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# How The Subprime-Mortgage Nightmare Grew, And Why Lawyers Share Blame

Abstracted from: *The 2008 Bankruptcy Of Literacy—A Legal Analysis Of The Subprime Mortgage Fiasco*
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**American dream; international nightmare.** Law professor Bernhard Grossfeld and attorney Hansjörg Heppe take the legal profession to task for the subprime-mortgage disaster. Attorneys contributed to the debacle, the authors reason, by documenting the creation and securitization of loans without analyzing the underlying economics, deferring instead to the supposed wisdom of self-regulating markets. In the debacle's prelude, tax-deductible mortgage interest at low rates had already maximized the number of people achieving the American dream of owning their homes. To extend the resultant rise in home prices, lenders targeted low-income buyers by offering onerous deals to compensate for the higher default risks. The lenders sold the notes and mortgages to securities firms, which pooled the instruments in off-balance-sheet, special-purpose vehicles. Those SPVs, in turn, issued securities that transferred the risks to mostly foreign investors. When a worsening economy left many borrowers jobless, the ensuing defaults caused an international nightmare: investors' 2008 losses on these securities are estimated to have topped $17 trillion.

**No bed of roses for borrowers.** Among the onerous deals were adjustable-rate mortgage loans, which lured borrowers with a fixed, discounted interest rate until the reset date, typically the loan's second or third anniversary. Then, subject to a cap, the rate increased substantially to a variable base rate (usually the London Interbank Offered Rate) plus percentage points that varied in proportion to the credit risk. Borrowers could prevent a rate increase by refinancing prior to the reset date, but lenders discouraged refinancing, which shrank their profits and those of securities firms, since securitizations ordinarily amortized over the lives of the loans. One study reported by the authors found that fewer than 2% of prime mortgages had prepayment penalties, but up to 80% of subprime mortgages had penalties of 1% to 6% of the original loan amount. Federal statutes require that borrowers receive informational booklets, telling them how to buy and finance homes and explaining ARM loans. Unfortunately, few borrowers were actually reading these legalese-filled masterpieces, written in a language that only accountants and lawyers comprehend easily.

**Sleepwalking through the big picture.** Securitization set up a chain of agents, who each had a false sense of security about the transactions to which they were not parties and who could deny liability for other agents' actions. Lending standards deteriorated as mortgage-backed securities grew so popular (trillions of dollars' worth were issued annually from 2003 to 2007) that loans were originated to generate fees and mortgage pools, not to finance home purchases. Another reason for the subprime-mortgage debacle, the authors write, was the markets' belief that housing prices would never drop. Moreover, the FASB did not clearly require public companies' financial statements to consolidate the special-purpose vehicles that were issuing mortgage-backed securities, so the risks were buried. Then, as the prices of the securities plunged, the FASB began requiring financial statements for fiscal years starting after November 15, 2007, to value the securities at the prices they would bring in orderly market sales on the quarterly and annual accounting dates. This mark-to-market rule resulted in huge write-downs.

**Two illusory security blankets.** Securities' ratings and credit default swaps obscured the severity of the crisis. Ordinarily, issuers of mortgage-backed securities divide a pool into tranches according to seniority and

apply losses in inverse order of seniority. Rating agencies gave higher ratings to the more-senior securities, but as the securities became increasingly intricate—with, e.g., seniority shifting between tranches—the agencies found it very hard to give accurate ratings. One agency official admitted to the authors that ratings could not fulfill their purpose of projecting risks forward. Purchases of credit default swaps were failed attempts to protect against the risks. Swaps—derivative contracts entitling buyers to payment if a default or other specified credit event happened—were not genuine insurance, because the event need not have affected the buyers and the sellers were unregulated (unlike insurance companies). The US government had to bail out AIG, the parent company of the major seller of swaps, in an amount most think was at least $170 billion.

**Wake up and smell the complexity.** Attorneys must understand how they hid economic reality, the authors insist. The documentation that lawyers wrote for subprime-mortgage-backed securities and the underlying loans was so complex that finding and weighing the risks became nearly impossible, not only for ARM borrowers but also for securities firms and investors. A 2007 amendment to a Form S-3 registration statement by a Lehman Brothers special-purpose vehicle exemplifies this complexity. The 187-page document had a three-page table of contents, a four-and-one-half-page index of terms, 26 chapters, and two annexes. Risk factors took up 33 pages, home loans 22 pages, and loan servicing 23 pages. Reality might be emerging, however: Massachusetts courts have begun denouncing the unfairness of subprime-mortgage loans; and an economic summit is calling for immediate improvement of accounting and disclosure for special-purpose vehicles, disclosure to investors about complex financial instruments, and enhanced governance for the International Accounting Standards Board.

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