

Sub-prime mortgages and securitisation:
A brilliant idea for widening access –
What went wrong and what can be rescued?

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Early Promise

In the years 1999-2005 the development of the sub-prime market in the United States was praised and welcomed by almost everyone in the USA, politicians, economists, borrowers and lenders. It represented a method for getting the disadvantaged of the country, the poor, Latinos, African-Americans, with poor or non-existent credit records, onto the housing ladder, with profits accruing to all. Fannie Mae and Freddie Mac were even urged to widen their criteria for guarantees.

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Robert Shiller, *The Subprime Solution*, (Princeton University Press, 2008). Quote from p. 23,

“Although the subject comes up only rarely in the public discourse on the current financial crisis, the advent of subprime mortgages during the 1990s reflected a start, albeit primitive, toward extending the benefits of financial innovation to more and more people – in other words, toward democratizing finance. Prominent commentators, from former Fed chief Greenspan through the late real estate economist Edward Gramlich, considered the subprime mortgage movement a positive development (despite some abusive lending practices) because it effectively expanded the franchise for asset ownership to millions of low-income people.”

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How did it work?

<u>Borrower</u>	<u>PD</u>		<u>Pooled and Trunched</u>	<u>PD</u>
A	10%	→	AAA 80%	0.05%
B	6%			
C	9%			
D	7%			
E	11%		A+ 10%	0.1%
•	•		Bs 5%	4.0%
•	•		Equity Toxic Waste 5%	50%
Z	6%			

Assumes independence of PD between borrowers for the most part. UE, 4
Sickness, Family problems, Gambling, Addiction, etc.

What went wrong?

Bet on housing prices continuing to rise over coming years. Despite regional house price collapses, New England, 1990-92, Texas 1996, California, no cases of US wide house price declines. So regional diversification protects.

Goodhart and Hofmann House Prices and the Macro-economy (OUP, 2007)

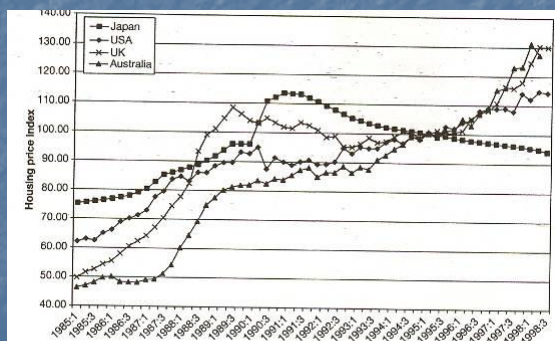


Figure 9.4. Housing prices, 1985–1998 (1995=100)

Note: Standard deviations: Japan, 11.01; USA, 13.92; UK, 20.23; Australia, 23.21.

Source: National central banks; national statistical offices.

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Procedure

Adjustable Rate Mortgages, 2/28, 3/27

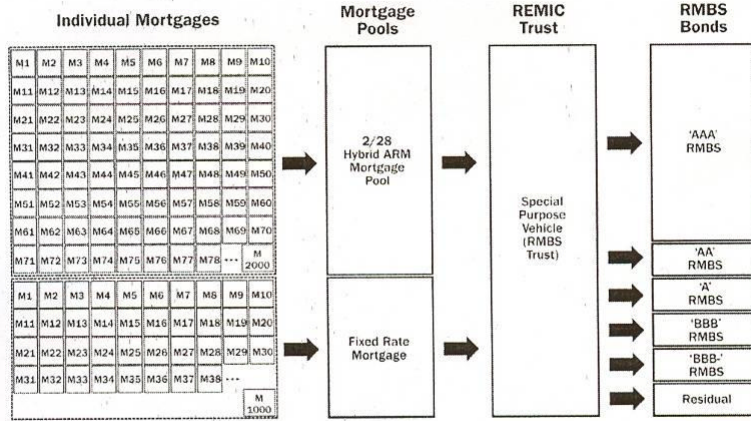
Teaser rates, and pre-payment penalties.

Refinance, not re-set, at lower interest rates.

Some evidence of fraud, predatory lending, and falling standards, but not much evidence of that worsening over time, (Gorton, 2008; Sengupta and Bhardwaj, 2008).

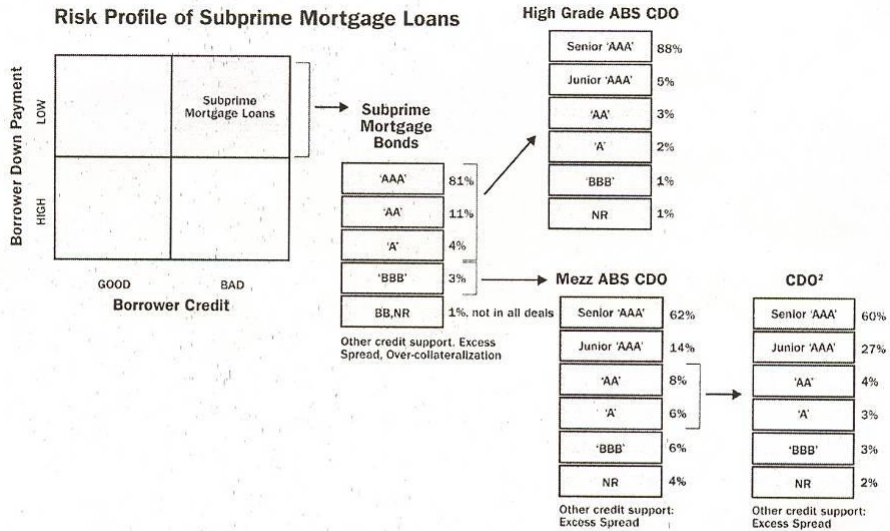
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Sample Subprime MBS Structure



Source: Kevin Kendra, Fitch, "Tranche ABX and Basis Risk in Subprime RMBS Structured Portfolios," Feb. 20, 2007.

Risk Profile of Subprime Mortgage Loans



Source: UBS, "Market Commentary," December 13, 2007.

Price decline 2006, driven by over-building.

Mortgages without recourse.

Jingle mail

Foreclosures

Distress sales

Securitisation

Uncertainty both about housing prices and underlying composition of residential assets.

Market for securitised mortgages dries up.

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Plans for reviving housing market

Conflicts of interest between classes of investors over foreclosure.

Who is counter-part lender, (in USA house-owner keeps deeds)?

Measures to help involve lower cost to borrower, lower immediate payment to lender, offset by guarantee or upside potential, Swaprent, Feldstein, Zingales, etc. All complicated by securitisation.

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How to Rescue?

It is not sensible to rely on ever-rising housing prices. Provide an equity buffer.

Maximum Loan to Value Ratio. 85 or 90%

As done in Continental Europe.

Register of dwellings, Hernando de Soto, The Mystery of Capital

- Appraisal (Land tax),
- Forbid second mortgages, foreign mortgages by prevention of foreclosures, i.e. unsecured lending.

Does that not undermine whole purpose?

Offset by fixed amount subsidy to first-time buyers, (resident in S.A., evidence of mortgage finance, register). (NB, as done in Australia).

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But what if housing price fall still exceeds buffer?

Provide each securitised instrument with a trustee.

Role of trustee is to decide on foreclosure policy, when/if foreclosure occurs. Trustee acts in court.

Trustee to act on behalf of holders of claims on cash flow, i.e. to maximise present value of claim, but also to take full account of government policy, when government sets out such a policy. (NB: Government policy will affect future interest rates, i.e. protecting defaulting borrowers will raise future interest rates.)

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Conclusion

Subprime plus securitisation remains a great idea.

What it needs are:-

- (1) LTV limit, plus first-time fixed subsidy;
- (2) Register, plus appraisal dwelling prices.
Forbid second (foreign) mortgages;
- (3) Trustee for RMBS securitised instruments to
decide on foreclosure policy.