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Where have you gone, George Bailey?

By Stephen A. Marglin | January 14, 2008

ANOTHER HOLIDAY season has come and gone with more reruns of Frank Capra's "It's a Wonderful Life." We could sure use banker George Bailey now that the mortgage mess threatens to do what the rapacious Mr. Potter, the town's richest citizen, could not: end the "nonsense" of providing mortgages for the working poor. For some time to come, people in the real world of 21st-century America without a good deal of money in the bank and super-secure jobs will find it difficult to qualify for mortgage loans.

George Bailey isn't coming to the rescue. If you are a borrower, you may send your monthly payment to Bailey's bank, but Bailey is long since out of the picture. Shortly after originating your loan, Bailey sold it to a consolidator, very likely a government-sponsored agency such as Fannie Mae or Freddie Mac that packages individual mortgages into a mortgage-backed security. With many mortgages packaged together, or "securitized," the law of averages is supposed to obtain, and investors without intimate knowledge of the particulars of each loan become willing to finance home ownership. The pool of money available for home mortgages grows, and the theory is that mortgage interest rates fall.

But even leaving aside various sorts of fraud and chicanery that have subverted mortgage securitization, especially in the subprime sector, the basic idea was flawed. Risks of default that were supposed to be random turned out to be anything but. What makes one borrower default turns out to affect other borrowers pretty much the same: higher interest rates when it's time to reset the rates on adjustable mortgages, especially for those who could just get by with a low teaser rate; an end to the upward spiral of housing prices that compensated for a multitude of sins; the absence of job and wage growth.

Though the subprime fraction is small, the ripple effect threatens a large swath of the US housing market. One hoped-for result of the meltdown is a tightening of lending standards, but beware what you wish for. Tighter standards will punish both those who would repay and those who would default. A lot of legitimate potential homebuyers will be turned away. This problem is in the very nature of securitization.

To calculate the risks for securitized loans, John Jones and Sally Smith must be reduced to a set of statistical characteristics: age, income, debt, credit history. But statistics have their limit. Sixty years ago, Bailey's bank held your loan until you paid it off. To keep the bank solvent and profitable, Bailey had to be able to distinguish the trustworthy borrower from the likely deadbeat, and to do so he had to know his customer, not just his customer's statistics.

Today's securitization leaves no room for knowing your customer and other intangibles. All that matters is that by hook or by crook - too often by crook - an application passes the statistical hurdles necessary to qualify a loan for inclusion in a package.

Securitization didn't come out of the blue. It is the latest stage in the unbridled expansion of markets. And central to an impersonal market system is the same process that makes George Bailey irrelevant: algorithmic knowledge, the knowledge of formulas, eclipses experiential knowledge, the knowledge of life that Bailey brought to bear on the lending process.

Markets, for all the good they've done, have also done considerable collateral damage.

An expanding market system takes over more of our lives, shaping and forming us into people whose relationships are circumscribed and reduced by the market. Community has been one casualty: markets have crowded out the economic reciprocity that made the community necessary for its members. Reciprocity once brought neighbors together in a barn-raising for the unfortunate farmer whose barn went up in smoke.

If my barn burns down, I call my insurance company.

Focusing on barns, or farmers as individuals, a case can be made for the greater efficiency of a system based on the division of labor and specialization that has produced insurance companies, contractors, and so forth. But if we focus on the community of people who build and use barns, an equally strong case can be made against undermining that community - warts and all - by the spread of the market.

Some 2,000 years ago Rabbi Hillel recognized the tension between the individual and the community.

"If I am not for myself," he asked, "who will be?" But he went on to ask, "And if I am only for myself, what am I?" This tension is desirable, healthy, and creative. We need more of it, not the headlong rush to the individualistic pole entailed in the market. We could also use less of an economics that is an accessory before and after the fact, an economics in which an ideology that glorifies algorithm, the knowledge system of homo economicus, is central. The mortgage crisis is the tip of an iceberg.

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