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The Entrance of Banks into Subprime Lending: First Union and The Money Store

I. INTRODUCTION

The subprime lending business has seen explosive growth over the past few years. National subprime loan volume was $90 billion in 1995 and is expected to reach $175 billion by the end of 1998. This growth, along with recent economic developments, has caused changes in the composition of the subprime lending industry. This is a trend that seems certain to continue. One of the most important changes is the increased participation of banks in the subprime market. On March 4, 1998, First Union agreed to pay $2.1 billion to purchase The Money Store, one of the largest subprime lenders in the country.

This Note will examine the banking industry's entrance into the subprime lending market by utilizing First Union's acquisition of The Money Store as a point of reference. Part II of this Note will provide a brief description of the mechanics underlying the business of subprime lending. Part III will discuss recent trends that have adversely affected the subprime lending industry. Part IV will use First Union's acquisition of The Money Store to illustrate the banking industry's interest in becoming more involved in subprime lending. Part V will discuss the reaction of bank regulatory agencies to the increasing activity of banks in this arena. Finally, in Part VI the Note will conclude that First Union's acquisition of The Money Store

2. At the end of 1998, First Union was the sixth largest bank in the United States, with a total of $225 billion in assets. See Ken Elkins, Wait and See, BUS. J. (Charlotte), Dec. 28, 1998, at 18.
4. See infra notes 9-32 and accompanying text.
5. See infra notes 33-63 and accompanying text.
6. See infra notes 64-115 and accompanying text.
7. See infra notes 116-145 and accompanying text.
should serve as a positive example of the type of consolidation that will likely occur in the subprime lending industry.®

II. A PRIMER ON SUBPRIME LENDING

Subprime companies® lend to consumers who generally cannot get a more "conventional" loan.® There are three broad categories of persons who turn to the subprime market for a loan. The first group is borrowers who have blemishes in their credit history.® These customers have one or more of the following on their credit report: multiple delinquencies, charge-offs, repossessions, bankruptcies, or low household annual income.® The second group of subprime borrowers turns to the subprime market because they have very little

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8. See infra notes 146-174 and accompanying text.
9. Mortgage and home equity loans account for 60% of the subprime market. See Karen Hube, In the Wild West of Subprime Lending, Borrowers Have to Dodge Many Bullets, WALL ST. J., March 18, 1998, at C1. An example of a subprime mortgage loan is the loan given to Mary Margaret Traxler, by Charlotte based EquiFirst Corp. See Christina Brinkley, Mortgage Lenders Pursue Once-Shunned Borrowers, WALL ST. J. (Florida Journal), Sept. 11, 1996, at F1, available in 1996 WL-WSJ 11797858. Ms. Traxler was given a loan for the down payment as well as the balance of the $89,000 purchase price of her home. See id. The interest rate on the down payment loan was 15.9% and the interest on the balance was 13.29%. See id. With subprime interest rates this high, as compared to a 7% or 8% rate on a conventional mortgage loan, it is no wonder that subprime lending is a lucrative business. Home equity loans are growing at the phenomenal rate of 15% each year even though these loans have interest rates that average between 13% and 15%. See Jessica Skelly, Risky Business, RETAIL BANKER INT'L, March 31, 1998, available in 1998 WL 10785388. Borrowers are willing to pay 15% on a home equity loan only because credit cards carry a higher rate. See id. Auto loans are also a component of the market. See generally R. Carter Pate et al., Subprime Auto Finance: The Year of the Bankruptcies, AM. BANKR. INST. J., May 1998, available in LEXIS, Bkrtcy Library, Abij File (discussing recent problems in the subprime auto lending business). High loan-to-value (HLTV) home equity loans are not actually subprime products. See Amy I. Stickel, Buying a High-Risk Home Lender? Take Note!, MERGERS AND ACQUISITIONS REP., July 20, 1998, available in 1998 WL 10104910. In an HLTV loan, the borrower may receive a loan for up to 150% of the house's value. See id. Since there is not enough collateral to back the entire loan, only good credit risks can qualify, and thus HLTV loans are not geared toward the subprime market. See id. Therefore, these loans will not be discussed extensively in this Note, although many of the same issues that arise in the HLTV market also arise in the subprime market.

10. However, some evidence suggests that some consumers are paying much higher fees and interest than is necessary. According to Freddie Mac, 35% of those mortgage borrowers who obtained loans in the subprime market, could have qualified for a lower-rate, more conventional loan. See Hube, supra note 9, at C1.
11. See Pate et al., supra note 9.
12. See id.
Among those in this category are the recently divorced who have no independent credit history and recent graduates from high school or college. The third group of subprime borrowers is composed of individuals who have become over-indebted and thus cannot qualify for additional credit in the prime market. Overall, about 25% of Americans have the type of negative credit history that forces them to rely on subprime options.

Subprime lenders charge much higher interest and fees than conventional lenders. Charging higher interest rates and fees can lead to much higher profit margins in the subprime industry. The increased costs associated with subprime loans are the result of three factors. First, subprime lenders must charge higher interest and fees to compensate them for the increased risk that subprime borrowers will default. Second, borrowers turn to the subprime market out of necessity and thus must pay whatever the market will bear in order to obtain credit. Third, servicing subprime loans requires more labor

13. See id.
14. See id.
15. See Hube, supra note 9, at Cl. Many of these borrowers are happy just to get any additional credit at all. See id. However, there is evidence to suggest that some customers may be paying higher interest than they have to. See id.
16. See Carol Frey, Subprime Time for Borrowers Isn't Now as Credit Tightens, NEWS & OBSERVER (Raleigh), Oct. 30, 1998, at 1D (citing Jeffrey Zeltzer, executive director of the National Home Equity Mortgage Association). Customers with a credit rating below A- are deemed subprime. See id. Credit ratings are based on a variety of factors including debt-to-income ratio, stability of employment, income, assets, number of late payments, and bankruptcy. See id.
17. See Brinkley, supra note 9, at Fl. Interest rates may be as high as 30% in some states. See id. Often origination fees are 5-10% of the loan. See id. There may also be additional charges for insurance, title searches, and other expenses associated with a loan. See id.
18. See Howard Schneider, Key Trends in Subprime, MORTGAGE BANKING, April 1998, at 15, 17. Profit margins on conventional mortgages will be approximately twenty to thirty-five basis points (0.2% to 0.35%), but around 250 to 350 basis points (2.5% to 3.5%) for subprime mortgages. See id. (citing E. Gareth Plank, director of USB Securities LLC in San Francisco). Another estimate is a profit margin of 1½% to 1% for conventional loans, but almost 3% for subprime loans. See Simon Barker-Benfield, "Subprime" Lending Pays Better Profits, FLA. TIMES-UNION, Nov. 16, 1998, available in LEXIS, News Library, Flatun File (citing Mark Zandi, chief economist for Regional Financial Associates of West Chester, Pennsylvania). Higher servicing costs for subprime loans will reduce the profit differential somewhat. See infra notes 21-23 and accompanying text. However, it is clear that subprime loans are extremely profitable.
20. See id.
and is therefore a more costly process than servicing prime loans.\textsuperscript{21} Subprime lenders monitor payments closely and some even call borrowers monthly to remind them to make their payments.\textsuperscript{22} The average cost of servicing a subprime loan is about four times the cost of servicing a conventional loan.\textsuperscript{23}

The subprime credit decision process seeks to differentiate chronic delinquents from those borrowers whose credit problems were caused by job loss or illness.\textsuperscript{24} Those borrowers, whose credit problems are due to temporary circumstances, rather than a lifetime of bad finances, are the safest customers. Subprime lenders focus on factors including income level, employment history, and the reasons behind past delinquencies or high levels of credit card debt in deciding whether to make a loan to a consumer.\textsuperscript{25}

Subprime companies finance their loans differently than banks involved in conventional lending. While banks can use customer deposits to fund their loans,\textsuperscript{26} subprime lenders typically must borrow the money they need to make loans.\textsuperscript{27} Thus, subprime lenders make money on the spread between the high interest rates they charge customers and the interest that they must pay to get the capital they need to make new loans.\textsuperscript{28} Another important difference between conventional bank loans and subprime loans is that subprime companies rely almost exclusively on a practice known as securitization.\textsuperscript{29} Securitization is a process in which the lender

\begin{itemize}
  \item \textsuperscript{22} See id.
  \item \textsuperscript{23} See Dona DeZube, \textit{The Stress of Subprime Servicing}, \textit{Mortgage Banking}, Oct. 1998, at 103, 103 (discussing the costs and labor involved in servicing subprime loans).
  \item \textsuperscript{24} See Bosetti, supra note 21.
  \item \textsuperscript{25} See id.
  \item \textsuperscript{26} See Paul Muolo, \textit{Subprime Meltdown: A Time to Buy?}, \textit{U.S. Banker}, Dec. 1998, at 78, 82 [hereinafter Muolo, \textit{Subprime Meltdown}]. Because of FDIC insurance, deposits are a risk-free investment for customers. Therefore, banks pay a relatively low interest rate to “borrow” from their customers. Banks thus have access to a cheap supply of capital.
  \item \textsuperscript{27} See Skelly, supra note 9. Subprime lenders pay more interest than banks do because they must borrow to fund their loans, whereas banks use customer deposits to fund their loans. See id.
  \item \textsuperscript{28} See id.
  \item \textsuperscript{29} See generally Steven Schwarz, \textit{Structured Finance: A Guide to the Principles of Asset Securitization} (1993) (discussing the technique of securitization). Securitizations, or structured financings as they are also called, began in the early 1970's.
repackages pools of loans as securities and sells them to investors.\textsuperscript{30} The investor, rather than the original lender, thus bears the risk that the borrower will default.\textsuperscript{31} This process provides the subprime lender with a revolving source of capital with which to make new loans.\textsuperscript{32} Therefore, if the lender is successful in selling its loans, it will not have to rely on banks to extend it as much additional capital with which to make new loans.

\section{III. RECENT PROBLEMS IN THE SUBPRIME INDUSTRY}

A number of factors have contributed to the recent decline in the health of the subprime industry. Increased competition is one of the most important factors. In 1994, there were only ten companies in the subprime lending business.\textsuperscript{33} By March of 1998, that figure had grown to fifty.\textsuperscript{34} Increased competition in the subprime market caused deterioration in overall credit quality.\textsuperscript{35} The proliferation of subprime lenders forced companies to go deeper into the credit pool to find customers.\textsuperscript{36} This reduction in credit quality has increased the risk of default.\textsuperscript{37} Moreover, consumer defaults have been on the rise as the average American has taken on an increasing amount of debt.\textsuperscript{38} The industry was also hurt by the entrance of inexperienced subprime lenders who incorrectly evaluated customers' credit ratings and thereby made bad loan decisions.\textsuperscript{39} As the stock prices of subprime lenders dropped because of financial difficulties, institutions were less willing to provide the capital to subprime companies to finance further

\textsuperscript{30} See id. at 3. One of the primary goals of the securitization process is to "insulate the securitized assets from the credit and bankruptcy risk of the originator of the assets." Carla E. Craig and R. Kenneth MacCallum, Recent Bankruptcy Filings Raise New Concerns for Investors, N.Y. L.J., Nov. 18, 1998, at 5.


\textsuperscript{32} See id.

\textsuperscript{33} See Skelly, supra note 9.

\textsuperscript{34} See id.

\textsuperscript{35} See id.

\textsuperscript{36} See id.

\textsuperscript{37} See Skelly, supra note 9.

\textsuperscript{38} See id.

\textsuperscript{39} See id. This article deals primarily with problems in the subprime auto loan market, but the problems are not unique to this segment.
Increased competition also forced lenders to lower rates to stay competitive. This decreased the spread between the interest that borrowers paid to the subprime companies and the interest that the companies paid other institutions for access to capital. Also, continuously falling interest rates have enabled borrowers to pay off loans sooner than lenders had anticipated by refinancing their existing loans at a lower rate. This increase in prepayments caused the investors that buy securitized loans to demand higher rates, thereby cutting the profit margin of subprime lenders.

Subprime delinquencies are on the rise even though unemployment is low and home prices and incomes are increasing. Competition is pushing lenders to go for even higher loan-to-value ratios, ultimately resulting in inadequate levels of collateral being kept to back loans. Consumer debt and personal bankruptcies are reaching the highest levels in history, despite the strength of the American economy over the past few years. Credit card defaults are rising as well. Some industry observers question whether current lending practices will seem reasonable if the economy takes a downturn. In a recession, subprime borrowers will find it even harder to make their loan payments. An outbreak of delinquencies could result.

Subprime lenders use an accounting technique known as gain-on-sale accounting to calculate the value of that portion of the loan pool that is retained by the lender. The securitization transaction and

40. See id. at 6.
41. See Skelly, supra note 9.
42. See id.
43. See id.
44. See Ip, supra note 30, at A18.
45. See Schneider, supra note 18, at 17.
46. See id.
47. See id. In 1997, 1.4 million Americans filed for bankruptcy, double the number from ten years earlier. See Williams Warns Banks on Consumer Credit, Points to Weakening Underwriting Standards, 71 Banking Rep. (BNA) 503 (Oct. 5, 1998).
48. See Schneider, supra note 18, at 17.
49. See id. On the other hand, others point out that a recession might benefit the subprime industry by creating new subprime borrowers. See id.
retention of the residual is accounted for as a sale. An accounting rule known as FAS 125 "requires that mortgage companies that securitize mortgage pools... determine the fair market value of the asset and calculate the book gains realized after accounting for costs." Fair market value of this type of asset is difficult to pinpoint because it rests on a variety of assumptions. Accountants must make assumptions about four factors: estimated rate of prepayments, the number of default rates, loss severity, and the discount rate associated with the securitization.

If reality does not match initial assumptions, then a subprime lender's actual earnings will be lower than expected earnings, and its credit rating will slip. In previous years, when interest rates remained stable and there was not much competition in the industry, this accounting technique resulted in excellent earnings. Recently, however, subprime lenders have had to sharply restate earnings downward because of bad loans and loan prepayments. The damage done to stock prices has forced some subprime lenders to look for a buyer.

Wall Street has provided much of the funding for the subprime industry. The recent crisis in foreign markets and the wild swings in

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51. See Simpson Interview, supra note 48.
52. See Conger, supra note 48.
53. See id.
54. See id. If any one of these assumption factors is off even a small amount, the asset's value will vary greatly. See id.
55. See id.
56. See id.
57. See Skelly, supra note 9. In 1997, Mercury Finance, a subprime car lender, saw its market value drop from $2.2 billion to $130 million after the company announced that it had overstated profits. See id.
58. See Rick Brooks & Stephen E. Frank, First Union Agrees to Buy Money Store, WALL ST. J., March 5, 1998, at A3. Cityscape Financial Corp.'s stock price went from $32 to zero; Southern Pacific Funding from $18 to zero; Pacific America Money Center from $28 to $1; FirstPlus Financial, one of the giants of the HLT V industry, from $62 to $2.50, before coming back up to $5. See Muolo, Subprime Meltdown, supra note 26, at 78.
59. See Liz Pulliam, Sub-prime Lenders Feel Pinch, NEWS & OBSERVER (Raleigh),
the U.S. stock market have caused banks and other financial institutions to shy away from risky ventures. Subprime lenders that sell off their loans must rely on capital from banks and brokerages to keep operating between the time loans are originated and sold. Subprime lenders are being hit doubly hard in the current market: institutional investors who had been buying the securitized loans are looking for safer investments and banks and brokerage houses are refusing to extend any more credit to subprime lenders because of fears of financial instability in the industry. If this trend continues, then lenders will have no one to borrow from in order to make loans and no one to sell the loans to even if they can be originated. Some in the industry feel that subprime lending will shift to “larger better-financed companies that can provide their own funding.”

IV. FIRST UNION’S ATTRACTION TO THE MONEY STORE

First Union’s acquisition of The Money Store closed on June 30, 1998. The acquisition will make First Union the nation’s biggest home-equity lender as well as a major force in student loans and small business lending. The Money Store has had phenomenal profit

Oct. 13, 1998, at 6D.

60. See id. Economic problems in Asia and Russia have scared many investors away from securitized loan pools and into safer instruments such as Treasury bills. See Mary Kane Newhouse, Equity Industry’s Woes Will Further limit Borrowers’ Choices, GRAND RAPIDS PRESS, Dec. 20, 1998, available in 1998 WL 24032314.

61. See Pulliam, supra note 59, at 6D.

62. See id.

63. See id.

64. FIRST UNION, 1998 SECOND QUARTER REPORT 2 (1998) (visited Jan. 25, 1999) <http://www.sec.gov/Archives/edgar/data/36995/0000950168-98-002707.txt>. The Money Store was founded in 1967 and has 4800 employees and 172 offices dispersed throughout all 50 states. See Skelly, supra note 9. In 1997, The Money Store lent more than $7.5 billion, which was up 50% from 1996. See id. The Money Store currently has three major segments of business: home equity loans, small business and commercial loans, and student loans. See Simpson Interview, supra note 50. Prior to late 1997, The Money Store also originated subprime auto loans, but these did not perform well. See id. The Money Store still services previously originated auto loans, but does not originate new ones. See id. The Money Store is the largest Small Business Administration lender in the nation. See id. In fact its small business portfolio is larger than that of the next four or five largest lenders combined. See id.

65. See Simpson Interview, supra note 50. The Money Store is among the ten largest student lenders. See id. It focuses on marketing its loans to the financial aid offices of universities rather than to the individual student. See id.

66. See Brooks & Frank, supra note 58, at A3. The Money Store has been the
growth over the past five years, with profits in 1992 around $15 million, increasing by 1997 to $124.5 million, a 25% return on equity. First Union expects The Money Store's earnings and revenue to grow about 20% annually.

The Money Store was acquired as an operating subsidiary of First Union National Bank, will retain its name, and will operate as a separate unit within First Union's consumer group. The acquisition will allow the combined entities to reduce some operating expenses by integrating basic overlapping staff functions. First Union plans to securitize the loans that the Money Store originates. The Money Store will keep its name, management, and offices and will operate as part of the First Union division that handles consumer loans, credit cards, and electronic banking. First Union will handle securitizations for loans originated by The Money Store through its capital markets group.

Even before acquiring The Money Store, First Union was already involved in the subprime lending business, through First Union Home Equity Corp. The strategy had been to keep A and A minus loans in its own portfolio, while packaging its subprime loans...
and selling them as securities. Banks have traditionally shied away from high-risk lending and thus First Union only began making B and C loans in 1994. Because of the growth of the asset-backed securities market, First Union is now able to securitize B and C credit loans which leads to increased capital and thus increased ability to originate more loans.

However, even with the reality of securitization, First Union was doing mainly B and B minus loans rather than the riskier C loans. First Union executives felt that they could learn a great deal from The Money Store’s thirty-one years of subprime experience. First Union now feels more comfortable going lower on the credit scale. Because of its years of experience in the subprime market, The Money Store was better “able to separate risk deeper down in the credit spectrum” than First Union. The Money Store deal gave First Union greater access and involvement in this profitable segment of the lending business.

First Union’s acquisition of The Money Store was timely. The subprime industry had some serious problems in 1998. First Union paid $34 per share for The Money Store, totaling $2.1 billion. If First Union had acquired The Money Store at its 52-week high price, it would have had to pay $4 billion. By waiting until The Money Store lost a large portion of its market capitalization value, First Union was able to acquire one of the giants of the subprime industry at a

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16. at 1D. Those borrowers with a grade of less than A minus are deemed subprime. See id. A variety of factors including income, debt level, payment history, and employment history determine a consumer’s credit rating. See id.
77. See Avidon, supra note 75.
78. See id.
79. See id. (citing Chris Oddleifson, president of First Union Home Equity Corp.).
80. See id. (citing Jim Maynor, chief executive of First Union Mortgage Corp.).
81. See Timmons, 1st Union Exec, supra note 72, at 8.
82. See id.
83. See First Union Exec Lays Foundation for Money Store Acquisition, NAT’L MORTGAGE NEWS, Apr. 20, 1998, available in LEXIS, Busfin Library, Nmn File (quoting Chris Oddleifson, president of First Union Home Equity Corp.).
84. See Skelly, supra note 9.
85. See supra notes 33-63 and accompanying text.
86. See Vandeviere, supra note 70.
First Union was enticed by the opportunity to expand its markets geographically. The Money Store has a great deal of national exposure, including such areas as California and New England, regions where First Union does not have branches. The Money Store acquisition will also allow First Union to expand its customer base for services such as secured credit cards and life insurance. First Union will distribute its credit cards through The Money Store’s nationwide network. As the credit records of these subprime borrowers improve, First Union can offer them other loans and services. Previously, First Union turned down about half of its loan applicants because their credit history was not good enough. First Union can simply refer these customers to The Money Store’s loan products.

According to First Union, shareholders have no cause to worry about the acquisition because The Money Store’s portfolio is not very risky. The government guarantees most of the student and business loans. Furthermore, First Union plans to keep only 3% of The Money Store’s loans. The rest will be repackaged and sold off to investors. Also, First Union has installed software that monitors high-risk loan accounts and helps predict customer bankruptcies. This type of software should be especially useful in dealing in the high-risk credit market. First Union expects that the acquisition will

88. See id.
89. See First Union Exec Lays Foundation for Money Store Acquisition, supra note 83.
90. See id.
91. See Skelly, supra note 9.
92. See Quinn, supra note 87, at 38.
93. See Skelly, supra note 9.
94. See id. (citing Jack Antononi, First Union’s top consumer credit official).
95. See id. According to Brian Simpson, a First Union executive, it will not matter whether customers initially contact First Union or The Money Store when seeking a loan. See Simpson Interview, supra note 48. Customers will have their credit rated under uniform criteria and will be offered the best loan for which they qualify. See id.
96. See Fishing Downmarket, supra note 3, at 81.
97. See id.
98. See id.
99. See id.
add about three cents per share to 1998 earnings (previously estimated $3.78) and a minimum of six to eight cents in 1999 (previously estimated at $4.36). Even with The Money Store in its camp, First Union’s subprime appetite may not yet be satisfied. First Union is reportedly among the potential buyers for Amresco Inc., another subprime lender.

The shareholders of The Money Store should be pleased with the acquisition as well. The Money Store’s stock price had dropped more than 25% because of “investors’ concerns about credit quality, accelerating loan prepayments, negative cash flow, and stiff competition.” The Money Store needed help from a banking giant. Because of the acquisition by First Union, The Money Store will have cheaper access to capital as well as a broader product line, including credit cards and other consumer loan products. First Union has enough capital so that The Money Store will be able to weather the liquidity crisis that has decimated other subprime lenders. Loans generated by the Money Store will be securitized under First Union’s higher credit rating, thus decreasing the cost of the capital needed to finance the loans. Ultimately, The Money Store’s shareholders received a good deal, as First Union paid relatively close to the asking price of $2.25 billion.

Banks had traditionally shied away from subprime lending because of the risk. However, with the rise of securitization of subprime loans, banks can become involved in the market.

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101. See Brooks & Frank, supra note 58, at A3. Not everyone is convinced that the acquisition will add to First Union’s bottom line. There is some concern that high rates of prepayment will cause headaches for First Union. See Skelly, supra note 9. This argument seems misplaced, because even during times of soaring prepayment rates, The Money Store has remained relatively financially healthy compared to other subprime lenders. See Simpson Interview, supra note 50. This could be evidence that The Money Store has learned how to keep its customers from refinancing loans with other lenders.


103. See Skelly, supra note 9.

104. See id.

105. See Anderson, supra note 3.

106. See Skelly, supra note 9.


108. See Skelly, supra note 9.

109. See id.
Securitization allows banks to originate loans, but transfer much of the risk to investors who buy pieces of the loan pools. Other banks besides First Union have become bigger players in the subprime market recently. Barnett Banks, recently acquired by NationsBank, entered the subprime market by acquiring Equicredit Corp. in 1994. Norwest Finance owns Fidelity Acceptance Corp., a subprime lender. Key Corp. of Cleveland agreed to acquire Champion Mortgage Co., a subprime lender, for about $200 million. Other banks such as Chase Manhattan Mortgage and Countrywide Credit Industries entered the subprime arena by forming their own subprime divisions.

V. REGULATORY RESPONSE TO BANK INVOLVEMENT IN SUBPRIME LENDING

Banks that want to acquire a subprime lender must receive approval from the appropriate regulatory body. As a national bank, First Union had to apply to the Office of the Comptroller of the Currency (OCC) for permission to acquire The Money Store and operate it as a subsidiary of the national bank. In evaluating First Union’s application, the OCC examined The Money Store’s activities to determine whether they are permissible for a national bank. Notably, the OCC stated that The Money Store was “engaged in making, purchasing, selling, servicing or warehousing loans... including consumer loans, commercial loans, residential mortgage

110. See id; see also supra notes 29-32 and accompanying text (for an introductory discussion of securitization).
111. See Karen Talley, Consolidation is Changing the Face of the Industry, Am. BANKER, Oct. 24, 1995, at 25; Quinn, supra note 87, at 37; Brooks & Frank, supra note 58, at A3; Skelly, supra note 9.
112. See Talley, supra note 111, at 25.
113. See Quinn, supra note 87, at 37.
114. See Brooks & Frank, supra note 58, at A3.
115. See Skelly, supra note 9. Banks that form their own subprime division, rather than acquiring an existing lender, may not like the results. See Quinn, supra note 87, at 37. Both Fleet and Bank of America sold the subprime divisions that they started. See id. Banks lacking subprime expertise might benefit more from buying an experienced subprime lender. See id.
116. See, e.g., OCC Decision, supra note 69.
117. See id.
118. See id. at 2-3.
loans, and commercial mortgage loans.” The OCC determined that these activities were permissible for a national bank. The OCC approved the acquisition on June 29, 1998 and will be able to directly supervise The Money Store since it was acquired by a national bank.

The OCC has urged banks “to maintain sensible underwriting standards for consumer credit products, saying an economic downturn could expose lurking problems.” Even during one of the greatest economic expansions in American history, debt levels are high, higher risk loans are growing, and the number of personal bankruptcies are increasing. Home equity and subprime mortgage loans require sound underwriting and administration. A loan that seems adequately collateralized when originated may turn out to be risky if there is a downturn in real estate markets. Also, costs associated with foreclosure and marketing are so high that any part of a mortgage loan that exceeds 85% to 90% of the home’s appraised value is the equivalent of the ill advised practice of extending unsecured credit at secured prices.

The OCC will soon publish guidelines that will give banks instruction in managing subprime lending. The guidelines will encourage banks to hire management that has experience in subprime lending. The OCC will require that banks explicitly define their standards for each credit grade and adhere to those standards.

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119. Id. at 2.
120. See id. at 2 (citing 12 C.F.R. § 5.34(e)(2)(ii)(L) and 12 C.F.R. § 1.3(g) (providing that a national bank may securitize and sell assets that it holds)).
121. See id. at 10-11.
123. Williams Warns Banks on Consumer Credit, Points to Weakening Underwriting Standards, supra note 47, at 503.
124. See id.
125. See id.
126. See id.
127. See id.
130. See id.
Banks must price subprime loans based on risk rather than on the rates the competition is charging. The agency has cautioned banks to be careful in verifying the financial information of subprime customers. The OCC will also caution banks not to allow customers to skip payments.

The FDIC was the first regulatory agency to warn banks about the dangers of subprime lending. A 1997 FDIC letter warned of the risks of default in the subprime lending industry, stressing the importance of being able to differentiate accurately between relative credit risk levels. The FDIC also cautioned that management expertise and operational controls are crucial in this higher risk area. Furthermore, for loans purchased from a dealer or broker, "banks must know the lending criteria used by the originating entity, the nature of service agreements and warranty contracts, and any other relevant item concerning the transactions." The FDIC is looking into possible risky activities in the subprime market and will likely raise deposit insurance premiums for those institutions that pose a threat to insured funds.

Federal Reserve Chairman Alan Greenspan has cautioned that the "drive to stretch traditional loan underwriting criteria is intensifying, and ... must be handled carefully." Greenspan warned the industry not to engage in excessively risky lending practices that would risk their financial well being. He pointed to evidence that certain loans to low and moderate income borrowers

131. See id.
133. See Seiberg, supra note 129, at 2.
136. See id.
137. Id.
140. See id.
have shown unfavorable delinquency rates.\textsuperscript{141} He also noted that liberal lending policies might not be in the best interests of consumers if they are given credit that they ultimately cannot afford.\textsuperscript{142}

Federal organizations such as the Department of Justice (DOJ) and the Federal Trade Commission (FTC) are looking into suspected abusive lending practices of subprime lenders in the areas of disclosure, underwriting, marketing, and pricing of loans.\textsuperscript{143} The subprime market serves a relatively larger portion of minority and low-income borrowers than does the conventional market.\textsuperscript{144} Therefore, the industry may feel more pressure from regulators, who want to protect historically disadvantaged groups from dishonest lending practices.\textsuperscript{145} Banks, currently engaging in subprime lending or which are considering acquiring subprime lenders, must be vigilant in monitoring possible lending abuses.

\section*{VI. CONCLUSION}

Because of the consolidation in the financial services sector as a whole, only those companies with a low cost structure will be able to

\begin{itemize}
\item \textsuperscript{141.} See id.
\item \textsuperscript{142.} See id. Greenspan noted that access to credit can be beneficial in that it allows low and moderate income families to buy homes and other goods and deal with emergencies. However, if lower income borrowers undergo financial troubles such as job loss, illness, or unexpected repairs, they may not have the means to pay back their loans. See Alan Greenspan, Remarks at the Economic Development Conference of the Greenlining Institute, San Francisco, California (Oct. 11, 1997) (transcript), available in LEXIS, Bankng Library, Fedsp File.
\item \textsuperscript{143.} See Hube, supra note 9, at C1 (citing Lee Douglass, Justice Department spokeswoman). Examples of some possible abusive practices are: equity stripping (where a loan is made based on the value of the property rather than the customers ability to repay), packing (where lenders tack on extra fees), and flipping (when a lender encourages a borrower to keep refinancing which earns the lender additional origination fees). See Lesley Mitchell, Feds Seek Records of S.L. Lender; But Mt. Olympus Financial Refuses to Comply with FTC; Feds Want Look at Records of S.L. Lender, SALT LAKE TRIB., Nov. 4, 1998, at D5, available in LEXIS, News Library, Strib File. The FTC and DOJ are currently probing Associates First Capital Corp. alleging such abuses as lending more than the borrower will be able to repay, tacking on high fees and unnecessary insurance to mortgage totals, and making “balloon” loans that the borrower will not be able to repay. See Associates First Capital Is a Part of U.S. Probe Of Subprime Lending, WALL ST. J., Dec. 10, 1998, at B22.
\item \textsuperscript{144.} See Bosetti, supra note 21 (citing the Federal Financial Institutions Examination Council of Freddie Mac).
\item \textsuperscript{145.} See id.
\end{itemize}
compete effectively. Although banks that make the foray into subprime lending have the advantage of cheaper capital with which to make loans, non-bank subprime lenders need not be overly concerned about the competition. Banks that start up subprime divisions often find it more expensive to service subprime loans. This is one reason why banks might acquire subprime lenders and keep them as a separate division. Banks have cheaper access to capital, but the acquired lender has more experience in the subprime field and will probably be able to service these loans more cheaply.

Because of the cheaper lending capital available to acquired lenders such as The Money Store and because of the increased competition in the industry, non-bank subprime lenders may have to find a bank to acquire them in order to stay competitive. Another benefit of mergers between banks and subprime lenders is that each entity can now market products to a larger customer base. Almost every subprime lender and servicer would be amenable to a merger if the deal was fair.

Widespread consolidation and acquisition of subprime lenders is a likely outcome of the current economic climate. Many subprime lenders started up at a time when capital was cheaper and profits in the industry were high. The proliferation of entrants into the subprime market has resulted in intense competition resulting in lower rates. This rate competition has allowed consumers to shop around and thus prepay higher rate loans, thereby hurting the profits of the original lender. Because of falling interest rates and increased competition, subprime lenders cannot count on holding onto

146. See Skelly, supra note 9.
148. See id. In fact, some banks that have begun their own subprime divisions have eventually sold them off because the banks lacked sufficient expertise in the area. See supra note 115 and accompanying text.
150. See Skelly, supra note 9.
151. See Quinn, supra note 87, at 36.
152. See id.
153. See id. at 36-37.
154. See supra notes 41-44 and accompanying text.
155. See supra notes 43-44 and accompanying text.
loans for five years. A rapid rise in prepayments forced many subprime lenders to adjust their quarterly earnings reports downward.

Banks are likely to be the chief acquirers of subprime lenders because they are generally familiar with running finance companies or subprime divisions. Now that subprime lenders are looking for acquirers, banks can have a subprime division that has already developed expertise in that specific area. Banks are shopping around for a variety of reasons. Banks have had a great deal of cash recently and have been on the lookout for profitable additions to their business. The return on assets is much better for subprime lenders than for conventional lenders. Subprime lenders are currently good deals because their stock prices have suffered. Banks can more easily securitize subprime loans than conventional loans because of the greater spread between interest received from the customer and interest paid on the capital to finance the loan. Finally, banks want to reach new customer bases in order to offer these consumers traditional bank products and services. Low funding costs will allow banks to continue to realize a profit even if subprime interest rates decrease in future years.

Existing subprime companies might merge with each other rather than being acquired by larger financial institutions such as banks. There is some uncertainty as to whether banks will be able to stay in the subprime business because they may be hesitant to go too

157. See id.
158. See Quinn, supra note 87, at 37. Banks will not be the only entities vying for subprime lenders. Mortgage banks, thrifts, other finance companies, and insurance companies are also potential buyers. See id. at 38.
159. See Quinn, supra note 87, at 37.
160. See id.
161. See id
162. See id. at 37-38.
163. See id. at 38.
164. See id.
165. See id.
166. See Schneider, supra note 18, at 17.
167. See id. at 19 (citing Stephen Wright, president of WMC Mortgage Corp., in Woodland Hills, California).
low in credit quality and will not be able to tolerate the high delinquency rate.⁶⁸ Although in coming months the situation may change, The Money Store is currently the only top ten subprime lender that is owned by a commercial bank.⁶⁹ Industry analysts doubt that small subprime companies will survive the liquidity crunch,⁷⁰ and therefore they predict that “large well-capitalized institutions will dominate the subprime business in years ahead.”⁷¹

In the final analysis, banks will be searching for subprime lenders like The Money Store. The Money Store has a nationwide network of lending offices with a great deal of name recognition and thirty-one years of experience in the business. The lender has shown consistent growth over the past five years. Its stock price had fallen off of its highs, but was not so low as to scare First Union away. Large banks should consider acquiring a lender like The Money Store for two main reasons. First, subprime loans generate high profits for the lender.⁷² Second, securitization has decreased the economic risks for companies that lend to consumers with bad credit.⁷³ Marc Turtletaub, the president of The Money Store agrees that the “logical evolution of the [subprime] business [is] to be a division of a very large bank.”⁷⁴

The subprime lending business is not for the faint of heart nor is it for those without access to a great deal of capital. Growth in the subprime industry has coincided with an excellent American economy. No one knows for sure what would happen if the economy hit a

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⁶⁸ See id. at 20 (citing Scott Reading, president of AMRESCO Residential Credit in Ontario, California). Banks should be able to tolerate the higher risks because the financial rewards are greater.


⁷¹ Marc Hochstein & Heather Timmons, First Tennessee and Wells Fargo Muscle Up in Subprime Mortgages, AM. BANKER, Jan. 7, 1999, at 1 (citing Judith Berry, president of Directors Acceptance, the subprime division of Wells Fargo's Norwest Mortgage unit). Because so many smaller subprime lenders are likely to be swallowed up or go out of business, there will be less credit available to consumers with low credit ratings. See Newhouse, supra note 60.

⁷² See supra notes 17-18 and accompanying text.

⁷³ See supra notes 29-32 and accompanying text. Of course, the risk of default remains present, but the brunt of the impact of default is borne by the investors who buy pools of loans, rather than the lender that originates the loans. See id.

⁷⁴ Anderson, supra note 3.
recession, or even something less than a recession. The acquisition of subprime lenders, as well as the formation of subprime divisions within banks, is best undertaken only by the large banks who can afford the losses that might accompany this risky business in harsher times. The regulators will probably not be so quick to restrict banks' subprime activities as long as the banks that are the biggest players are also the biggest banks.

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