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Don’t Blame the Bondholders

Now that delinquencies, defaults and foreclosures on sub-prime mortgages are rising, people who’d never heard of them two months ago are now trying to figure out who’s responsible. Financial market participants were stunned last week by the suggestion that they were somehow blameworthy. Representatives Barney Frank and Spencer Bachus, the chairman and ranking minority member of the House Financial Services Committee, in a rare display of bipartisan outrage, say they want bondholders to bear the risk for sub-prime loans.

There are plenty of potential culprits for this national financial disaster-in-the-making, but there’s no poster child for this one like Ken Lay or Henry Blodgett were for the last two. Lawmakers and regulators are picking on bondholders because most of these sub-prime mortgages—loans extended to less-creditworthy individuals—end up pooled together to back bonds called mortgage-backed securities. If the holders of these bonds are the ultimate owners of these mortgages, then they must be the villain. Sheila Bair, Chairman of the FDIC, testifying in front of Frank’s committee on April 17, seconded this idea that any policy response had to take into account the obligations of all the “various securitization stakeholders,” including bondholders. Ms. Bair’s comments are ironic, given that the FDIC doesn’t even regulate most of the offending sub-prime lenders. Nor does the Federal Reserve, the Office of Thrift Supervision, the Comptroller of the Currency or the Department of Treasury. This might be a good direction to start pointing the fickle finger of blame.

Let’s stick with Ms. Bair for a minute, and her remarkable testimony in front of the House. In form and substance it read like a primer on the mortgage securitization market, complete with two flow-chart diagrams. (http://www.fdic.gov/news/news/speeches/chairman/spapr1707.html.) The first diagram, entitled “Borrowing under the traditional borrower/lender relationship,” has on it just two baby blue boxes—one marked “borrower” and the other marked “bank”—with two arrows showing money flows from one box to the other. The bank loans the money, and the borrower pays it back. Nice and simple. Bair describes how the traditional lender not only underwrote and serviced the loan, but also had a relationship with the borrower.

The second flow chart, on the other hand, entitled “Borrowing under a securitization process,” is as tangled as the backside of a cheap Persian carpet. It has ten different boxes showing all the parties involved in creating a mortgage-backed security. Besides the borrower and the lender, there is the mortgage broker, servicer, trustee, underwriter, rating agency, credit enhancement provider, issuer and investor, i.e., the bondholder. There are 15 different solid and dashed lines connecting the boxes, as well as four pop-ups that explain the steps in the process. Ms. Bair concludes that the new model is worse than the old, simply because of its complexity. “With so many parties and components involved,” she says, “securitizations are significantly more complicated than the traditional borrower/lender relationship….[T] he increased complexity of the structure and the different interests of the various securitization parties can make credit workout strategies more complicated than in a direct borrower/lender relationship.”

The mortgage loan process has indeed changed since the days when our parents applied for one at their local bank, but one thing hasn’t changed: Everyone still has to do his or her job. In Sheila Bair’s two-box model of traditional mortgage-lending, different people at the bank were still performing all the functions that have been disaggregated in the securitization model. There was the banker interfacing with the borrower, a credit officer qualifying the loan applicant, a loan desk setting the interest rate, a servicing department collecting payments, a compliance department reviewing the marketing pitch, a CFO figuring out how much capital can be loaned, and a portfolio manager watching that loan on the bank’s balance sheet. If one of those guys fell down on the job, they got fired.

The portfolio manager, however, was not blamed for the failings of the credit officer, the CFO, the servicing department, compliance or the bank manager. If Frank, Bachus, Bair et al want to go after the party or parties responsible for the sub-prime mess, they should start with those who are at fault—the mortgage brokers for not adhering to prudent underwriting standards, the regulators who weren't watching their activities, the compliance officers who did not ensure that the risks of taking out risky loans were adequately explained to borrowers, the appraisers who were complicit in the sales and refinancing process, the ratings agencies who were conflicted in their ratings process and, yes, the borrowers who lied on their loan documents.

William D. Dallas, CEO of now-defunct sub-prime lender Ownit Mortgage Solutions, also tried to deflect blame to the bondholders for forgetting every lesson he'd ever learned about underwriting standards. "The market is paying me more to do a no-income verification loan than it is paying me to do the full documentation loans," he explained. "What would you do?"

Bondholders can be blamed for not hedging the risks that they now face, including loss of value and credit losses, but don't blame them for the sins of William Dallas. Mr. Dallas and other lenders should have done their jobs and not originated a loan that they were pretty sure would not get repaid. One thing a bondholder cannot do is hedge against fraud.

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