Home Ownership and The Subprime Mortgage Debacle: Lessons for the Future

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Abstract

With any type of careful analysis, the subprime mortgage (SPM) debacle should never have happened. There were so many mistakes made that it made the "Keystone Cops" look an orderly group. This paper analyzes what went wrong and how future financial programs might profit from the SPM errors.

Introduction

For many decades, prospective home buyers shopped and subsequently decided to buy or build personal residences contingent on suitable financing arrangements. Those arrangements were set up so that the probabilities for repayment were very high and, in fact, a very low percentage of defaults occurred. As a rule, individuals financed their purchases utilizing fixed rate mortgages with a loan amortization schedule of 15 to 30 years. However, there were other financing options that could be utilized by home buyers. FHA, VA, and conventional mortgages were readily available to those who could qualify for the loans. Then, with payments for 15 to 30 years, home buyers progressed from having very little equity in their homes to total and complete ownership of their homes.

If home buyers' economic position improved and they desired to "move up" to a nicer home, it was relatively easy to sell their homes to others who were coming up. After qualifying for financing for their new home, home ownership was transferred to the new buyer and the former owner moved into a nicer home. This type of financing was not "rocket science" but provided a very effective and efficient means of home ownership for a large percentage of the U. S. population. Additionally, home ownership contributed to the prosperity, stability, and well-being of the nation. Many responsible citizens believed that there was "no place like home" and worked very hard to achieve home ownership.

Congress supports home ownership in many direct and indirect ways. Income tax provisions generally allow deductions for home mortgage interest on a first and second home and property taxes which provide small subsidies for home ownership through reduced income taxes.

Also, in most instances in the past, profits from the sale of a principal residence could be deferred until a person passed away and then receive a "step-up" in basis at the decedent's passing with no income tax due at all on the subsequent sale by the heirs in many cases. In those sales where a gain had to be recognized on the sale of a principal residence, the gain was generally taxed at capital gains rates which provided another tax benefit.

Now, I.R.C. Sec. 121(b) provides that if a principal residence is sold at a profit, up to $500,000 in gain can be excluded from taxable income. The general rule is that if the taxpayer/s lived in the home for two years or more during the five years ending on the date of the sale or exchange, then a married couple can exclude up to $500,000 in gain while a single individual can exclude only $250,000. If there is gain over and above those figures, then the gain is a capital gain with its associated benefits.

The Veterans Administration set up favorable financing for military veterans. First-time home buyers received some very attractive financing terms. In summary, the Federal government and some states promoted home ownership in a variety of ways.

Previously, what was required to qualify for home purchase financing? Most lenders carefully checked some "C's"—Credit, Cash-Flow, Collateral, Capacity, and Character. Credit reports were obtained, prior years' tax returns were reviewed, employment and compensation were confirmed, personal balance sheets with supporting documentation were required, the property was appraised, and any other documentation necessary for the loan approval was acquired.

What was the essential and fundamental question that had to be answered positively before credit was granted? "Is there a high probability that the prospective borrower will be able to repay the loan in accordance with the amortization schedule?" If that very basic question could not be answered affirmatively, then the requested loan was generally denied. Those procedures were designed to help people rather than harm them.

With such a successful system in place for many decades, what caused the philosophy to change and create a global financial crisis which destroyed the dream of home ownership for some, caused Bear Stearns to collapse and be absorbed by J. P. Morgan Chase, claimed the end of professional careers for top CEO's, and spread financial chaos around the globe? This paper will analyze some of the causes and effects of the subprime mortgage debacle and provide recommendations for future avoidance of similar problems.

A Brief History of Subprime Mortgages

What is a subprime mortgage? The prefix "sub" means under. A submarine cruises under the sea. A subpar performance is below par or standards. The subprime loan is one made to borrowers who are generally suffering with less than pristine credit. Personal bankruptcy, poor credit history, or other repayment difficulties may force a borrower to utilize a sub-prime lender. According to Federal Reserve Board Governor E. M. Gramlich: "Everything else being the same, borrowers with Fair Isaac & Co. (FICO) scores below 620 are viewed as higher risk and generally ineligible for prime loans unless they make significant downpayments."[1]

Why would a lender agree to a subprime mortgage knowing that there is a higher probability of default than would be present in a prime or conventional mortgage? Utilizing the law of large numbers, the answer to that question is that higher total interest rates and other fees were *supposed* to offset the larger total default rates and provide profitable operations. Ultimately, the subprime mortgage "chickens came

home to roost" and the lending practices proved to work inappropriately when compared to the "game plan."

Three new laws really provided impetus to the subprime mortgage movement. *The Community Reinvestment Act of 1977*, with more liberal regulations subsequently, provided additional inducements to lend to potential subprime borrowers. *The Depository Institution Deregulation and Monetary Control Act of 1980* allowed lenders to charge higher interest rates to those with elevated credit risk. Finally, the *Alternative Mortgage Transaction Parity Act of 1982* authorized variable-rate loans and balloon payments.[2]

As a result of those changes, subprime mortgage originations really skyrocketed in the 1990's. In 1994, subprime mortgages constituted only 4.5% of total originations and amounted to a mere $35 billion. In 1999, it had grown to 12.5% of total originations and increased to $160 billion (more than 4.5 times the 1994 amount). The incredible jump occurred in 2003 when the amount ballooned to $332 billion (a 1/3rd of a trillion dollars and almost a tenfold amplification over 1994).[3]

In that ten year period, it seems that virtually everyone was jumping on the subprime bandwagon. Boards of directors of financial institutions seemed to be saying: "Everyone else is doing it why can't we join them?" When I was a young boy, I used to tell my mother that everyone is doing it (whatever the activity might have been). Her response was: "Well, if everyone else jumped off the roof, would you?" She made her point very well and my argument was over. Someone should have asked those boards the same question that my mother asked me. The "subprime train wreck" is a financial catastrophe that never should have happened.

Today, the carnage of those subprime loans is still present and few are willing to speculate about how much more damage is to occur. The "subprime train wreck" is still going on with more "financial boxcars" crashing off of the track regularly.

It is ironic to note the way that FRB Governor Gramlich ended his speech in 2004. He said:

> There are challenges for everybody. Rising to these challenges will ensure that continued subprime mortgage lending growth will generate even more social benefits than it *seems* to have already generated.[4] (Emphasis mine)

Little did he realize that there would be many more "social problems" resulting from subprime mortgages than "social benefits."

<u>Perceived Social Benefits</u>

Some would argue that the rationale for subprime mortgage lending is to provide home ownership to an underserved market. The philosophy goes that some minorities and other poor people should be in a position to own homes just like the more affluent. With just little relaxation of lending standards, virtually all who desire to own a home can do so. There will be higher interest rates and lending fees but the underserved market can lift itself up by its bootstraps and become happy homeowners.

For a while, it *seemed* like it was working according to the predetermined strategy. However, even if the interest rate is 25% APR, the effective rate becomes 0% APR if the borrower has no money and provides no cash flow. Everybody loses.

The grim reality of the subprime mortgage debacle is that many borrowers have lost their home, their self-esteem, and their credit rating. What seemed like a very laudable social endeavor has turned out to be a nightmare of grave proportions. It has achieved the exact opposite of its intended objectives

Who Is to Blame for the Subprime Mortgage Debacle?

There are a number of culprits in this case. Many are culpable and some do not even realize it. Borrowers signed contracts without understanding them fully. Mortgage lenders made loans with borrowers who were warm and breathing with a pulse but had virtually no possibility of repayment. Investment bankers bundled mortgages into securities and passed the buck. Ultimate investors made investments in the bundled securities based on AAA ratings by the ratings agencies. Government agencies promoted subprime securities. The subprime mortgage market is reminiscent of the card game of "Old Maid." Ultimately, in that game, someone ended up with the old maid and lost the game. In like manner, someone (or some institution) ended up with the subprime mortgage investment and lost in the process.

How Did the Subprime Lending Scheme Last So Long?

The subprime mortgage system continued for quite a few years before it had a total collapse. How did that happen? The predominant reason for the *apparent success* of the subprime mortgage market was primarily tied to increasing real estate values. Some apparently felt that rising real estate values would remain into eternity. Guess what! Real estate values move like *all* investments on this earth. Those investments are guaranteed to do one of three possibilities: go up, go down, or remain the same.

There are "corrections" in markets where "irrational exuberance" overcomes rational decisions. The all-time high water mark was reached in the real estate market in the summer of 2005. A year later, in August, 2006, the market unraveled and began its collapse.[5]

A typical scenario functioned in the following way. A subprime borrower bought a home with a variable-rate mortgage (VRM) and virtually no money down. The borrower could just barely make the payments but was able to do so perhaps with some fees for late payments. At a later date, the VRM rate was reset to a higher payment but the borrower's income level remained essentially the same. No problem. Why? The value of the home had also gone up and the borrower's equity increased concurrently allowing him to borrow more money and continue making payments.

What caused this beautiful apple cart to stop rolling smoothly? When real estate prices began going down, home equity was reduced and the subprime borrower could not make payments. This resulted in default and foreclosure. Whoever owned the mortgage lost money and this became a snowball which joined other snowballs and drifted into an avalanche known as the "Subprime Mortgage Debacle." There were numerous variations on the above scenario but the basic elements were essentially the same.

Subprime Borrowers

By definition, subprime borrowers are below prime borrowers. Some borrowers signed contracts with "interest only" provisions. Perhaps they could afford to pay the interest. However, could they ever afford the principal repayment and have ownership? Were there balloon payment provisions which they did not understand? What is meant by a "prepayment penalty"? What does an adjustable rate mortgage *actually*

mean for the future? Misunderstanding on any of these basic provisions may have provided disaster for any unsuspecting borrower.

To be knowledgeable about a contract, one must *read* it and *understand* it. Because a mortgage contract deals with the future, a potential borrower should project all possible future outcomes and determine whether any of those outcomes could have an adverse impact on the individual. Of course, some outcomes have a very remote probability of occurring and may be discounted to some degree. Others, such adjustable rate resets or balloon payments, have a very high probability of occurring and should be evaluated very carefully.

Is it possible that some subprime borrowers do not have the capacity to understand the technical points of mortgages because they are products of a failed public education system? Or, do they have the capability of comprehending some nuances of the English language? Ah, but that is another story.

The bottom line is that some subprime borrowers are their own worst enemies. As Pogo used to say: "We have met the enemy and it is us." A knowledgeable and educated borrower can avoid some of the pitfalls of a subprime mortgage. Another viable alternative would to seek someone who is knowledgeable to assist in the loan negotiations.

Mortgage Originators

Many mortgage originators had one primary purpose in their business: get their fee and move on to the next potential borrower. Were they responsible for seeing that the loan was repaid? There was a giant disconnect between mortgage originators and ultimate collection of the debt. Federal Reserve Chairman Ben Bernanke stated: "Depending on the terms of the sale, when an originator sells a loan and its servicing rights, the risks (including, of course, any risks associated with poor underwriting) are largely passed on to the investors rather than being borne primarily by the company that originated the loan."[6]

If the originators' fees were placed in an escrow account and paid in installments as the loan was repaid, and stopped if it were not paid, some mortgages might not have been made. Also, if some material penalties were levied on the originators for loan nonpayment, then careful review of the potential borrower might have reduced the default rate for subprime mortgages. Other options which make it disadvantageous for loan originators to make shoddy loan decisions should be considered.

Another problem associated with subprime mortgage originators was to loosen underwriting standards. According to Ben Bernanke, Chairman of the Federal Reserve Board: "So-called risk-layering—combining weak borrower credit histories with other risk factors, such as incomplete income documentation or very high cumulative loan-to-value ratios—became more common." [7] Obviously, those deficiencies should be eliminated.

Bernanke also stated: "In addition, incentive structures that tied originator revenue to the number of loans closed made increasing loan volume, rather than ensuring quality, the objective of some lenders."[8] Regulatory agencies were "asleep at the switch" when these excesses were occurring.

In summary, some subprime mortgage originators played the same role that a fox would play when guarding a hen house. It was not a pretty picture and could be improved significantly.

Ratings Agencies

Ratings agencies deserve some denunciation for their role in the subprime mortgage crisis. It is hard to imagine a more speculative instrument than a subprime mortgage. Yet, these instruments received AAA ratings in some cases and should have been rated no higher than someplace in the B category. Many investors were lead like a sheep to the slaughter because they believed that AAA meant, in effect, that the investment was relatively safe.

In a recent example involving credit unions, one of the most risk-averse financial sectors in our economy, the following facts were revealed. There were five so-called "corporate credit unions" which do not deal with ultimate consumers but provide investment services and financing to "regular credit unions" which do deal routinely with ultimate credit union consumers. The five together reported "unrealized losses" of almost $5.7 billion. How could that have happened? Bruce Fox, chief investment officer of Southwest Corporate FCU, stated that as of May, 1994, 94% of its mortgage securities were rated AAA. However, as of May, 2008, Southwest had to show unrealized losses of $672 million from that securities group out of $12.2 billion in assets. Fox indicated that they plan to hold those instruments "until they recover or until maturity."[9]

In good faith, many sophisticated investors made investments in subprime mortgages based on high ratings only to discover subsequently that their decisions were less than desirable. Rating agencies have criteria to evaluate various investment opportunities. In light of the subprime mortgage crisis, is it possible that rating agencies need to review and update their evaluation criteria?

Lenders Holding Subprime Mortgages Now

Lenders who hold subprime mortgages now are often distraught over their losses. Will they be able to avoid recognizing unrealized losses on their subprime mortgages? An affirmative answer to that question is highly unlikely. However, there are some steps which may reduce expected losses to some degree. In his May 17, 2007 speech, Bernanke had the following positive suggestions:

> The Board and other federal supervisory agencies have taken actions to encourage the banks and thrift institutions we supervise to work with borrowers who may be having trouble meeting their mortgage obligations. Often, loan workouts are in the interest of both parties. With effective loan restructuring, borrowers facing temporary economic setbacks may be able to work through their problems while staying in their homes, and lenders may be able to avoid the costs of foreclosure and the losses usually associated with selling a repossessed home.[10]

When one receives a "lemon," the best option may be to make lemonade. Lemonade in this case may be a "workout" of the loan. The joint press release of the financial regulators stated that the "workout" may include "modifying loan terms, and/or moving borrowers from variable-rate loans to fixed-rate loans."[11] A well structured "workout" may provide benefits to both parties of the loan.

Government Agencies

It is readily apparent from Gramlich's comments (cited earlier in endnote 4) the Federal Reserve Board encouraged home ownership and the subprime mortgage system. Generally, it was only after the cattle were out and the damage was done that the Federal Reserve Board moved to shut the gate.

Chairman Bernanke summarized general procedures that financial regulators have at their disposal:

> Broadly speaking, financial regulators have four types of tools to protect consumers and to promote safe and sound underwriting practices. First, they can require disclosures by lenders that help consumers make informed choices. Second, they can prohibit clearly abusive practices through appropriate rules. Third, they can offer principles-based guidance combined with supervisory oversight. Finally, regulators can take less formal steps, such as working with industry participants to establish and encourage best practices or supporting counseling and financial education for potential borrowers.[12]

Unfortunately, Bernanke may have been too broad in his comments with very little new information added and few substantive steps toward application.

Policies That May Prevent Future Financial Calamities

As a nation with an economy that is generally the envy of almost all people on the planet, we have allowed some "dumb" things to occur. Recently, we have had frauds involving Enron, WorldCom, Adelphia, HealthSouth, *et. al.*, ad nauseam. We have seen the junk bond scandal, the stock options fiasco, Long Term Capital Management go south, and other minor glitches in the most wonderful economic system that the world has ever experienced. Now, we have the subprime mortgage debacle. What can CPA's and other business and financial advisors do to avoid the next economic crisis?

The answer to that question is probably "very little." However, there are some lessons to be learned from the subprime mortgage debacle which may be helpful in future financial decisions:

1. If we are going to replace some successful financial procedure with something that is, untried and unproven with questionable rationale, we would do very well to evaluate any proposed investment with healthy skepticism. Actually, the subprime market (SPM) worked reasonably well for quite a while.

   However, from 1994 through 2003 when subprime offerings increased by a factor of 10 during that 10 year period, the SPM became the "in thing" to do. Furthermore, when loan originators advertised that almost no documentation was needed for loan approval and what documentation was received was reviewed superficially at best, the seeds for unraveling were sown. Movers and shakers continued to push the envelope until almost all rational thinking was abandoned in the SPM. Elementary questions such as: "Can the principal and interest be repaid in accordance with the amortization schedule?" were not answered in a responsible and thoughtful manner. Basic questions should be answered appropriately before financial agreements are consummated.

2. The assumption that any market will go straight up indefinitely is very naïve. When the real estate market cratered and fell in 2006, it threw the SPM into a state of disarray. There were no equity increases to take care of the additional financial burden. The SPM crisis demonstrated that "corrections" are present in all markets and should be expected by sophisticated investors.

3. "Interest only" loans and other gimmicks in the SPM were DOA [dead on arrival] and should not have been allowed. Where were the regulators?

4. A four-letter word which is spelled with five letters, greed, will overtake rational thinking in short order if recognized checks and balances are essentially eliminated. Where loans are involved, there should be appropriate documentation showing that the criteria for the proposed loan has

been met. That same concept is generally true for most financial arrangements such as appropriate investments for an investor's risk tolerance criteria.

5. Adjustable rate mortgages can be viewed as sticks of dynamite with lighted fuses. Beware. They can blow up in your face! There should some type of cap to prevent the debt from being overwhelming for the debtor. Any kind of debt which has some type of future adjustment (rate increase, balloon payment, or other change) should be considered cautiously and carefully.

6. An educated borrower is more likely to repay a loan than an ignorant one. Borrowers should understand all provisions in a loan agreement before signing the contract. In too many cases, SPM borrowers did not understand fully what they were agreeing to do. Common sense has become an uncommon attribute in many today and there should be understood explanations for those deficiencies when appropriate.

7. Ratings, such as AAA, are not the end all, be all. You may need to do your own "due diligence" where there are large sums of money involved. It may also be desirable when relatively small sums of money are involved.

8. When gigantic firms such as Citigroup and Merrill Lynch as well as a whole host of other very large financial institutions are burned severely by the SPM, it is very regrettable. It is even more distressful that they, in turn, advise investors on how to make investments when they themselves have "lost their shirts" in the SPM. One must question the quality of advice that they provide. A small David may provide better advice than a giant Goliath. Investment advice and performance should be monitored constantly by the seasoned investor.

9. Mortgage originators originated many problems suffered in the SPM. In general, market forces and industry self-regulation provide adequate safeguards for financial consumers. However, in the SPM episode, those factors failed miserably. In that case, government regulation of some sort may be desirable. At any rate, the mortgage originators should be adequately licensed with a very strict code of ethics which is enforced.

10. Current state and federal regulators should be proactive and take action before a problem becomes completely unmanageable. The SPM crisis confirmed even the most laudable social goals can go awry if they are not handled appropriately with adequate supervision and oversight.

Summary and Conclusions

The SPM crisis damaged many people in its wake. It is simply inconceivable that our sophisticated system would allow procedures to deteriorate to such a low point that billions of dollars could be lost by financial institutions that claimed to be sagacious and thousands of borrowers lost virtually all that they had in the process. It was the worst of all financial worlds and could easily have been avoided completely if clearer thinking had come into the picture. If we can profit from the mistakes that were made in the SPM debacle, we may move forward with an even stronger economy and financial system.

Endnotes

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12. Bernanke, *op.cit.*