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Denver Subprime Loan Report

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The Denver metropolitan area had the ninth highest rate of foreclosures among the nation's hundred largest metropolitan areas for 2007.[1] Defaults by subprime borrowers have been widely implicated as a key factor boosting foreclosures nationally. Yet our analysis of the data indicates for the Denver-Aurora metropolitan area (MSA), many subprime borrowers are successfully paying their mortgages and may see lower interest rates in the future. The key findings show that:

1. Denver-area subprime loan originations peaked earlier than the nation in 2005 and very few subprime loans were originated in 2007.

2. Over 60% of Denver-area subprime loans are current, but Denver has more "foreclosed houses already owned by the lender" than the nation.

3. Denver-area subprime loans had lower down payments (indicated by a loan-to-value ration greater than 90%), but Denver borrowers had higher average credit scores compared to the nation.

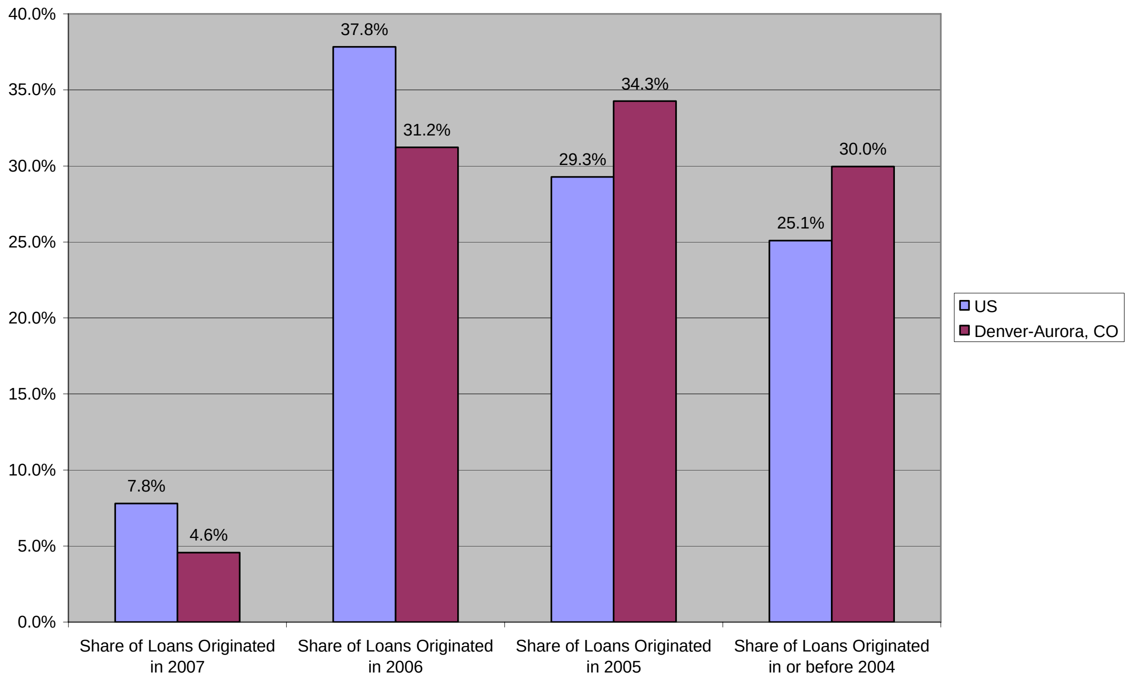
4. Denver-area loans are more likely to have adjustable rates, but the average initial rates for these loans were 7.3%.

5. 46% of the Adjustable Rate loans in the Denver-area had not reset as of December 2007, but declining international interest rates should help borrowers.

Denver-area subprime loan originations peaked earlier than the nation in 2005 and very few loans were originated in 2007.

As of December 2007, over 65% of the pool of outstanding subprime loans in the Denver-Aurora MSA were originated in 2005 or 2006. The origination of privately-financed subprime loans all but disappeared in 2007, nationally and in Denver. The share of subprime loans originated in 2007 represents less than 5% of outstanding subprime loans for Denver versus about 8% for the US.

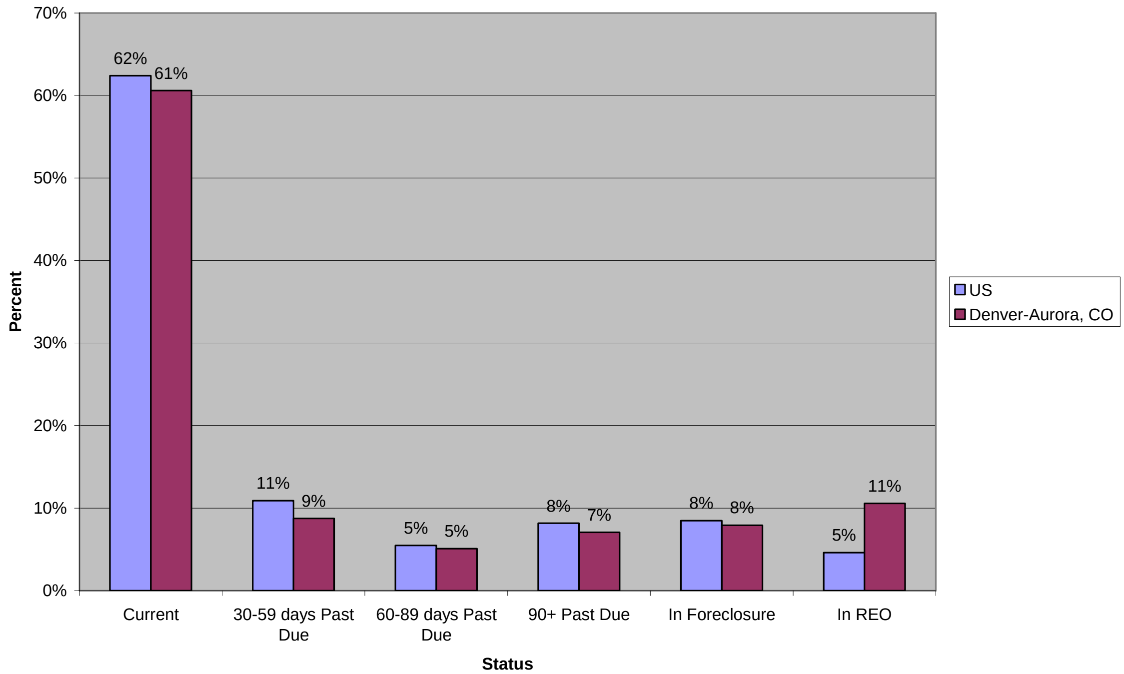
Chart 1: The Timing of Subprime Origination



Over 60% of Denver-area subprime loans are current, but Denver has more "foreclosed house already owned by the lender" than the nation.

In the Denver-Aurora MSA, 21% of subprime loans are past due by more than 30 days, 8% are currently in foreclosure and 11% are in "REO," which means the lender has already taken ownership of the property. The most striking difference is in the REO status, with the Denver-Aurora MSA are more than twice the US rate. This reflects prior periods' foreclosures, which tended to occurred earlier in the Denver-Aurora MSA. Looking only at houses still in the borrowers' hands, the Denver-Aurora MSA has similar or lower levels of delinquencies now, suggesting that in the future foreclosure rates should be more similar to the national average.

Chart 2: Subprime Loan Status



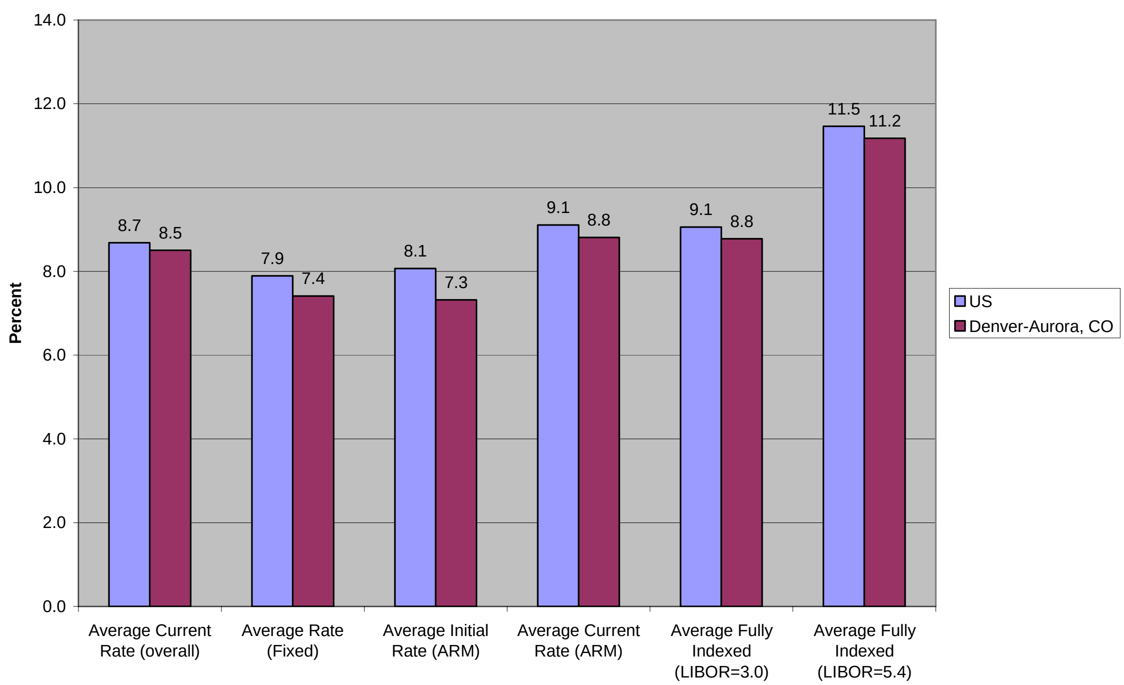
Denver-area subprime loans were more likely to have had low down payments (indicated by a loan-to-value ration greater than 90%), but Denver borrowers had higher average credit scores compared to the nation.

Though it is often thought that the FICO credit score determines whether a loan product is subprime, several factors come into play. FICO is the credit score developed by Fair Isaac & Company and frequently used by many mortgage lenders to determine the possibility that the borrower may default. In reviewing the average FICO scores for subprime borrowers, Denver-Aurora MSA borrowers had a higher score, 629, in comparison to the US at 617. The share of the property financed also affects the classification of the loan, particularly when the loaned amount is above 90% of the value of the property. “High” initial loan to value ratio loans (LTV greater than 90%) were more common in the Denver-Aurora MSA: 53% compared to 37% of subprime loans nationally. Low documentation loans are also more likely to be classified as subprime. Subprime loans in the Denver-Aurora MSA were mostly full documented**,** 73% compared to the US average of 67%.

Denver-area loans are more likely to have adjustable rates, but the average initial rates for these loans were 7.3%.

Over 78% of subprime borrowers in the Denver-Aurora MSA have an adjustable rate mortgage (ARM) versus 65% of national subprime borrowers. Adjustable rate products can lower initial payments, but subprime borrowers did not tend to receive a very low “teaser” rate. The average initial rate for an ARM in the Denver-Aurora MSA was 7.3%, compared to the US rate of 8.0%. The average current rate for an ARM in December 2007 was 8.8% and 9.1% respectively.

Chart 3: Average Interest Rates on Subprime Loans



46% of the Adjustable Rate loans in the Denver-area had not reset as of December 2007, but declining international interest rates should help borrowers.

Many people are concerned about the potential for these loans to reset to high rates, but this depends on the underlying interest rate. Subprime ARMs are generally indexed to the London Interbank Offered Rate (LIBOR). Throughout much of 2007, the LIBOR was near 5.4% making resets to over 11% likely in the Denver-Aurora MSA. However, the LIBOR has declined substantially over the past few months making resets likely to be closer to 8.8% in the Denver-Aurora MSA. Subprime loans tend to reset every six months after the first reset, so many households may see their rates decrease from past resets. Many loans may be restricted to fall no lower than the initial interest rate, but resets would still typically be lower than current rates.

Subprime borrowers may still want to refinance their properties as their financial situation or the interest rate change. Like last year's relative high interest rates, today's relatively lower interest rates are subject to change. One factor limiting refinancing options are prepayment penalties, which depending on their size can make refinancing prohibitively expensive. Over 93% of the Denver-Aurora MSA subprime loans included a prepayment penalty at origination compared to 73% for the US. However, as of December 2007, the prepayment penalty was still in effect for about 44% of the loans in Denver versus about 42% of US subprime loans. For the group of homeowners with prepayment penalties still in effect, the decline in LIBOR is particularly helpful and may alleviate some of expected difficulties from resets.

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This analysis of subprime loans in the Denver-Aurora MSA was conducted using estimates provided by the Federal Reserve Board and the Federal Reserve Bank of KC based on First American Loan Performance data from December 2007. This data source includes over 70% of subprime loans made nationally so these estimates should accurately reflect the subprime loan pool in the Denver-Aurora MSA. Jane Dokko and Andreas Lehnert at the Board of Governors provided many of the estimates used in this report.

The analysis and views in this report are the authors' and do not necessarily reflect the views of the Federal Reserve System.