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What The "Subprime Crisis" Really Means For Your Business

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What has loosely been called the subprime mortgage crisis is the most visible and vulnerable aspect of a much broader credit crisis. The housing market is passing through the collapse of an asset price bubble and the accompanying credit bubble that sustained it. The problem is worst for subprime borrowers and those who have invested in the securities backed by subprime mortgages. Because of the peculiar nature of subprime mortgages and the securities based on them, the resulting losses will create the potential for litigation beyond the ordinary aftermath of a real estate boom.

It is hard to predict how far the impact of this credit crunch will spread, but it is clear that it will spread well beyond home buyers and their lenders. With the enormous growth in the mortgage backed securities markets during the last few years, the risk of a declining real estate market is spread to many businesses who do not think of themselves as participating in the real estate market. Understanding the risks and the efforts of those affected by the falling real estate market to shift their losses to others is the first step in preparing for the inevitable change that is upon us. This article provides some background and an introduction to the coming wave of litigation.

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There is no standard definition of subprime mortgages. The median credit score in the United States is 723. Subprime mortgage borrowers are generally considered to be those with a credit score of less than 620, or those with better scores who are borrowing on a loan to value ratio of more than 80%. These are the highest risk borrowers with the most questionable capacity to carry their debt.

In many cases, subprime mortgages involve a balloon payment of principal, sometimes coupled with negative amortization that adds accrued but unpaid interest to the debt. Such loans depend for repayment on sale or refinancing at a higher price. The most common type of subprime mortgage, the so-called 2/28 loans, offered a below-market "teaser" rate fixed for two years, followed by an adjustable rate for the remaining 28 year term. To compensate for risk, the adjustable rates are higher than those on standard mortgages. Once the teaser period expires, many borrowers will be unable to carry the adjustable interest payments unless overall interest rate levels remain low.

There is approximately $1.3 trillion of subprime mortgage debt outstanding, and approximately 20% of outstanding home mortgages are subprime. The great bulk of this debt was borrowed in 2005 and 2006 at the height of the housing boom. Almost two thirds of it has been packaged into mortgage backed securities. As of the third quarter of 2007, approximately 16% of outstanding subprime mortgages are in default, and almost 7% are in foreclosure – rates far higher than for prime home mortgages. Default and foreclosure rates are rising. The teaser period on the 2/28 mortgages made in 2005 and 2006 is expiring, and it is anticipated that default and foreclosure rates will increase further as adjustable interest rates rise. The collateral will be sold into a weak market.

The subprime borrower is the Atlas supporting an immense structure of credit, and the weight has proven to be beyond his strength. A great deal of money is unavoidably going to be lost. Litigation will determine by whom.

The immediate losers fall into two categories. At one end of the continuum are the borrowers facing foreclosure. At the other end are the ultimate lenders – the investors in mortgage backed securities, whose funds financed the lending boom and who are now facing the consequences of default by the overburdened borrowers. Between them are the mortgage brokers and bankers who made the loans, the underwriters who packaged and sold the securities that the loans support, and the rating agencies who told buyers that the securities presented acceptable levels of risk. We can be sure that both borrowers and investors are going to try to pass as much pain as they can onto these middlemen. As in previous market downturns, we can also anticipate that imaginative legal minds are working hard on novel theories of liability to accomplish this.

Subprime borrowers can be said to fall into several classes. At the one extreme are simple and credulous people with insufficient incomes, who allowed themselves to be persuaded that they too could share the American dream of owning their own home. At the other are speculative borrowers who thought that they would be able to flip houses for a profit in a rising market. In between are those who wanted a larger loan for a better house than they could get on prime terms, or who borrowed against their equity for other purposes.

These borrowers are going to be looking for relief against foreclosure, and they are all are going to try to present themselves as victims of cunning and unscrupulous lenders. They will have some facts in their favor. It was recently

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reported in the Wall Street Journal that up to 55% of subprime borrowers had credit scores that would have qualified them for more conventional mortgage products. Although this will be hotly disputed by lenders, the article cites allegations that some such borrowers were steered into subprime loans by brokers and lenders whose commission structure gave them an incentive to market loans bearing higher interest rates. In addition, the proportion of non-white borrowers who obtained subprime loans is substantially higher than the proportion of white borrowers.

We can therefore anticipate that subprime borrowers will raise claims of common law fraud, misrepresentation and non-disclosure, as well as violation of state consumer fraud and consumer lending statutes, and perhaps racial discrimination. Such claims will be made as individual defenses and counterclaims in foreclosure suits, often under the rubric that the lender has unclean hands. Foreclosure is historically an equitable remedy, and courts of equity have broad discretion to respond to fraud or inequitable conduct. Among the remedies available to equity court is the power to reform instruments. Sympathetic and imaginative judges will be able to invoke the traditional arsenal of equity if they are convinced that the lender has behaved unfairly in the marketing of the loan. Equitable relief to debtors will mean increased defaults and increased losses for investors.

Issues of fraud, non-disclosure and discrimination will not be confined to the defense of individual foreclosure suits. Entrepreneurial plaintiffs' counsel can be expected to raise them in class actions, either as counterclaims to an individual foreclosure or in stand alone suits under state consumer fraud, consumer lending and civil rights laws. Such statutes have a lower threshold of proof than common law fraud. They often provide for treble damages and attorneys fees. It will not be surprising to see class actions claiming the recovery of fraudulently induced excessive interest charges and fees as damages. Lenders will respond that the broad range of subprime borrowers and the individual nature of their decisions make such claims unsuitable for class treatment.

Because many of the loan originators are either financially weak or insolvent, we can also anticipate that plaintiffs will pursue warehouse lenders and the pools that ultimately bought the mortgages for securitization, claiming that these deep pockets are vicariously liable for the originators' alleged misdeeds as aiders and abettors, civil conspirators or otherwise.

Before considering investor claims it is useful to review the structure of mortgage based securities backed by subprime debt. While mortgage backed securities based on pools of mortgages have been sold since the 1980s, those based on subprime mortgages are a more recent development. In every credit boom, there is a financial innovation that makes credit available to previously unsuitable borrowers. In the 1980s, it was the insight that a properly diversified portfolio of so-called "junk" bonds had a much lower aggregate risk than the individual bonds that comprised it. In the 2000s, it was the discovery that cash flows from a pool of mortgages could be structured so that one class of investors bore a minimal risk of default while others bore increasingly greater risk. As a result, investment grade securities could be created to finance mortgages for people who previously were not creditworthy.

Overall risk to bondholders from default on the underlying subprime mortgages was supposedly diminished by a margin between the amount of mortgages held by the pool and the amount of bonds issued, by an interest rate spread between the mortgages and the bonds, and by various guarantees, insurance and hedging techniques. The remaining risk of default was allocated among different payment tranches, so that some would be exposed to the earliest defaults while the most secure would have priority for whatever payments came in. The most secure tranches were rated investment grade by the credit rating agencies, which made them eligible for purchase by insurance companies and ERISA regulated pension funds. The less secure received speculative grade ratings and many were purchased and pooled as the basis for so-called collateralized debt obligations.

Because the structure of these securities was novel, the accuracy of the ratings had not been tested. Experience of the past 18 months has shown that the risk of default was higher than anticipated and the ratings optimistic. There have been repeated downgrades by the rating agencies, accompanied by declines in the value of the securities.

Mortgage backed securities depend on a complex network of contracts among the loan originators who sold mortgages to the pool, the trustee who operates it, the servicer responsible for collecting and enforcing the loans, various guarantors and insurers, and the underwriters. Buyers of the resulting securities can be expected to claim that they are the intended third party beneficiaries of these contracts, and to hold all concerned responsible for fraud or misrepresentation in the sale of mortgages to the pool, for any failure to enforce the underlying mortgages and for failure to make good on insurance and guarantees. There may also be claims that the content of the mortgage pools and the risk of the securities was misrepresented by the underwriters, and that accountants, attorneys and appraisers connected to the transactions committed malpractice.

It has been reported that the credit rating agencies played more than their usual role as evaluators of creditworthiness, being deeply involved in the actual design and structuring of these securities through what one rating agency has called an "iterative process" of consultation with the underwriters. No doubt their potential liability will be examined as well.

If sued by bondholders, all of the parties involved with the assembly, design, underwriting and marketing of subprime mortgage backed securities can be expected to cross-claim against one another.

There are at least three other areas of potential litigation. First, many of the firms who profited from the subprime lending boom have suffered severe losses from its contraction; if they are not already insolvent, their stock prices have declined accordingly. The first wave of securities fraud litigation against such firms and their directors and officers has already begun. Second, there has been at least one suit against an ERISA fiduciary, alleging breach of fiduciary duty by investing in subprime mortgage backed securities. Last but not least, a financial debacle of this scale calls for explanatory scapegoats, and the collapse of values often reveals previously unsuspected fraud. Both the SEC and the Attorney General of New York have already opened investigations of the underwriting and sale of mortgage backed securities. The bursting of the housing bubble may turn out to produce its own Enron or Global Crossing; those who are candidates for that dubious honor will be occupied in defending themselves against the investigators.

Finally, governmental pressure on lenders to show forbearance will complicate the situation. Widespread foreclosures create political discontent and further depress the real estate market. The federal government has already begun jawboning lenders to restructure loans to the most vulnerable subprime borrowers by freezing teaser rates. With defaults expected to increase and a presidential election pending, this will probably not be the last government intervention. Because most subprime mortgages have been securitized, the complex web of contracts among originators, underwriters, investors, guarantors and pool trustees may make it difficult even for creditors so inclined to show flexibility. Who, if anyone, has the final say will depend on the terms of the contracts.

So what does this mean for the businesses likely to be impacted? Unfortunately, it means that you are likely to be either the target of a litigation or be in the position of needing litigation to shift losses. Smart managers will analyze their exposure to the credit crunch by examining the economics of their position to determine whether their company is likely to be a winner or a loser due to the change in the market. The next step is to study your contracts to determine what rights you have with your contracts to either shift losses or protect against losses being shifted to your business. Those who recall the 1980s savings and loan crisis remember that it took many years of litigation before the resulting losses were portioned out among lenders, borrowers, former managers and professionals. As the housing bubble of 2000-2006 is liquidated, we can anticipate the same.