

4.1.4: A House Is Not a Piggy Bank- A Few Lessons from the Subprime Crisis

Learning Objectives

1. Discuss the trend in the U.S. savings rate.
2. Define a *subprime loan* and explain the difference between a *fixed-rate mortgage* and an *adjustable-rate mortgage*.
3. Discuss what can go wrong with a subprime loan at an adjustable rate. Discuss what can go wrong with hundreds of thousands of subprime loans at adjustable rates.
4. Define *risk* and explain some of the risks entailed by personal financial transactions.

Joe isn't old enough to qualify, but if his grandfather had deposited \$1,000 in an account paying 7 percent interest in 1945, it would now be worth \$64,000. That's because money invested at 7 percent compounded will double every ten years. Now, \$64,000 may or may not seem like a significant return over fifty years, but after all, the money did all the heavy lifting, and given the miracle of compound interest, it's surprising that Americans don't take greater advantage of the opportunity to multiply their wealth by saving more of it, even in modest, interest-bearing accounts. Ironically, with \$790 billion in credit card debt, it's obvious that a lot of American families are experiencing the effects of compound interest—but in reverse (Frank, 2005).

As a matter of fact, though Joe College appears to be on the right track when it comes to saving, many people aren't. A lot of Americans, it seems, do indeed set savings goals, but in one recent survey, nearly 70 percent of the respondents reported that they fell short of their monthly goals because their money was needed elsewhere. About one-third of Americans say that they're putting away something but not enough, and another third aren't saving anything at all. Almost one-fifth of all Americans have net worth of zero—or less (Taylor, 2007; Frank, 2005).

As we indicated in the opening section of this chapter, this shortage of savings goes hand in hand with a surplus in spending. "My parents," says one otherwise gainfully employed American knowledge worker, "are appalled at the way I justify my spending. I think, 'Why work and make money unless you're going to enjoy it?' That's a fine theory," she adds, "until you're sixty, homeless, and with no money in the bank" (Gardner, 2008). And indeed, if she doesn't intend to alter her personal-finances philosophy, she has good reason to worry about her "older adult" years. Sixty percent of Americans over the age of sixty-five have less than \$100,000 in savings, and only 30 percent of this group have more than \$25,000; 45 percent have less than \$15,000. As for income, 75 percent of people over age sixty-five generate less than \$35,000 annually, and 30 percent are in the "poverty to near-poverty" range of \$10,000 to \$20,000 (as compared to 12 percent of the under-sixty-five population) (Rubin, et. al., 2000).

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