Subprime Mortgage Blues

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by Nicholas von Hoffman

Anybody who knew anything shook their heads while the politicians and the bankers and home builders boasted. The boast was that almost three-quarters of American households were homeowners.

Anybody who knew anything knew the reason was all you had to do to get a mortgage was to show the loan officer that your body was warm. Can't afford a down payment? Don't worry about it. You've got an abominable credit rating? So who's looking? You don't have a dime in the bank? We don't ask embarrassing questions. We just hand out loans.

This is what they call the subprime mortgage market, where in the last few years 6 million bad risks have gotten the financing they needed to buy a house. No banker in his right mind would make such a mortgage, but for the last few years the sane bankers have been hiding under their desks or have left for the grocery business.

As long as housing prices were jumping higher almost by the hour, the subprime mortgage holders pretty much managed their monthly payments, although there are stories out there in real estate land of people missing their first payment on a no-down-payment mortgage. People who ran into trouble could refinance the house and cover their payments that way, something that ceased to be possible when house prices went flat and began to move downward.

Other subprimers ran into trouble when the period of the introductory teaser interest rates expired and their monthly payments jumped by hundreds of dollars, which they did not have. Official figures do not exist, but it appears that somewhere between 15 and 20 percent of subprime mortgages are behind in their payments. That works out to a lot of people, a lot of families and a lot of money.

Between subprime mortgages and prime mortgages, which are those with the lowest interest rates and the best terms, there is an intermediate category of loans. These are known as Alt-A loans. Alt-A borrowers may have good credit ratings but may have bought a second house to flip as a speculation. They also are facing increases in their monthly payments and as a result a still small but rising number of these people have fallen into arrears on their payments.

The situation is complicated by the suspicion of a significant amount of fraud in the feverish real estate market of the last few years. The fraud would have taken the form of overvaluation in property appraisals, leading to owners borrowing more money than the property is worth. If it is true, it would not be the first time.

If hundreds of thousands or even millions of buyers welsh on their mortgages, what happens? The sensible next step is to modify the terms of the mortgage with the mortgage holder. To the extent that some banks hold the mortgages they make, that can be done, but most institutions
that originate mortgages sell them to others, who bundle them and convert them into bonds.

Who owns the bonds? Who knows? It could be pension funds, universities, hedge funds, a Chinese bank. They are all over the place and, to make matters more confusing, they are not all the same.

Some bonds must be repurchased by their issuers if things go south; others have some kind of rainy-day fund to cover defaults of the underlying mortgages. Some of these bonds are made up of only the best, most reliable mortgages; some are a mix.

The long and short of it is that we are in uncharted territory. The setup today is unlike the arrangements at the time of the last real estate flop twenty-five years ago. From homeowner to investor, we do not know who is going to be injured or how badly. Maybe a lot of people take a small hit and everybody wiggles out of this mess. Or maybe it gets messier and we have to face some people being tossed out of their homes.

And just think, it was only a few years ago that those smart men and women they released from the think tanks to lecture us were explaining that the days of uncertainty and worry were all in the past.

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