

# Who's to Blame for the U.S. Subprime Mortgage Meltdown?

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## I. INTRODUCTION

As the prospect of a U.S. recession looms in the horizon, the expected blame game is already on. The primary cause cited for the economic downturn is the so-called U.S. Subprime Meltdown; but observers, analysts, government agencies, and finance industry players are looking for something, or someone, specific to blame for this debacle.

## II. PRIMARY SUSPECTS

The biggest blame is being put on lenders (mortgage originators) who granted loans to borrowers mostly with poor credit ratings and high risks of default.<sup>1</sup>

Mortgage originators would have not been blamed at all back in 2001 where increased capital liquidity motivated them to lend out funds to more borrowers, considering that there was also a growing demand for loans brought about by dropping interest rates. There was a great number then of would-be homebuyers but banks were not willing to extend them loans because of poor credit scores. This was when subprime mortgage lending

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1. Eric Petroff, *Who Is To Blame For The Subprime Crisis?*, available at <http://www.investopedia.com/articles/07/subprime-blame.asp> (last accessed Nov. 3, 2008).

became a popular solution.<sup>2</sup> Since demand was there, capital was available, and the economy was good at that time, subprime mortgage lending was not viewed as risky.<sup>3</sup> By 2006 through 2007, however, everything went unhinged: housing prices flattened,<sup>4</sup> borrowers were unable to make mortgage payments, and foreclosures were made left and right.<sup>5</sup> Even though the median household income increased,<sup>6</sup> interest rates increased even more.<sup>7</sup> The once rosy projections of mortgage banks and investors have gone gloomy.<sup>8</sup>

Meanwhile, blame is also being put on those who bought houses they could barely afford (homebuyers).<sup>9</sup> Lured by low, adjustable rate mortgage (ARM),<sup>10</sup> most homebuyers blindly jumped into purchasing their houses

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2. *Id.* See also, Barry Nielsen, Subprime is Often Subpar, *available at* <http://www.investopedia.com/articles/pf/07/subprime.asp> (last accessed Dec. 19, 2008).

Subprime mortgages are often associated with borrowers who have tainted or limited credit history. This is because subprime mortgages enable borrowers to purchase homes while they repair or build their credit history. [Since] subprime mortgages carry substantially higher interest rates compared to other mortgages available, [ ] subprime mortgage borrower[s have more] incentive to repair or establish [their] credit [so they could] refinance the subprime mortgage into a prime mortgage;

3. Petroff, *supra* note 1.

4. Mark Skousen, 2006 Housing Market Bubble: Today's Selloff In Real Estate ... and How Many Years Before the Next Bull Market, *available at* <http://www.investmentu.com/IUEL/2006/20060302.html> (last accessed Dec. 19, 2008).

5. Petroff, *supra* note 1.

6. U.S. Census Bureau, American Community Survey Reports, *Income, Earnings, and Poverty Data From the 2007 American Community Survey 5* (Aug. 2008), *available at* <http://www.census.gov/prod/2008pubs/acs-09.pdf> (last accessed Dec. 19, 2008).

7. Foresight Analytics, Interest Rate Outlook — May 2006, *available at* [http://www.foresightanalytics.com/Interest\\_Rates\\_May2006.pdf](http://www.foresightanalytics.com/Interest_Rates_May2006.pdf) (last accessed Dec. 19, 2008).

8. *Id.*

9. Petroff, *supra* note 1.

10. See Nielsen, *supra* note 2. A subprime 2/28 ARM is an adjustable-rate mortgage with an initial two-year, fixed-interest rate period. A subprime 3/27 ARM is an adjustable-rate mortgage with an initial three-year, fixed-interest rate period. These are the subprime mortgage market equivalents to what is commonly known in the prime mortgage market as a “hybrid” or “fixed-period ARM.” After the fixed interest rate period the interest rate starts to adjust according to an index, plus a margin. The index value plus the margin is known as the “fully-indexed interest rate.” For example, 2/28 ARMs are frequently tied to

through ARMs without fully understanding the drawbacks. They have been totally convinced of the prospects of investing in the housing market and were indeed looking towards refinancing in the future?<sup>11</sup> Unfortunately, with housing prices depreciating, refinancing even more taxing, and the amortizations escalating as they fall due, “payment shocks”<sup>12</sup> inevitably led to defaults and foreclosures.

All in all, the crash of the subprime mortgage market was described by Todd Sinai, a Wharton real estate professor, as a “‘perfect storm’, given that three things had to happen for the subprime market to tank: Borrowers’ incomes had to drop, interest rates had to rise and housing prices had to fall. ‘It is extremely rare that all three things happen.’”<sup>13</sup> Yet, it did happen and now the housing, real estate, and credit markets are in a tail spin.

### III. ACCOMPLICES AND ACCESSORIES

Arguably, a large spate of foreclosures should only have affected the lenders and borrowers since they are the only parties to the mortgage. Truth is, however, even the securities and finance markets are not spared from the ill effects of the incessant foreclosures and, sadly, from the finger pointing.

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the six-month London Inter Bank Offered Rate (LIBOR) index. If the six-month LIBOR index is 6% and the margin on the loan is 5%, the fully indexed interest rate will be 11%. Subprime 2/28 and 3/27 ARMs carry a higher fixed period interest rate and a larger margin than prime fixed period ARMs. *Id.*

11. See Nielsen, *supra* note 2.

12. Nielsen, *supra* note 2. Nielsen further explains that

[i]f the mortgage cannot be refinanced as planned before the end of the fixed-interest rate period, there is a high probability that the fully indexed interest rate will be higher than the initial fixed interest rate, which could lead to a substantial increase in a person's monthly payments. While no one can predict with certainty the future direction of interest rates, borrowers should have an understanding of the probable future course of both long and short-term interest rates, and know how future interest rates will affect their current mortgage and the interest rate on the mortgage that they intend to refinance into. Ideally, a borrower should run scenario analyses based on varying interest rate courses, and identify and measure the risks associated with varying future interest rate outcomes.

13. Peter Comitini, Subprime Meltdown: Who's to Blame and How Should We Fix It?, available at [http://www.comitini.com/2007/04/subprime\\_meltdown\\_whos\\_to\\_blam.php](http://www.comitini.com/2007/04/subprime_meltdown_whos_to_blam.php) (last accessed Dec. 19, 2008).

Richard Rosen, a senior economist at the Federal Reserve Bank of Chicago, narrates in an essay<sup>14</sup> the process of “securitization”<sup>15</sup> (or how most mortgage loans are sold to investors):

Thirty years ago, if you got a mortgage from a bank, it was very likely that the bank would keep the loan on its balance sheet until the loan was repaid. That is no longer true. Today, the party that you deal with in order to get the loan (the originator) is highly likely to sell the loan to a third party. The third party can be Ginnie Mae, a government agency; Fannie Mac or Freddie Mac, which are government-sponsored entities (GSEs); or a private sector financial institution. The third party often then packages your mortgage with others and sells the payment rights to investors. This may not be the final stop for your mortgage. Some of the investors may use their payment rights to your mortgage to back other securities they issue.<sup>16</sup>

Additional players hence enter the ongoing blame game, each of them figuring prominently: securities investors, investment banks, credit rating agencies, and hedge funds.<sup>17</sup>

Investors in subprime mortgage-backed securities blame a seeming conspiracy between their Investment Banks (for not having been upfront about the quality of the mortgages securing their investment securities) and the ratings agencies (who have given their imprimatur on these securities — “Moody’s and Standard & Poor’s had put their ‘AAA’ or ‘A+’ stamps of approval on many of these securities, signaling their relative safety as an investment.”)<sup>18</sup>

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14. Richard J. Rosen, Chicago Fed Letter, *The Role of Securitization in Mortgage Lending* (Nov. 2007), available at [http://www.chicagofed.org/publications/fedletter/cfnovember2007\\_244.pdf](http://www.chicagofed.org/publications/fedletter/cfnovember2007_244.pdf) (last accessed Dec. 19, 2008).

15. See also Securitization, available at <http://www.riskglossary.com/link/securitization.htm> (last accessed Dec. 19, 2008); What is Securitization?, available at <http://www.investopedia.com/ask/answers/07/securitization.asp> (last accessed Dec. 19, 2008).

16. Rosen, *supra* note 14.

17. See Petroff, *supra* note 1.

18. Ryan Barnes, The Fuel that Fed the Subprime Meltdown, available at <http://www.investopedia.com/articles/07/subprime-overview.asp> (last accessed Dec. 19, 2008). See also, Kathleen M. Howley, Rating Subprime Investment Grade Made “Joke” of Credit Experts, available at <http://www.bloomberg.com/apps/news?pid=20601170&refer=home&sid=ajdL7eUHeUro> (last accessed Dec. 19, 2008). The latter provides:

[I]nvestment banks including Bear Stearns Cos., Deutsche Bank AG and Lehman Brothers Holdings Inc. sold \$1.2 trillion of these securities in 2005 and 2006, said Brian Bethune, director of financial economics for Global Insight Inc. in Waltham, Massachusetts.

Feeling the heat, investment banks and originators of mortgage-backed securities are now looking for somebody else to blame (like the originating lenders and the rating agencies) to ward off potential liabilities and lawsuits.

The mere divergence of opinions by observers, analysts and pundits — each of them having their own stand on who should be blamed — all the more emphasize the widespread confusion. As a Reuters article shows, finger-pointing has become a weekly thing.<sup>19</sup>

Putting blame has even evolved close to a Hollywood-type conspiracy. A Bloomberg article has in fact traced the beginnings of the subprime securities market to a “Group of 5” — a group of Wall Street traders who supposedly “set the trading rules and designed the new product” and made millions for Wall Street.<sup>20</sup>

#### IV. OVERALL DAMAGE

No matter how confusing the attempts are to try and establish fault, the subprime meltdown’s effect is far-reaching and debilitating. It has caused substantial losses to some of the largest U.S. banks: Citigroup lost U.S.\$9.83

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None of this could have happened without the participation of Wall Street's three biggest arbiters of credit — Moody's Investors Service, S&P and Fitch Ratings. About 80 percent of the securities carried AAA ratings, the same designation given to U.S. Treasury bonds.

This implied the investments couldn't fail, says Sylvain Raynes, a former Moody's analyst who now is a principal at R&R Consulting, a structured securities valuation firm in New York.

19. Herbert Lash, In Subprime Meltdown, Lots of Blame to Go Around, *available at* <http://www.reuters.com/article/gco6/idUSN1340018620070713> (last accessed Dec. 19, 2008). The article provides:

This week lots of fingers were pointed at the rating agencies. Many investors castigated the credit assessment firms, which made lots of money reviewing and grading bonds tied to these risky home loans, for being late with warnings on these securities.

Two weeks before, Wall Street firms were the culprits — for buying these risky securities and then making them into multi-tiered credit cakes with a punch and selling them to funds and investors.

And earlier in the year, it was greedy home loan brokers and lenders, and naive or desperate consumers looking to buy a home with risky loans who were the instigators of the subprime crisis.

20. Mark Pittman, Subprime Securities Market Began as ‘Group of 5’ Over Chinese, *available at* <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aA6YC1xKUoek> (last accessed Dec. 19, 2008).

billion;<sup>21</sup> Merrill Lynch, U.S.\$9.8 billion;<sup>22</sup> and Morgan Stanley, U.S.\$9.4 billion.<sup>23</sup> Furthermore, according to a recent Bloomberg report,

[a]s many as 1.5 million more Americans may lose their homes, another 100,000 people in housing-related industries could be fired, and an estimated 100 additional sub-prime mortgage companies that lend money to people with bad or limited credit may go under, according to realtors, economists, analysts and a Federal Reserve governor. Financial stocks also could extend their declines over mortgage default worries.<sup>24</sup>

## V. WHAT NOW?

Considering all the foregoing, what then is the point of playing the “blame game?” Would it not be more important to seek for solutions rather than establishing fault? Indeed, various solutions have been offered and undertaken in hopes of relieving the economy from the stress brought by the subprime mortgage meltdown.<sup>25</sup> Whether those solutions would actually help boost the U.S. economy remain to be seen. Nevertheless, being able to establish and piece together the specific elements that brought about the subprime meltdown would allow banking and securities regulators to provide proper regulations, guidelines and even legislation that would prevent this event from recurring.

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21. Neil Irwin and Tomoeh Murakami Tse, A Double Hit for the Economy, *available at* [http://www.washingtonpost.com/wp-dyn/content/article/2007/10/15/AR2007101500328\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2007/10/15/AR2007101500328_pf.html) (last accessed Dec. 19, 2008).

22. Merrill Lynch Losses Balloon to 9.8 Billion Dollars, *available at* [http://afp.google.com/article/ALeqM5h0ea-COjNuDfm\\_haq6mAiLgILWtg](http://afp.google.com/article/ALeqM5h0ea-COjNuDfm_haq6mAiLgILWtg) (last accessed Dec. 19, 2008).

23. Joe Bel Bruno, Morgan Stanley Posts Loss on Writedown, *available at* [http://www.usatoday.com/money/economy/2007-12-19-3628080920\\_x.htm](http://www.usatoday.com/money/economy/2007-12-19-3628080920_x.htm) (last accessed Dec. 19, 2008).

24. Bob Ivry, Foreclosures May Hit 1.5 Million in U.S. Housing Bust, *available at* <http://www.bloomberg.com/apps/news?pid=20601087&sid=ahwzaBwuNaII&refer=home> (last accessed Dec. 19, 2008).

25. The Federal Reserve has cut interest rates, hoping to allow banks to replenish their flagging capital, and relive the credit crunch. The U.S. Government is also preparing to enact through Congress tax rebates for individuals and tax breaks for companies as a form of an economic stimuli package. *See* Martin Crutsinger, Fed Cut Interest Rates by 1/2 Point, *available at* [http://money.aol.com/news/articles/\\_a/bbdp/federal-reserve-cuts-keylending-rate/230783?icid=sphere](http://money.aol.com/news/articles/_a/bbdp/federal-reserve-cuts-keylending-rate/230783?icid=sphere) (last accessed Dec. 19, 2008).

Banking regulators have provided a “Statement on Subprime Lending” as guidance to banks and loan originators of subprime mortgages on how to undertake and manage their subprime mortgages. Statement on Subprime Mortgage Lending, OCC, Federal Reserve System, FDIC, OTS & NCUA, for

Happily, the law is not concerned with profits or clairvoyant determination of economic boom cycles. It is focused on tempering improper risk-taking, fraudulent lending and securities practices, and questionable practices in the credit and finance industry. In applying the law to the scenario at hand, three key issues must be addressed. The first is whether these lenders engaged in improper lending practices. The second issue is whether the issuers of the asset-backed securities properly set forth in their prospectus the conditions and terms of the mortgages backing the security.

The third issue is rather compounded: whether the ratings agencies did a proper appraisal of the securities they rated; why, if true, they were slow in downgrading the securities when became evident that the asset-backed securities were losing value due to the foreclosures? Was there any existing conflict of interest between the ratings agency and the issuer? Could there be another system that would allow a more transparent arbiter of credit in the market?

Perhaps there are only two parties in this whole subprime mess that should be given assistance: first, the borrowers who were misled into signing up for adjustable rate mortgages without being appraised of the fine prints (indeed a violation of the Truth in Lending Act); and second, the investors who were misled into investing in subprime mortgage backed securities without being provided information and proper appraisal of a true cross-section of the mortgages securing the investments. Note that these parties need to show that they were indeed misled into the transaction, for if they had gone into the mortgage or the purchase of the security with eyes wide open or with knowledge of the risks involved, then they should bear the loss.

Some borrowers are actually finding relief in avoiding foreclosure by mortgage banks because of some inadequate disclosures and compliance with the Truth in Lending Act<sup>26</sup> by these lenders, noting how “2/28 ARMs ran afoul ... [where]: [t]hey failed to meet the disclosure laws regarding actual interest amounts and payments.”<sup>27</sup> This relief is an important rule in ensuring that no borrower was misled into entering an onerous contract without being properly appraised of its fine print and risks. Furthermore, if there is no expectancy of Federal aid or bail-out for lenders, mortgage banks and loan originators may be compelled to undertake a restructuring of the loan, which

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publication in the Federal Register, *available at* <http://www.fdic.gov/news/news/press/2007/pro7055a.html> (last accessed Dec. 19, 2008).

26. Consumer Credit Protection Act, 15 U.S.C. 1601 (1968).

27. Truth-in-Lending Disclosure Failure Leads to Mortgage becoming “UnSecured,” *available at* <http://bigpicture.typepad.com/comments/2007/08/coming-soon-tru.html> (last accessed Dec. 19, 2008).

can be viewed as a way of rendering relief for both parties to the mortgage contract.

Securities investors are well-versed with the capital markets that aiding them is not a proper recourse. Risk taking has its rewards and pitfalls. Nevertheless, if they are to sustain any losses, it should be based on true and adequate information that was available to them at the onset of the securities purchase. Thus, if such information is false, then the mortgage originators can equally be held liable for misrepresenting the facts set forth in their prospectus.

But how about the banks, shouldn't they be helped as well?

Before proceeding to answer this question, it must be clarified however that the U.S. banking industry is quite unique in that there exists a conglomerate of non-bank banks,<sup>28</sup> such as mortgage banks, conduits and investments banks. These "non-bank" banks are kinds of financial institutions that in the 1980's did not meet the legal definition of a commercial bank, and thus avoided the prohibition against branching across U.S. state lines. They did this by not engaging in one of the two lines of business cited in the law to define commercial banks, demand deposits or commercial loans, and offered only a range of bank services.

With such a differentiation, it is evident that the reported staggering losses incurred by banks was generally not by regulated commercial banks but by these non-bank banks that were entangled in either subprime mortgages or investing in asset-backed securities secured by subprime mortgages. Mr. Axel Weber, president of the Bundesbank, categorically described what is now transpiring as a "non-bank bank run," pointing out that

[t]he current turmoil in the financial markets has all the characteristics of a classic banking crisis, but one that is taking place outside the traditional banking sector ... Mr Weber told fellow central bankers and economists at the Federal Reserve's Jackson Hole symposium that the only difference between a classic banking crisis and the turmoil under way in the markets is that the institutions most affected at the moment are conduits and investment vehicles raising funds in the commercial bond market, rather than regulated banks.

These entities were inherently vulnerable to a sudden loss of confidence on the part of their funders because 'there is a maturity mismatch' on the part of financial institutions that have invested in long term mortgage-backed or asset-backed securities using short-term finance.<sup>29</sup>

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28. Explain Non-bank Bank, *available at* [http://www.teachmefinance.com/Financial\\_Terms/non-bank\\_bank.html](http://www.teachmefinance.com/Financial_Terms/non-bank_bank.html) (last accessed Dec. 19, 2008).

29. Paul Kedrosky, The First Non-Bank Bank Run, *available at* [http://paul.kedrosky.com/archives/2007/09/03/the\\_first\\_nonba.html](http://paul.kedrosky.com/archives/2007/09/03/the_first_nonba.html) (last accessed Dec. 19, 2008).



There are no clear relief avenues for these non-bank banks other than bankruptcy, considering that what their problem is not liquidity but a shortfall in profit which had the effect of constricting capital. Bailing them out is not an option that must be pursued because they entered into these subprime mortgage transactions knowing its risks. What must be pursued now is isolating the problem to these non-bank banks.

One interesting aspect of the subprime mortgage meltdown is how the credit rating agencies have come under fire for having rated these subprime mortgage securities as “investment grade.” The result is that credit ratings are now seen as suspect. What compounds this problem further is that Basel II or the new capital regulatory framework to be applied internationally utilizes credit ratings for regulatory purposes, putting specific assets in rating baskets based on the findings of the same credit rating agencies.<sup>30</sup>

As of present, rating agencies are accredited by the U.S. Securities and Exchange Commission under the auspices of the Credit Rating Agency Reform Act.<sup>31</sup> International accreditation may be necessary for credit rating agencies, since securities are no longer sold locally but are made available internationally. International accreditation should be a means to look into removing various sources of conflicts of interest such as in “issuer-pay” business models and should be an avenue for resolving conflicts between issuers and the rating agencies where ratings are reassessed or an agreed methodology to arrive at the rating.

#### VI. WHAT’S IN IT FOR THE PHILIPPINES?

Taking cue from this, it is evident that proper lending practices and securitization disclosures in the Philippines must be addressed through legislation or regulation.

Updating the Philippine version of the Truth in Lending Act (T.I.L.A.)<sup>32</sup> may be a good start. The penal provisions therein limit the impossible penalties for T.I.L.A. violations to mere fines. This, in a way, overlooks the fact that the borrower is the party wronged. Borrowers should

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30. Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version (June 2006), *available at* <http://www.bis.org/publ/bcbs128.pdf> (last accessed Dec. 19, 2008).

31. Securities and Exchange Commission, Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 17 CFR Parts 240 and 249b (Feb. 2, 2007), *available at* <http://www.sec.gov/rules/proposed/2007/34-55231.pdf> (last accessed Dec. 19, 2008).

32. An Act to Require the Disclosure of Finance Charges in Connection with Extensions of Credit [TRUTH IN LENDING ACT], Republic Act No. 3765, § 6 (1963).

be given the ability to void the mortgage and treat the contract as a simple loan instead, given that they have been misled into constituting the mortgage. Such would be a better deterrent for improper lending practices because banks and lenders would then be wary of resorting to these practices which would impair their own security.

The *Bangko Sentral ng Pilipinas* (BSP) plays a very important role in ensuring that the Philippines would not be dragged into a similar subprime situation. Though the Philippine securitization market is not as sophisticated as its U.S. counterpart, it is nevertheless necessary that the BSP take the lead in initiating a review of the Monetary Board's Securitization Circular issued on 8 December 1998.<sup>33</sup> Lessons learned from the past months' events should find their way into the revisions, particularly the amount of information that must go into the prospectus of the security being released. In a mortgage-backed security situation, the prospectus should provide a cross-section of the Asset Pool especially if it is comprised of individual mortgages. Furthermore, the lack of procedural rules to manage massive defaults should be addressed to give investors an avenue to recoup some of their investment and limit their losses.

The problem with regard to subprime mortgages is not as prolific in the Philippines because low-cost, low-interest housing loans are covered by the operations of the Pag-Ibig Fund and the National Home Mortgage Finance Corporation (NHMFC). However, the BSP should still look into the extent Philippine banks have been exposed to sub-prime mortgage backed securities and provide guidelines regulating such exposures. Using credit ratings to judge the investment viability of a bond, asset or security is an acceptable utility for regulatory purposes but the BSP should work with other country regulators in creating regulations meant to remove whatever suspicion there exists against these credit rating agencies.

## VII. EPILOGUE

The U.S. Subprime Mortgage Meltdown affords us a glimpse of how unfettered risk-taking can cause so much distress and heartache. The most important lesson from this whole debacle is that parties should be completely informed even of fine prints in a transaction or a venture, considering not only the rosier gains but more importantly the risk factors inherent in it. The bottom line is that the law can only protect a borrower or investor from improper lending or investment practices but not from naivety or, to a certain extent, stupidity.

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33. Monetary Board Circular No. 185, Series of 1998 (Dec. 8, 1998).