

The “Subprime Mortgage Crisis”: An Overview of the Crisis and Potential Exposure

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In early 2007, the term “subprime mortgage crisis” became widely used to describe the deterioration of the U.S. mortgage market, and losses from mortgage backed securities (MBSs) and collateralized debt obligations (CDOs) backed by subprime mortgages.

In an effort to clarify potential exposure from the developing financial crisis, this article discusses the key parties to the mortgage lending process and their roles, the causes of the boom and crisis in subprime lending, as well as current and potential regulatory actions and civil litigation against those parties.

A. Relevant Parties and Their Roles

Mortgages in the U.S. used to involve a relatively straightforward relationship between a lending bank and a borrower. In the past decade, however, this process evolved into a complex series of transactions and relationships among numerous parties.ⁱⁱ

The key participants and their roles in the subprime mortgage lending process are discussed below. Each of these parties, as well as directors and officers of the entities and other professionals who participated in the process, could face exposure from the deterioration of the mortgage market.

1. Borrowers

Subprime borrowers have characteristics making it more likely that they will default on a loan. Some of these factors include a high debt-to-income ratio, a weak or minimal credit history or a credit or FICO score of less than 620 on a scale of 300-850. As they are considered inherently high risk, lenders charge higher interest rates and costs for subprime mortgages.

2. Mortgage Brokers

Mortgage brokers originate up to two-thirds of subprime mortgages. They market the mortgages, assess a borrower’s credit risk and submit loan applications to the lender who funds the loan.

3. Lenders/Originators

Lenders are the entities that fund mortgages. They are also referred to as originators because they initiate the securitization of the mortgages.

Lenders/originators finance mortgages in a number of ways, including the use of revolving lines of credit from warehouse lenders, loan sales and the issuance of securities backed by the mortgages.

The contracts pursuant to which lenders/originators sell the mortgages often include repurchase agreements that may require them to repurchase the loans from the buyer if default rates are excessive or based on representations or warranties regarding the sale of the mortgages. They are required to keep adequate reserves to meet potential repurchase demands.

4. *Servicers*

The servicer of a mortgage collects payments and penalties for late payments, monitors the amount of principal and interest paid, acts as escrow agent for taxes, and forecloses on the collateral if the borrower defaults. Lenders/originators often continue to service mortgages for a fee after they sell or securitize the loans.

5. *Trust Special Purpose Entities*

Lenders/originators often create a trust and sell their rights for payment on mortgages to the trust. These trusts are typically special purpose entities (SPE) and subsidiaries of the lenders/originator or an investment bank that underwrites the lenders/originator's issuance of MBSs.

The SPE controls the mortgages backing the MBSs. Its structure is designed to insulate investors from liabilities of the lenders/originator and provide tax benefits to the lenders/originator.

6. *Underwriters*

Investment banks often provide both the credit facilities for the mortgages and underwriting services for the issuance of MBSs. The investment bank profits from interest and fees on the lenders/originator's credit line, as well as underwriting fees from the issuance of MBSs.

7. *Rating Agencies*

MBSs are rated by one or two of the three dominant rating agencies in the U.S., Standard & Poor's, Moody's or Fitch Ratings. Rating agencies essentially analyze the credit risk on the mortgages backing the MBSs, and assess the likelihood of timely payment on the security. Significantly, rating agencies are retained and compensated by fees from the issuer of the MBSs who solicit the rating.

8. *Investors*

Hedge funds, mutual funds, insurance companies, pension funds and other institutional investors invest in MBSs. Pension funds and other investors may be prohibited from investing in MBSs that are rated below investment grade.

B. Subprime and Alternative-A Mortgage Products

There are generally two types of mortgages in the U.S.: (i) fixed-rate mortgages (FRMs), which have an interest rate fixed for the life of the loan; and (ii) adjustable-rate mortgages (ARMs), which have variable periodic interest rates based on an index plus a fixed margin.

Subprime mortgages are loosely defined as mortgages to borrowers with blemished or limited credit histories. Between 2003 and 2006, a high number of alternative mortgage products (AMPs), or mortgages other than traditional FRMs or ARMs, were issued to subprime residential borrowers. AMPs have a higher rate of defaults than traditional mortgages.

Many subprime mortgages are hybrid ARMs and FRMs. Such mortgages provide for a fixed rate for the first two to three years, which is known as the “teaser rate,” and after that period the interest rate becomes adjustable semiannually.ⁱⁱⁱ

In addition, the number of option ARM, interest only and piggyback mortgages issued to subprime borrowers rose significantly during the past three years. Option ARMs, or negatively amortizing mortgages, allow borrowers to pay back less than the full amount of interest due, although the unpaid interest is then added to the principal of the loan. Interest Only Mortgages are either FRMs or ARMs requiring borrowers to pay only the interest for a set period of time. Piggyback mortgages are second mortgages that borrowers use to make a down payment on another mortgage.

Another type of non-prime mortgage that has recently raised concerns is the Alternative-A or Alt-A mortgage. These mortgages are in a category between prime and subprime due to one or more nonstandard features regarding the borrower, property or loan. Alt-A mortgages are often provided with limited documentation (“low doc”) or no documentation (“no doc”) of the borrower’s income. Low doc or no doc Alt-A mortgages may create an incentive for borrowers to misrepresent their income in order to obtain larger loans.

C. The Securitization of Subprime Mortgages

Lenders/originators often securitize mortgages into MBS bonds sold to investors. Payment of interest and principal on MBSs derive from the borrowers’ payments on the mortgages backing the bonds.

Pools of subprime mortgages securitized into MBSs are divided into tranches or slices of bonds so that cash flow from the bonds may suit particular investment requirements. Each tranche is assigned a credit rating by rating agencies. Through this credit enhancement process, MBSs backed by subprime mortgages may obtain investment grade status even though the underlying collateral is of poor quality.^{iv}

MBS bonds are paid in order of seniority, and more senior bond tranches pay before lower tranches. Lower tranches may not be paid if sufficient cash flow is not received from the underlying mortgages. In view of the higher risk that they will not be paid, the lower tranches of bonds receive higher returns.

Further, investment banks have repackaged lower level tranches of MBSs into CDOs.^v CDOs also create tranches for their bonds. Investment banks have been able to obtain the highest credit rating for senior CDO tranches even though they contain MBS bonds rated below investment grade.

MBSs and CDOs backed by subprime mortgages are difficult to value because they do not trade on active markets. Investors are usually required to value MBS or CDO bonds by marking them to market, or valuing them based on the price they think they can obtain in the current market.

As defaults increase on subprime mortgages backing MBSs and CDOs, and less cash flow is available to pay lower bond tranches, investors may be required to revalue those securities. This may result in cash or collateral calls by entities that lent money to the investors for purposes of investing in the MBSs or CDOs.

D. The Rise and Fall of the Subprime Mortgage Market

1. The Subprime Boom

As real estate prices rose in the early years of this decade, and securitization provided more working capital for mortgages, lenders relaxed their underwriting criteria in order to issue more mortgages. At the same time, investors demanded higher returns on their investments and raised demand for MBSs and CDOs backed by subprime mortgages.

Between 1995 and 2005, subprime mortgages increased from 5 percent to 20 percent of the mortgage market. In 1994, \$35 billion in subprime mortgages were originated, and by 2006, that number had increased to more than \$600 billion. Further, between 2003 and 2006 AMP originations tripled for residential mortgages.

The most significant cause for this boom appears to be the increase in the securitization of mortgages. Securitization provided lenders/originators with additional capital to issue more mortgages, including a higher number of AMPs, and to pass off the risk of defaults to investors.

2. The Deterioration of the Subprime Market

It appears that a combination of industry trends and economic and financial factors combined to create the current crisis in the mortgage markets.^{vi}

In 2006, short-term interest rates rose while the value of homes leveled off or dropped. Borrowers with financial difficulties could not refinance or sell their homes to pay off mortgages when they were unable to make monthly payments. Further, in 2006 and 2007, borrowers suffered “payment shock” when teaser rates on many hybrid ARMs expired and higher variable rates became effective.

As a result, default rates on subprime and Alt-A mortgages increased significantly in late 2006 and 2007. Early payment defaults, where a borrower fails to make a payment within the first several months of the loan, became more common in 2006.

With rising defaults, purchasers of mortgages sought to force lenders/originators to buy back nonperforming mortgages. Many smaller lenders that were inadequately reserved and unable to comply with such repurchase demands filed for bankruptcy.

Rising defaults on subprime and Alt-A mortgages have caused rating agencies to downgrade MBS and CDO bonds backed by subprime mortgages. Investors in those securities have already suffered substantial losses, and uncertainty in the financial markets about the value of such securities and potential losses has adversely impacted liquidity in the financial markets.

Some commentators believe that losses from MBSs and CDOs backed by subprime mortgages could exceed \$100 billion. To date, however, it remains unclear which entities are invested in MBSs and CDOs backed by nonperforming subprime mortgages, and whether and when those entities will be forced to decrease the value of those securities held on their books.

E. Investigations and Litigation Arising From the Subprime Mortgage Crisis

Although it appears to be in its early stages, a significant number of governmental and regulatory actions and civil lawsuits have already resulted from the subprime mortgage crisis.

1. Regulatory and Governmental

The U.S. Senate, the Securities and Exchange Commission, the Attorneys General for Ohio and New York, and the Massachusetts Secretary of State have each announced investigations into the subprime lending industry.^{vii} It is likely that other federal and state regulators will investigate the subprime crisis, and that there will be increased regulation of the mortgage industry.

2. Private Civil Litigation

A number of lawsuits involving lenders/originators, warehouse lenders, loan purchasers, underwriters of MBSs, rating agencies and their directors and officers have been filed, and more are expected. Other professionals who played some role in the lending or securitization process may be targeted in lawsuits, including mortgage brokers, lawyers, accountants, auditors, investment advisors and investment fund managers, among others.

a. Repurchase or Misrepresentation Lawsuits Against Lenders

Purchasers of subprime mortgages have filed numerous lawsuits against lenders/originators alleging that they failed to comply with repurchase obligations. The purchasers generally allege causes of action for breach of contract, fraud, fraudulent inducement and negligent misrepresentation.

Liability in repurchase lawsuits may turn on the representations and warranties of the contract pursuant to which the mortgages were purchased.

b. Shareholder Class Actions Against Lenders/Originators

Shareholders have filed securities class actions against at least six lenders/originators and related companies and their directors and officers. Investment banks that underwrote the securities offerings of the lenders/originators have also been named as defendants in some of these actions.

Class actions alleging violations of the Employee Retirement Income Security Act may also be filed on behalf of employees of companies whose pension plans invested in the company's own stock despite knowledge of exposure to subprime lending.

c. Investor Lawsuits Against Rating Agencies

Rating agencies have been the target of substantial criticism for their alleged failure to properly rate MBSs and CDOs backed by subprime mortgages, and their delay in downgrading the bonds as default and foreclosure rates rose.^{viii}

Investors may allege that they would not have bought the bonds had the agencies properly rated them, or that they would have sold them sooner had they known the true value of the bonds. To date, however, rating agencies have successfully avoided liability in securities lawsuits on the grounds that their ratings are protected First Amendment speech.^{ix}

d. Investor Actions Against Underwriters and Investment Managers

Investors in MBSs and CDOs backed by subprime mortgages may sue the underwriters of those securities, as well as brokers and hedge funds that managed their investments.

For example, on April 23, 2007, an institutional investor filed a lawsuit against Credit Suisse, certain of its affiliates and others in connection with their underwriting and servicing of certain MBSs.^x The plaintiff essentially alleges that Credit Suisse failed to perform due diligence on the low quality mortgages collateralizing the MBSs.

e. Borrower Actions Against Lenders/Originators and Warehouse Lenders

Numerous lawsuits alleging predatory lending and misrepresentations about the terms of subprime mortgages have been filed by borrowers against lenders/originators, as well as warehouse lenders and other parties. For example, the NAACP recently filed a lawsuit against lenders/originators alleging that they discriminated against African Americans by steering them toward mortgages with higher rates.

Borrowers may assert that recent decisions support their claims against lenders/originators and other entities for violations of the Truth in Lending Act (TILA) and other consumer protection statutes. On January 16, 2007, a federal court in Wisconsin found that Chevy Chase Bank violated TILA by failing to clearly and conspicuously disclose the ARM loan payment period, annual percentage rate and variable interest rate features of the mortgages.^{xi}

Further, courts may hold warehouse lenders and other parties liable for aiding and abetting improper practices by lenders/originators. In *In re First Alliance Mortgage Co.*^{xii}, the Ninth U.S. Circuit Court of Appeals upheld a jury verdict in a class action brought on behalf of borrowers against Lehman Brothers, which had provided a line of credit to the subprime lender. The court found that Lehman Brothers could be held liable because it knew of the lender's fraudulent practices, but continued to finance the mortgages. Significantly, the Ninth Circuit rejected Lehman Brothers' argument that the plaintiffs were required to prove specific intent, rather than mere knowledge of the fraud.

f. Derivative Actions

Shareholders may also file derivative actions against officers and directors of lenders/originators on the grounds that the officers violated their fiduciary duties by misleading investors about the company's loan delinquency rate and preparedness for a downturn in the mortgage market while selling their own personal holdings in the company.

g. Bankruptcy-Related Litigation

Several subprime lenders have already filed for bankruptcy protection as a result of the termination of funding by warehouse lenders and the significant increase in repurchase demands by purchasers of the mortgages. As bankruptcy filings will stay other litigation against the companies, it appears that many of the liability issues relating to the subprime crisis may be determined in the bankruptcy claims process and adversary actions filed in bankruptcy courts.

The ultimate scope and impact of the subprime crisis will not be determined for some time, and there remains much uncertainty regarding the extent of potential losses. It appears, however, that insurers of lenders, brokers, investment banks, rating agencies and other entities involved in the subprime lending process may face an increasing number of claims relating to the subprime crisis.

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ⁱⁱ Dr. Faten Sabry and Dr. Thomas Schopflochler, "The Subprime Mortgage Meltdown: A Primer," *NERA Economic Consulting*, June 21, 2007.

ⁱⁱⁱ One such mortgage product is the 2/28 hybrid, which has a low fixed interest rate for the first two years of the mortgage, and then an adjustable rate for the remaining 28 years of the 30-year amortization period.

^{iv} Jonathan R. Laing, "Garbage In, Carnage Out," *Barron's*, July 9, 2007.

^v CDOs are similar to mutual funds that buy bonds in that they are managed pools of bonds that raise money by issuing their own bonds. The CDO bond proceeds are used by the CDO to invest in its own portfolio, and payments on the CDO's portfolio are the main source for repayment of the CDO's own bonds. "CDOs in Plain English," *Nomura Fixed Income Research*, September 13, 2004.

^{vi} "Assessing Global Financial Risks," Chapter 1: "Deterioration in the U.S. Subprime Mortgage Market – What are the Spillover Risks?" *IMF World Economic and Financial Surveys*, April 2007.

^{vii} The SEC has reported that it has at least a dozen active investigations relating to subprime lending, including investigations into whether companies have properly valued MBSs backed by subprime mortgages and adequately disclosed risks and valuations associated with such securities. Further, in June 2007, the Ohio Attorney General sued 10 mortgage lenders, accusing them of pressuring real estate appraisers to inflate home values.

^{viii} Aaron Lucchetti and Serena Ng, "How Rating Firms' Calls Fueled Subprime Mess," *The Wall Street Journal*, August 15, 2007.

^{ix} John C. Coffee, "Grade Inflation," *The Wall Street Journal*, September 10, 2007.

^x *Bankers Life Insurance Company v. Credit Suisse First Boston Corporation*, Case No. 8:2007cv00690, United States District Court for the Middle District of Florida.

^{xi} *Andrews v. Chevy Chase Bank, FSB*, 240 F.R.D. 612 (E.D. Wis. 2007).

^{xii} 471 F.3d 977 (9th Cir. 2006).