Subprime Mortgages: A Case of Back to the Future

by

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Subprime mortgages are home loan instruments with special features. The key features of interest here are: (1) Loans may be extended to borrowers with less than stellar credit ratings; and (2) loans may have an adjustable-rate component—that is, borrowers may begin paying off loans at a low interest rate and a low monthly payment, but will later face a higher interest rate along with a higher monthly loan payment amount.

Currently, financial markets and millions of homeowners are in a tizzy because defaults on subprime loans are skyrocketing. What happened and how? What will happen now? What does the future hold?

What Happened and How?

Like every other phenomenon in creation, credit—that is, access to borrowing—has cycles. Credit is usually easy to obtain when the Federal Reserve Board (FRB) is stimulating economic growth. However, borrowing usually becomes more difficult when the FRB tightens the money supply to slow the economy to prevent or slow inflation.

Given low levels of income, borrowers will take every advantage of easy credit. Why? Because they want to purchase what everyone else seems to be purchasing. In addition, they may not see themselves as facing unbearable penalties for over-borrowing. If they default on loans and file for bankruptcy, then they simply start over again. Recent changes in bankruptcy laws were designed to make taking this approach to solving financial problems more onerous.

The current defaults on subprime loans follow this pattern of over-borrowing, except that they involve one of the three essential requirements for life: Shelter. On the upside of the current housing cycle, renters became homeowners because advertisers, lenders, even the government urged them to take this route. In addition, many existing homeowners took advantage of what appeared to be easy credit to refinance their homes, take out equity to remodel their homes, or to buy this, that, and the other. Everybody played the game of getting people into homes or getting money out of homes while the getting was good. Now the getting has turned bad. This was a prime example of "act now, think later."

The fortunate side to all of this is that certain borrowers were able to use subprime loans to take equity out of their homes, to pay off debt or to make improvements to their homes, then payoff the loan and refinance the outstanding balance of their subprime loan using a new low-rate prime loan. From the perspective of Black Americans, the unfortunate side to all of this is that certain Black Americans were sold down the river by other Black Americans who received handsome broker's fees for arranging loans. In these cases, brokers are likely to have known that borrowers would experience great difficulty meeting loan payment when they adjusted upward. These brokers facilitated the loans in spite of these circumstances so that they could "benefit" by collecting broker's fees.

What will Happen Now?

Now, many of those who overextended themselves are experiencing foreclosures. In the best case scenario, they will be able to refinance their loans with an amenable lender and spend the rest of their lives paying off the debt. In a worse case scenario, they will lose their places of abode, be sentenced to homelessness, and/or be thrown into poverty.

Although certain congresspersons have called for the Federal government to step in and help, it is difficult to ascertain broadly who was harmed because they simply did not understand the nature of the loans agreement that they accepted. Investigating each loan would be very costly, and it may be difficult to develop a taxonomy of subprime loans that will reveal all of the factors that identify the loans as having been extended through unfair lending practices.[1] At this point, it is very uncertain what the government will do. Government should not be expected to make whole those borrowers who were harmed by unfair lending practices; however, government should ensure that financial enterprises that are guilty of such practices make borrowers whole. Without government intervention, borrowers may be left out in the cold.

What does the Future Hold?

For financial vultures, an inventory of foreclosed homes presents a tantalizing feast. In other words, certain financiers may be circling and awaiting foreclosed homes to go onto the market. They will swoop down and purchase these homes at a deep discount, and then await the next housing cycle when they will sell them and earn a fine profit. On the other hand, they may invent a new type of subprime mortgage that they can use to recycle the houses through another set of unsuspecting borrowers who will experience their own default crisis.

However, it is hoped that government, social organizations, and other groups will intervene and bailout those who fell victim to subprime mortgages through no fault of their own—other than lack of knowledge. There must be some merit in saving those who cannot save themselves.

At the same time, the same forces (government, social organizations, and other groups) should petition the U.S. Congress to force regulators to monitor and police the long-term and broad implication of new financial instruments as they evolve. It is not sufficient for a regulatory agency to say after the fact that "we could have done more."

If such action is not taken, by the 2080s or before, we will find ourselves right back where we are today with circumstances that resemble so precisely conditions in the 1880s when southern Whites used laws, rules, and financial instruments to wrest valuable property from, and to re-enslave, unsuspecting Black Americans during Reconstruction.

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[1] Loan documents that reflect "excessive" broker's fees (paid by borrowers and lenders) and mortgage points may signal unfair lending practices because few rational economic agents would normally agree to excessive loan costs.