The coming mortgage bailout

By Sean Olender

Daily reports for a month now inform us of the "surprise" that subprime borrowers are delinquent on payments. But everyone in the business has expected it since 2004. What happened from 2004 to 2006 in the mortgage markets can be fairly described as a scam. And you are about to pay for it.

Here's how it worked.

In late 2003, Wall Street investment banks realized that with interest rates so low they could make a bundle selling shares in baskets of mortgage loans. Investors craved higher returns in a low-interest-rate environment and welcomed this investment vehicle. Then-Federal Reserve Chief Alan Greenspan encouraged this scenario by keeping the federal funds rate at a 45-year-low of 1 percent. In a Feb. 23, 2004, speech to the Mortgage Bankers Association, he noted that the common man had long suffered under his fixed-rate mortgage and needed help to something a bit more exotic. This unusual advice is a clear example of a tacit promise that if investors are reckless and things go bad, the Federal Reserve will bail them out.

As a result, mortgage banks no longer worried about a borrower's ability to repay because they didn't hold the note. Instead, you own it. You own it because Wall Street sliced and diced these loans into "tranches" of mortgage bonds containing different risk classes and then sold them to your pension fund, retirement investments — even your insurance company.

Investors priced risk based on recent experience. As home prices rose rapidly, delinquencies were unknown. A hot market rescues everyone because investors seeking deals buy lists of delinquent borrowers, and then stop by their homes to explain how they'll be rescued, for a small profit, of course.

Bankers, real estate agents, appraisers and mortgage brokers had an incentive to keep the game going. Out-of-work computer programmers, waiters, even a security guard in my old office building, became real estate agents or mortgage brokers. Some went from $10-an-hour jobs to a $200,000-a-year gig of giving away money to anyone with a pulse.

I've read the mortgage documents of illegal immigrants. One I knew worked as a restaurant-delivery driver making $42,000 a year and held a $650,000 interest-only mortgage on a home bought with zero down. Bankers call such loans "Alt A" — alternative documentation and a grade "A" borrower. This driver might have good credit because he paid his $300 car payment on time, but that doesn't mean he will pay his $4,000 mortgage payment when his rate resets. For his "alternative" documentation, he could have written on his loan application that he makes $200,000 a year.

What made home prices rise so fast? If credit liquidity defines the market because few people write a check for a house, then loose lending drives up prices. Lenders and Congress complain, "We need these loans so people can afford the high prices." But the truth is the reverse — it is loose lending that drives up prices. The purpose is to have homeowners take on big debts so that we become an income-generating investment. Rising home prices benefited banks, not ordinary Americans. When your home's price rises, other homes rose in price, too. The capital gains still make you unable to buy a house without a risky loan. Thus, you continue to live in the same house, too poor to buy a larger one without risky financing..

All but a handful of subprime and "Alt A" borrowers made no down payment. A few put down 5 percent to secure the loan. The law may protect many of these borrowers in California. If they walk away, the law bars lenders from going after their other assets.

There are two ways out of this: inflation or deflation. Either home prices drop until they return to their historical relationship to wages, or the price of everything except houses goes up as the Federal Reserve and Congress bail out "homeowners." The Federal Reserve can do it with its current chief's money-dropping helicopters, or Congress can do it by using our tax money to pay off the bad debts of investment banks while pretending to "bail out homeowners who will lose their homes!" Either way, we taxpayers lose and banks win.

U.S. Sen. Christopher Dodd, D-Conn., suggested that just less than $200 billion could rescue these poor "homeowners." But a bail out will amount to at least five times that when the Alt A market fails.

When your congressional representative says, "but we have to help him with your tax money because he's going to lose his house," remember: He doesn't own his house, the bank does. He didn't put any money down and if he walks away, he doesn't lose anything because he never had anything. He only had the obligation to make a monthly payment and the hope that in 30 or 40 or 50 years, he would "own" a home. For most of these borrowers, their house is worth less than when they bought it and they'd be better off walking away.

Would you like to teach investment bankers that they shouldn't package $650,000 zero down loans for people making $42,000 a year? Then let's tell the Federal Reserve and Congress that they cannot give them our tax money for a bailout.

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