

Subprime Mortgages – Rise And Fall

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HISTORY OF CRISES

Although there have been many financial panics and crises, the most notable crises have been Wall Street Crash (1929), the last to rival the current problem in terms of scale; the OPEC driven Oil crisis (1973); Black Monday (1987); the Japan Asset Bubble (1990); Asian Banking Crisis (1997); Russian Crisis (1998); and the so-called Dot-com Bubble (2000). While the rating agencies made mistakes prior to the Great Depression, and there were many defaults, the US government embedded ratings in the new banking regulations created at the time to forestall a recurrence of the multiple bank failures.

Obviously rating agencies had a limited or no role in most of these crises. However, it must be admitted that the importance of the rating agencies has increased manifold during the last two decades primarily because enhanced marketing by credit rating agencies has resulted in increasing reliance of investors on the rating agencies. This means the failure to properly rate the mortgage backed securities and CDOs, had a much greater impact than it might have had decades ago.

BACKGROUND OF SUBPRIME LENDING

Sub-prime lending consists of loans to borrowers who do not meet traditional standards of income, credit history and capacity to make loan repayments.

The consequences of the current sub-prime mortgage crisis go far beyond anything seen in history. It began with United States regulators presuming that historical lending standards for conforming mortgages were more rigorous than necessary and therefore forced lenders to make loans to formerly ineligible borrowers and in neighborhoods that were viewed by lenders as unsatisfactory. Bankers declining to offer such loans found their applications for acquisitions and new branches blocked by regulators. Moreover, the mortgage agencies were induced to act as though the assets were normal and could be securitized.

This would have been true, except that the investment bankers and rating agencies used incorrect assumptions in their pricing models, and the paper created was treated as if the obligors were qualified and the mortgages conforming. Rather than pricing the paper to allow for significant defaults like 35 or 40 per cent, it was priced to cover minimal defaults like 5% or less.. This mispriced paper was then used to create collateralized debt obligations, again mispriced, and often insured by companies like American International Group for premiums that were not reflective of the risk because they did not know how to measure it.

GROWTH OF SUB-PRIME LENDING

In the early 1990's sub-prime loans were rare. But starting in the mid-1990s, sub-prime lending began surging. According to some estimates, these loans comprised 8% of all mortgages in 2001, soaring to 20% percent by 2006. Since 2004, more than 90 percent of the sub-prime mortgages came with adjustable rates.^{1**}

With low interest rates, housing prices on a steady rise, and highly lax government regulation, banks and mortgage finance companies expanded the universe of borrowers substantially in a way that inevitably resulted in loans to unqualified borrowers. They bent the rules that define conforming mortgages, like loan-to value ratio, mortgage installments to disposable personal income and borrower's credit history, thereby lowering normal lending standards. Investors, in a low-interest rate environment and high liquidity, liked the paper that could be created with these relatively high rate loans. By 2007, the sub-prime business had become a \$1.5 trillion global market for investors seeking high returns.^{2**}

It is also important to understand that while the subprime lending was increasing at a phenomenal pace, the problem became more complex because the sub-prime lenders didn't hold on to these loans. Instead, they sold them -- and the risk to investment banks for securitization. Over the past few years, large bank lenders and mortgage bankers have refined strategies for securitizing credit --that is, they originate mortgage loans or purchase them from specialized brokers and transfer them to a special purpose vehicle, which then packages them into mortgage backed securities and collateralized debt obligations (CDOs) for sale to other investors.

ROLE OF STAKEHOLDERS

The growth of this industry at this phenomenal pace was amazing, however it needs to be understood that this growth was fuelled by a perceived win-win situation for all the stakeholders involved.

Borrowers were happy because previously being ineligible they could not afford a loan, which was made possible through these instruments. They thought that the interest rates will continue to remain low and housing prices will continue to increase and therefore they were tempted to take these loans.

Mortgage companies jumped into it as they made money through the origination and subsequent sale of loans to large banks and investment companies. Their stake in the system was low because once they sold the loans, they were virtually out of it.

Origination fees, servicing fees and underwriting fees all provided economic incentives for investment bankers to focus their attention towards this business and actively participate in generating more transactions.

Rating agencies, found a new avenue of income generation and the fees earned were so high that they may be perceived to have relaxed their standards.

¹ The conservative origins of the sub-prime mortgage crisis by John Atlas and Peter Dreier –

² The conservative origins of the sub-prime mortgage crisis by John Atlas and Peter Dreier –

The investors found that these papers, while offering a substantially higher yield, have a low risk profile. This perception of the lower risk was largely driven by the higher ratings given by the rating agencies.

Regulators and government believed that they are fulfilling their social responsibility in providing housing to the low income groups and therefore they were willing to help nurture the industry.

No one was very concerned about the future implications of this kind of lending, so far as the individual aims of stakeholders were satisfied.

WHAT WENT WRONG ?

However, once interest rate began to rise and housing prices started to drop moderately in 2006-7 in many parts of the US, refinancing became difficult. The whole scheme worked as long as borrowers made their monthly mortgage payments. When borrowers couldn't or wouldn't keep up the payments on loans that were re-priced to higher interest then what looked like a bonanza for everyone turned into a national foreclosure crisis and an international credit crisis, which still seems to be far from over. This crisis has led to the demise of institutions like Lehman Brothers and bailout of another number of institutions like Citibank and AIG.

ROLE OF RATING AGENCIES:

While it is difficult to pinpoint one particular reason for failure of ratings, I would say that it was a combination of the three factors i.e. errors in judgment, conflict of interest and element of complacency.

Rating agencies made an error in the judgment of the characteristics of these securities. The basic premise of securitization is that you can create economic equity in a pool of assets by virtue of allocating cash flows to senior and subordinate tranches of funding. Thus you can price a pool to cover losses of say 35% or 5%. In the case of sub-prime pools, minimal losses were assumed and the securities were given prime ratings with limited protection against loss. This proved a significant error on the part of rating agencies. Moreover, it was compounded by the insurers who stepped in to offer default insurance, thereby enhancing the ratings and making it more attractive to investors.

One of the most common criticisms on rating agencies since the crisis began has been the conflict of interest. It is alleged that rating agencies first earn fees from advising on how to structure bonds and derivatives so that these receive the desired rating³. They then rate those issues in a manner which at times would lead to a belief that business considerations may have had an impact on ratings. While it is difficult to say whether this criticism is fair or not, no doubt that such practices should be avoided.

It has also been alleged that there was a sense of complacency among the big three global rating agencies. This perhaps is due to the dominant position of rating agencies. The fallout of such a dominant position was the comments made by SEC in their report of June 2008 which states that there was a substantial increase in the number and in the complexity of RMBS and CDO deals and some rating agencies appear to struggle with the growth.

³ Ten questions about subprime crisis by Barry Eichengreen, Professor of Economics and Political Science, University of California, Berkeley

The reason for such a dominant position of global rating agencies is that credit rating agency market is perceived to be having high barriers to operate, due to the so-called credibility factor which is used by both the regulators in recognizing credit rating agencies and by issuers in their selection of rating agency. The credibility and reputation takes time to achieve, since a perceived essential element of credibility is the history. New rating agencies, because of their short history are not perceived to be as credible as global rating agencies. However, it is feared that this overuse of history factor by both the regulators and investors would help to only maintain the dominant position of the established global credit rating agencies – and thus potentially diminish credit rating quality as was seen during the sub-prime crisis.

DOES CREDIT RATING ADD VALUE

The question that is most frequently asked these days in the financial circles is that is there a role of rating agencies and do they add value. My view is that the rating agencies on an overall basis have done decent job in providing an independent, third party, unbiased opinion which has in general helped the investing community in arriving at their investment decisions.

However, we believe that the structural changes are required to breakdown the oligopolistic nature of the credit rating industry and to allow newer rating agencies to flourish. To better understand this, we need to understand the dominant position of the three global credit rating agencies.

THE STORY OF BIG THREE

If we look at the history of the big three rating agencies, we will find that

- Moody's Investors Service, a publisher established in 1900; took the idea for ratings from Dun & Bradstreet in 1909 to enhance the value to investors of his statistical manuals
- Fitch Investors Service established 1913; ratings from 1924
- Standard Statistical and Poor's Corp merged in 1923

In a testimony before the US House Committee on oversight and government reform, Sean J. Egan, Managing Director of Egan-Jones Rating Co mentioned that according to Moody's itself, the three companies are responsible for 95% of global ratings with Moody's and S&P having approx. 40% share and Fitch having 16% share.⁴

The total revenues of the credit rating industry, in 2007, were approx. USD 5 billion. Moody's which is the only publicly listed company among the three, had revenues of USD 2.3 billion in 2007 and an operating margin of 50.1%.

These facts clearly demonstrate that the nature of the industry is largely oligopolistic and dominated by only a few players.

⁴ Testimony of Sean J. Egan, Managing Director, Egan-Jones Rating Co. before the House Committee on Oversight and Government Reform

HOW TO ENCOURAGE COMPETITION IN THE CREDIT RATING INDUSTRY

The question remains how to improve the nature of the industry where 95% of the ratings are undertaken by only three main players and enhance the role for alternate credit rating agencies. My view is that the present rating industry structure that led to the recent happenings has made it quite evident that there is a definite and positive need for new credit rating agencies. The competition will help improve quality of the ratings and restore confidence of the market in the ratings. To achieve this objective, an effort and initiative is required from all the stakeholders.

The existing global rating agencies should be the first one to realize the importance of broader market. While this may sound naïve, existing big global players must realize that the new players may help broaden the overall global rating market and restore the confidence of investors and regulators. However, what we have seen so far is quite disappointing, as the existing global rating agencies in one form or another, have been opposing the regulators in opening up the industry to new players. We believe that this attitude should be reviewed and such opposition should be withdrawn in the best interest of credit rating industry and investors at large.

We also strongly believe that the regulators too have a great role to promote competition between the rating agencies. This can be achieved by recognition to the relatively new local or regional rating agencies. Such recognition should be given after a thorough review of the management and procedures of the new rating agencies. It is a bit disappointing to note that in the whole GCC region, only one regulator has given recognition to a local rating agency. I believe that others should follow suit and provide more opportunities to the local rating agency. This will help not only to increase transparency and disclosure but also provide regulators and investors a chance to judge the quality of the work and the rating basis of each of the competing organizations.

The last, but perhaps most important player, is the investor community. Investors should realize that ultimately they are the victims of any judgmental or unintentional error by the global rating agencies and therefore it is their job to encourage more competition in the rating industry. The investors can achieve this through use of ratings as means to bring more transparency, disclosure and stability in the system and through selection of alternate local rating agency. If the investors adopt these practices, then there is a higher probability of bringing not only stability in the market but also the depth in the long run. The investors therefore should give up their undue reliance on the global rating agencies and provide an opportunity to relatively new rating agencies for rating the instruments managed by them. However, if they continue to have the same herd mentality and do not participate in breaking down the oligopolistic nature of rating industry, then I am afraid that the crisis may be repeated.

FOOD FOR THOUGHT !

At the end of my presentation, I just want to leave you with a food for thought. Have we learnt from the mistakes. If so, are we prepared to take steps to ensure that similar crisis does not happen in future. If the answer is yes, then we need to take immediate steps to help restore market confidence. One of such step is ensure greater transparency and disclosure, better risk management and use of third party independent, unbiased opinion giving by local rating agencies .

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