'Subprime' mention makes people edgy

by: FRED RUSSELL Business Viewpoint
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It was a few minutes after dinner, one night last week, when the phone rang. The person on the other end did not identify herself.

The way she pronounced my name -- Frederick Rousell, with all the accents played out -- made it appear that perhaps she thought I was a French movie star when in fact I am an ordinary money manager practicing my pedestrian trade in Tulsa.

"I want to be sure that you are getting the best rate possible," she said.

The called identified herself as being from Bank of America, and said she wanted to offer me a special credit card deal.

There was a long pause. She did not know that she was wasting her time. I have two credit cards that I pay off every month. I don't like debt.

Nevertheless, I pretended, just for fun, to be interested in her offer, as I wondered out loud whether I would qualify for a good rate, and not be put into the "subprime" category. At the mention of subprime, her mood darkened. I decided not to tease her anymore, and I hung up.

Her reaction to the term subprime was of interest to me. As the news of the past few weeks indicates, some banks have made their lives miserable by buying securities constructed from pools of mortgages, some of which were less secure than everyone in the mortgage chain realized.

It once made sense to thoroughly review a loan prospect -- credit score, credit history, employment status, etc. But the last 15 years produced an ebullient real estate market, fueled by cheap money and frequently irresponsible lending.

We need oil and gas to power our economy. We also have an acute dependence on credit. Consumers almost always borrow money to buy their biggest single asset -- a house. Since 2000, thanks to low interest rates, home and commercial real estate has boomed, with prices in most areas of the country rising much faster than the pace of wage increases.

No big troubles ensued until the mortgages began to take a bite out of consumers' monthly pay checks.

Consumers taking out mortgages are like diners eating onion rings and creme brulee: They are enjoying a momentary escape from reality but delaying the consequences of no discipline.

When the rates were adjusted upwards in the last 18 months, many consumers could not make their payments. They defaulted. Delinquencies rose.

Then bankers faced their classic conundrum: Do they want to be in the banking business or in the real estate business?

There is nothing less attractive to a beleaguered banker than a home whose occupants are not making payments on the mortgage. So it was with reluctance that the bankers foreclosed

Lenders then demanded higher credit scores, raised rates on home mortgages (and on commercial loans) and demanded more thorough documentation.

Common stock investors picked up the newly cautious stance of the banking industry, and these investors saw a contracting economy -- an economy reacting to years of aggressive lending for businesses, and especially homes.

Common stock investors did not like what they saw. They sold. Markets declined.

What was the Federal Reserve to do? It has a tough position. It is supposed to fight inflation and raise interest rates to cool down the economy when things get too hot. But the Fed does not like to see sinking stock prices.

The answer: The Fed made it easier for banks to borrow from the Federal Reserve.

The central bank also used its massive buying power to buy government securities, injecting cash or liquidity into the markets.

Everyone likes cash, especially in an overheated economy. Markets rebounded -- at least for a while -- setting the stage for another round of aggressive borrowing.

Meanwhile, I have returned to my practice of turning my phone off at night, so I am not tempted by any overworked employees at bank call centers.

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