

# CREDIT

## ACTIVITY 8



### Prime and Subprime Lending

#### RECOMMENDED TIME

Allow 50-60 minutes. Required time may vary depending on the audience.

#### OBJECTIVES

Participants will:

- Define subprime and prime lending, while differentiating from predatory lending.
- Understand why people with poor credit pay much more for loans.
- Recognize alternative institutions (payday lenders, rent-to-own stores, etc.) that provide higher-cost loans.
- Understand strategies to improve credit in order to qualify for prime loans.

#### MATERIALS NEEDED

- Overhead projector and screen\*
- Overhead transparency, flipchart, or white board
- Activity handouts

#### ADVANCE PREPARATION NOTES

Review the activity plan. Think about the audience, and decide whether to present the total activity or to use parts of this activity in combination with other activities.

For clarity, use print instead of script when writing on a flip chart, white board, or transparency.

The suggested dialogue in the delivery notes does not always mirror the wording on a transparency. Try to vary the dialogue, rather than reading transparencies verbatim.

This activity uses handouts. Have sufficient copies for all participants; a few extras provide good insurance.

Discussions about subprime and prime lending can elicit strong feelings from some participants. Some participants may confuse subprime lending with predatory lending and believe it is a harmful practice. Others may equate subprime lending solely with individuals who have low incomes. It is important to be aware of these misconceptions and also to be sensitive to your audience. Allow participants to share their perspectives, but be careful not to let the conversation become a session for participants to vent their frustrations.

\* If an overhead projector isn't available, consider making photocopies of the overhead transparencies for handouts instead.

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**Determine for yourself whether or not you are truly comfortable presenting this lesson. If you are not, you should ask for assistance, team teach with a colleague who is comfortable with the material, or teach a different lesson.**

Facilitators cannot be expected to know everything about prime and subprime lending. Be honest with all questions. If you do not know the answer to a question, be honest and explain, *"I do not know the answer to your question. However, I will find the answer and get back to you."* Be sure to write down the question and follow through when you commit to finding an answer.

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## ACTIVITY 8 - DELIVERY NOTES



### Prime and Subprime Lending

#### Presentation Opening

- Welcome the participants.
- Introduce yourself briefly.
- If this is the first meeting with the class or group, do a brief round of introductions by everyone.
- When introducing yourself, print your name where participants can see and refer to it during the session. Some people may be a little nervous and may not remember your name. Just as you want to use their names, encourage them to call you by your name.

#### Activity Overview

Review the topics for discussion in this activity:

- Learn the difference between prime and subprime lending.
- Understand the important role that subprime lending plays in providing credit-challenged customers with access to capital.
- Understand how much more consumers pay for subprime loans.
- Learn about other high-cost loans such as payday loans, title loans, and rent-to-own loans.

Write the terms mortgages, prime, and subprime on the board, flipchart, or blank transparency.

- Ask participants to define the terms.
- Ask participants the following questions: What are the characteristics of prime mortgage loans? Subprime mortgage loans?
- Debrief participants by showing **“Overhead 1: Prime and Subprime Mortgage Lending.”**

Discuss the following points:

- While not all subprime and prime loans are mortgages, we will discuss mortgages in this lesson. Most people with prime credit have successfully managed their credit by living within a budget and realistically categorizing needs (vs. wants). Typically, they apply only for the loans and credit cards they need to accommodate the lifestyle their income will support. People with prime credit typically have good to excellent credit scores. However, it is not necessary to have prime credit to qualify for a decent interest rate—people with lower credit scores may still qualify for lower rates, depending on the amount of equity in their home and certain other criteria.
- Borrowers typically fall into the subprime category for one of two reasons: either because they made late payments on credit cards or loans, abandoned loans, or filed bankruptcy in the past seven years (so-called blemished credit); or because they have very limited

### Visual Aids

#### Overhead 1 Prime and Subprime Mortgage Lending

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## ACTIVITY 8 - DELIVERY NOTES



### Visual Aids

financial experience (so-called thin file or no credit). Subprime lenders offset their risk in making loans to customers with blemished credit or a thin file by charging these borrowers a higher interest rate and sometimes additional fees.

- Lenders consider many factors in a process called “risk-based pricing” when they come up with mortgage rates and terms. Subprime rates are higher, but how much higher depends on factors such as credit score, size of down payment, and what types of delinquencies the borrower has in the recent past. Although it is difficult to generalize about subprime rates, a report from the Federal Reserve Board of San Francisco reported that over the 1998–2001 period, the subprime mortgage rate exceeded the prime mortgage rate by an average of 3.7 percentage points.

Subprime mortgages do serve a purpose. They allow people with blemished or no credit to get credit that they would otherwise be unable to access and thereby to own a home, starting down the path of wealth-building with the acquisition of what is most often the largest asset one will have in a lifetime.

- Subprime loans are not by definition predatory loans. Predatory loans have abusive terms and generally are marketed to people with less bargaining power, unsophisticated consumers, and elderly homeowners who own their homes outright but who have small incomes. These loans may have no economic justification and the borrower may not have a chance of repaying them. Frequently, they are characterized by excessive rates and fees.

It is important to recognize that subprime loans provide credit to people who may have been previously denied loans and offer them the chance of homeownership. Nevertheless, there is a cost for this service and borrowers should carefully and continuously evaluate their need for these types of loans. Distribute **“Handout 1: The Price of Subprime Lending”** and walk participants through the examples.

Display **“Overhead 2: Other High-Cost Loans”** and discuss the following.

- There are a variety of high-cost, short-term loans available. Overhead 2 lists a few high-cost loans. Have participants work in pairs to identify other high-cost loans to avoid.
- Call time and discuss responses as detailed below:

*Car-title lenders (also known as auto title pawn)* – A person who has clear title to his or her car can borrow up to 25 percent of the car’s value. The owner must grant the lender power of attorney to transfer the title in the event that a loan payment is not made. If the borrower defaults on the loan, the lender repossesses (takes ownership of) the car.

*Check cashers* – Fees for cashing checks can range from 1.5 to 3 percent of

**Handout 1**  
The Price of  
Subprime Lending

**Overhead 2**  
Other High-Cost Loans

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a check's value for payroll and government checks. Personal checks can have fees as high as 20 percent. If a check casher charged 18 percent on personal checks, for example, the fee for cashing a \$250 check would be \$45!

*Pawnshops* – These businesses accept personal property, such as jewelry, electronics, cameras, musical equipment, or guns, as collateral for loans based on the value of the goods. Most pawnshops lend less than half of an item's resale value. Borrowers have several months to repay the loan and are charged very high interest rates until they do. Many pawnshops also charge storage costs and insurance fees. If the loan is not repaid, the pawnshop keeps and sells the borrower's pawned property.

*Payday lenders* – Payday loans are relatively small loans, typically between \$100 and \$500, and are repaid in one payment within a short time period (usually 13 to 17 days). These loans or cash advances are secured by a postdated personal check from the consumer or by their next direct-deposited benefits check or paycheck. The price of these loans is very high, especially when loans roll over or additional loans are used to pay previous loans.

*Rent-to-own stores* – These stores carry new and used household items that can be rented by the week or month, or can be purchased by making a set number of payments. This is a very expensive way to buy things. If the borrower misses a payment, the store takes the item back and the borrower loses any money paid toward owning it.

Stress the amount of money that can be saved by avoiding high-cost loans and qualifying for prime loans.

Distribute "**Handout 2: Moving from Subprime to Prime**" and walk participants through the tips for qualifying for prime loans.

### Closing

In closing, remind everyone that there is a purpose to prime and subprime lending. Subprime offers a service to people who otherwise would not be able to access credit. Improving your credit is the best strategy to move from subprime to prime credit.

Thank everyone for their participation, and encourage them to return for additional sessions. If such sessions are planned, you might provide a "sneak preview" of any activity to come.

### Visual Aids

**Handout 2**  
Moving from  
Subprime to Prime



## PRIME AND SUBPRIME MORTGAGE LENDING

**Prime** – Prime credit is typically available to an individual who has paid his or her outstanding credit (car loans, credit cards, and mortgages) on time.

**Subprime** – A subprime loan is typically available to a person with either no credit history or a damaged credit history and who is considered to be a high-risk borrower, which means that the borrower is more likely to default on the loan than low-risk borrowers. Subprime loans have higher-than-average interest rates. Subprime lenders reduce their risk in making loans by charging borrowers a higher interest rate and sometimes additional fees.

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## ACTIVITY 8 - HANDOUT 1



### THE PRICE OF SUBPRIME LENDING

How much does a subprime loan cost you? If you have a lower credit score and qualify only for subprime loans, it can cost you hundreds of dollars more each month and thousands of dollars over the life of the loan.

#### Automobile Financing

If you are making payments on a car, you could be paying significantly more just for getting a loan with a higher interest rate. This added interest is significant over the life of the loan.

*\$20,000 car paid over 5 years:*

Rate	Monthly Payment	Cost of Credit
7%	\$396.02	\$3,761.12
14%	\$465.37	\$7,922.20

#### Home Mortgage

Getting the best interest rate is particularly important when you get long-term loans such as home loans. A loan that has an interest rate that is just a couple of points higher can cost you more than \$50,000 over the life of the loan.

*\$100,000 home paid over 30 years:*

Rate	Monthly Payment	Cost of Credit
7%	\$655.30	\$139,508.00
11%	\$952.32	\$242,835.20

**CREDIT**  
**ACTIVITY 8 - OVERHEAD 2**



## **OTHER HIGH-COST LOANS**

1. Check-cashing stores
2. Pawnshops
3. Payday lenders
- 4.
- 5.
- 6.
- 7.

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## ACTIVITY 8 - HANDOUT 2



### MOVING FROM SUBPRIME TO PRIME

If your credit score is low, you will likely qualify for subprime loans and have to pay a much higher interest rate than the rate for people with prime credit. If you currently have a lower credit score and want to be able to qualify for prime loans in the future, you should take steps to improve your credit. The following steps can help.

- **Pay bills on time.** The most important rule for maintaining good credit is to pay your bills on time. You can begin to improve your credit history immediately by making at least the minimum payments on time. Within a few months, it will be obvious that you are managing your credit responsibilities better and a new, stronger credit report will result.
- **Correct mistakes.** Your credit is a reflection of the information in your credit report. If your credit report contains negative information, it will negatively impact your credit regardless of whether or not the information is accurate. Review your reports from all three credit bureaus for accuracy once a year, as well as several months before applying for a loan.
- **Pay more than the minimum required.** When you pay only the minimum due each month, you end up paying a lot of money in interest charges.
- **Use credit sparingly.** Be cautious about the amount of debt you incur. Try to use credit cards only for purchases that have long-term value, such as furniture, medical care, or emergency repairs. Don't depend on credit cards for everyday expenses like dining out or entertainment.
- **Work with a reputable nonprofit credit counseling organization.** Reputable nonprofit community-based credit counseling organizations can provide one-on-one assistance to help you improve your credit. See curriculum appendix for resources.