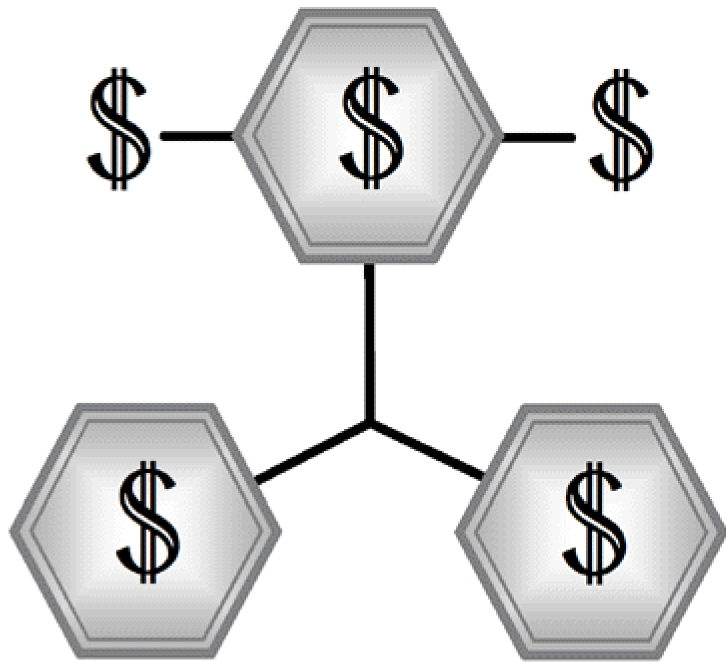


How to Cook Financial Meth

Act 1 - Where it All Begins

- People borrow money from a lender to buy a home – this is called a **mortgage loan**.
- Every month, a borrower sends in a mortgage **payment**: part of it goes to pay off the **principal**, while the rest is kept by the bank as **interest** on the loan.
- As a borrower pays off the loan, they gain **equity**: this is a vested stake in the property and means that they can keep the **difference** between what a house sells for and how much they owe on the loan.
- Sometimes, people borrow more money against their equity – this is called a **second mortgage**.

Where it All Begins

- Mortgage loans are built on **trust**: banks have to trust people to pay back their loans, and people trust banks not to loan money to people who won't pay it back.
- When someone fails to make payments on a loan, they are in **default**. The bank takes the home and sells it to get their money back.
- When a bank sells a home in default, it is called a **foreclosure**, and the borrower loses everything they invested in the house.
- Banks invest the money people keep in their savings accounts, and we expect them to do it in a socially **responsible** manner.

How to Cook Financial Meth

Where it All Begins

Then

and

Now:

Act 2 – Where Bubbles Come From

- People like to be **optimistic** – and if enough people think something will become worth more, it often does.
- Houses, and real estate in general, **appreciate** over time: they usually gain value at a modest rate (3-5%).
- In some locations, houses gained a lot of **value** due to an increase in **demand**. When this happened, people started to buy and sell homes to make a quick **profit**.
- As more and more people tried to make money from buying, selling and financing homes, it created an **investment bubble**.
- Banks **inflated** the bubble by making money available to people who shouldn't have taken out loans.

Where Bubbles Come From

- **Deregulation** of the banking industry allowed lenders to take greater risks by making sub-prime loans and charging higher interest rates.
- Banks packaged the new, risky loans into **bonds** and then sold shares in them to investors.
- The banks then insured the bonds by creating a new product called a **derivative**, which paid off when too many people failed to pay their mortgage.
- This new schema **rewards bad investment practices**, and wound up hurting a lot of people who tried to play by the old rules.

Mathematical Intermission

Budget for an average mortgage:

```
Here are the numbers ...
-·-·-·-·-·-·-·-·-·-·

          Loan: $140,000

Monthly Payment:   $1,250

     Principal:     $125

      Interest:   $1,125
```

Mathematical Intermission

After Six Years:

And a Quick Multiplication Exercise

Out-of-Pocket	Principal	Interest
$1,250 x 72	$125 x 72	$1,125 x 72

Mathematical Intermission

- **Appreciation:** the **value** a house gains over time.
- **Inflation:** money is **worth less** today than it was yesterday
- **Improvement:** the seller fixed or added something
- **Demand:** more people want it and they'll pay extra for it

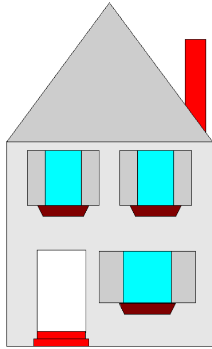
Multiply 140,000 x .03 to estimate appreciation

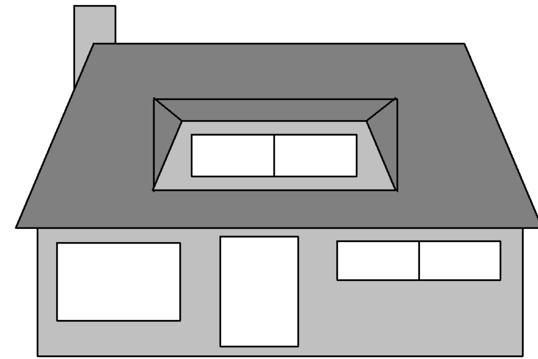
- Add it to 140,000 to get a **fair market value**.

Act 3 – Why We Can't Go to Disneyland

- When part of the economy goes down, it can take other parts with it. When big companies lose money on their investments, people can lose their jobs.
- When people lose their jobs, they may have to move to another city to find work – and try to sell their home.
- In the boom years, people borrowed money to buy homes they couldn't really afford. When the bubble burst, the banks had to sell them for whatever they could get.
- If you're trying to buy a home, the "bust" years are good: there are lots of good deals on expensive homes.
- The **break-even** price is what the banks care about.

Why We Can't Go to Disneyland





	House 1		House 2
Loan:	$140,000	Loan:	$300,000
Sale Price:	$144,200	Sale Price:	$309,000
Interest:	$81,000	Interest:	$162,000
Break Even:	$59,000	Break Even:	$138,000

Offer: $120,000

Offer: $150,000

Why We Can't Go to Disneyland

- A bank will look at a $150,000 offer for a $300,000 house in foreclosure as a pretty **good deal**. They can get the loan "off their books" and still make about $12,000.
- Whoever buys the house for $150,000 comes out ahead: the house will gain value when the **market recovers** and the price of homes goes back up.
- The person who took out the loan, however, gets nothing except for a failure on their **credit report**. This means it will be very hard for them to borrow money again.
- When someone **loses all of their equity** in a house, it means they won't be able to afford the extra things, like a trip to the magic kingdom.

Why We Can't Go to Disneyland

- **What is Financial Meth?**

  Money can act like a **dangerous drug**, when people decide they are willing to hurt others in order to get it.

- **What can we do about it?**

  Contact our elected representatives in Congress and ask them to **do their jobs**. Remind them it is up to them to protect our interests, and our future, so that people can own their homes and keep what they've earned.

- **Why should we care?**

  If nobody is willing to play by any rules, we'll have to keep reading **Lord of the Flies** until we retire.