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The Subprime Market Roller Coaster

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(Title)

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The subprime lending market can be likened to a roller coaster descending with ominous velocity after an exhilarating ride. The ascent of the subprime roller coaster ride was phenomenal, the rips and waves were exhilarating, and the top was breathless. However, its descent, which has no visible end, has changed both the faces of its riders from joy and exhilaration to weary and worry and has scarred the face of our economy. The riders include the usual cast of characters – commercial and investment bankers, non-bank lenders and investors – found at the center of most financial market losses threatening the stability of the economy and creating the real risk of systemic loss. But this time, as the coaster descends, a group of unsuspecting riders – scores of debtors obligated on variable rate mortgages – also bear worrisome and weary facial expressions. And afar, the faces of those who opted not to ride witness its descent with perplexed and disconcerted faces knowing that they will have to pay for the price of the ride.

For years, state and federal government agencies responsible for regulating lending and securities practices watched the reckless, sometimes fraudulent behavior of mortgage brokers, mortgage lenders, securities firms, and investment banks in the subprime market. They did nothing of substance to halt such practices almost as if they were complicit with the lending and securities industries fueling the subprime market. They watched as subprime losses began changing the face of our economy. Now financial markets are illiquid and key economic sectors – housing, job, and credit markets – essential to the country's economic health are depressed.

Until recently, the Treasury Department (Treasury), the Federal Reserve (Fed), the Office of Comptroller and Currency (OCC), the Securities and Exchange Commission (SEC), along with state banking failed to utilize its regulatory authority in any significant manner to stymie the burgeoning losses. Most likely, their apparent complicity stemmed from President Bush's mandate that every American citizen should be able to enjoy homeownership. A mistaken view that suggests home ownership is a right, not a privilege. Obviously, federal government regulators did not foresee that the costs of their complicity would overshadow the esoteric and economic benefits citizens received from their ephemeral enjoyment of home ownership. While subprime debtors obtained the American dream, they did so at enormous cost to the economy, only to have to surrender that dream because of the economic consequences of the lending practices that enabled them to purchase homes in the first place. Ironically, the subprime lending practices hailed as a means for providing homeownership to those who historically could not access the housing market has rendered the housing market stagnant.

During the subprime market heyday, mortgage brokers forcefully solicited and lenders aggressively extended mortgages loans using lax lending standards to earn lucrative loan fees. They made loans to applicants' whose credit lenders traditionally used as a basis to deny them credit; and uncharacteristically, lenders even crossed the "redline" (historically, lenders drew an imaginary redline around poor inner city areas over which they would not cross to lend money.) Hence, the loans were called "subprime." The demand for subprime mortgages was enormous. Current estimates indicate that over 10 million subprime mortgages have made by lenders.

Subprime mortgage debtors fell into one of three categories. The first category included debtors that entered mortgage contracts with low teaser rate mortgage payments knowing that reset provisions in their contracts would cause their mortgage payments to increase beyond their income capacity within two to three years of the loan's inception. The second category included debtors who, at the inception of the loan, knew that their incomes could not service their initial mortgage payment amounts. These two categories of debtors knowingly incurred mortgage obligations beyond their income capacity speculating that in the short term their home values would increase sufficiently to enable them to refinance at lower mortgage payment amounts. The third category included debtors who were victims of predatory lending. They did not know their mortgage payments would increase. They were deceived about the nature and terms of their mortgage loans by mortgage brokers and lenders. Nor did they know about the reset rate provisions contained with their mortgage contracts. Of the estimated 10 million plus subprime mortgage loans many contain reset rates provisions that still have not been activated.

Lenders made substandard loans because they knew they could shift the risk of loss associated with such loans by securitizing their subprime mortgage receivables. Lenders pooled their mortgage receivables into trusts, and Wall Street investment banks securitized the mortgage pool by slicing them into specialized debt securities referred to as "collateralized mortgage obligations" (CMOs), whose yield was contingent on debtors paying the mortgage debt underlying the CMO. Investment banks received millions of dollars in fees from lenders, and lenders were poised to collect from investment banks certain future cash flow payments from the pool of mortgage receivables securitized.

More than a million CMOs were purchased by investors – primarily institutional investors including pension and hedge funds, as well as foreign central banks. Strong investor demand for CMOs fueled the subprime mortgage market. Investors purchased numerous CMOs relying on the debt securities' triple-A ratings, instead of engaging in due diligence to determine the worth of the loans and real estate underlying their CMOs. The lack of transparency in the CMO market was to the detriment of investors. Even though numerous documents concerning the securitization of the mortgage receivables underlying CMOs were available, for the most part, investors did not have skills to determine the validity of the CMOs. Even for those who possessed such skills, the evaluation process would have involved an inefficient use of investors' resources in light of the number of mortgage receivables securitizing just one CMO debt security.

The lack of transparency enabled lenders to engage in rent-seeking behavior misusing CMOs to externalize the cost of making substandard loans. Lenders employed a liberal, sometimes deceptive application of the Three Cs of credit lending – credit; capacity and collateral. Lenders mechanically used credit scores as a basis for determining applicants' creditworthiness, without analyzing applicants' credit reports. Credit reports include a wealth of credit information such as bankruptcies, judgments, late payments, repossessions and other negative information. A credit score may reflect the negative information, but it does not provide the lender with that information. Knowledge of negative credit information provides the lender with more information on which to assess an applicant's creditworthiness. Nevertheless, subprime lenders mechanically applied credit scores in lieu of analyzing credit reports knowing they would not have to internalize the costs of making loans to non-creditworthy loan applicants.

Subprime lenders also applied liberal, sometimes reckless methods of determining a debtors' income. Usually, mortgage loan applicants are required to provide lenders with wage statements and 3 to 5 years of federal tax returns to verify income. Abandoning traditional lending standards, subprime lenders made loans with little or no verification of income. In many cases, lenders relied on applicants' representations of their income amount; and lenders used that figure to determine their capacity to repay their mortgage loans.

Typically, lenders determine debtors' ability to repay by calculating its debt ratio, which is the percentage by which net monthly income exceeds monthly payment obligations. They usually include within a debtor's monthly obligations the amount of the new mortgage payment, and they also make adjustments as needed to reflect any future payment increases. If an applicant's debtor's ratio is 50% to 55%, lenders become very conservative in their lending, and at higher capacity ratios, they usually deny an applicant's loan request. Abandoning traditional capacity measurements, subprime lenders approved applicants' loans even though their debt ratios far exceeded 55%. They also failed to include the increased monthly obligations debtors would incur once reset rate provisions contained in their mortgage contracts were activated.

Subprime lenders also abandoned the traditional lending standards used to evaluate homes collateralizing their mortgage receivables. Generally, lenders hire appraisers to engage in an independent evaluation of a home. The "comparative approach" is the most common method used by appraisers evaluating residential real estate. Utilizing that approach, appraisers evaluate a home by comparing its structure, age, functional utility, acreage, and quality to at least 3 residential homes within the neighboring vicinity that were sold within the past 1 or 2 years. Subprime lenders also used appraisers, but the appraisers were instructed by lenders to manipulate their appraisals with a goal towards insuring that homes were valued at, or greater than their sales price. Some subprime lenders abandoned the appraisal process altogether, instead, they relied on computer models to determine the values of homes.

Subprime lenders also abandoned the traditional practice of limiting financing amounts to 80% of a home's value. Even lower loan-to-value percentage rates have been used by lenders when the age, quality, structure of the home or the neighborhood in which the home is located requires a larger cushion to protect against default. Limiting the loan value ratio insures that sufficient equity exists in the home; thus, better protecting the lender's position. Subprime lenders provided 100% or more financing to accommodate subprime debtors who, characteristically, could not afford to make down payments. In some cases, lenders provided more than 100% financing, giving the difference to the debtors as kickbacks. On paper, the appraised values appeared sufficient to sustain the mortgage balances they were underwriting, but in reality the homes were worth far less. The true values became apparent when debtors sought to refinance mortgage obligations at lower interest rates because their income could not service their existing mortgage payments. The majority of refinance requests were denied because the homes collateralizing the subprime mortgages were worth far less than the mortgage obligations.

By abandoning the Three Cs of credit, lenders built a circular house of card, whose foundation was built with CMO debt securities and whose walls were fortified with the illusion of strong housing values. Lenders began drawing the circle by making substandard loans collateralized by overvalued housing. The circle's curve descended as lenders pooled the mortgage receivables collateralized by overvalued homes. The circle's curve ascended as the CMO debt securities generated from the securitization process were sold to investors. Investors completed the circle by demanding that lenders securitize additional mortgage receivables; thus, creating an incentive for lenders to make more substandard loans. However, the investors did not know that both the mortgage receivables underlying, and the homes collateralizing the CMOs were worth far less than they appeared.

The weak link in the circle was overvalued housing. Once debtors were denied refinance requests, the house of cards started falling down and the foundation came crumbling after it. Faced with debtor defaults, most CMO investors sought recourse against the real estate property collateralizing their CMOs. While others recouped their losses from originating banks against which they had recourse for defaulted mortgage obligations. In some cases, investors were forestalled from foreclosing on real estate because the securitization paperwork was so deficient that neither lenders nor investors could determine which homes actually securitized an investor's CMO debt securities.

The lack of transparency in the CMO market prevented investors from knowing the true value of the debt securities they were purchasing. They relied on the Triple-A ratings that most CMOs enjoyed. At the time, their reliance appeared reasonable given the conservative reputation of the bond rating agencies that provided those ratings. Traditionally, the rating agencies' culture was one of aloofness toward their clients requesting that the agencies evaluate and rate their debt securities. The conservative environment insured the integrity of their ratings and gave them a well-deserved reputation. During the subprime market boom however, rating agencies became more accommodating to their clients in an effort to increase their market share. Rather than being aloof, top management socialized with their clients as they rated most of their clients' debtor securities Triple-A. The impropriety of their relationships explains the inaccurate ratings and has prompted regulators to investigate the manner in which rating agencies evaluated CMOs.

As debtor defaults revealed the true value of CMOs and as investors incurred losses, investor demand for CMOs decreased substantially. Without investor demand, lenders had no secondary market to which they could shift their risk of loss; thus, no opportunities to earn lucrative loan fees and investment bank payments. Consequently, they restricted subprime credit facilities. Prime credit facilities were also restricted as lenders had to make billion dollar subprime mortgage receivable write-downs. The absence of credit has created a credit crunch. And, the consequence of the credit crunch is our failing economy. Now, its apparent that the strength of the housing market was just an illusion and that the value of the CMOs, which fueled the market, was based on that illusion.

The results of the illusion are found in numerous neighborhoods throughout the country. In the millions, subprime debtors have defaulted on their mortgage loans, and in many instances, have abandoned homes in which they were never really vested. Some subprime debtors are barely holding on their homes, while others have become subject to foreclosures. A map depicting the inner cities would show areas concentrated with abandoned homes and foreclosure signs. On many streets, all or almost all of the homes are foreclosed or abandoned. Suburban areas have also fallen victim to subprime lending. The Census Bureau recently indicated that nationwide home vacancies have risen 2.8% in the last quarter of 2007, which is the highest vacancy rate since the Census Bureau began monitoring them in 1960. Throughout the country, cities are compelled to pay for yard and pool maintenance and security to protect the homes against vandals. The foreclosures and abandonments have prompted local officials to deliberate on how to prevent speculators, who mostly likely would become absentee landlords, from purchasing the homes. Also, they are faced with increased homeliness causing them to deliberate on how to find residences for displaced subprime debtors. Many of these debtors are frequenting local charities whose inventory of food and clothes have decreased substantially because of the increased demand.

Now, the ominous descent of the roller coaster is upon us. Numerous debtor defaults have prompted many banks and other lenders to tighten their credit standards. Lenders have moved from one end of the spectrum, reckless lending, to the other end, overly strict lending, the former causing financial meltdowns in the economy, and the latter, exacerbating the financial mess they created. Driven by their greed, mortgage brokers and lenders engaged in reckless, and in some instances fraudulent behavior without any consideration of how such practices would impact the financial health of our economy. Consistent with that self-centeredness, the same very lenders are now tightening the screws without such consideration. Their credit restrictions have caused enormous collateral damage creating liquidity problems throughout the economy.

The burning question is: What were our federal regulators doing during the initial descent of the subprime market? As the subprime market was descending into a recession, federal and state government regulators did very little to stymie the losses.

The Treasury, the Fed, OCC, SEC, and state regulatory authorities are primarily responsible for regulating the financial markets. They all watched as commercial banks and other lenders, mortgage brokers, credit rating agencies and debtors behaved recklessly, and in some cases, deceptively, taking enormous bets on an overvalued housing market. Perhaps, to some degree, regulators inactions reflect their receptivity to Wall Street's demand for less regulation in the financial markets. However, as the story unfolds, it appears that their inaction was primarily due to their inability to foresee the impact that subprime losses would have on the economy.

Historically, regulators have been slow to react in any substantial manner to burgeoning financial market losses involving the misuse of esoteric financial products until such transactions seriously began to threaten systemic loss in the financial markets. In the past 20 years, time and time again, financial market regulators have watched as it became evident that certain impending losses involving trade transactions with esoteric financial products had the potential to threaten systemic loss in the markets. The misuse of esoteric financial products like CMOs at varying times has caused enormous losses in the market threatening the possibility of systemic loss in the markets. Some examples include the massive losses incurred by Orange County, West Virginia, Long Term Capital Management, and Enron. In each case, the parties' were investing heavily in esoteric financial products. In each case, financial market regulators knew or should have known that these losses would be problematic for the financial markets and the economy, but in each case they watched, and only responded once the transaction had imploded.

Repeatedly, regulators have waited until a massive loss was imminent before they implemented any remedial measures to prevent systemic loss. Regulators repeated this pattern with subprime mortgage and CMO losses. They all watched as the financial markets incurred burgeoning losses from the misuse of CMOs, only engaging in substantive measures after trade transactions have destabilized the markets. Consistent with risk taking behavior, these products are very popular even though investors can lose billions when investing on the wrong side of trade transactions. Their popularity stems from the potential to earn enormous profits if an investor bets the correct way. Also, they provide protections to investors that successfully use them to hedge against the possibility of loss from other trade transaction within their portfolio. Financial markets also benefit from them because they allow investors to further diversify their portfolio, especially those investors who have an appetite for risk. To insure maximal economic benefits from these transactions, these transactions must be monitored carefully to protect against their misuse and the consequent losses that stem from such misuse.

When the subprime descent began, regulators' posture concerning subprime losses was rather lackluster. The Fed, OCC and state regulators did issue subprime lending guidelines to banks (the guidelines did not apply to unregulated lending institutions) regarding appropriate subprime lending practices. Apparently, the regulators did not adequately examine subprime loans against their own subprime lending guidelines. Because, a basic examination of just a sample of subprime loans would have revealed their substandard nature and alerted regulators to the extent to which lenders had deviated from the subprime guidelines.

In 2003, Democrats in Congress did request that the Fed devise rules to penalize banks for unfair and deceptive practices, but then Chairman Alan Greenspan refused to devise such rules. Recently he stated that he "erred in thinking that other investors and market participants would adequately monitor lending standards in the mortgage-backed securities market." The Office of Comptroller and Currency defended its position by noting that only 10% of national banks over which the OCC has control were part of the subprime mess, as if that justified their lackluster response to subprime losses. Instead, it pointed the finger at state regulators for failing to regulate both their state-chartered banks and other lenders subject to their regulatory authority. The evidence suggests that OCC's position has merit. For example, in 2006, New Century, a major subprime lender, passed a California state audit, but seven months later they were insolvent because of numerous subprime mortgage defaults.

The Securities and Exchange Commission also has been criticized for it failure to identify risks associated with CMO trading, and its failure to insure that investment banks and securities firms were not make false or misleading representations about the value of the CMOs they were offering to investors. Specifically, the SEC has come under heavy criticism for its failure to identify the liquidity problems at Bear Sterns, a major player in the securitization of mortgage receivables.

Much would have been gained had regulators performed their appointed functions. Had the Fed used its monetary tools to increase the interest rate environment to discourage lending and to devise rules penalizing fraudulent lending practices (as recommended by Congress in 2003) it might have thwarted the country's current economic crisis. Had the SEC used its regulatory authority to review the valuation process used by investment banks and securities firms that securitized mortgage receivables, it could have discovered that they were over evaluating future cash flows from CMOs to receive millions of dollars in fees from lenders. It could have discovered the fraudulent practices employed by investment banks and securities firms to entice investors to purchase worthless CMOs. It could have discovered that the securitization practices of investment banks and securities firms threatened their liquidity positions. It could have discovered that rating agencies had compromised their integrity in light of the social relationships they were fostering with their clients. Having discovered any of the above irregularities, the agency could have used its enforcement authority to sanction violators.

Had the OCC and state regulators worked in tandem, rather than engaging in turf wars, they could have readily identified and sanctioned regulated entities whose subprime loans failed to comply with subprime lending guidelines. Regulation and enforcement actions by one of these governmental regulators would have caused a chilling effect that would have deterred other entities from high risk speculation on the value of the residential market. In addition, had banking and securities regulators engaged in more than passive examinations of subprime loans they would have discovered the extent to which banks and other lenders had abandoned the traditional Three Cs' credit standard. Perhaps, that would have alerted them that the CMOs securitized by those subprime mortgages were worthless, and that their triple-A ratings were suspiciously inaccurate.

Their inaction reflects their inability to appreciate and grasp the speculative nature of esoteric products such as CMOs, and their inability to foresee how financial market players may misuse them in ways that might threaten the liquidity of the economy. Time and time again, the government has failed to educate itself concerning the risks involving such products, only to emerge on the scene after the fact, brandishing regulatory weapons that should have been employed much earlier. Even, former Fed Chairman Alan Greenspan admits that the risk and econometric models used by the Fed were too simple to forecast the massive losses and their impact on the economy.

Admittedly, regulators were handicapped with respect to forecasting the overall economic impact subprime losses could have on the economy. However, they should have foreseen that lenders would misuse CMOs to engage in rent-seeking behavior, and a review of subprime loans and securitization documents would have substantiated that misuse. Documentation review would have disclosed the irregularities in the lending and securitization practices; thus, providing a justification to impose sanctions. Those sanctions would have served as deterrent to other lenders, securities firms, and investment banks to engage in more conservative practices in compliance with the regulatory rules governing their lending and investment practices.

The price tag for the regulators' lack of competence and diligence will be astounding as the subprime losses/credit crunch story unfolds. Even now estimates indicate a government bailout of subprime debtors will cost over $200 billion to purchase 10 million subprime mortgages. Subprime losses threaten to render the financial markets illiquid, and the credit crunch resulting from the losses has depressed the housing and labor markets causing prominent economists to posit that the country is in a recession. The market value of CMOs held by investors has decreased by more than $200 billion. Commercial banks and lenders are taking billion dollar write-downs for those mortgage receivables underlying CMOs that provided investors a right of recourse against them and for those subprime mortgages that were not securitized. Credit markets also have been severely impacted by subprime losses. Investment banks and securities firms are taking billion dollar write-downs on their CMO holdings. And like domestic banks, foreign investments banks with large CMO holdings are devaluing CMO values in the tunes of billions of dollars.

Securities markets are strained as investors uncertain about the market's liquidity have turned away from equity and debt securities. The Dow Jones Index is plummeting, and even when it occasionally makes a gain, the following day the gain is offset by an equal decline. Bear Sterns, a major securities firm recently sold its assets to J.P. Morgan at the prompting of the Fed at a fire sale price. The Federal Reserve pushed the deal because Bear Sterns was financially crippled by its supply of uncollectable CMO securities, and two large hedge fund losses. Without the intercession of J.P. Morgan, its financial decline was imminent. The Federal Reserve feared that Bear Sterns' financial demise would have relentlessly disrupted financial markets and triggered systemic loss. The global markets trading CMOs also have been impacted by subprime market losses.

Housing markets are glutted with an oversupply of new homes constructed when the housing market was "booming." The glut is attributing to the downward slide of home values throughout the country. The glutted market has also caused increased unemployment rates in construction and other related industries. In addition to the construction industry, employers in other industries are downsizing their businesses and laying off existing workers. They are also reluctant to hire new workers. Overall, the job market is in a slump. February employment figures indicated that the unemployment rate had increased from 4.8% to 4.9%. While this increase may appear minimal, the Labor

Department indicated that 4.7 million people who wanted jobs cannot find them prompting them to leave the job market. The 4.9% employment rate does not include them. If those individuals are included in the unemployment figure the rate increases from 4.9% to 5.5%.

Only after subprime losses have brought the economy to halt, did the federal government emerge on the scene as "Johnny Come Lately." Predictably, the governments' knee-jerk reaction to the financial crisis has been to hastily promulgate new regulations and enact new legislation to protect the economy against massive subprime losses. As usual, regulators and legislators a pushing new regulations and legislation without any serious deliberation whether existing regulatory laws could have thwarted the subprime losses had regulators utilized them.

It is quite apparent that the current regulatory powers granted to banking and securities regulators were more than sufficient to avert those losses; thus, negating the need to create new laws. The Fed had sufficient regulatory authority to rein in lenders engaging in reckless or fraudulent behavior. The Divisions of Corporate Finance and Market Regulation of the SEC had the authority to monitor and detect irregularities in the CMO markets; and to determine to what extent the securitization of mortgage receivables threatened the liquidity of any investment banks or securities firms. The SEC's Enforcement Division had the authority to initiate investigations to determine whether sanctions were necessary for any of the practices in which investment banks or securities engaged concerning the securitization process, as well as the practices they used to sell CMOs. The regulatory authority of the OCC and state banking regulators were more than adequate to identify and sanction those lenders that engaged in lending practices in violation of its rules and guidelines. No new laws are needed. All that was needed were zealous regulators willing to exercise the authority given them under existing regulatory frameworks.

However, the knee-jerk reaction has predictably prevailed. Recently, the Treasury announced sweeping changes to remodel U.S. financial regulation and streamline the patchwork of regulatory agencies whose authority often overlaps. The plan grants the Fed a significant increase in regulatory power to render it the “super cop” of the financial markets. Presumably, the Fed would monitor and assess financial risk to determine whether risky trade transactions threaten systemic loss. Towards that goal, the plan proposes the elimination or merger of the Securities and Exchange Commission, which Treasury Secretary Paulsen has blamed for the CMO losses. Most likely, the Treasury’s plan will lay stagnant in this election year. In reality, the plan reflects a hasty and hurried proposal to respond to public concerns without any real deliberation concerning how to prevent misuse of them or whether CMO debt securities should be used to fuel the residential housing market in light of the devastating effects of their misuse by lenders.

Moreover, the plan is disingenuous. The Treasury’s proposal to eliminate or merge the SEC reflects its attempt to deflect all the blame for subprime losses from the Fed, banking regulators and the Treasury to the SEC. Banking regulators and the Treasury had an obligation both to monitor subprime lending and securitization practices, and to halt such practices threatening the liquidity of banks and other regulated lenders. The SEC was responsible for regulating the CMO market, but the CMO debt securities traded in that market were generated by lenders for which banking regulators were responsible. Both banking regulators and the SEC were responsible for the subprime losses and the consequent credit crunch. Either party could have averted the subprime losses. To choose one party over another reflects a bias and disingenuous approach taken by the Treasury to escape public scrutiny.

The Treasury's disingenuous approach is evidenced by its earlier position that the Treasury was taking a hands-off approach to the subprime debacle. Before the recent economic decline, Secretary Paulsen posited that the market forces would squeeze out the inefficient lenders. Admittedly, principles of economic efficiency compel firms to exit an industry if they become unprofitable when market forces require them to internalize their negative externalities. In this case, the negative externalities are the subprime losses stemming from lenders' substandard loans. Unfortunately, the institutions affected by the market squeeze as they internalize the costs of subprime mortgage defaults are the major financial institutions on which the economy has traditionally relied as a source of liquidity. This reality compels the government to rescue these institutions abandoning a strict compliance to the free market theory as necessary to protect the health of the economy for the livelihood of its citizens.

In that vein, faced with a recession, the Federal Reserve is trying to bandage the wounds of the investment banks and securities firms holding CMOs. Rescue relief is directed towards the financial markets because its current illiquidity is a major threat to the country's economic stability. In an effort to stimulate the economy, the Federal Reserve has successively reduced interest rates five times. The most recent federal funds rate decrease from 3% to 2.25% was an aggressive move by the Federal Open Markets Committee. Also, the Federal Reserve has created a lending facility providing primary dealers (those to which the Fed sells Treasury securities) credit funding up to $200 billion in Treasury securities to help "revive strained financial markets." Primary dealers can use various types of collateral including CMOs to secure credit obtained through the lending facility. The Federal Reserve is extending the payback period to 28 days from its usual overnight period. It is also providing a lending facility for other securities dealers. In addition, the Treasury Department has authorized Fannie Mae and Freddie Mac to reduce their capital requirements from 30% to 20% so that they can purchase up to $200 billion in CMO securities. And, the SEC has initiated an investigation of Bear Sterns to determine if it engaged in fraudulent or misleading practices in connection with the mortgage receivables it securitized and sold to investors.

As the government scrambles to forestall a recession, the economic impact of subprime mortgage lending begs the question whether lenders should be allowed to use CMOs in residential markets. Initially, CMOs increased liquidity in the housing market because they were securitized by collectable subprime mortgages. But as lenders began engaging in rent-seeking activities they abused CMOs as risk-shifting devices to justify making subprime substandard loans. Their abuse erased any liquidity gains derived from the securitization of collectable loans.

Outside of the real estate context, securitization has provided liquidity to the credit markets and the economy. Historically, the securitization of receivables has provided lenders more flexibility in lending by allowing them to make loans to persons with less than prime credit profiles knowing that they could shift their risk of loss to the CDO market. Well before the emergence of the subprime market, lenders were securitizing receivables including collateral debt obligations (CDOs) such as credit card, automobile and student loan receivables. Although recently, lenders are reporting increased debtor defaults in the automobile and credit card markets. Nonetheless, consumers and businesses have benefited from "securitization" because it has provided them with more credit; thus facilitating their ability to spend and to invest money, both of which enhance the economy's liquidity. Increased lending activity also benefits lenders because it provides them opportunities to earn additional loan and credit card fees.

However, problematic to the CDO market generally including the CMO market is their lack of transparency rendering it difficult to assess the true value of the debt securities traded in those markets. For the most part, the quality of subprime loans went undetected for so long because the only evaluations of CMO debt securities were the ratings given them by rating agencies, which failed to accurately evaluate them. Investors had access to documents from which they could have evaluated the collectability of the mortgage receivables; however, such evaluations would most likely have involved an inefficient allocation of their resources. In lieu of reviewing numerous documents, investors relied heavily on the Triple-A ratings that bond rating agencies gave CMO debt securities. Apparently, many of the investors assumed that the rating agencies, which are subject to regulatory authority, would provide accurate ratings. However, these agencies had conflicts of interest since they were being paid by the originating banks to rate the CMOs that investors were purchasing. In an effort to bring greater transparency, federal regulators are currently drafting rules identifying the factors that rating agencies will be required to analyze in evaluating CMOs.

Also problematic to the CDO market and to CMO market specifically is the lack of lender accountability for the substandard loans made by lenders. The lack of accountability encouraged lenders to make substandard loans since they could use CMOs as risk-shifting devices. To preserve the integrity of employing CMOs as risk shifting devices without jeopardizing the stability of the housing markets, some have called for regulation that requires lenders to retain all or part of the risks associated with making subprime mortgages. Regulators could promulgate an implied warranty of collectability rule in which lenders warrant the collectability of their loans. A breach of that warranty could render lenders monetarily liable in treble damages based on the defaulted mortgage obligation amount. In addition, sanctions could be imposed on lenders whose lending practices were grossly negligent, reckless, or fraudulent. Confronted with possible monetary damages and sanctions, most likely, lenders would tighten their lending standards. Tightened lending standards would decrease consumer demand to those applicants with more creditworthy profiles.

The fundament problem in using CMO debt securities as risk-shifting devices in residential real estate market is that such lending threatens the integrity of the housing market. The securitization of mortgage receivables uncharacteristically encourages lenders and their debtors to speculate on one of the country's major infrastructures – residential real estate. Regulations increasing transparency and rendering lenders accountable for defaulted subprime mortgage loans may contain decrease subprime losses, but neither law will relieve the speculation problem. In fact, the creation of such laws would suggest that the federal government is implicitly endorsing such speculation.

Speculation stems from the securitization process. The genesis of the CMO market was based on the desire of investors and lenders to speculate on the housing market; and its viability was dependent on the parties continued desire to speculate.

Investors, motivated by the potential to earn lucrative dividends, wanted a market in which they could speculate on the collectability of mortgage obligations collateralized by homes against which investors had recourse if debtors defaulted. Lenders wanted a market in which they could earn loan fees from making mortgage loans without having to bear the risk of loss associated with those mortgages. They speculated that investors in the market would always bear the risk of loss. Lenders provided 100% or more financing to subprime debtors calculating that their risk of loss was minimal in light of the CMO market. Like investors and lenders, debtors also speculated on home values. They speculated that homes would significantly appreciate in value enabling them to pay for mortgage obligations, which at the time of consummation they could not afford. The origin and life blood of the CMO market was speculation. Without it, the market could not survive. We are witnessing its slow death because no one wants to speculate on home values at the present time.

Securitization severed the traditional creditor-debtor relationship which promotes both parties vested interest in the homes securing mortgage obligations. The parties' divorce severed that vested interest. The CMO market was created because the lender wanted to sever that relationship to earn lucrative loans fees without assuming the risk of loss associated with mortgage lending. Without a vested interest, lenders did not think twice about providing debtors 100% or more substandard financing. The lucrative financing obviated debtors from having the type of vested interest that debtors ordinarily have in their property. Without that vested interest, subprime debtors had no problem obtaining loans they could not afford. They speculated that their homes would appreciate in value to allow them to refinance their mortgage obligations at an affordable interest rate. Speculation fever not only infected willing investors and lenders, but also the subprime debtors.

The numerous abandoned and foreclosed home throughout the streets of America reflect the consequences of such speculation in the country's residential real estate. Even with implied warranties, the CMO market provides a safe haven that will, to some extent, serve as an incentive for lenders to overextend. While the implied warranties will make lenders cause lenders to engage in traditional lending practices, as long as they can shift the risk of loss to the CMO market, they have an incentive to make loans.   Admittedly, CMO investors will invest with greater caution and rating agencies will provide more conservative ratings. However, the profit lenders can earn from making loans without having to bear the risk of loss will encourage them to overextend themselves. Most likely, they will focus on prime debtors including those whose capacity ratio is high and whose credit profile is less than stellar. Prime debtors represent a compromise that the investment community would be willing to purchase, especially those debtors with high incomes earned in professional jobs and sufficient net worth.   In many instances, however, prime debtors over extend themselves in light of their income sources. Lenders overlook their high debt ratios speculating that loans to such debtors are collectible given their credit, employment status, and net worth. However, their excessive spending keeps them on edge tittering to avoid bankruptcy.

Driven mainly by greed, lenders, mortgage brokers, and debtors thought they could outwit the obligatory pricing components of home ownership, getting something without incurring any significant economic costs. In reality, all they were doing was externalizing such costs to the cities and states throughout this nation that currently are struggling to maintain their identity as their landscapes are deteriorating. The costs have also been externalized onto our nation's economy. Many believe these costs should be internalized and the market forces should be allowed to squeeze out inefficient parties, even at the price of a recession. Perhaps, the economy wants to take a rest to emerge as a leaner and more pristine machine in the future. That decision will be left to the federal government. So far it has decided to rescue market players. It also appears poised to rescue subprime debtors.

Some view its decision to provide both parties relief as creating a moral hazard – providing a safety network that will merely encourage market players to continue engaging in reckless behavior knowing they will not have to incur the costs of their behavior. Others view such relief as necessary to stabilize and to provide liquidity to the financial markets and the economy. Either way, the costs will be borne by the taxpayers. If the government rescues the roller coaster riders, taxpayers will pay the price of the rescue. If the government chooses not to rescue the riders, the taxpayers will be the victims of the subprime-loss induced-recession. Alternatively, if the government rescues efforts do not thwart a recession, taxpayers will be the victim of recessionary forces. Whatever the government chooses, the costs of its choice will be borne by the taxpayers.

We look at the subprime lending transactions and just wonder: What were they all thinking – the debtors, the commercial and investment banks, other lenders, mortgage brokers – as they shifted risk from one to another motivated by greed? But more importantly, what was the government doing and are its rescue regulatory efforts too late to remedy the financial turmoil the country is undergoing? Moreover, does the Bush Administration, Congress and regulators have sufficient foresight to appreciate how the

CMO market threatens the integrity of the country's landscape begging questions whether securitization of mortgage receivables should be permitted?

During the heyday of the housing market, few would even discuss the possibility that the housing market would eventually go flat; or that scores of debtors' would default as interest rates rose. But both did happen because the government turned a blind eye to subprime lending practices for too long.

As the government scrambles to devise the "great plan" that will solve the country's economic woes, the Bush Administration, financial regulators, and market participants should consider the overall societal, as well as economic consequences of using CMO debt securities to fuel the residential housing market. The integrity of our country's residential real estate has been tarnished by the misuse of CMO debt securities. Perhaps, using them to fuel the residential housing market should be banned. The country's land was once nurtured by the hopes, aspirations, toils, and labors of people who struggled and fought for the real estate on which they ultimately settled. That landscape has been ravaged by subprime lending practices and securitization. The fruit harvested by the CMO securitization process is a landscape that is glutted with new homes and spotted with abandoned and foreclosed homes; and also stunted growth due to economic and societal problems consequent to vacant homes and credit woes. This landscape is a stark contrast to the landscape that those before us nurtured. The government should slow down its regulatory overhaul mindset, and in its stead, weigh the costs of preserving the integrity of the country's residential real estate and the social and economic wellbeing of its citizens against the benefits of promoting wealth maximization for a few (the transactional versus distributive justice discussion.)

As the roller coaster descends, from afar, people who opted not to ride the subprime market, witness its descent into the shadows of a recession with anxious and perplexed faces. Now, the worry and weariness seen on the faces of those who rode on the subprime market is seen on the face of our country as the velocity of the descent has substantially impacted major sectors of our economy, as well as sectors of the global markets. As usual, the ordinary citizens will have to pay for the recklessness and criminal acts of others, who, motivated by sheer greed, have endangered the financial health of our country and substantially weakened its credibility in the global arena.