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Subprime mortgages: An invitation to a meltdown

by Bob Yates

Sometimes, looking at the subprime crisis and the housing slump, it seems like the same old story: Somebody figures out a way to make a lot of money because the market is booming, and everyone else just piles on, taking a good idea and pushing it and pushing it until, inevitably, the once-good idea, stretched beyond the limits of common sense, collapses.

It happened in the '90s with the Internet, and it's happened again. Subprime mortgages, an opportunity for people who didn't qualify for home loans under the traditional guidelines, surged into the marketplace a few years ago, riding on the continuing steady growth in home values.

"We've had prosperity for a long time," said Steven L. DeGraff, a partner at Much Shelist Denenberg Ament & Rubenstein. "Real estate kept this economy propped up for 15 years. We've seen some real good times in the real estate world."

Why should the good times stop?

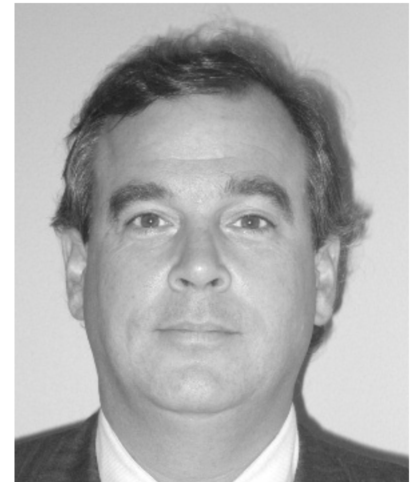
"The comfort in the market was that the value of real estate was there," said Jeffrey J. Stahl, a name partner at Stahl, Cowen & Crowley. "If you couldn't pay, you could get the loan value from your house value — people could even get home equity loans in excess of the value of their homes."

And then, of course, housing prices dipped, and the wheels started to fall off.

"It seems to have come on pretty quickly," Stahl said.

Homeowners who had borrowed heavily against their houses found themselves "upside down" — the size of their debt exceeded the value of their homes — and a sizeable number of homeowners who took out mortgages with the first two years at a low interest rate, had their rates reset this spring and summer.

Jeffrey J. Stahl



William J. Mitchell

Some homeowners found themselves trapped — they weren't able to pay the new interest rate, and they couldn't refinance or sell because of the reduced value of their homes.

The immediate fallout was a cascade of financial trouble — homeowners going into foreclosure, the collapse of the market for subprime mortgage-backed securities, write-offs of $20 billion by some Wall Street investment banks, and an announced bailout fund by Wall Street of between $80 and $100 billion to protect the credit and mortgage markets from "future liquidity problems."

We're at the beginning of the subprime crisis, and nobody knows how far or deep the reverberations will go. Because the residential housing market is connected through the home mortgage business to the entire financial system, the impact of the subprime crisis spreads out to residential housing development, condominium development, commercial real estate, local banking, investment banking, and even municipal tax revenues and growth.

And, because it is so complex, *Chicago Lawyer* will run a two-part series on the subprime crisis. This month's story will focus on the creation and meltdown of subprime mortgages. Next month, the *Lawyer* will discuss the fallout.

To start, subprime mortgages were home mortgages made to borrowers who didn't qualify for a mortgage under the traditional guidelines relating to income, employment, and good credit rating. (The term "subprime" refers to the borrowers, not to the interest rate on their mortgages.)

Traditionally, the buyer of a

home had to have a steady job with a verifiable income that could handle the monthly mortgage payments — typically, the payments would be around one-third of the buyer's monthly income, and the ability to plunk down 20 percent of the purchase price. These were the standards.

The source of the traditional standards was a government program, Fannie Mae (the Federal National Mortgage Association), established in 1938 to encourage home ownership. Fannie Mae was rechartered by Congress in 1968 as a private corporation, and is now funded solely by private capital.

The idea behind the rechartered Fannie Mae was to create a secondary market for home mortgages.

A bank, or other mortgage lender, loans money to the buyers, and then packages a number of individual mortgages together (the size of the package varies, but it can reach into the billions of dollars) and converts the packages into mortgage-backed securities, which are sold on Wall Street in the same way that bonds are sold.

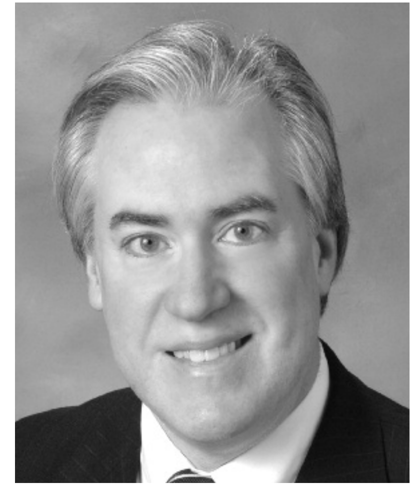
The secondary market is key, because it keeps the money flowing back into banks and out again as more loans to more home buyers.

"They [Fannie Mae, and two government agencies created later, Ginnie Mae (Government National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation)] were basically the only buyers for mortgage-backed securities," said William Mitchell, a partner at Meltzer, Purtill & Stelle.

"They created a market to take residential mortgages and create mortgage-backed securities. Essentially, the federal government created federal corporations to make banks lend money because the banks could get the mortgages off their books.

"So, Fannie Mae and Freddie Mac established credit lines for buying mortgages," Mitchell said. "These companies were the only place you could really package and sell on the secondary mortgage market, and for years all mortgages

Brian Meltzer



Ralph J. Schumann

conformed to their guidelines.

"If they didn't conform to the guidelines, there was a very narrow market for selling them — it was such a small market that a lot of lenders didn't even bother — if you had a big, huge mortgage, and you were a bank customer, they'd keep them."

Meltzer: "Investors weren't paying attention — they kept wanting more and more."

Before the subprime market was created, the packaging of mortgages and the sale of mortgage-backed securities outside of the Fannie Mae market consisted of REMICs (Real Estate Mortgage Investment Conduits) and was limited to commercial mortgages where lenders could impose prepayment restrictions and mortgage returns could be fixed for a certain period.

Residential mortgage packages were, Mitchell said, "a nonstarter," because the ability of a residential mortgage holder to prepay and thereby eliminate the interest payments flowing to the investor meant that the investor could not rely on a steady return.

The REMIC is a mortgage-backed security offering that is rated by a rating agency, like a bond, and marketed at a rate commensurate with the rating. It can be marketed as a whole or in tiers of risk.

If it is marketed as a whole, then it is a blend of the mortgages in the portfolio and is a blended risk. If it is marketed in tiers of risks — called tranches — then some investors buy the A portion, some the B portion and down the line, with each portion priced according to risk.

The holders of the interests in the REMIC take in the monthly interest from the mortgage payments.

So, for many years, what Mark Simon, a partner at Katten Muchin Rosenman, called "a very efficient market" existed.

Residential mortgages fell under the guidelines of Fannie Mae, and commercial mortgages were structured as REMICs and engineered to produce anticipated returns for purchase by institutional investors.

But the boom in the housing market continued: home values kept increasing and builders kept building homes, because there was always going to be a buyer for each new home. And Wall Street got into the act.

"With the expanding housing market, there was a great deal of optimism that the market would keep expanding, that people could refinance forever," said Michael Seng, a professor at The John Marshall Law School. "It was

obviously unrealistic, but there was so much money to be made here that people weren't looking at the long-term effects of this. Wall Street got into it, pension plans, all of the different packaged securities began to invest in loans."

"In the '70s, builders were more entrepreneurial, now you had national builders subject to Wall Street pressures," said Brian Meltzer, name partner at Meltzer, Purtill & Stelle. "They had to have more and more house sales, more closings, so they could meet Wall Street expectations."

In response to the pressure from Wall Street to find new outlets for money, much of it international money, and in response to the need to find a point of sale for mortgages that were not marketable to Fannie Mae, Wall Street created new investment vehicles, mortgage lenders relaxed their Fannie Mae-level standards, loosened them, and then, in some cases, threw them completely out the window.

And — despite the instability of returns and yields — the residential REMIC was born. These ultimately standard-free mortgages were the subprime mortgages, and the REMICs created to market these mortgages were essentially a new form of junk bond.

"What happens is, someone comes up with a mortgage program outside the box and others follow suit to stay competitive," said Frank Wolff, senior vice president of Market Street Mortgage in Schaumburg.

"All of a sudden, it was: 'Maybe we'll have no money down, or a lot less money down.'

"Someone else will say, 'If they had good credit before, they're not going to change the way they do things because they're buying a home. Even if they're stretching, if the person is working and has good credit, why verify the income?'

"Then it got to, 'If they're putting money down, why do we care where the money came from?'"

Along with the booming market in real estate came a lot of new money into the market, the demand outstripping the supply — in this case, the supply of mortgage-backed securities. And the market responded.

"All of a sudden, there was all this international money," said Mitchell, "and no longer is the market contained by predominantly Fannie Mae guidelines. So, once the fences were down, lenders were saying, 'I don't have to sell it to Fannie Mae, I can sell it to the Dutch investor group.'

"And now, what used to be controlled by a highly regulated, very well-thought-out mortgage-backed security program created, and really policed, by the government that existed up until 2003, 2004, was now wide-open.

"I'm telling you," Mitchell said, "you had a lot of cowboys riding through buying these investments and they were basically just buckets of paper, buckets of mortgages, and they'd say well, 'Fannie Mae would never buy that; that's okay, they're stupid.'

"Until very recently," he said, "one of reasons Fannie Mae was losing money is that they weren't getting enough of the share of the mortgage business because nobody wanted to comply: 'Forget you guys, your guidelines are too rigid. We don't want to do your deal, we want to do our own deal, because institutions and foreign investors want to buy our deal.'"

And part of the deal was — or, at least the part of the deal that avoided the hassles of Fannie Mae regulations — was that the subprime mortgages would be packaged with conventional mortgages. That was where the good money was.

"The 20 percent [subprime] piece behind the 80 percent [conventional] piece was going off at 8 1/2 percent, prime plus one," Mitchell said. "It was a really good return in a market where Treasuries were at 4 1/2."

Unfortunately for all concerned, propping all this up were millions of loans made to subprime borrowers who were barely holding onto their homes. A large percentage of the subprime loans made were "2/28" loans — 30-year mortgages that feature a low-interest "teaser rate" for the first two years of the loan, with a loan "reset" after two years.

"You would come in and have something like a 3 percent interest rate and stay that way for a year or two years," said Meltzer, "then it jumps up.

"But people — I had intelligent people tell me this — figured they'd start with the low-interest rate mortgage, then just refinance — get the mortgage, then a year later get another mortgage before the rate goes up, but then the rate went up and they couldn't refinance, and they were stuck."

"They were looked upon as lucrative and fairly safe investments," Seng said, "but so many of these loans — especially the ARMs were sold to seniors or people with relatively fixed income — the chance of them being able to repay when interest rate went up, they should have been able to predict these loans would go into default."

"When things started getting bad," Meltzer said, "the builders didn't mind, they still had record sales, but then it finally reached this point where it's all falling apart, they're letting people go, trying to sell houses for whatever."

And the next group to get stuck were the investors who were — and are — holding those investments with subprime mortgages in them, found themselves (1) with investments that were not performing as they had anticipated, as defaults on subprime mortgages eliminated at least a portion of their income, and (2) with investments they could not sell. Now, who will buy these investments? Nobody.

"What investors are going to buy these packages of securities and groups of mortgages?" Mitchell said. "I think you've got problems. You don't have Moody's saying they're A-paper or BB-paper anymore. I think it is possible that you're going to see lawsuits — the rating agencies may be in trouble now because the hindsight patrol has begun the rumor that they were rating these packages perhaps higher than they should have been

as far as quality of paper, and because they were mixing them a little, A, B, and C paper, and they were kind of giving them a little better rating.

"I think you're going to find that the buyers have all dried up," he said. "If you can't package them and sell them, they're going to go away. You took a whole class of buyer out of the market, and perhaps spooked them out of other SIV [Strategic Investment Vehicle] markets."

Crazy? It sure looks that way now, but, in the middle of all this, everyone was making money. And nobody was watching the store. Not the lenders — they were tossing the loans into bonds, so the repayment of the mortgages wasn't their concern. And not the bond buyers — they just wanted more. There was nobody applying the brakes.

"Everybody knew," DeGraff of Much Shelist said, "but nobody wanted to do anything."

"Why would anyone get into subprime lending? Because there were buyers out there," Meltzer said. "So, the lenders were making money in the form of origination fees on the loans, and then they were making money on the sale of the loan. Basically, they were saying, 'We don't care really if there's a buyer out there; we can sell it to them. We don't care if this guy's going to default, because that's not our problem, that's the investor's problem.'

"Investors weren't paying attention — they kept wanting more and more," Meltzer said. "They were looking for returns, big returns, and they got them. But when the market started going down, they got stuck with the foreclosures. It was the investor's problem, not the mortgage originator's problem."

"A lot of people were doing refinancing; a lot of people were making a lot of money for the origination of mortgages — there was a big push to make money on that. When the gravy train from refinancing dried up, there was pressure to find other ways to keep things going," said Ralph Schumann, a sole practitioner in Elk Grove Village and president of the Illinois Real Estate Lawyers Association. "A lot of people were relying on these things to be performing, and a lot of people looked the other way. Wait until this comes home to roost."⋆

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