

The subprime mortgage mess: 5 myths put to rest

By Carl Prine

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Pittsburgh Tribune Review - Sold to the American consumer as a chance for marginal borrowers to buy into the dream of home ownership, "subprime" mortgages are becoming the catalyst for an expected 1 million-plus foreclosures annually for the next few years.

Potential losses of \$300 billion for homeowners and lenders -- and an undetermined amount of punishment to a \$57 trillion U.S. financial system -- stalk global securities markets and seem poised to tip the nation into economic recession.

Yet despite the headlines of recent weeks generated by the response of markets and governments to the global credit crisis spurred by the subprime meltdown, much of its cause and effect remain shrouded in myth.

In interviews with the Tribune-Review, more than 20 of the nation's real estate, securities and regulatory gurus challenged some of those myths being spun as gospel.

Myth 1: The "subprime crisis" was unexpected and it will ruin the financial system.

To longtime hands at the Federal Deposit Insurance Corp., it isn't nearly as bad as the freefall in real estate and financial houses during the savings and loan crisis of the mid-1980s to early 1990s. Compared to S&L, the subprime mess might not be a "crisis."

"What was happening with subprime was unsustainable, but it's not necessarily new. What we faced during the S&L crisis certainly was far worse. I don't even like calling this a 'subprime crisis.' It's a 'subprime situation,'" said William M. Isaac, former chairman of the FDIC during the most turbulent years of the S&L implosion.

Today, Isaac is a managing director at LECG, a global expert services firm in Vienna, Va.

"The good thing is that the banking regulatory system so far has done a good job containing the fallout. The subprime situation is not going to harm, in any substantial way, the banking industry. What we're seeing now is more of a sense of panic that will cause more financial losses than anything caused by non-performing loans."

When his watch over the FDIC ended, Isaac served on government panels to corral the S&L crisis and jump-start a home construction slump that had fallen to its lowest rate since World War II. Eventually, federal regulators bailed out most of the \$168 billion in losses, closing 1,426 failed lending institutions.

"Subprime" loans emerged from that rubble. By the mid-1990s, changes in federal law and regulatory practices allowed banks to finance mortgages that typically would have

been denied to borrowers because of low credit scores or lack of a substantial down payment.

According to the Federal Reserve, in 1995 subprimes accounted for about \$65 billion in loans, about 5 percent of a mortgage market heavily weighted toward traditional "prime" borrowers with good credit, proven income history and willingness to put some of their savings down as a deposit. Nearly all loans began with a wannabe borrower's trip to a neighborhood bank.

Eleven years later, however, lenders OK'd nearly 10 times more subprime mortgages -- \$625 billion worth -- with about 60 percent of those loans initiated by mostly unlicensed third-party brokers. Prime mortgages had come to make up only about one of every four new loans, according to the Federal Reserve.

Some of those brokers emerged as quick-buck salesmen who were unlikely to weed out potential buyers who couldn't afford the subprime loans they were accepting, according to litigators now bringing class-action lawsuits against some of those brokers.

"We now know that the (broker) community was rampant in fraud, was generally dishonest and took bad credit risks and then layered onto that bad credit, more lies and more deceptions and created investments that were worse than advertised," said Indianapolis-based attorney Tom Hargett, who has won major victories against firms tied to the subprime brokers.

But bankers didn't keep their hands clean. They often told brokers the terms of deals they would accept. Wall Street trading firms, banks, rating agencies and bond insurers made fees every time they handled securities based on the subprime mortgages.

What began as deals between dishonest or unsophisticated buyers and mortgage brokers creating "liar loans" ended up as globally traded complex debt securities that weren't exposed as shaky until the tide of subprime defaults began to rise in 2005.

Now, Hargett says "there's a bull market for white-collar criminal defense lawyers" tasked with defending everyone in the subprime chain -- from shifty mortgage brokers to investment fund managers trapped in the muck.

Myth 2: Poor first-time homeowners who never could have been expected to make mortgage payments or cavalier investors who "flipped" properties to make quick speculative bucks are typical subprime borrowers.

Most subprime borrowers -- nearly 90 percent -- aren't first-time home buyers, and fewer still are the flippers using subprime financing to turn junk bungalows into posh digs on cable TV shows, according to studies by the nonprofit Center for Responsible Lending in Washington.

"These are people who are living in their homes who are really in trouble, not just people who made a bad investment decision," said Center economist Debbie Gruenstein Bocian.

What credit experts call "serial refinancing" by existing homeowners fueled the subprime fire. Because interest rates remained low through the late 1990s and early

2000s -- and residential housing prices kept rising -- homeowners could take advantage of "cash out" re-fi deals that provided progressively larger loans than the value embedded in first mortgages. Borrowers pocketed the difference.

To lure clients, an increasingly larger pool of mortgage brokers took chances on borrowers carrying greater risk of default. Their most tantalizing "teaser" was a no-down-payment loan bearing low initial interest rates that would "adjust" to higher rates and, therefore, higher payments. Most applicants could afford the low starter bills, but if the rate floated higher, many would be put at risk of defaulting.

"Cash out" home equity re-fi's and other subprime loans account today for one-fifth of all outstanding mortgages -- and more than half of all foreclosures, according to the Mortgage Bankers Association's National Delinquency Survey. Although adjustable-rate mortgages make up only 7 percent of the mortgage market, they're tagged to 43 percent of foreclosures.

"Here's the way these things were sold: People got phone calls that said, 'I'm going to lower your monthly bills by \$300 and you can use that to pay off your credit card bills, or pay off your medical bills. Come in and sign the paperwork.' People assumed they were getting a good deal, because interest rates were going down and no one told them that the loan would re-set and they could lose their homes," said Bocian.

Myth 3: Once borrowers fall behind on payments or lapse into default, banks want to take their homes.

"There's nothing further from the truth. The last thing in the world the bank wants to do is foreclose, because that becomes a non-performing asset for them. They have to go through the legal process to get title. Selling the property? They're not in that business," said David Milton, senior lecturer of finance at Boston's Bentley College and director of the school's graduate real estate program.

"Their primary goal in banking is to collect the monthly payment so that their investors are happy because they're getting cash flow. People leave the problem until it gets so no one can do anything about it."

Milton's advice: If you get a first notice that you're late on your mortgage, call the bank immediately to arrange a payment plan. The Federal Reserve recently slashed interest rates to make borrowing money cheaper. That's serving as a pause to wed nervous bankers and borrowers to amended mortgages, typically at cheaper fixed rates. Federal housing agencies have pledged to rescue subprime refugees who qualify for their programs.

Of 384,000 foreclosure starts studied by Mortgage Bankers Association economists in the third quarter of 2007, more than half of the borrowers received either modified loans or new repayment plans.

The rest either abandoned their homes or didn't respond to foreclosure notices, leaving banks no option but to seize the properties.

Myth 4: Local banks will suffer from the subprime implosion elsewhere.

Actually, a Trib survey of Pittsburgh-based banks and large investment houses found little exposure to subprime lending.

Aside from the Bank of New York Mellon Corp.'s \$118 million write-down for potentially risky mortgage-backed securities -- a pittance compared to Merrill Lynch's \$2.2 billion in losses or the \$18.1 billion impacting Citigroup -- Pittsburgh's lending institutions are cautiously optimistic about weathering the storm without long-term loss.

"We did an analysis here and we determined that we had minimal loss exposure because of subprime," said PNC Financial Services spokesman Fred Solomon. "We don't originate those kinds of loans. Our strategy for mortgages has been to avoid 'teaser' rates. Home values in our region have remained strong."

PNC reported a 53 percent tumble in fourth-quarter profits because of "credit deterioration" tied to underperforming commercial loans, not subprime residential mortgages.

An exception: Reeling from subprime shocks in Florida and Michigan, Evansville-based National City Bank was forced to sell its First Franklin subprime mortgage sideline. In October, it declared \$526 million in lost income.

This might not be a bad strategy, according to those who study Wall Street. Scrapping today's non-performing loans -- including deals with no ties to the subprime implosion such as PNC's bad commercial losses -- will make future revenue reports look sunny.

"Their earnings compared to the previous years will look staggering. They'll look brilliant," said Sanford Kahn, a business author and analyst who formerly hosted TV's "Ask the Economist."

Myth 5: No one can make money on mortgage securities in the midst of the meltdown.

With capitalism, someone's loss is another's gain, and smart institutions fat with cash are exploiting weakened competitors by gobbling mortgage-backed securities they know will rebound in value.

Credit risk experts at Downtown-based mutual fund manager Federated Securities warned years ago that residential mortgage-backed securities appeared to be increasingly dicey deals; they spent money elsewhere to protect clients.

By avoiding the subprime woes, Federated now can pounce on mortgages backed by federal housing agencies such as Freddie Mac, where defaults are rarer and returns are richer than what are found in government bonds.

"You really have to do your homework, but the agency-backed securities right now are good values," said Federated's Senior Vice President Robert J. Ostrowski.

"The problem with subprime is that the crisis is going to affect Main Street longer than Wall Street. Wall Street is moving aggressively to correct the market and will come out of this sooner than a lot of people expect. The real pain will occur with homeowners who won't realize the original values of their homes for years."