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Subprime Market Roller Coaster Disaster

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THE SUBPRIME MARKET ROLLER COASTER

The subprime lending market can be likened to a roller coaster descending with ominous velocity after an exhilarating ride. The ascent of the subprime roller coaster ride was phenomenal, the rips and waves were exhilarating, and the top was breathless. However, its descent, which has no visible end, has changed both the faces of its riders from joy and exhilaration to weary and worry and has scarred the face of our economy. The riders include the usual cast of characters – commercial and investment bankers, non-bank lenders and investors – found at the center of most financial market losses threatening the stability of the economy and creating the real risk of systemic loss. But this time, as the coaster descends, a group of unsuspecting riders – scores of debtors obligated on variable rate mortgages – also bear worrisome and weary facial expressions. And from afar, the faces of taxpayers who opted not to ride witness its descent with perplexed and disconcerted faces victimized by the cost of ride – the current recession.

For years, state and federal government agencies responsible for regulating lending and securities practices watched the reckless, sometimes fraudulent behavior of mortgage brokers, mortgage lenders, securities firms, and investment banks in the subprime market. They did nothing of substance to halt such practices almost as if they were complicit with the practices of lending and securities firms that fueled the market. They watched as subprime losses began changing the face of our economy. Now financial markets are illiquid and key economic sectors – housing, job, and credit markets – essential to the country's economic health are depressed.

Until recently, the Treasury Department (Treasury), the Federal Reserve (Fed), the Office of Comptroller and Currency (OCC), the Securities and Exchange Commission (SEC), along with state banking failed to utilize its regulatory authority in any significant manner to stymie the burgeoning losses. Most likely, their apparent complicity stemmed from President Bush's mandate that every American citizen should be able to enjoy homeownership. A mistaken view that suggests home ownership is a right, not a privilege. Obviously, federal government regulators did not foresee that the costs of their complicity would overshadow the esoteric and economic benefits citizens received from their ephemeral enjoyment of home ownership. While subprime debtors obtained the American dream, they did so at enormous cost to the economy, only to have to surrender that dream because of the economic consequences of the lending practices that enabled them to purchase homes in the first place.

During the subprime market heyday, mortgage brokers forcefully solicited and lenders aggressively extended mortgages loans using lax lending standards to earn lucrative loan fees. They made loans to applicants' whose credit lenders traditionally used as a basis to deny them credit; and uncharacteristically, lenders even crossed the "redline" (historically, lenders drew an imaginary redline around poor inner city areas over which they would not cross to lend money.) Hence, the loans were called "subprime." The demand for subprime mortgages was enormous. Current estimates indicate that over 10 million subprime mortgages have made by lenders.

Lenders made substandard loans because they knew they could shift the risk of loss associated with such loans by securitizing their subprime mortgage receivables. Lenders pooled their mortgage receivables into trusts, and Wall Street investment banks securitized the mortgage pool by slicing them into specialized debt securities referred to as "collateralized mortgage obligations" (CMOs), whose yield was contingent on debtors paying the mortgage debt underlying the CMO. Investment banks received millions of dollars in fees from lenders, and lenders were poised to collect from investment banks certain future cash flow payments from the pool of mortgage receivables securitized.

More than a million CMOs were purchased by investors – primarily institutional investors. Strong investor demand for CMOs fueled the subprime mortgage market. The purchasers of CMOs primarily were institutional investors including pension and hedge funds, as well as foreign central banks pension. The lack of transparency in the CMO market prevented investors from knowing the true value of the debt securities they were purchasing; however, Triple-A ratings that most CMOs enjoyed prompted investors to purchase them. .

At that time, their reliance appeared reasonable given the conservative reputation of the bond rating agencies. Traditionally, the rating agencies' culture had been one of aloofness toward their clients requesting that the agencies evaluate and rate their debt securities. The conservative environment insured the integrity of their ratings and gave them a well-deserved reputation. During the subprime market boom however, rating agencies became more accommodating to their clients in an effort to increase their market share. Rather than being aloof, top management socialized with their clients as they rated most of their clients' debtor securities Triple-A. The impropriety of their relationships explains the inaccurate ratings and has prompted regulators to investigate the manner in which rating agencies evaluated CMOs.

The weak link in the subprime market was overvalued housing. Once debtors were denied refinance requests, the house of cards started falling down and the foundation came crumbling after it. Faced with debtor defaults, most CMO investors sought recourse against the real estate property collateralizing their CMOs. While others recouped their losses from originating banks against which they had recourse for defaulted mortgage obligations. In some cases, investors were forestalled from foreclosing on real estate because the securitization paperwork was so deficient that neither lenders nor investors could determine which homes actually securitized an investor's CMO debt securities. As debtor defaults revealed the true value of CMOs investor demand for CMOs decreased substantially. Without investor demand, lenders had no secondary market to which they could shift their risk of loss prompting them to restrict subprime lending. Now, its apparent that the strength of the housing market was just an illusion and that the value of the CMOs, which fueled the market, was based on that illusion.

Historically, the securitization of receivables has provided lenders more flexibility in lending by allowing them to make loans to persons with less than prime credit profiles knowing that they could shift their risk of loss to securitization markets. Well before the emergence of the securitization of consumer mortgage receivables, lenders were securitizing credit card, automobile and student loan receivables. Consumers and businesses have benefited from such "securitization" because it provided them with more credit; thus facilitating their ability to spend and to invest money, both of which enhance the economy's liquidity. Increased lending activity also benefited lenders because it provided them opportunities to earn additional loan and credit card fees.

However, problematic to the CMO market with large receivable amounts, is its lack of transparency rendering it difficult to assess the true value of the debt securities traded in those markets. For the most part, the quality of subprime loans went undetected for so long because the rating agencies inaccurately rated many CMOs as Triple-A debt securities. Investors had access to documents from which they could have evaluated the collectability of the mortgage receivables; however, such evaluations would most likely have involved an inefficient allocation of their resources. In lieu of reviewing numerous documents, investors relied heavily on the Triple-A ratings that bond rating agencies gave CMO debt securities. Apparently, many of the investors incorrectly assumed that the rating agencies, which are subject to regulatory authority, would provide accurate ratings.

Also problematic to the CMO market is the lack of lender accountability for the substandard loans they made. Lack of accountability encouraged lenders to make substandard loans since they could use CMOs as risk-shifting devices. To address the accountability problem market regulators could promulgate an implied warranty of collectability rule in which lenders warrant the collectability of their loans. A breach of that warranty could render lenders monetarily liable in treble damages based on the defaulted mortgage obligation amount. In addition, sanctions could be imposed on lenders whose lending practices were grossly negligent, reckless, or fraudulent. Most likely, confronted with possible monetary damages and sanctions, lenders would tighten their lending standards.

The most fundamental problem with securitizing mortgage receivables is that it encourages debtors and lenders to speculate on residential real estate, an essential infrastructure of our country. Quite naturally, the genesis and continued viability of the CMO securities market is based on investor speculation concerning the value of the real estate underlying CMOs and the creditability of debtors obligated on the securitized mortgage receivables. In contrast, the traditional nature of debtor-creditor relationship has not been one of speculation. Traditionally, creditors and debtors have had a vested interest in the homes securing mortgage obligations. Securitization severs that traditional relationship by relieving lenders of concerns about whether a home's value justifies the extension of credit requested by an applicant. Consequently, subprime lenders routinely extended 100% or more substandard financing to debtors based on overinflated home values. Accordingly, subprime debtors had no financial stakes in homes they were purchasing because they received 100% or more financing. Without any vested financial interest, these debtors had no problem with obtaining loans they could not afford speculating that their homes would appreciate in value to allow them to refinance their mortgage obligations at affordable interest rates. The origin and life blood of the CMO market was based speculation. Without it, the market cannot survive. We are witnessing its slow death because no one wants to speculate on home values anymore; and the numerous abandoned and foreclosed home throughout the streets of America are the product of that speculation.

Driven mainly by greed, lenders, mortgage brokers, and debtors thought they could outwit the obligatory pricing components of home ownership, getting something without incurring any significant economic costs. In reality, all they were doing was externalizing such costs to the cities and states throughout this nation that currently are struggling to maintain their identity as their landscapes are deteriorating. The costs have also been externalized onto our nation's economy. Many believe these costs should be internalized and the market forces should be allowed to squeeze out inefficient parties, even at the price of a recession.

That decision will be left to the federal government. So far it has decided to rescue market players, and appears poised to rescue subprime debtors. Some view the bailouts as creating a moral hazard – providing a safety network that will merely encourage market players, lenders, and debtors to continue engaging in reckless behavior knowing they will not have to incur the costs of their behavior. Apparently, the federal government has calculated the cost associated with moral hazards and has determined that the benefits the economy will accrue from such bailouts far exceed those costs.

Arguably, the bailout requirement that obligates those bailed out to repay government funding addresses the moral hazard concern. The current bailouts for investment banks and securities firms require them to repay the funding they receive from the Fed. Plans for debtor bailouts are predicated on debtors repaying mortgage obligations, but only in amount equal to the value of their homes. However, the counterargument is the uncertainty of repayment by parties who have exhibited such fiscal irresponsibility. If investment banks or securities firms remain illiquid despite large cash infusions taxpayers will bear loss.

Typically, defaults among subprime debtors are high because they often overextend themselves financially and they usually have poor credit histories. What recourse will the government pursue against such debtors to satisfy the defaulted mortgage obligations, which was purchased with taxpayer money? Ultimately, the government has two alternatives: (1) repossess the homes; or (2) allow debtors to maintain their homes for free. The first option is incredible. The Congress and the Administration would be hard-pressed to repossess homes on wide scale basis from its very own citizens. The section option demoralizes fiscally responsible taxpayers who pay their obligations.

During the heyday of the housing market, few would even discuss the possibility that the housing market would eventually go flat; or that scores of debtors' would default as interest rates rose. But both did happen because the government turned a blind eye to subprime lending practices for too long. As usual, taxpayers will bear the loss as they become the victims of a recession that the government could have been averted.