The Subprime Mortgage Crisis and Economic Impact for the Future

By Deborah Sturges

I would like to begin today with a story that I tell to help put you in the mindset of my topic and to attempt to explain the market meltdown and present an understandable explanation on just how derivates work.

Heidi is the proprietor of a bar in Detroit. In order to increase sales, she decides to allow her loyal customers - most of whom are unemployed alcoholics - to drink now but pay later. She keeps track of the drinks consumed on a ledger (thereby granting the customers loans). Word gets around about Heidi's drink now pay later marketing strategy and as a result, increasing numbers of customers flood into Heidi's bar and soon she has the largest sale volume for any bar in Detroit. By providing her customers' freedom from immediate payment demands, Heidi gets no resistance when she substantially increases her prices for wine and beer, the most consumed beverages. Her sales volume increases massively.

A young and dynamic vice-president at the local bank recognizes these customer debts as valuable future assets and increases Heidi's borrowing limit. He sees no reason for undue concern since he has the debts of the alcoholics as collateral. At the bank's corporate headquarters, expert traders transform these customer loans into DRINKBONDS, ALKIBONDS and WINOBONDS. These securities are

then traded on security markets worldwide. Naive investors don't really understand that the securities being sold to them as AAA secured bonds are really the debts of unemployed alcoholics. Nevertheless, their prices continuously climb, and the securities become the top-selling items for some of the nation's leading

brokerage houses who collect enormous fees on their sales, pay extravagant bonuses to their sales force, and who in turn purchase exotic sports cars and multimillion dollar condominiums.

One day, although the bond prices are still climbing, a risk manager at the bank (subsequently fired due his negativity), decides that the time has come to demand payment on the debts incurred by the drinkers at Heidi's bar. Heidi demands payment from her alcoholic patrons, but being unemployed they cannot pay back their drinking debts. Therefore, Heidi cannot fulfill her loan obligations and claims bankruptcy. DRINKBONDS and ALKIBONDS drop in price by 90%. WINOBONDS performs better, stabilizing in price after dropping by 80%. The decreased bond asset value destroys the banks liquidity and prevents it from issuing new loans.

The Suppliers of Heidi’s bar, having granted her generous payment extensions

and having invested in the securities are faced with writing off her debt and losing over 80% on her bonds. Her wine supplier claims bankruptcy, her beer supplier is taken over by a competitor, who immediately closes the local plant and lays off 50 workers. The bank and brokerage houses are saved by the Government following dramatic round-the-clock negations by leaders from both political parties. The funds required for this bailout are obtained by a tax levied on employed middle-class non-drinkers.

Finally an explanation I can understand…

A word about my manners today… I will have none. I apologize in advance for offending everyone of any political ideology and for an occasional four letter word.

Four years ago I had the task of talking about the deficit and I pointed out how dangerous it was.

I hate being right.

But I was.

I said then that the deficit was not caused by 9/11 or the war on terror but primarily because of Social Security and Medicare part D. Under his watch George W. Bush ran our deficit up to 1.3 trillion dollars a year. Pretty un-republican wouldn't you say? Don't worry the Democrats will also get their shot.

However, this makes me think of the next step in this economic tragedy. We all know what happens when the government puts more and more money into circulation?

Yes, we get inflation. And with my luck that will be my next paper.

Now fortunately I am here to talk about the current subprime mortgage crisis and its economic impact. The deficit and the current crisis are related. Because of the irresponsibility of the previous administration we are in a very precarious situation, making it almost impossible to safely solve our current crisis.

I would like to start by going back to the "good old days" when that great economic forecaster Barney Frank in 2003 announces, "These two entities -- Fannie Mae and Freddie Mac -- are not facing any kind of financial crisis."

I'm so glad he was right. And I'm sure banks and investment companies alike were glad to hear that too

Oh — that's right he wasn't right.

But there were people who knew that the banks were getting themselves in trouble. We will get to that later

But yet we still can't solely blame the distinguished congressman from Massachusetts.

From the other side of the aisle there was that economic innovator Phil Gramm from Texas who was instrumental in creating a little financial instrument called the "Credit Default Swap." Imagine, in 1999 you made a loan to someone but you were scared it would default. You find someone who tells you they have assets to cover the loan and for a small monthly fee would offer you insurance—just in case. Well Phil Gramm comes along and creates the Commodity Futures Modernization Act. Besides contributing to the Enron disaster it also shields any transparency concerning Credit Default Swaps. One thing you can always rely on is American ingenuity. The geniuses on Wall Street decided now was the perfect time to push the swaps. However, what made it different than before was that these Einstein's

decided to do them without any assets what so ever. It was great. Billions of dollars in bonuses were being made. Then came that first dreadful phone call.

"Hey my loan went bad, can I get my money?"

And from Wall Street you could hear the giant collective, "Oh Shit."

And the a deafening silent crash heard around the world.

I use the Congressman and the Senator, to illustrate the ignorant and greedy environment, that was not solely responsible for the current economic situation but they did contribute to it.

However, the two underlying questions everyone is asking themselves is:

"Who the heck really caused this mess?"

"Why didn't anyone see it coming?"

Well, as I said before, some people did know the worst was coming. In an article for the December 2008 issue of *Portfolio,* magazine, Michael Lewis wrote,

"At the end of 2004, Eisman, Moses, and Daniel shared a sense that unhealthy things were going on in the U.S. housing market: Lots of firms were lending money to people who shouldn't have been borrowing it. They thought Alan Greenspan's decision after the internet bust to lower interest rates to 1 percent was a travesty that would lead to some terrible day of reckoning." (Lewis, www.portfolio.com, 2008)

Wall Street professionals knew what was going on. When the interest rates were low they watched non-qualified buyers get loans. These loans were then bundled in to bonds. That were sold and traded as securities. When loans started to default the bonds became nearly worthless creating the debacle we are in now. That's a broad explanation of our current economic situation. What I would like to do is examine closely the factors that got us here.

There are four root causes of the current crisis.

1. The executive branch of the federal government started tweaking and changing bank regulations in 1974 without truly examining the ramifications of changes. And every administration since, continued to make changes, softening regulations to the point that there was hardly any oversight.

2. The U.S. Federal Reserve lowered the interest rates and kept them low to stimulate the economy after the 9/11 and the "tech bubble" burst.

3. For the first time in history, these high subprime and Alt-A loans were packaged into securities (now audience, remember the ALKIBONDS) making them very attractive to banks and investors.

4. The lack of transparency in the banking industry on both a national and global level made it impossible to judge the amount of exposure of the banks and lending institutions.

To start looking at how we got here we have to go all the way back to 1974. Yes way back to the Nixon administration and the Equal Credit Opportunity Act (ECOA). I know you are all aware of the phrase, “The road to hell is paved with good intentions.” This was the beginning of the road. The idea was to keep bankers from discriminating based on race; and assumptions based on federal financial aid. This law stated it was unlawful for any creditor to discriminate, “On the basis of race, color, religion, national origin, sex or marital status, or age.” (Equal Opportunity Act, 1974)

In 1977 during the reign of that brilliant economic thinker Jimmy Carter he went one step further and the 1977 Community Reinvestment Act was put into law. Not only did banks have to be aware of a person’s race, creed or color so not to discriminate but also banks and lenders had to, “demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business.” (Community Reinvestment Act, 1977)

Asking banks and lending institutions to serve their community based on its economic and social identity seems fine and good. However, the problem arises when an outside agency is assigned to enforce the regulation. This law further

states, “It is the purpose of this title to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered.” (Community Reinvestment Act, 1977)

The words “federal supervisory” scare the heck out of me, how about you?

I even think it should be a law that they can never be used together in the same sentence.

The Equal Opportunity Act of 1974, and the Community Reinvestment Act of 1977 were the genesis that created the mortgage and banking universe that we are currently in. They were created with the best ideals in mind. To provide financing and credit for people who in the past might have been discriminated against. But like many altruistic endeavors somewhere down the line it went wrong.

Look I realize explaining these laws to you may be boring, but just think of all the blame I gave away. It lies with “tricky Dick”, the Carter administration, through the Reagan administration all the way up to the Clinton administration. I decided to trip over Gerald Ford.

Yep, I said it.

Before you a fall asleep while I’m going over these laws please keep this in mind that an audience is the only group of people that can get tired sitting down.

I’ll continue.

In 1995, under yet another presidential administration, banks were mandated to be assessed on the types of loans and the economic status of their customers. Two criteria that would be closely examined by the Federal agency are, “The current distribution of the bank's branches among low-, moderate-, middle-, and upper-income geographies.” (Community Reinvestment Act , 1995)

This law was directly targeting banks that would serve lower income customers. Not only that it goes on further to install a type of quota system when it says, “ In the context of its current distribution of the bank's branches, the bank's record of opening and closing branches, particularly branches located in low- or moderate-income geographies or primarily serving low- or moderate-income individuals.” (Community Reinvestment Act , 1995)

Establishing the fact that banks will be monitored based on the numbers of openings in the low income areas.

These laws were not meant to hurt the economy again they were enacted with the best ideals in mind. The government was giving an opportunity for people who might not ordinarily be able to own a house, to own one.

The question is, should everybody be allowed to own a home?

What’s interesting about this is in the spring 0f 2008 then Presidential Candidate Barack Obama said, “Every American should be able to own a home.” A few weeks ago President Obama said, “Not everyone should be a home owner.”

So maybe the federal government learned their lesson and should leave the lending of money to the lenders. Or if you are running for public office everyone should own a home, and when you are trying to save the U.S. economy only the people that can pay their obligation should.

I don't know?

It's just an observation.

Let's fast forward to 2001. The tech industry that led the U.S. economy in the late 90s and the turn of the century burst. I know you remember every time you turned around there was another internet company with an IPO. Well that ended. To further help slow the U.S. economy we had 9/11. In order to keep Wall Street investing Alan Greenspan kept interest rates at one percent. What did this do? This drove financial institutions to a lending frenzy. In 2000 there were $130 billion subprime loans with $55 billion packaged as bonds. However, in 2005 there were $625 billion in subprime loans with $507 billion ending up in mortgage bonds. In five years not only did the amount of subprime loans increase $495 billion dollars but the percentage that were created into worthless bonds nearly doubled from 42 percent to 81 percent. Business was just as rampant as Heidi's bar.

The greed the investor showed makes me think of what the Devil told this down on his luck real estate developer when he asked him to make him rich he said,

"You must pander, trivialize and deceive. You must gain victory by exploiting bigotry, fear, envy and greed."

"So what's the catch?" Mr. Trump replied.

Need I say more.

Well I guess I do. To go one step further and to confuse us all even more, to make these securities more attractive Commercial Collateralized Debt Obligations or CDOs were added. A CDO is a type of Structured Back Asset whose value and payments are derived from a portfolio of fixed-income underlying assets. What makes them extremely attractive is that CDOs are given a higher credit rating than the assets they are backed. The higher credit rating makes them very lucrative but at the same time makes them twice as risky because value is based on pure speculation.

The subprime mortgages and CDOs backed securities were valued by "mark to market" fair value accounting principles.

Susan Lee in an article in *Forbes* explains "Mark to Market" value this way,

"For assets, fair value is the price that would be obtained if an asset were sold right this minute. For liabilities, it's the price that would be paid to transfer a liability right this minute--or its "exit value"--other than in a liquidation." (Lee, 2009)

Banks trade positions based on the fair market value. At the time the bonds seemed healthy so they were traded at a high value. But once the housing market tanked the values of mortgage backed assets became extremely depressed, and as more subprime loans defaulted the values decline. Currently the values of these assets remain in a kind of limbo with bankers being scared of which loans and how many loans remaining will go into default.

By keeping interest rates low to encourage investing, was Greenspan playing to his favorites, to his cronies at the big Wall Street banks?

Who knows?

But it was definitely on his watch when there was a piranha like frenzy to gobble up the now worthless subprime loan backed mortgages causing a pandemic.

Let's step away from the "big boys" for a second and look at the mortar that laid the ground work for this house of cards, "the housing bubble."

In a collection of articles by leading economists, called *The Economists Voice,* published in July of 2008, Dean Baker wrote about the reasons behind the bubble,

> "The best evidence that fundamentals are not the cause of the run up in housing prices is the fact there has been no comparable increase in rental prices. Although rental prices did rise somewhat more rapidly than the overall rate of inflation during the first part of the

> housing price run-up, in the last couple of years they
> have been falling behind inflation.” (Baker, 2008)

According to statistics from the Office of Federal Housing Enterprise Oversight Housing Price Index, between 2003 and 2005 the increase in rent on rental properties stayed even. However, home sale prices had an increase of almost 73 percent. This supports Bakers point that the housing bubble was not based on the solid foundation of supply and demand but on the speculative notion, “if I build it they will come.” Does it matter what type of bubble? Yes? Because we might see the warning signs if it occurs again.

Once the oversupply of housing was absorbed by the speculators and the rental vacancy record increased the speculative demand was over and the bubble burst. (Baker, 2008)

However, I personally only agree with part of this statement. Yes it was a bubble, driven partially on the increasing value of real estate. However, money was being poured out to borrowers, not just people speculating on the value of their houses, but to first time home buyers who had money thrown at them.

In agreement with myself is Dr. Robert Shiller, Professor of Economics at Yale University, when he said in his recent book, *The Subprime Solution,*:

> "Overly aggressive mortgage lenders, compliant appraisers, and complacent borrowers proliferated to feed the housing boom. Mortgage originators, who planned to sell off the mortgages to securitizers, stopped worrying about repayment risk. They typically made only perfunctory efforts to assess borrowers' ability to repay their loans— often failing to verify borrowers' income with the Internal Revenue Service, even though the lender say they possessed signed authorization forms permitting them to do so. Sometimes these lenders enticed the naïve, with poor credit histories, to borrow in the ballooning subprime mortgage market." (Shiller, 2008)

The loans themselves were the bait. As interests dropped in 2003 and 2004 the banks, mortgage bankers and investment bankers developed products with very attractive teaser periods. For example in 2003 the average annual interest on a 30 year fixed rate loan dropped to 5.82%. Customers who would not normally qualify for conventional loans at this rate were able to get subprime loans at this rate or

better, with say a 2 year teaser period. After that the interest rate would increase and so would the payments. (Board, 2009)

Being in the mortgage banking business I saw the irresponsibility of some well known lending institutions. Bear Stearn for example, sold products with little or no oversight. They were one of many huge lending institutions selling lucrative loans such Alt-A loans. How Alt-A loans work is the person need 20 percent and would get a loan on 80 percent on the value of the home they were purchasing. The problem arose because they didn't care where the 20 percent came from. It could have been another loan. Then to further add to the problem no one verified the loan application. A colleague of mine at Waterfield showed me one where the applicant claimed they were a teacher making $8000 a month. I mean that should have been a red flag right there. I can't imagine too many teachers making that. Well after a little research it turns out the applicant was never a teacher, at one time they were a bus driver but were currently unemployed.

It was this type of environment that got people into trouble. Now there is not one person in here that has never run into money problems now and then. There are records for example the First North American Bank that showed even Benjamin Franklin was over drawn three times a week. However, the banks should have been more responsible with their application inquiries.

That explains the situation on a national level. However, how did such small loan amounts collapse the U.S. 11 trillion dollar economy?

It started when the attractive high yield interest of these new subprime loans, Alt-A loans, CDOs, and a variety of other products with high yields and high risks were securitized. They were put on the open market and traded.

The greatest financial minds in the world didn't recognize the danger. Even as the housing market started to collapse and loans started to default investors and banks were still buying and trading these assets. And the economists and bankers who we rely on to alert us of economic dangers were like the lookout on the *Titanic.*

These securities were then traded from one bank to another and to individuals at "mark to market" value. At this point you might be asking yourself, where was the federal oversight. Unfortunately the rating agencies were caught up in the inflating bubble of the real estate market. Agencies like *Moody's* and *Standard and Poor's* continued to give the securities a AAA rating. Like other ratings companies they focused on the credit risk and not on the liquidity of the assets. These values were not based on the sound principal of supply and demand but on a speculative housing market. And as more "teaser periods" on the loans were up, higher interest rates would come into play adding more value to the securities. Banks bought them

when interest rates were low. Knowing full well, sooner than later the value would increase.(Shiller, 2008)

However, what actually happened is the collateral being the home, became worth less than the liability being the house. Thereby, causing this vicious chain reaction.

For the first time in history the whole world took notice of the little loans taken out by every person.

Well, in a global environment the existence and the cause and effect of one individual can impact the entire world.

Leading financial advisor and author David Smick put it best when he wrote about the worthless securities, “Soon the toxic waste was sprinkled throughout the entire industrialized world’s financial system but nobody knew where.” (Smick, 2008)

That was the big problem, nobody knew which institutions had the worthless securities. The big obstacle was lack of international transparency. Each country had different laws regulating securities so nobody knew exactly who had them.

How did this freeze the global economy?

When the U.S. banks started to collapse it sent a panic throughout the world nobody wanted to do business with anyone else. They had no idea of the value of

the securities or how many each bank had. This brought international lending to almost a complete stand still. (Smick, 2008)

Remember when I mentioned “mark to market” value. Well this is where it becomes a huge problem. The face value of these assets are so depressed that banks and investors with huge exposure to these securities have a huge loss on their books. Unless someone puts value to them the flow of money will never be unfrozen.

What is being done so this doesn’t happen again? I walked you through the problem and its impact, now let’s take a look at some of the solutions.

First let’s address one of the grass roots of the problem, the appraisers. As of January 1, 2009 the FDIC issued these new guideline for appraisers and lenders to be enacted in May of this year.

Some of them include:

- Brokers are no longer allowed to order Appraisals.
- No lender can have an "in-house" appraiser.
- The lender must use a third party uninvolved with the loan of the subject for ordering appraisals or a separate uninvolved division.
- Lenders can no longer put any value estimate on appraisal request. Only acceptable estimate is the purchase agreement for purchases.

The president also instituted new laws to help people with their mortgages. Such as:

- People who stay current with loans securitized by Fannie Mae and Freddie Mac can refinance into 15 and 30 year fixed loans. (Obama, 2009)
- If the first mortgage does not exceed 105 percent of the value of the house you may qualify to refinance. (Obama, 2009)

For people who have fallen behind on their loans will be helped, by providing mortgage lenders with financial incentives to modify existing first mortgages, the Treasury hopes to help as many as 3 to 4 million homeowners avoid foreclosure.

In October of 2006 President Bush seemed to do something right. He signed the Credit Rating Agency Reform Act of 2006 which went into effect in June 2007. The new law grants the SEC more oversight over the five big rating agencies Moody's, S&P, A.M. Best, Dominion Bond Rating Service, and Fitch Ratings. The SEC can now inspect the agencies, making sure the ratings of securities are based on value. Also, it prevents a conflict of interest between the agencies and the securities rated. The other important aspect is that it released the monopoly on the big five agencies opening the door to the many other ones who were not considered nationally recognized by the SEC.

Trying to help the people who got behind on their mortgages and addressing the lending environment that started the housing bubble will go a long way in preventing foreclosures. Changing SEC laws for ratings agency will help hold financial institutions more accountable we hope.

Now we are at the point where we will be coming full circle. At the beginning I mentioned that my speech four years ago has a huge bearing on what we can do for the subprime mortgage crisis well it starts with TARP.

On October 3rd 2008 President George W. Bush signed the Troubled Asset Relief Program which released 700 billion dollars from the U.S, Treasury to buy toxic assets associated with subprime mortgages originated or issued on or before March 14th, 2008. The oversight of TARP was granted to the Treasury's New Office of Financial Stability. I don't know about you but for the Federal Government to have any office with the title of "Stability" in it is an oxymoron, with emphasis on "morons". As of February 9, 2009 388 billion had been allotted with 296 billion being spent. The two major payouts were:

- $250 billion to purchase bank equity shares through the Capital Purchase Program ($195 billion spent);
- $40 billion to purchase preferred shares of AIG, Fortune 500 through the program for Systemically Significant Failing Institutions ($40 billion spent);

It makes me look back to the days when a billion dollars was a lot of money.

Other payouts were to smaller financial institutions and let’s not forget 25 billion to the automotive companies. Wouldn’t Henry Ford be proud.?

Was this wrong?

I don’t know something had to be done.

Here’s a thought. Maybe the environmentalists and conservationists who want to spend money to stop deforestation to prevent global warming, can use what they get from the Federal Government to invent trees that grow money.

I don’t know.

Just a thought.

On a positive note the Federal Reserve just recently agreed to buy up 300 billion dollars of the U.S. debt and use another 750 billion to buy up devalued mortgage back securities. This will go a long way to loosening up the big lending institutions. It will hopefully inspire them to invest and get the economy growing again.

Back to the bad news. I have to mention the one trillion dollar stimulus package that was signed into law a little while ago by a congress and president who both admitted they didn’t have time to read the whole thing.

Come on. There is not a single person here who doesn't check the bill after they dine out. Don't you think with a trillion dollar bill they could double check to make sure they didn't pay for something they shouldn't.

And this brings me to the beginning of the paper.

Where does all this spending leave us?

More in debt.

Somebody is going to have to pay. That 1.3 trillion dollar yearly deficit has nearly tripled and U.S. deficit is pushing 10 trillion.

Do we just keep printing more money?

What happens to inflation and value of the dollar?

Again, with my luck that's the next subject you ask me to speak on.

I would like to finish with this caveat. The subprime mortgage crisis and its economic impact have changed so fast, that even though I finished this paper last night, all my observations and assessments might be wrong.

Who knows?

In a world where money grows on trees?

If I bump into you at Heidi's bar…I'll buy you a drink.

Thank you.

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