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The Monterrey Process on Financing for Development: The Road Ahead

Lessons from the US Subprime Mortgage Mess

Roger M. Kubarych
Chief US Economist, UniCredit Markets & Investment Banking, &
Henry Kaufman Adjunct Senior Fellow for International Economics and Finance,
Council on Foreign Relations

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Stunning developments have taken place in the US housing and housing finance markets. From an unsustainable boom in US housing markets, we have watched a massive contraction in activity since 2006, evidenced by plunging housing starts, sales and prices. The consequences have been truly painful for many. Numerous homeowners are struggling with mortgages they cannot afford. Major banking and other financial institutions here and abroad have suffered enormous losses, and their ability to conduct normal lending activities is impaired. And the whole sorry episode has contributed to diminished respect internationally for the integrity of the US financial system and its guardians, perhaps most conspicuous in the decline in the value of the dollar in foreign currency markets since the crisis broke out last summer and a worrisome escalation of commodity prices, not least crude oil.

What can the emerging markets learn from this fiasco? Before suggesting a few lessons, let me start with a few points that might help put the current mess in some perspective.

1. Securitization of mortgages is not new. Securitization – that is, the pooling together hundreds or thousands of individual mortgage loans into a mortgage-backed security, MBS, that can be sold to institutional investors much like a traditional corporate bond – got started in the early 1980s. That was a time when high inflation and correspondingly high interest rates were making it almost impossible for many commercial banks and savings & loan associations to offer mortgages. Within a few years, the useful innovation had caught on to such an extent that over half of all outstanding mortgages were securitized (the rest were held mostly by banks and thrifts). Here's some useful data, drawn from the Federal Reserve's Flow of Funds accounts, showing how quickly and pervasively mortgage securitization caught on:

Mortgage Securitization: **From humble beginnings to central part of the system**

	1975	1980	1985	1990	1995	2000
Total mortgages $ trillion	0.46	0.96	1.52	2.62	3.46	5.13
% securitized	5.3	11.1	25.2	39.9	50.2	54.8

Source: Federal Reserve Board, Flow of Funds

[I left out the more recent data until later: since 2000 the market has had a new element: explosive growth in subprime mortgages and a different way of securitizing them, but I will come back to that shortly.]

2. Securitization done prudently provides immense benefits to nearly everyone: borrowers, investors, and the banks who engineer the process. From humble beginnings, securitization blossomed because it is a superior way of doing the business. Its inventors recognized that the traditional business practiced by banks and thrift institutions of originating mortgage loans, doing the servicing of those loans in-house, and holding them on their balance sheets posed enormous problems. Those problems were especially nasty when short-term interest rates were elevated or when individual cities and towns encountered localized economic distress. It was far more efficient to divide the single business model into three parts, with specialization in origination of mortgages, loan se

penalties, a sharp break from normal US customs, and agree to pay sharply higher interest rates when their initial low rates were adjusted in a year or two. A more responsive regulatory system would have stepped in to catch the most abusive tactics before thousands were message is to learn from the mistakes of others, take the best parts of the approaches of different countries and craft one of your own that most suits your size, stage of development, and sophistication of domestic financial institutions. Mistakes will be made even with this tailor-made composite but maybe they will be easier to fix when all of the principal players have a stake in its creation.