cooperative State Research, Education and Extension Service, Smith-Lever Special Needs project number 2007-41210-03986.

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Pub. 3087-E 09/08