

## **Investment**

### **The Origins Of The Subprime Fiasco In The U.S.**

By: Joe the Investor

The subprime meltdown has been documented by many sources, but where did it really come from? How long were the seeds planted before the eventual calamity took place? Who or what are the key factors in allowing it to happen?

#### **Poor Credit History**

Subprime mortgages are mortgages issued to people with poor credit history, poor work history, no down payment, and sometimes lower than market 'teaser rates' that eventually jump much higher after a certain amount of time. People who need a subprime mortgage to buy a home likely cannot afford the home in the first place and will be the first to lapse on mortgage payments when the real estate market or the job market heads south.

Subprime mortgages existed as far back as the 1980s, but were a very small niche market within the U.S. mortgage market.

During the 1990s, the market steadily expanded. It has been stated that the subprime crisis originated after 2001 when the Federal Reserve headed by Chairman Alan Greenspan lowered the Federal Reserve Funds rate to one per cent. However, subprime mortgages were already at \$160 billion in value in 1999, and the credit default swaps based on them were already at \$632 billion in value by the year 2000.

Lower interest rates undoubtedly accelerated this trend, but they were not the cause. The first company that issued these mortgages on a large scale was First Alliance, back in the 1990s. They had a lucrative business, but due to its riskiness, they faced many lawsuits from homeowners. Eventually the company went bankrupt under the weight of the legal actions. When First Alliance went under in 2000, Lehman Brothers took the company over. They assumed what was left of the business and rebuilt it, becoming the largest subprime lender in the U.S. It is widely known what happened to Lehman Brothers in 2008.

#### **Large Slice**

The issuers of these mortgages were part of the problem, but there were other factors in the picture as well. Since banks outsourced their mortgage operations, a large slice of the mortgage business went to private mortgage brokers. Their business is to generate sales and commissions, but they don't necessarily have a stake in the risk of homeowners not keeping up their mortgage payments. Since mortgage commissions depend on mortgage size, they want the biggest mortgages they can possibly get.

What is necessary to determine the value these mortgages? Every home qualifying for a mortgage needs to have an appraisal to ensure an unbiased third-party home valuation. These appraisers received all of their business from mortgage brokers. They were under pressure to inflate home values by as much as 10 per cent and an estimated 75 per cent of appraisers were pressured to inflate home values in the U.S.

There are mortgage issuers, mortgage brokers, and appraisers doing questionable things, but how did the subprime crisis get so big?

The next phase of this sequence is with the regulators.

In 1999, the Commodity Futures Modernization Act was passed in 1999. This allowed Credit Default Swaps (CDS) to trade off the exchanges and be deregulated. This means there was no

accounting for these transactions and limited transparency. This market grew from under \$1 trillion to \$57 trillion in almost 10 years.

Continuing with the regulators, securitized packages containing these mortgages were given AAA ratings. This is a rating reserved for governments which have unlimited taxing powers on the resources of a country, including its people, natural resources, and businesses. How does a group of mortgages – even of the highest calibre – compare to a government in credit quality? The rating agencies worked with the banks to facilitate these AAA ratings and make them feasible.

### **Opened The Door**

This opened the door to many investors who otherwise would not have considered buying these securities. These include pension plans, hedge funds, and endowments. Due to the blessing of the rating agencies, these investors bought these securities and are now facing writedowns as a result.

It is clear that there are many players involved in the development of the subprime fiasco, but there was also a lot of time involved in getting to the current situation. There were many winners and losers in the subprime game. Only in tracing the causes can we be prepared for what may come next.

*Joe the Investor is Joe Barbieri, an investment research analyst, public market investments, at a Canadian pension fund ([joetheinvestor.today@gmail.com](mailto:joetheinvestor.today@gmail.com)).*