Viewpoint

The Subprime melt

Today there is a frequent refrain that the subprime collapse came as a surprise. We contend that, on the contrary, many saw it coming.[1] Starting in the 1990s, there were white papers by consumer organizations and articles in newspapers about abuses in the subprime market. Consumer advocates repeatedly testified before House and Senate committees, citing evidence that, for example, home foreclosures had tripled between 1982 and 1997, high-cost subprime loans accounted for 22 percent of all foreclosures in 1998, and many subprime loans were simply unaffordable.

Illustration: Barrie Maguire

by Kathleen C. Engel
and Patricia A. McCoy

down: *Who Knew What When?*

These issues, flagged by consumer groups and reporters during the 1990s, were a harbinger of things to come. Risky adjustable-rate mortgages (ARMs) and interest-only ARMs made up less than 5 percent of nonprime mortgages in 2001; by 2006, that percentage was more than 50 percent. Loan-to-value ratios climbed for subprime and so-called Alt-A loans (considered less risky than subprime but more risky than prime); low- and no-documentation loans proliferated. To compound matters, borrowers who could not afford old-fashioned, fixed-rate loans ended up with loans offering teaser rates that would eventually become unaffordable.[2]

Warning Signs

As the subprime market grew, so did consumer protection lawsuits charging lenders with predatory lending. In 2002, Citigroup Inc. settled a Federal Trade Commission predatory-lending claim for $215 million. In 2004, the Federal Reserve Board issued a $70 million civil money penalty against Citigroup and its nonbank subprime arm, CitiFinancial Credit Company, for abusive loans. Household Finance, owned by HSBC, paid $484 million to settle state consumer protection claims. In 2006 Ameriquest paid $325 million to resolve lending claims brought by state attorneys general.

Federal agencies were already tracking lending abuses before the mortgage market collapsed. Between 1998 and 2001, banking regulators grappled with the failure of several insured depository institutions, including BestBank, Pacific Thrift and Loan Company, First National Bank of Keystone, and Superior Bank FSB, which were brought down, in part, by bad subprime loans. In 1998, the Department of Housing and Urban Development (HUD)—together with the Federal Reserve Board—produced a report pointing out deficiencies in subprime mortgage disclosures.[3] In 2000, Treasury and HUD issued a joint report on subprime abuses.[4]

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The states also were aware of troubling practices in the subprime market. Starting in 1999, states enacted a succession of anti-predatory lending laws in response to the proliferation of problem loans. By 2005, more than half the states had adopted such statutes.

The private mortgage industry also knew of the issues. Behind the scenes, investment banks and other securitization actors had proof that many subprime lenders were up to no good. Investment banks had years of data showing that highly leveraged borrowing went hand-in-hand with higher defaults. Despite that, they financed and bought loans even when borrowers had no equity in their homes. The big banks knew that private-label mortgage-backed securities and related derivatives were spawning increased risk. As a former risk manager at Morgan Stanley told a *New York Times* reporter, “You absolutely could see it coming.”[5] Nevertheless, Wall Street generally failed to impose greater controls on the loans it securitized.

Then there were Fannie Mae and Freddie Mac. According to the *Wall Street Journal*, Fannie Mae's chief risk officer wrote a memo in 2005 warning that the loans backing Fannie's subprime bonds would lose value if housing prices dropped. He expressed concern that the rating agencies had not adequately assessed the risk in subprime and Alt-A loans.[6] Similarly, according to an article in the *New York Times*, Freddie Mac's chief risk officer advised his higher-ups in 2004 that subprime loans "would likely pose an enormous financial and reputational risk to the company and the country." But as the head of Freddie Mac told the *Times* reporter, the company "couldn't afford to say no to anyone."[7] The same sentiment reigned at Citigroup, where Charles Prince, then CEO, opined that as long as "the music is playing, you've got to get up and dance."[8]

Rating agencies were aware of the looming crisis, too. In 2003, a director at Fitch Ratings told *Investment Dealers' Digest*, "One of the things we will be watching closely for is a loosening in underwriting guidelines. ... If we start to see changes for the worse, moving down the credit scale, that would raise red flags."[9] By 2005, the rating agencies were fielding complaints that ratings on mortgage-backed securities were too high and did not accurately reflect default risk.[10]

The Lessons of History

Perhaps the strongest evidence that players knew of the risks associated with subprime lending comes from history. The subprime crisis that began in 2007 was not the first. During the 1990s, companies like Green Tree Financial were financing the purchase of manufactured homes—trailers and double-wide homes. Like many types of subprime mortgages, these loans frequently had terms that borrowers could not afford. To keep volume high, Green Tree began making loans to people who did not meet the company's underwriting guidelines. Every month, the underwriting deteriorated further as Green Tree salespeople tried to meet quotas. Green Tree, later part of Conseco, sold the loans for securitization on Wall Street. By 2002, Green Tree's improvident loans had brought Conseco down and forced it into bankruptcy.

At the same time, several good-sized subprime mortgage lenders also were promoting high-risk loans. In 1998 and 1999, some of these firms failed. Investors in securities backed by the failed institutions' loans accused the investment banks of lax underwriting and charged the rating agencies with incompetence.[11] Similarly, in the late 1990s, risky subprime car loans prompted a spate of bankruptcies among auto finance companies.

Too many actors, from mortgage brokers to investment banks and beyond, believed they could make money on subprime and pass the risk along the food chain.

This should sound familiar. What is hard to understand is why it was mainly consumers, their advocates, outside researchers, and a handful of politicians and state officials who yelled "fire" when the flames were at the door. One would think that if lenders were making loans to borrowers who could not afford to pay them unless home values rose forever, the market would have shut them down.

Why didn't that happen? The answer is that so many actors, from mortgage brokers to investment banks and beyond, believed they could make money on subprime and pass the risk along the food chain.

Market participants believed they could extract themselves by selling any risky holdings if the market started to tank. With scant concern about borrowers, society, or even the survival of the industry, subprime lending and subprime securitization descended into a Hobbesian nightmare. Mortgage brokers originated high-risk subprime loans because they collected their fees at closing and did not bear any credit risk. Lenders made reckless loans because they earned up-front fees and could pass the loans to investors by way of investment banks and other entities that converted loans into securities. Investment banks glossed over the risks because they made money from securitizing the loans—and curtailing abusive lending would have been bad for quarterly earnings reports.

Investors, at least, should have cared about loans that might not be repaid, even if the people in the middle didn't. After all, next to borrowers, investors had the most to lose from bad subprime lending. In reality, investors also threw caution to the wind. They believed that they were insulated from credit risk. Credit rating agencies had awarded high ratings, and investors had received their high-yield interest payments on time for years, so they did not question the performance of the underlying loans. They also hedged their risk by buying protection on the underlying securities.

All told, the saga of subprime mortgage lending was a game of hot potato, and few of the players can legitimately deny that they knew the potato was hot.

Kathleen C. Engel *is a professor of law at Suffolk University in Boston, and* **Patricia A. McCoy** *is the Connecticut Mutual Professor of Law and director of the Insurance Law Center at the University of Connecticut School of Law in Hartford.*

Endnotes

1 This article is adapted from Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus* (New York: Oxford University Press, forthcoming).

2 Patricia A. McCoy, Andrey D. Pavlov, and Susan M. Wachter, "Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure," *Connecticut Law Review* 41 (2009): 493-541.

3 *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act* (Washington, DC: Department of Housing and Urban Development and Board of Governors of the Federal Reserve System, July 1998).

4 *Curbing Predatory Home Mortgage Lending* (Washington, DC: Departments of the Treasury and Housing and Urban Development, June 20, 2000).

5 Joe Nocera, "Risk Mismanagement," *New York Times*, January 4, 2009.

6 James R. Hagerty, "Fannie, Freddie Executives Knew of Risks," *Wall Street Journal*, December 10, 2008.

7 Charles Duhigg, "At Freddie Mac, Chief Discarded Warning Signs," *New York Times*, August 5, 2008.

8 Nocera, "Risk Mismanagement."

9 Bill Shepard, "Perils and Phantasms," *Investment Dealers' Digest*, February 3, 2003.

10 Roger Lowenstein, "Triple-A Failure," *New York Times*, April 27, 2008.

11 Antony Currie, "The Nine Lives of CDOs," *Wall Street Journal*, November 26, 2007.