On the Economics of Subprime Lending

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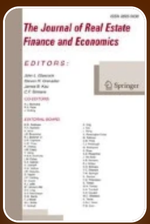

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Abstract

US mortgage markets have evolved radically in recent years. An important part of the change has been the rise of the “subprime” market, characterized by loans with high default rates, dominance by specialized subprime lenders rather than full-service lenders, and little coverage by the secondary mortgage market. In this paper, we examine these and other “stylized facts” with standard tools used by financial economists to describe market structure in other contexts. We use three models to examine market structure: an option-based approach to mortgage pricing in which we argue that subprime options are different from prime options, causing different contracts and prices; and two models based on asymmetric information–one with asymmetry between borrowers and lenders, and one with the asymmetry between lenders and the secondary market. In both of the asymmetric-information models, investors set up incentives for borrowers or loan sellers to reveal information, primarily through costs of rejection.

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