

Saturday, April 14, 2007

Chuck Schumer, Please Use Your Brain!

Recently Mr. Schumer has proposed a "bail out" for subprime borrowers who are in trouble.

Let me expound on why I think this is an *incredibly bad idea*.

Wall Street, along with the rest of the financial industry, is *all about risk allocation*. That is why you pay more than the Fed Funds rate for a loan of any kind. The less secure that loan is, the more you pay. A credit card carries a higher interest rate than a mortgage because there is a higher risk you will not pay the credit card balance back, while a mortgage (in theory) has a lower risk of default.

What has happened over the last few years is that Wall Street has *intentionally mispriced risk to keep the deals flowing*. That is, it might have been "reasonable" to think that most people would not default when their house was appreciating by 20% a year; they could simply refinance (and increase their total debt, but decrease their debt to equity ratio) so long as the house kept going up in value.

Now this is an unsustainable proposition in the long run (look up "[Ponzi Scheme](#)" for why) but in the short run it appears to make sense (kind of like Social Security does, no?)

But now the appreciation, which was beyond sustainable rates, has come to an end. In fact, home prices are likely to *fall* for the next few years, as this "phantom" appreciation has run out of steam.

So now, the risk of default is in fact very real on loans that just a year or two ago looked reasonably safe.

Well, the people who made those loans *knew at the time that the music had to stop at some point*. They may have not known *when*, but they most certainly knew *it would happen, because it always does*.

So now you intend to come in and do what - use *taxpayer money* - to bail out an unsustainable asset bubble?

And how is this going to solve the problem, Mr. Schumer?

Of course it won't. Indeed, there's not enough money available to do that, and under your very own propounded "PayGo" rules (which the Democratic Party claims to hold near and dear) you can't afford it either.

I have a better suggestion - let those who made unsustainable loans *eat them*. That's right - the lenders who made them, the big money center banks (who we know contribute mightily to your campaign coffers) who packaged them up and sold them, and, for those who chased outside returns without regard to risk, the CDO buyers!

Now what do we do about the home buyers? I have a few suggestions there; let's go ahead and check them out.

- Get the FHA program in order, and price it properly for risk. This means that FHA loans need to get more expensive. Potentially, a lot more expensive (in terms of interest rates). That's ok. Higher risk should come with a higher price.
- Allow the foreclosures to happen. Really. I mean it. If you want to add assistance to the public role, put it into Section 8 subsidies.
- Get the money from a tax on lenders. Put a 2% gross receipts tax on all fundings *that are*

non-conforming. You want to make "liars loans", that's fine - but you'll pay a tax on them to do so, since they're demonstrably unsafe.

- Bar Ginnie, Freddie and Fannie from buying any loans that are made with a "back end" ratio exceeding 36% or where the home price to income ratio exceeds 3:1. Require that all three mandate PMI for any loan where the CLTV is >80% - at issue or at any other time during the life of the mortgage (e.g. no more games with "silent seconds" and HELOCs.) Forbid these organizations from purchasing any loans with a CLTV >90% at all.
- Bar any recovery or receipt of federal funds in this program by anyone who (1) materially misstated any aspect of their application or (2) took an application from such a person, was able to verify the statements made *and did not do so*. *Force anyone who requests assistance to document that their originating paperwork was true, correct and complete.*
- Provide that any CDO, RMBS or other mortgage-backed security, in whole or part, which contains any material misstatement in more than 1% of its originating documents is transformed into a bond with a "PUT" feature - that is, it can be "PUT" back on its issuer. Most bonds don't have "PUT" features as they allow creditors to escape from under bad underwriting.

Once the market settles out and asset prices return to historical norms *then* these people should be able to requalify for a home to own at a *reasonable* market price. This will take several years as house prices unwind - but by then, you can have FHA running in a fashion to process those applications and make those loans.

In the meantime the people who were swindled will have a place to live.

Attempting to keep the bubble inflated not only won't work, it will make the hit to our economy *far greater* when it unwinds.

It is far better for us to take this hit now, and allow the lenders who unjustly profited from exploiting these people to fail, as should be the case.

It is unacceptable under any reasonable interpretation of the law to in any way allow those responsible for making these loans under unsound underwriting provisions to escape the just deserts that the market has, and will continue, to heap upon them.

Posted by Karl Denninger at 18:43

What's good for Wall Street is good for Chuck Schumer's campaign donations...His thinking doesn't go beyond that! Anonymous on Aug 12 2007, 14:43