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Defining Subprime: Easier Said Than Done

The Securities and Exchange Commission's probe into Fannie Mae and Freddie Mac appears to be hinging on a simple question: What's the definition of a subprime mortgage?

The SEC is investigating whether the mortgage titans' disclosures to investors of subprime and other risky mortgages may have misled investors about their decisions to take on more risk. So far, four current or former officials of the companies have acknowledged that they could face civil charges from the SEC, including Daniel Mudd and Richard Syron, the former chief executives of Fannie Mae and Freddie Mac, respectively.

The trick in this case is that there never was an agreed upon definition of a "subprime" mortgage. Fannie and Freddie got into even more trouble by buying up lots of Alt-A mortgages, which is even harder to define but generally consisted of loans between prime and subprime where borrowers didn't have to document their incomes.

So what are some of the potential definitions of subprime?

The FDIC in 2001 said that loans with credit scores below 660 generally had a "relatively high default probability." The mortgage industry, by contrast, generally said that loans below 620 were subprime. (While there weren't explicit definitions of subprime loans, federal regulators did have detailed definitions of "high cost" mortgages. Those were often confused with subprime loans because those mortgages were the most likely to go to borrowers with weak credit.)

In other cases, subprime referred not to the borrower, but to the loan. Some in the industry considered subprime mortgages to be those that weren't eligible for sale to Fannie and Freddie. Over the past decade, the mortgage titans gradually relaxed their loan-purchase standards, which made that definition unusable.

While around 5% of loans guaranteed by Fannie in 2007 had credit scores below 620, the company said that only 0.3% of its loans were considered "subprime." That was because Fannie defined subprime loans only as those that were flagged as "subprime" by the loan seller or that were purchased from subprime originators.

"There's a broad agreement on what the qualities of a subprime loan are, but there's no very technical definition. There's a big gray area," says Mark Calabria, director of financial regulation studies at the libertarian Cato Institute who recently published a paper exploring some of these issues.

Further muddying the waters, as lending standards deteriorated, more borrowers were able to take out mortgages with no down payments, with minimal income verification, and with special "interest only" features that allowed them to avoid making principal payments for several years.

Some analysts have argued for a much broader definition of "subprime" to include these loans. Here's an example: nearly 15% of loans bought by Fannie in 2007 were "interest only." If those loans went to borrowers with great credit, it would be hard to argue that they were subprime loans. But if they went to borrowers who made minimal down payments, it would similarly be hard to argue that these were traditional "prime" loans. These definitions were the subject of some intense debate by members of the Financial Crisis Inquiry Commission.

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