The origins of the subprime market

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In the early 1990s, an analyst approached the head of the currency options desk of a large investment bank and offered an explanation of events by looking into how they originated. The manager answered with a question: “How can I make money off that?” Since the analyst didn’t offer a way to exploit the information, the conversation ended.

Motivated by personal monetary reward, a trader’s horizon doesn’t go beyond year-end, when bonuses are paid based on the year’s performance. In a broad sense, the extent of a trader’s theoretical concerns are limited to: (a) all relevant information—including historical economic data—is contained in the price, (b) information that won’t have consequences over the price in the *very near future* is considered irrelevant and should be excluded, and (c) once the trade is done, all responsibility of the seller ceases.

The shortsighted way of looking at the future is echoed by a similar shortsightedness in looking for answers by examining the past. There is a rationale for this method. As new financial markets are constantly evolving, the argument goes, historical information older than five years, for example, cannot explain the present situation because things have changed so much. But this, if anything, makes the job of estimating future market behavior much more difficult. This is not a minor point; it played a significant role in market participants’ inability to correctly value financial assets during the 2007 credit crisis.

Such a view of historical information influences how people think about markets. Reading the New York and world financial press, one is puzzled by how reporters take as starting point of their analysis the beginning of the subprime market boom in 2002, without looking into the origins of these financial instruments. After all, if all relevant information—including that flowing from historical economic relations—is in the price, why dig into the past to explain the present?

This is not to say that there aren’t people in the financial markets concerned with the historical origins of subprime mortgages. One of these, for example, is the financial tycoon and liberal George Soros. According to a recent report in Bloomberg News: “The cause of the current troubles dates back to 1980, when US President Ronald Reagan and UK Prime Minister Margaret Thatcher came to power, Soros said. It was during this time that borrowing ballooned and regulation of banks and financial markets became less stringent. These leaders, Soros said, believed that markets are self-correcting, meaning that if prices get out of whack, they will eventually revert to historical norms. Instead, this laissez-faire attitude created the current housing bubble, which in turn led to the seizing up of credit markets...”

Soros says nothing about the consequences the emergence of subprime mortgages had for those who took them. That is not a story in which investors are interested. One has to look beyond the mainstream of Wall Street financial reporting and bankers’ newspapers like the *New York Times*, *Wall Street Journal* and *Financial Times* to get an idea of why subprime mortgages were created in the 1980s.

In *The Changing Face of Inequality in Home Mortgage Lending*, published in 2005, authors R. Williams (University of Notre Dame), R. Nesiba (Augustana College—South Dakota) and E. Diaz McConnell (University of Illinois at Urbana-Champaign) explain the impact of deregulation on low-income areas. The body of the report provides historical data supporting the main findings described in the report’s abstract, where the authors write:

“We compare and contrast neoclassical economic theory—which suggests that banking deregulation, increased competition, better information, and improved risk assessment reduce or eliminate mortgage market discrimination—with a sociological theory of networks—which argues industry restructuring can disrupt markets and social relationships and create new opportunities for exploitation.

“We argue that, as the old inequality in home mortgage lending has slowly diminished, a new inequality has emerged that is characterized by less favorable loan term, sometimes problematic forms of housing, and a lack of adequate consumer protection from predatory and abusive practices.”

Furthermore, the report describes how, “As neighborhood bank branches close, new lenders and new kinds of lenders have entered the market. The connection of networks that formerly existed—though underdeveloped in many cases—among local borrowers and local lenders are transformed. Economic restructuring and the disruption of old networks have created additional loan opportunities for underserved markets, but the nature of these loans is often very different from those made to other borrowers.”

The report goes on to explain that, based on data collected in the 1990s, predatory practices—like targeting minorities, low-income families and the elderly, offering “toxic waste” products with negative amortization and “teaser rates,” as well as charging excessive fees—were widely used at that time.

If these forms of exploitation were common practice so many years ago, one must ask, why do lawmakers make all sorts of harsh statements, echoed by the press, calling for cleaning up the injustices of predatory lending today? Why was no action taken then, when these injustices and the bad consequences flowing from them were first known and could have been stopped?

Another report titled *Run while you still can: Subprime demand and predatory lending in rural areas*, March 2004 (www.ruralhome.org) funded by the US Department of Housing and Urban Development (HUD), adds information concerning the early history of subprime mortgages. (Note: some of the quotes that follow belong to other studies that are cited in the HUD report.)

“Up to the late 1970s, home equity loans (HELs) were virtually non-existent. In fact, in 1980, total HELs were a mere $34 billion. However, at the end of 1995 they totaled approximately $340 billion.” (By 2006 the amount had reached into the trillions!)

"At the same time that home equity lending was gaining in popularity, so were credit cards ... When the US recession of 1991 occurred, many consumers with high credit card debt were unable to pay their monthly balances due to job loss or other financial problems. The recession was particularly hard on single and recently-divorced women."

Between 1981 and 1999, "bankruptcy fillings by women rose by 838 percent—four times as fast as other categories—from 53,000 to 497,000. Once a small minority in bankruptcy court, as of 1999 single women comprised the largest bloc—39 percent—of all personal bankruptcy cases."

The report continues, "This new population of credit-impaired consumers provided ... a new opportunity: marketing home-secured subprime loans as a way to consolidate and pay off credit card debt."

One subprime industry analyst wrote in 1997: "Due to wide economic swings, massive layoffs and regional recession, as well as increases in the divorce rate and the high number of business failures over the past 10 years, the subprime market has mushroomed." Furthermore, the analyst continues, approximately 45 percent of second-lien subprime mortgages were used for debt consolidation.

The two reports cited above, and surely many more that the interested reader will find on the Internet, provide empirical evidence that most of the criticisms of subprime mortgages made by politicians and the press today, looking for at least partial answers to the current financial catastrophe, have been around since the 1980s and 1990s. Furthermore, the origins of subprime mortgages are linked to a rise in poverty, unemployment and a decrease in the quality of life for working-class families. These reports reveal how subprime mortgages were designed to exploit the most vulnerable sectors of the population.

To summarize: The subprime mortgage originated as an instrument devised by finance capital to replace bad debt with new loans to people who had lost their jobs or had suffered wage cuts and needed cash to continue feeding their families. In exchange, bankers got a security—i.e., guarantee—on the borrowers' homes. In other words, banks "traded" risky, unsecured debt for a new loan backed by the guarantee that if a borrower failed to pay the mortgage, the bank had the legal means to repossess the family home.

Of course, the motive for the "trade" was to make handsome profits from charging high interest rates. The bank will charge the cost of funding—what it pays for money borrowed— plus an additional amount, called the spread, to make up for the likelihood of not getting paid back. This likelihood is the probability of default, also called the default rate.

Since the bank expects to make a profit from lending money, the mortgage interest rate should be composed of three elements: the funding rate, plus a spread implied by the default rate, plus a profit margin based on the average profit rate in the housing industry, which is determined by the market at that time.

But the rates charged to working class and low-income families taking subprime mortgages far exceeded the amount suggested by profit levels in housing. This is due to several reasons:

First, there is the asymmetric relationship between real estate lenders and subprime borrowers. It is known that originators targeted the most vulnerable sectors of the population, like the elderly, immigrants and single mothers. One example will suffice to see how this is done.

The HUD article cited above illustrates how single or recently divorced women were targeted to take a subprime mortgage as a means of consolidating credit card debt. For these people, who often are under significant psychological pressure, experiencing difficulties in making ends meet, one can imagine that any loan that cost less than the more than 20 percent they paid in credit card interests could sound like a good deal. They generally are not aware of the default rate for someone of their economic condition, as loan originators make sure that they have no access to such information.

If buyers and sellers are equally educated in the market, then whatever price they agree to transact is considered "fair game." But, if the relationship is asymmetric, tilting heavily in the side of the seller, such seller should provide the best market price to the buyer. In a free-market economy, the buyers will not be able to defend themselves until they become aware of the problem. And even then, he/she will need access to deep pockets to hire lawyers capable of fighting large lending institutions, which have developed an expertise from the large number of lawsuits they have been involved in.

Second, as long as house prices kept going up and subprime borrowers refinanced for better rates, the actual default rates remained below historical rates. This prompted investors and collateral managers—people responsible for investing funds—to go for *yield* and not *risk-adjusted yield*.

As a result, little money, if any, was allocated to reserve accounts needed for potential defaults by mortgage borrowers in bad years; instead, those funds were added to profit. The common knowledge among market participants that historical default rates go through cycles—some years it is below the average default rate and other years it is above—was ignored.

So, what is the significance of the "extra" profits financial capital made from lending for subprime mortgages? In the long run, the extra profit must come from taking away some basic consumption good, like food, education, gasoline, medicines. In effect, by reducing the amount of money these families had to satisfy their needs—what is called the cost of reproduction of the working class—financial capital found a way to increase the exploitation of the working class, without passing through industrial production. This is a source of parasitism that has become the predominant feature of US capitalism today.

As a corollary to this analysis, the hundreds of billions lost in the subprime meltdown roughly correspond to the dollar amount that should have been reserved, instead of being declared a profit, in the years the actual default rate was below the average rate in the mortgage markets. To date, this amount is more than half a trillion dollars.

This, in the eyes of the author, presents adequate grounds to demand confiscating all bonuses paid to Wall Street firms' senior management. And this measure should be extended to all individuals around the world who profited from the subprime market.