

# THE IMPACT OF RISKY MORTGAGE LENDING AND SECURITIZATION ON THE FINANCIAL CRISIS

## The Financial Crisis Inquiry Report and the “Mortgage Machine”

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The Financial Crisis Inquiry Commission (“FCIC”) recently released a report entitled, “The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States Official Government Edition (2011),<sup>2</sup>” (the “Report”). The Report discusses contributing factors of the financial crisis,<sup>3</sup> including inflated home prices, irresponsible borrowing and lending practices, a “financial euphoria” that consumed the nation, risky investing, untenable securitization, and overall lack of oversight. Such practices proved unsustainable after the housing bubble burst.<sup>4</sup> In combination, these factors resulted in a greatest collapse to our financial system since the Great Depression.

Changes to our financial system began with the development of a shadow banking industry.<sup>5</sup> The shadow banking system consisted primarily of investment banks operating in unregulated markets.<sup>6</sup> After a while these investment banks rivaled Fannie Mae and Freddie Mac (“Government Sponsored Enterprises” or “GSEs”), in the amount of mortgages that they purchased and securitized.<sup>7</sup> Securitization consists of purchasing mortgages, then pooling and selling them as mortgage-backed securities. Where the GSEs traditionally followed conservative

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<sup>2</sup> FINANCIAL CRISIS INQUIRY REPORT (Authorized Edition, Public Affairs) (2011) [hereinafter Report].

<sup>3</sup> *Id.* at 3.

<sup>4</sup> *Id.* at 4.

<sup>5</sup> *Id.* at 27.

<sup>6</sup> Report, *supra* note 2.

<sup>7</sup> *Id.* at 28.

purchasing and securitization guidelines, investment banks such as Lehman Brothers or Morgan Stanley, purchased and securitized the riskier loans.<sup>8</sup> The investment banks earned fees from bundling and pooling the mortgages into mortgage-backed securities, and separating the securities into tranches.

The securitization process was beneficial to originating banks because it helped them move loans off of their books.<sup>9</sup> In turn, banks reduced the amount of capital needed to protect against losses.<sup>10</sup> Banks began to lend money based on fees earned by selling loans and not based on the amount of money held through deposits.<sup>11</sup> Investors bundled or “pooled” the loans into a single security, selling off portions of the security in the form of “tranches.” The tranches were categorized based upon risk. Risk adverse investors purchased the top-rated tranches that carried lower risk, but a higher yield. Return-oriented investors purchased the low-rated tranches that carried greater risk, but a higher yield. In the event of a default on a mortgage in the security, the top-rated tranches in the security were paid off first while the bottom tranches were paid off last.

After the housing bubble burst, demand remained for more mortgage-backed securities. To generate more mortgages, banks lowered their lending standards. Even then, banks could not originate enough mortgages to satisfy investor demand. Investors compensated for the loss in the production of new mortgages by creating and investing in derivatives.<sup>12</sup> “Derivatives are financial contracts whose prices are determined by, or ‘derived’ from the value of some

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<sup>8</sup> *Id.* at 41-42.

<sup>9</sup> *Id.* at 39.

<sup>10</sup> Report, *supra* note 2, at 43.

<sup>11</sup> *Id.* at 42-43.

<sup>12</sup> *Id.* at 45.

underlying asset, rate, index, or event.”<sup>13</sup> Derivatives are not based upon capital, but are based upon speculating changes to capital, such as to prices, interest rates, or credit risk.<sup>14</sup>

The most common forms of derivatives are the over-the-counter (“OTC”) swaps and exchange traded futures or options.<sup>15</sup> An OTC derivative that played a large part in the financial crisis was the credit default swap (“CDS”).<sup>16</sup> A CDS operated similar to insurance, except that the investing party did not own an actual insurable interest. A CDS is a speculation on the default of the underlying loan, or a bet that a borrower will pay or fail to pay his mortgage. The two sides to the bet were one party investing in borrower default, and the other borrower in payment. Those that bet on default would purchase insurance on the default, such as through AIG Financial. In fact, AIG emerged as the dominant guarantor of CDSs, writing an overwhelming amount of protection against default.<sup>17</sup>

Before truly discussing the CDS market, it is necessary to touch upon the financial instrument known as the “collateralized debt obligation” (“CDO”). The CDS market developed out of the CDO market. CDO investors first purchased the riskier tranches of the mortgage-backed securities.<sup>18</sup> The CDO managers created new pools of mortgage-backed securities from those purchased. The new CDO pools were further separated into tranches and rated according to risk (even though they were essentially all risky loans).<sup>19</sup> The CDO tranches were given generally higher ratings in the CDO than they held in the initial mortgage-backed security.

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<sup>13</sup> *Id.* at 42-43.

<sup>14</sup> Report, *supra* note 2, at 46.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 50.

<sup>17</sup> *Id.*

<sup>18</sup> Report, *supra* note 2, at 50.

<sup>19</sup> *Id.* at 128.

From the “cash CDO” described above, emerged the “synthetic CDO.” “Synthetic CDOs were complex paper transactions involving credit default swaps.”<sup>20</sup> Compared to the cash CDO, the synthetic CDO contains no mortgaged backed securities. Instead, they contain simple references to mortgage backed securities, replacing actual mortgage-backed securities with credit default swaps.<sup>21</sup> Those investing in the synthetic CDOs profited depending on how the mortgage-backed security performed (bet on the borrower paying or defaulting on the mortgage). The “long” investors made money if the mortgage-backed security performed, and the “short” investors who hedged their money on default.<sup>22</sup> A short investor purchased credit default protection on the reference securities in the CDO, in order to recoup money upon default. Some investment firms, like Goldman Sachs, made a long and short investment on the synthetic CDOs that they created, therein, betting on the success and default of its own CDOs.<sup>23</sup>

The entire credit default scheme was, as Michael Greenberger, a professor at the University of Maryland School of Law termed it a “casino.”<sup>24</sup> As the CDO market grew, so did the demand for subprime mortgages to fuel securitization. The synthetic CDO market on the other hand did not depend upon the creation of new mortgages to function, but instead depended upon reorganizing references to existing mortgage-backed securities. When the mortgage market dried up, the synthetic CDO was a means for the investor to keep betting on the success or default of mortgages. “By layering the correlated risk, they spread an amplified exposure to losses when the housing market collapsed.”<sup>25</sup>

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<sup>20</sup> *Id.* at 142.

<sup>21</sup> *Id.*

<sup>22</sup> Report, *supra* note 2, at 142.

<sup>23</sup> *Id.* at 143.

<sup>24</sup> *Id.* at 146.

<sup>25</sup> *Id.* at 155.

The rating agencies perpetuated the risky cycle by imperviously rating CDOs higher than deserved. Rating agencies, such as Moody's and Standard & Poor (S&P) rated the tranches based upon the likelihood of default and the revenue lost to investors upon default.<sup>26</sup> The erroneously high rating gave investors incentives to keep creating, purchasing, and betting on the success of CDOs. The repackaging and selling of mortgage backed securities, and the ever growing securitization of CDOs exposed the many players to more and more risk. "By layering the correlated risk, they spread and amplified exposure to losses when the housing market collapsed."<sup>27</sup>

Whereas the rating agencies had previously rated securities higher than deserved, in 2007, when an increased number of borrowers began to default the rating agencies reacted by downgrading various securities. The rating agencies voiced that downgrading was due in part to an increase in delinquencies and foreclosures. In July 2007, Moody's downgraded a large number of subprime mortgage-backed securities and put many others on watch.<sup>28</sup> Soon afterwards, S&P downgraded numerous other subprime tranches. Moody's made another large downgrade in October 2007 and put more on watch.<sup>29</sup> "Through 2007 and into 2008, as the rating agencies downgraded mortgage-backed securities and CDOs, and investors began to panic, market prices for these securities plunged."<sup>30</sup>

Those companies with the greatest subprime exposure were hit the hardest. The first company to collapse was Bear Stearns, which JP Morgan acquired with government assistance.<sup>31</sup> Lehman Brothers collapsed afterwards, which the government chose not to bail out and Lehman

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<sup>26</sup> Report, *supra* note 2, at 71.

<sup>27</sup> *Id.* at 155.

<sup>28</sup> *Id.* at 249.

<sup>29</sup> *Id.* at 250.

<sup>30</sup> Report, *supra* note 2, at 254.

<sup>31</sup> *Id.* at 280.

Brother went bankrupt.<sup>32</sup> Thereafter, AIG went under, and the federal government decided that due to AIG's connections to large commercial and investment banks, that AIG was too big to fail. After the AIG collapse, investors lost total confidence and the markets plummeted.<sup>33</sup> In reaction, government went on to rescue a number of failing institutions that it decided were too interconnected, and too big to fail. The government made a trade-off between risking a total collapse of the financial system and using trillions of taxpayer dollars to bail out failing investment and commercial banking institutions.

Overall, banks that chose to invest in the success of, or purchase the risky mortgages, traded long term sustainability for short term profit. Even Fannie Mae and Freddie Mac lost sight of the benefits of conservative investing.<sup>34</sup> Many other factors contributed to the financial meltdown, but the risky lending practices had a substantial impact on the fluctuation of events leading up to it. The mortgage securitization process depended on accurately predicting which borrowers could pay and which ones would default. As it turned out, “the concept of lawful betting on billions of dollars on the question of whether a homeowner would default on a mortgage that was not owned by either party, [] had a profound effect on the American public and taxpayers.”<sup>35</sup> Once it became clear to the rating agencies and the majority of investors that many of the securities contained failing mortgages, the markets collapsed, banks failed, and the financial crisis struck the nation. Our country is still recovering from the financial crisis. The Report discusses many contributing factors, but it remains unclear how the crisis may have been entirely averted.

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<sup>32</sup>*Id.* at 324.

<sup>33</sup> *Id.* at 381.

<sup>34</sup> Report, *supra* note 2, at 280.

<sup>35</sup> *Id.* at 146.