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Ground Chuck

The united voice of millions cannot lend the smallest foundation to falsehood. – Oliver Goldsmith

In one of the latest attempts to put lipstick on a pig, the term "subprime lending" has entered the vocabulary. This deceptive euphemism is about as accurate as calling Anna Nicole Smith a subchaste woman.

The issue, of course, is just how *sub* is subprime lending. Subprime lenders have operated in the dark corners of the lending market for many years. In the past, these lenders extended credit to those who didn't qualify for traditional credit sources, either because of lack of income, poor credit history, or the type of asset that served as collateral. Most of this lending was limited to mobile home buyers with low incomes and bad credit scores.

With the significant drop in interest rates precipitated by the last economic downturn in 2000 new sources and uses for subprime lending began to emerge. With interest rates at forty year lows, the normal profit spread between deposits and loans didn't exist, sending financial institutions scrambling for new sources of revenue. Not only did a significant number of new companies appear, but even venerable banks like Citigroup, and stodgy companies like GM, through its finance subsidiary Residential Capital, joined the fray. Along the way these and others changed the way the game was played. As they saw the easy money that could be made charging higher than market rates of interest, they looked to expand the market for these types of loans and entered the residential housing market. Soon loans were being made for traditional single family homes in a not so traditional way. Loans were creatively packaged as "no income documentation" (no outside verification of income), "high loan to value" (up from the traditional 80% loan to value to upwards of 125%), "interest only" (no principal paydown for an extended period), and my personal favorite, the "reverse amortization loan" (payments insufficient to cover the interest payment, so the loan gets bigger not smaller over time). In 2006, over 20% of new home loans issued were in the subprime category.

All of this easy credit helped fuel the recent housing boom, and has hastened its bust. Apparently not a lot of thought was given to the new class of borrower created by this type of lending. Someone able to step into home ownership with little or no money down has very little "skin" in the game. As overheated markets cooled off and home values sagged, many of these debtors found that they owed more (in some cases much more) than their homes were worth. Many of these folks who had been able to get into homes with bad credit in tow were only too happy to walk away from yet another obligation, leaving lenders with properties worth far less than the money lent.

As with all excess, this too will work itself out. However, along the way the effects will be felt far a field of just these lending institutions. Much like the technology collapse in 2000, the ripple effect of the housing slide will be far reaching. We remain watchful for its impact.