Banking by John Hoefle

The System Is Subprime

When high prices meet low incomes, the buyers always lose.

One of the biggest lies regarding current real estate prices is that the "housing industry" is in the business of putting people in houses. These days, the building of a house is merely the by-product of what could more properly be termed Venetian-style debt farming, a process by which vastly over-priced mortgages are created by building and selling a home. It is the mortgage, not the house, which is the primary product!

Rising prices, on both new and existing housing, has been one of the key ways in which the financial bubble has been maintained. Higher values means rising assets, which means more money for the casino. Higher values also mean greater debt, and more interest income to the Shylocks of the world; and as every good Venetian understands, the more money people owe you, the more control you have over them. It's what some people would call a "win-win" situation, at least until you need the suckers to actually pay off that debt, and they can't.

The United States used to have a system—the savings-and-loan system, or thrifts—which was created to help American families buy affordable housing. The S&Ls would take in deposits from a community, then issue long-term mortgages at reasonable interest rates, helping the communities prosper—which meant more deposits, and more mortgages, as the rising tide lifted all boats.

This system worked well, which is why it was deliberately destroyed in the 1980s, and replaced by a system in which money, not people, was paramount. The result is what we have today: housing prices in the stratosphere, and families and individuals taking on huge debts to cover the outrageous mortgages.

Today, mortgages are sold by the original lender almost immediately, bought by giant companies like Fannie Mae, and packaged into pools. The income streams from these pools of mortgages are then used as the basis for the issuance of mortgage-backed securities, which are sold all over the world. The buyers of these securities are not buying the mortgages, but only a piece of the income stream from them. Thus the mortgage-backed securities market serves as a way to "share the risk" of the U.S. housing market with our friends around the world. "Risk," in this case, is a euphemism for loss.

This is the mechanism which provides the liquidity for today's mortgage market, that provides the money to buy all those overpriced homes. But having money to lend is not enough—you also have to find buyers who can afford the payments, or, and this is where it gets interesting, find a way to structure the mortgages so that you can sell homes to people who cannot afford them.

This is precisely why the banks created the subprime market, with its array of mortgages structured to get people in the door. First you lower the lending standards so a given income suddenly qualifies for a larger mortgage. Then you create loans with lower initial payments—low interest rates that adjust upwards later, little or even no money down, and even loaning people more than the purchase price, to give them a little cash cushion. The wider the spread between rising prices and falling incomes, the greater the need for creative bookkeeping to keep the game going. The lenders understand that a certain portion of the loans will go bad, but the need to keep the bubble going outweighs the danger. After all, why go broke today, when you can put it off until tomorrow?

Many of the subprime loans now going bad are in the Midwest, once the heart of U.S. industrial might but now a rusting hulk. This is a direct consequence of the post-industrial policy decision to strip the U.S. of its industrial capacity. When you take wealth-producing activities, and the high-paying jobs that go with them, out of a region, the result is, and was, predictable.

A good percentage of the mortgages which go bad are made to people in what are considered the middle- and upper-income strata. One study showed that in Ohio, the state with the highest foreclosure rate in 2006, four times as many subprime loans had been issued to households with annual incomes above $65,000, as were issued to those with incomes below $27,000. Nearly three-fourths of the mortgages issued in Ohio in 2005 and 2006 which were subsequently delinquent, were made to middle- and upper-income households.

What does it say about the state of the economy when so-called middle- and high-income households are leading the delinquency parade? Most people already know, because they are living on the edge, with incomes which they stretch to try to cover expenses, making up the difference with debt.

U.S. government statistics show that, from 2000 through 2006, the total debt in the U.S. grew $4.88 for every $1 increase in GDP, compared to $3.17 in the 1990s and $2.93 in the 1980s. We are living, and choking on, debt.