

why subprime problems matter to everyone

by Mike Keliher

WHAT IS SUBPRIME?

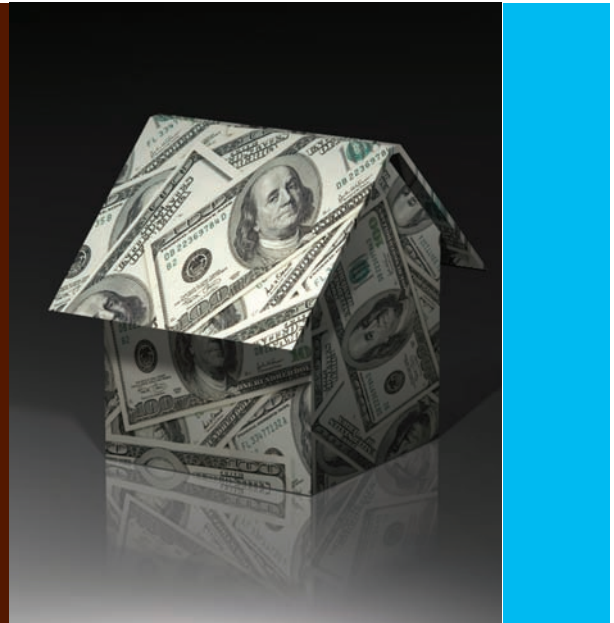
What is subprime? Subprime refers to a group of borrowers identified by low credit scores. Low credit scores are primarily attributed to debt and income levels and prior history of credit use. Recently, subprime buyers were enticed by new products and relaxed scrutiny into buying homes in record numbers. In April 2005, Alan Greenspan lauded the “rapid growth in subprime mortgage lending [as] fostering constructive innovation that [was] both responsive to market demand and beneficial to consumers.”

It was only in the last several months that it became clear that tens of thousands of borrowers had been induced into loans they

prices went up. The current problems not only decrease the number of potential buyers, they also increase the supply of homes. When the subprime borrowers default, the lender can end up with a house instead of a mortgage payment. This house will then be put up for sale and the greater the foreclosures, the greater the inventory for sale.

The financial system problems are a result of the proliferation of exotic financial instruments called derivatives. Historically mortgages were held at the originating lender, a government-regulated bank or savings and loan. However, financial firms in an

Financial news has been dominated recently by problems in the “subprime” industry. Several major lenders specializing in the subprime area have gone under. Rather than sound the alarm, the popular press regards subprime problems as at most an inconvenience. Investors are encouraged to “buy the dips” and federal officials have quickly held up the “all clear” sign. So, for those on sound financial footing should the subprime issue be a concern? Is the related drop in the markets merely a “buying” opportunity?



could not afford. Defaults in the subprime area have accelerated alarmingly.

Why do subprime problems matter?

Subprime problems matter for a number of reasons, among them: pressure on the financial system, downward pressure on real estate prices, and lower stock prices.

Perhaps the easiest to explain is the real estate issue. Subprime borrowers were a significant source of upward movement in home prices. These borrowers provided a solid buyer base for others selling first homes to move to a large home. As loans became easier to obtain, there were more buyers than homes for sale and naturally

effort to generate substantial fees devised ways for lenders to package loans and sell them to investors. This worked well as long as the borrowers paid. Now that many borrowers have ceased paying, these derivative instruments have grown in risk and loans to non-subprime borrowers are being impacted. Should the deterioration spread into other loans, great economic pain is likely to follow.

Subprime may still remain someone else’s problem. However, it may also land on your doorstep. Further, if you think it provides a “buying” opportunity, keep in mind *caveat emptor*. +

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