Statement on the topic “Subprime Mortgage Crisis and America’s Veterans”
Prepared for a hearing of the Subcommittee on Economic Opportunity of the House Committee on Veterans’ Affairs

Roger M. Kubarych
Chief US Economist, UniCredit Markets & Investment Banking, &
Henry Kaufman Adjunct Senior Fellow for International Economics and Finance,
Council on Foreign Relations
Washington, DC
February 28, 2008

Madame Chairwoman, members of the Subcommittee:

Thank you for inviting me to testify on the important topic “Subprime Mortgage Crisis and America’s Veterans.” As a financial-sector economist trying to make sense for UniCredit management and clients of what has gone wrong in the US mortgage market, and as a part-time scholar with the Council on Foreign Relations engaged in a multi-year project assessing the strengths and deficiencies of what I’ve called “Americanization of Finance,” I am still stunned by the severity of the developments that have taken place. From an unsustainable boom in US housing markets, we have watched a massive contraction in activity since 2006, evidenced by plunging housing starts, sales and prices. The consequences have been truly painful for many. Numerous homeowners are struggling with mortgages they cannot afford. Major banking and other financial institutions here and abroad have suffered enormous losses, and their ability to conduct normal lending activities is impaired. And the whole sorry episode has contributed to diminished respect internationally for the integrity of the US financial system and its guardians, perhaps most conspicuous in the decline in the value of the dollar in foreign currency markets since the crisis broke out last summer and a worrisome escalation of commodity prices, not least crude oil.

Veterans are affected by the subprime mortgage crisis and the broadening financial turbulence that developed in its wake in at least four ways:

First, some veterans are directly involved because they bought homes financed by subprime mortgages, which too often contained a raft of unfriendly or outright abusive terms and conditions, and are now unable to stay current on their debt-servicing obligations. Some portion of these veterans may be already facing delinquency or even loss of their homes through foreclosure.

Second, many other veterans are impacted indirectly, as a result of the widespread decline in the value of houses throughout much of the United States. The current values of their homes are caught in the overall housing slump, and their personal net worth is or will be contracting. Not all will be impacted equally. Those veterans who bought their homes years ago probably still have substantial unrealized capital gains, despite the recent moderate declines in average home prices. But any recent veterans who bought houses near the peak in the housing boom are going to lose a good portion, maybe all, of the equity they had in their homes. The standards of living of many veterans will take a hit.

Third, all veterans, just like every American, are hurt by the diminished availability of credit because of the squeeze on many banks and other financial institutions who made unwise investment decisions, suffered losses, and are now straining to repair wounded balance sheets.

Fourth, veterans, along with the rest of us, are facing higher costs for energy and other imports as a result of the decline in the value of the dollar and the rise in commodity prices, both traceable in part to the erosion in confidence in our financial markets and our currency.

These are big negative effects. That’s why it’s understandable why so many economists, whether in the private sector, in the Federal Reserve or in the US Government, are either predicting a business recession or raising the odds that a recession might develop.

Before making a few suggestions about what might be done to ameliorate the adverse effects on veterans and other homeowners with these radioactive subprime mortgages, let me make a few points – highly abbreviated to save time – that might help put the current mess in some perspective.

1. Securitization of mortgages is not new. Securitization – that is, the pooling together hundreds or thousands of individual mortgage loans into a mortgage-backed security, MBS, that can be sold to institutional investors much like a traditional corporate bond –.got started in the early 1980s. That was a time when high inflation and correspondingly high interest rates were making it almost impossible for many commercial banks and savings & loan associations to offer mortgages. Within a few years, the useful innovation had caught on to such an extent that over half of all outstanding mortgages were securitized (the rest were held mostly by banks and thrifts). Here's some useful data, drawn from the Fed's Flow of Funds accounts, showing quickly and pervasively mortgage securitization caught on:

Mortgage Securitization: From humble beginnings to central part of the system

	1975	1980	1985	1990	1995	2000
Total mortgages $ trillion	0.46	0.96	1.52	2.62	3.46	5.13
% securitized	5.3	11.1	25.2	39.9	50.2	54.8

Source: Federal Reserve Board, Flow of Funds

[I left out the more recent data until later: since 2000 the market has had a new element: explosive growth in subprime mortgages and a different way of securitizing them, but I will come back to that shortly.]

2. Securitization done prudently provides immense benefits to nearly everyone: borrowers, investors, and the banks who engineer the process. From humble beginnings, securitization blossomed because it is a superior way of doing the business. Its inventors recognized that the traditional business practiced by banks and thrift institutions of originating mortgage loans, doing the servicing of those loans in-house, and holding them on their balance sheets posed enormous problems. Those problems were especially nasty when short-term interest rates were elevated or when individual cities and towns encountered localized economic distress. It was far more efficient to divide the single business model into three parts, with specialization in origination of mortgages, loan servicing, and investing. By this separation, large mortgage-market participants could amass expertise and advanced technology. And they could do it on a national playing field, reducing the risk of undiversifiable geographic lending concentrations that were often the bane of many local banks and thrifts.

3. Securitization couldn't have thrived without indispensable government support. Mainly that came from GNMA, FNMA, and FHLMC, commonly referred to as Ginnie Mae, Fannie Mae, and Freddie Mac. These government-sponsored enterprises, GSEs, facilitated the bundling of loans into MBSs, most importantly by taking over the risk of loss through default by individual homeowners on their mortgages and by setting high standards on the quality of the mortgages that they were prepared to guarantee (called "conforming" mortgages). That meant that buyers of pass-through securities (the simplest kind of MBS) didn't have to worry about credit risk so they could focus on the very difficult, but manageable, exposure to market risk that they took when investing in mortgage-backed securities. The private markets couldn't do it alone, but didn't have to, because of the integral role of the GSEs in the financial system.

4. Until the early 2000s, subprime mortgages represented a modest, almost inconsequential, part of the mortgage financing system. But by about 2002, things were changing rapidly. What happened? First, Fannie and Freddie, stockholder-owned and privately-managed since the early 1990s, lost control of their operations. They got in the habit of doing more than absorbing credit risk and facilitating securitization but instead began to hold more and more mortgages in their own portfolios, financed through borrowing (relatively cheaply because of an implied US Government safety net) in the capital markets. Some market professionals thought of them as running the biggest hedge funds in town. But in so doing they were taking huge market risks and relied on massive transactions in financial derivatives in order to try to hedge the risks they were taking. They handled this badly and for years their financial accounts have been a mess.

CEOs and CFOs were replaced, fines were paid, and their overseer, OFHEO, essentially put limits on their growth until they got their financial houses in order.

5. This opened the door for major players in the private sector to move into the home mortgage financing business in a major way. And that included pushing the envelope on creditworthiness of borrowers. Long-tested rules of thumb on what once constituted sound banking practices went out the window. By 2006, upwards of 40% of all new mortgages being originated were subprime or Alt A, i.e. deficient in some ways. It created a time-bomb when these loans were securitized through privately-issued MBS or then recombined into collateralized debt obligations, CDOs. These are complex securities comprised of a variety of MBSs and other financial instruments, often involving substantial leverage. Last summer, they became almost unmarketable when buyers realized the potential for loss was far greater than they had ever imagined.

6. The growth in mortgage-related securities by what the Fed calls "asset-backed securities issuers" was stupendous. The data are in the chart below. From a relatively modest level, private securitization, increasingly involving subprime mortgages in the 2002-2007 period, has taken on an increasing and probably inordinate share of overall mortgage financing business:

Mortgage securitization in this decade, end of period

	2000	2002	2003	2004	2005	2006	Q3 2007
Total home mortgages $ trillion	5.13	6.44	7.23	8.28	9.34	10.42	11.03
Total % securitized	54.8	56.1	53.6	52.1	53.5	55.4	57.0
% securitized privately	7.5	8.5	9.2	12.7	16.7	19.7	19.8

Source: Federal Reserve Board, Flow of Funds

7. The US financial regulatory system was ill-equipped to deal with abusive lending practices of financial institutions not under the formal supervisory authority of the Fed or other traditional bank regulators. The majority of mortgage banks fell between the cracks. That was dangerous once their role in the mortgage financing suddenly escalated. As the housing boom fueled soaring home prices, large numbers of potential home buyers were eager to get in on the action. Many were not creditworthy under normal standards. But the mortgage bankers developed variations on conventional loans to allow them to borrow. Subprime mortgage products offered low teaser rates to attract customers. They let applicants lie about their incomes and put up small or even zero down payments. But those borrowers would have to accept stiff prepayment penalties, a sharp break from normal US customs, and agree to pay sharply higher interest rates when their initial low rates were adjusted in a year or two. A more responsive regulatory system would have stepped in to catch the most abusive tactics before thousands were trapped in loans they would likely not be able to carry.

8. The ratings agencies made poor judgments and were subject to intense conflicts of interest, since their compensation was paid by the issuers. They awarded high ratings evidently with little or no evaluation of the likelihood of default should house prices fall back.

9. Institutional investors were lazy and cheap: lazy, because they relied almost entirely on credit ratings rather than performing their own due diligence; cheap, because they didn't pay outside experts to "stress test" the conclusions of the ratings agencies under differing scenarios.

10. And many borrowers cynically got themselves into trouble by assuming that the housing price boom would go on forever. Instead they chased the dream of becoming mini-real estate speculators, while subjecting themselves to high and escalating interest rates in return for not having to tell the truth about their incomes and not having to put up sizable down payments.

In short, there is more than enough blame to go around. What can be done, now that the situation has gone beyond the danger point?

While I don't have a formal policy proposal to offer, I do have four observations with which to conclude:

First, every first-year economics student comes across the concept of "externalities" or what are also described as "neighborhood effects." What this means is there is a market failure. And when there is market failure there is a strong case for public policy to counteract the negative effects. Foreclosures present an especially brutal externality as the adverse neighborhood effects are visible to everyone: who wants to live next door to a boarded up home taken over by a lender? Isn't it obvious that the value of every house in such a neighborhood is going to be undermined, to some extent or perhaps a lot, by foreclosures? So isn't there a strong public policy case for preventing them? Yes, and President Bush himself acknowledged such a case in his remarks of early September 2007. The sad thing is that the administration was agonizingly slow in following up on his call for a program to assist troubled borrowers so as to minimize foreclosures. Subsequent efforts, from Hope Now to the latest iteration announced by the Treasury Secretary a few days ago, are useful but insufficient.

Second, the case for a public policy response is further strengthened by another example of market failure: the provision of flood insurance. Everybody knows that private insurance companies have no interest whatsoever in offering flood insurance. Most homeowners are not at risk and wouldn't buy it. Only those who live in familiar exposed areas, along the Gulf Coast, or the Ohio River system, or similar spots, desperately need coverage but couldn't afford what a private insurance company would have to charge in order to provide such coverage profitably. So government has to step in, and even then not everybody who would benefit bothers to buy the affordable coverage government provides. Analogous arguments can be made for credit risk insurance.

Third, now that hundreds of thousands of homeowners, including veterans, are at risk of becoming delinquent and possibly losing their homes, the voluntary program for individual loan work-outs that is in place needs to be supplemented by something more comprehensive. The simplest approach would be for the government to offer affordable medium-term loans to low and middle-income individuals to allow them to repay abusive subprime mortgages on their primary residences. That may require legislation to override particular terms in mortgage contracts that impose stiff prepayment penalties, a feature that was almost unheard of in American mortgages before the subprime mortgage explosion.

Finally, the financial regulatory system governing mortgage financing and securitization, by far the largest part of the credit markets and easily the most important for the vast majority of Americans, has to be fundamentally upgraded. The administration has put its emphasis on FHA and the GSEs. That is their prerogative. But other key elements of the system failed to function in the public interest. Appropriate implementation of the Banking Holding Company Act by the Federal Reserve has been spotty. The SEC has been slow in recognizing its enormous mistake in giving special pride of place to credit ratings agencies, thereby nurturing an unwarranted complacency among investors that somehow the SEC stands behind their methods and the ratings themselves.

America's veterans have served this country with skill and valor. They have a right to expect that the economy and financial system of this country is similarly managed in the national interest, even if that sometimes means that certain participants in financial markets must accept restraints on their activities. No one should be proud of what has happened in the field of mortgage financing in the past five years. And it shouldn't be allowed to get worse.