Subprime Blues Sound Familiar

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The rapid unravelling of the U.S. subprime mortgage market reminds us of the adage that history repeats itself: many of the sad excesses of today's subprime market are but an echo of the costly savings and loan crisis of the early 1980s. Perhaps history will have taught the American taxpayer to resist vigorously picking up the bill, which this time around could prove even more costly than the earlier S&L meltdown.

At the heart of today's subprime crisis is the unfortunate interaction of financial innovation gone awry, inept market regulation and a failure of the rating agencies to exercise their fiduciary responsibility to protect the average investor.

It began with the increased securitisation of mortgage market loans in the late 1990s. This increasingly separated the originator of mortgage loans from their final outcome. It also gave the originator every incentive to push out mortgage loans at an increasing pace without regard for how they would perform over the longer term.

Two further financial market innovations have played important roles. The first was the increased use of collateralised debt obligations, which allowed AAA ratings to be obtained for the larger part of subprime mortgage loan pools, thereby substantially expanding the participation in this market to pension funds and insurance companies.

The second was the introduction of financial market instruments such as adjustable rate mortgage loans or negative amortisation loans. These instruments, which were introduced with the encouragement of the Federal Reserve, allowed very much less creditworthy borrowers to qualify for mortgage financing for the first time.

Financial market innovation alone could not have spawned the phenomenal growth in the subprime market. Rather, what was needed was for both federal and state regulators, including the Federal Reserve, to be asleep at the wheel as loans totalling $1,300bn were issued--the equivalent of 10 percent of U.S. gross domestic product.

Like today's subprime crisis, the S&L meltdown of the 1980s also had its origins in financial market innovation and poor regulation. Towards the end of the Carter administration, the balance sheets of savings and loans--the U.S. equivalent of building societies--came under severe pressure from higher interest rates. Congress then substantially loosened S&L lending standards and allowed them to diversify into riskier and very much more profitable commercial real estate lending. At the same time, federally backed deposit insurance at these institutions was raised from $40,000 to $100,000. Not only did this trigger a rush of money into the S&Ls, it also further encouraged the S&Ls to increase risk taking.

Compounding the S&L crisis was the considerable loosening of regulatory standards. In particular, the S&Ls were given the option of choosing whether they were to be state or federally regulated. Predictably, this encouraged many states, which stood to earn large fees from registering S&Ls, to enter a race to the bottom by offering ever more lax supervisory regimes.

A cautionary lesson to be learnt from the S&L crisis is how official estimates of its scale were repeatedly ratcheted up and how in the end it was the taxpayer who got stuck with the bill. Initially, the cost was put at some $50bn. However, when the dust settled, it turned out that the federal bail-out of the S&Ls cost the taxpayer some $150bn.

Last week, after previously downplaying the fallout from the subprime mortgage lending crisis, Fed chairman Ben Bernanke finally admitted that losses to the financial system could total up to $100bn. If experience is any guide, this estimate will also prove to be on the low side. One only need contemplate that subprime and Alt-A loans (those made to people with only somewhat better creditworthiness than subprime borrowers) might in the end have to be written down on average by 10 percent to arrive at a total cost of the crisis more in the order of $250bn. Were that to turn out to be the case, today's subprime lending crisis would be of a similar magnitude to that of the S&Ls, even in real dollar terms.

As the subprime mortgage market was vigorously expanding, many of its financial market proponents argued that the securitisation of those loans healthily spread the risk of such lending among many market participants. Now that the bottom is falling out of this market, it is important that the financial institutions, which stood most to gain from that lending, rather than the taxpayer, foot the bill.

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