THE SUBPRIME M

It is really quite simple: subprime mortgages were very profitable to those who originated them, those who helped finance, and those who helped securitize and sell them to investors around the world.

by Douglas Timmons

In 2007, the term "subprime mortgage" became a household word. From 2001 to 2006 the subprime market in the U.S. had grown remarkably. The rise in this type of mortgage contributed to an increase in U.S. homeownership rates. However, it took a sharp increase in loan delinquencies and foreclosures in 2006 and 2007 for the subprime market to capture the public spotlight. The sudden shift in fortunes in the subprime market appears to have caught borrowers, lenders, and policymakers off guard. The spillover from the subprime meltdown has reached deep into financial markets, causing substantial upheaval in the U.S. and abroad. The subprime mess is responsible for the financial crisis being felt around the world and will undoubtedly contribute to a lengthy recession. Bailouts of banks, invest-

ORTGAGE CRISIS

HOW DID WE GET IN THIS MESS?

ment bankers, insurers, and secondary mortgage market guarantors is placing an enormous burden on our country's resources.

Consider the numbers: Bear Stearns $29 billion, $700 billion originally to buy toxic bank assets, and now for who knows what; Fannie Mae and Freddie Mac another $200 billion, originally $85 billion, and then another $37.8 billion to shore up AIG; Citigroup $20 billion with an agreement to shoulder hundreds of billions in possible losses; and a new government program in late November that will provide $800 billion to try to help unfreeze the market for consumer debt. Additionally, let's not forget hundreds of billions in guarantees to back up money-market funds and to guarantee bank deposits. What about bailing out the big three auto companies? It may happen. As a new president and Congress come into office, there is also talk of a massive spending plan to stimulate the economy. The national debt is skyrocketing. The biggest debtor nation in the world, the U.S., continues to borrow more and more funds from China, Japan, Korea, and other countries around the world.

According to James J. Saccacio, chief executive officer of RealtyTrac, October of 2008 marked the 34th consecutive month for which U.S. foreclosure activity increased compared to the prior year. A total of 936,439 homes have been lost to foreclosure since the housing crisis hit in August of 2007. In August of 2008 foreclosures hit a record high when 304,000 homes were in default and 91,000 families lost their houses.[1] Since August a number of states have legislated freezes on foreclosures and given homeowners a chance to modify their mortgages. Despite these various state programs that are artificially keeping foreclosures down, foreclosures are still up 25% from a year ago. Many homeowners are defaulting because they have fallen on hard times or their mortgage payments were reset at higher rates; others have simply stopped paying because home prices have fallen so much that they are "upside down" on their loans—the house value is less than their loan. How could such a mess have occurred? It is really quite simple: subprime mortgages were very profitable to those who originated them, those who helped finance, and those who helped securitize and sell them to investors around the world. Highly profitable financial instruments often spin out of control without regard for long-term consequences.

Over the centuries and across countries, economic crises of all types have followed a similar pattern. In the financial markets, as innovations emerge, new and complex financial instruments enter the market promising to increase leverage and returns or reduce risks. Tools of financial engineering, such as the joint-stock company, junk bonds, mortgage-backed securities, and credit swaps, create the possibility of extraordinary returns that investors cannot seem to ignore. Financial intermediaries, generally banks and investment companies, find a way to stretch their balance sheets so as not to be left out. They seem to think that leverage is always rewarded. At the same time, policymakers often turn their head to the possibility that these new financial instruments might not be as safe or prudent as they should be. Lobbying interests are always seeking new ways to exploit a tax loophole or deregulate the marketplace. Special-interest groups contribute millions to political organizations around the country, seeking to influence legislation or entice the proper vote. Regrettably, all too often, the taxpayers get stuck with the bill as the risks associated with some of these financial instruments and the problems they cause to the financial system come to light.

The Economic Environment 2000–2007

The story goes back to the stock market collapse of 2000. The recession of 2001 followed the collapse of the Internet bubble. With the support of Federal Reserve Chairman Alan Greenspan, President George W. Bush pushed through a tax cut designed to benefit the richest Americans but not necessarily lift the economy out of the recession. Joseph Stiglitz, a Nobel laureate in economics, says that given that mistake, the Fed had little choice if it was to fulfill its mandate to maintain growth and employ-

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ment: it had to lower interest rates, which it did in an unprecedented way—all the way down to 1 percent (the federal funds rate).

Lower interest rates worked, but not in the way monetary policy normally does. Usually, low interest rates lead firms to borrow more to invest more, and greater indebtedness is matched by more productive assets. Given the overinvestment by businesses in the 1990s that was part of the problem underpinning the recession, lower interest rates did not stimulate much business investment. The economy grew but mainly because American families were persuaded to take on more debt, refinancing their mortgages and spending some or all of the proceeds. And so long as housing prices rose as a result of lower interest rates, Americans could ignore their growing indebtedness.

The economy grew but mainly because American families were persuaded to take on more debt, refinancing their mortgages and spending some or all of the proceeds. And so long as housing prices rose as a result of lower interest rates, Americans could ignore their growing indebtedness.

Even this did not stimulate the economy enough, and to get more people to borrow more money, credit standards were lowered, fueling growth in subprime mortgages. Moreover, new products were invented, which lowered upfront payments, making it easier for individuals to take on bigger mortgages. Adjustable-rate loans were particularly attractive to those with marginal credit records. These loans had "teaser rates," which allowed even lower payments for the first few years and played off the fact that many borrowers were not financially sophisticated and didn't really understand what they were getting into. By some reckonings, more than two-thirds of the increase in output and employment between 2000 and 2006 had been real-estate related, reflecting both new housing and households borrowing against their homes to support a consumption binge that brought the economy out of the recession.

Fed Chairman Greenspan egged borrowers on by encouraging them to use variable-rate mortgages. He pointed out that "many homeowners might save tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade." Fortunately, most Americans did not follow Greenspan's advice to switch to variable-rate loans. Regrettably, many subprime lenders were forced to use this type of mortgage.

The housing bubble induced Americans to live beyond their means. As home values escalated we borrowed more and more. With this engine of growth turned off, it is easy to see how the American economy will suffer from a slowdown. The collapse of the real-estate bubble should have been predictable, and so are its consequences—housing starts and sales of existing homes are down, and housing inventories are up. A return to fiscal sanity will be good in the long run, but it will reduce aggregate demand in the short run and has pushed the American economy into a recession that has the potential to be quite severe.

Mortgage Securitization

Thirty years ago, when you were likely to get a mortgage from a bank or savings and loan, it was typical for the savings institution to keep the loan on its balance sheet until it was repaid. Today, the party that originates the mortgage loan, most likely a mortgage broker or mortgage banker but possibly a bank or savings and loan, is highly likely to sell the loan to a third party. The third party could be Ginnie Mae, a government agency; Fannie Mae or Freddie Mac, which were government-sponsored entities but have been recently taken over by the federal government; or a private-sector financial institution. The third party often packages the mortgage with others and sells the payment rights to investors. Some of the investors may use their payment rights on the mortgages to back other securities they issue.

This process was quite beneficial to the mortgage industry from its inception in the 1970s until the turn of the century. Securitization allowed loan originators to move long-term mortgage loans off of their balance sheets; this mitigated some of the interest-rate risk exposure they faced. Additionally, securitization helped attract investment dollars to the mortgage markets, allowed the transfer of potential mortgage funds from deposit-rich regions of the country to areas needing mortgage money, and helped keep interest rates reasonably low.

The process by which most mortgages are sold to investors is referred to as securitization. In the mortgage market, securitization converts mortgages into mortgage-backed securities (MBS). Mortgage-backed securities are not necessarily the end of the line. In the recent past, pools of MBS's have routinely been collected and securitized. Bonds that are backed by pools of bonds are referred to as collateralized debt obligations (CDOs). In recent years, a number of CDOs have purchased MBS's and the securities of other CDOs. The issuers of CDOs were the major buyers of the low-rated classes of subprime MBS's. Another variation of the CDOs is called a structured investment vehicle (SIV). The difference between SIVs and CDOs is the type of debt they issue, with the SIVs issuing short and medium-term debt rather

than the longer-term debt of most CDOs. As of midyear 2008, of the $10.6 trillion of U.S. residential mortgages outstanding, $6.6 trillion were held by MBS's or CDOs and $3.4 trillion by traditional depository institutions.[2]

It was only after subprime mortgages started to experience problems that a variety of organizations that supported or owned CDOs and SIVs began to suffer losses. A number of hedge funds and banks, including many foreign banks, reported losses related to investments in U.S. subprime mortgage loans or subprime loan based securities. And so began the financial meltdown the world faces today.

Subprime Mortgages

Subprime lending is a general term that refers to the practice of making loans to borrowers who do not qualify for market interest rates because of problems with their credit history or the inability to prove they have enough income to support the monthly payment on the loan for which they are applying. Generally, subprime mortgages are for borrowers with credit scores under 620. Credit scores range from about 300 to 900, with most consumers landing in the 600s and 700s. Someone who is habitually late in paying bills, and especially someone who falls behind on debts by 30, 60, or 90 days or more, will suffer from a plummeting credit score. If it falls below 620, the consumer is in subprime territory. For people with excellent credit, rates don't vary much from lender to lender for equivalent loans. That is not the case with subprime loans.

A subprime loan also is more likely to have a prepayment penalty, a balloon payment, or both. A prepayment penalty is a fee assessed against the borrower for paying the loan off early, either because the borrower sells the house or refinances the high-rate loan. A mortgage with a balloon payment requires the borrower to pay off the entire outstanding amount in a lump sum after a certain period has passed, often five years. If the borrower can't pay the balloon payment when it is due, he/she has to refinance the loan or sell the house. There is little doubt that prepayment penalties and balloon payments are associated with higher foreclosure rates. The subprime industry contends that borrowers get lower interest rates in exchange for prepayment penalties and balloon payments, but that point is debatable.

A large portion of the subprime loans were adjustable-rate mortgages (ARMs). This type of loan is particularly risky because the future mortgage payments are uncertain. Subprime borrowers, the most suspect credit risks, were borrowing billions of dollars without knowing the ultimate costs. The estimated value of subprime adjustable-rate mortgages resetting at higher interest rates in 2007 was $400 billion, and during 2008 the number should hit $500 billion. Reset activity was expected to peak in March of 2008 at nearly $100 billion before starting to decline. An average of 450,000 subprime ARMs are scheduled to undergo their first rate increase each quarter of 2008.

The value of U.S. subprime mortgages was estimated at $1.3 trillion as of March 2007 with over 7.5 million first-lien subprime mortgages outstanding.[3] Approximately 16% of subprime loans with adjustable rate mortgages (ARM) were 90-days delinquent or in foreclosure as of October 2007, roughly triple the rate of 2005.[4] By January of 2008, the delinquency rate had risen to 21%,[5] and by May 2008 it was 25%.[6]

Mortgage Origination Statistics

Outstanding U.S. residential mortgages (1-4 unit buildings) totaled $10.6 trillion as of midyear 2008.[7] During 2007, lenders had initiated foreclosure proceedings on nearly 1.3 million properties, a 79% increase over 2006.[8] By August of 2008, 9.2% of all mortgages outstanding were either delinquent or in foreclosure.[9] RealtyTrac estimates that more than three million U.S. families will be in foreclosure by the end of 2009.

Predatory Lending/Borrowing

The *Investor Dictionary* defines predatory lending as "the practice of a lender deceptively con-

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Mortgage Origination Statistics

	Total Originations (Billions $)	Subprime Originations (Billions $)	Subprime Share in Total Originations (% of Dollar Value)	Subprime Mortgage-Backed Securities	% Subprime Securitized (% of Dollar Value)
2001	2,215	190	8.6	95	50.4
2002	2,885	231	8.0	121	52.7
2003	3,945	335	8.5	202	60.5
2004	2,920	540	18.5	401	74.3
2005	3,120	625	20.0	507	81.2
2006	2,980	600	20.1	483	80.5
2007	2,306				

Source: *Inside Mortgage Finance*, *The 2007 Mortgage Market Statistical Annual*, *Top Subprime Mortgage Market Players and Key Data* (2006)

The Subprime Facts and Figures

Number of families who now hold a subprime mortgage	7.2 million
Proportion of subprime mortgages in default	14.44%
Dollar amount of subprime loans outstanding	$1.3 trillion
Number of subprime mortgages made in 2005-2006 projected to end in foreclosure	1 in 5
Families with a subprime loan made from 1998 through 2006 who have lost or will lose their home to foreclosure in the next few years	2.2 million
Proportion of subprime mortgages made from 2004-2006 that come with "exploding" adjustable interest rates	89-93%
Proportion approved without fully documented income	43-50%
Proportion with no escrow for taxes and insurance	75%
Proportion of completed foreclosures attributable to adjustable rate loans out of all loans made in 2006 and bundled in subprime mortgage-backed securities	93%
Number of subprime mortgages set for an interest-rate reset in 2007 and 2008	1.8 million

Source: Center for Responsible Lending, "A Snapshot of the Subprime Market."

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vincing borrowers to agree to unfair and abusive loan terms, or systematically violating those terms in ways that make it difficult for the borrower to defend against." Although predatory lenders are most likely to target the less educated, racial minorities, and the elderly, victims of predatory lending are represented across all demographics. Many borrowers who could qualify only for subprime mortgages were told to think of these simply as "bridge loans," with the lender suggesting that in a couple of years, as house prices continued to rise, the subprime loan would be replaced. The idea was that higher home prices would translate into more home equity, which would allow the borrower to refinance at more favorable rates.

There is a great deal of dispute between lenders and consumer groups as to what constitutes predatory practices, but often cited are:

- excessive fees;
- abusive prepayment penalties;
- single-premium credit insurance;
- failure to disclose loan price is negotiable;
- short-term loans with disproportionally high fees;
- steering and targeting;
- mandatory arbitration; and
- loan flipping.

Some borrowers were also guilty of knowingly borrowing funds they could not afford or were not going to pay back. In a *New York Times* article, economics professor Tyler Cowen described predatory borrowing as potentially a larger problem than predatory lending. Professor Cowen says: "As much as 70 percent of recent early payment defaults had fraudulent misrepresentations on their original loan applications, according to one recent study. The research was done by Base Point Analytics, which helps banks and lenders identify fraudulent transactions; the study looked at more than three million loans from 1997 to 2006, with a majority from 2005 to 2006. Applications with misrepresentations were also five times as likely to go into default. Many of the frauds were simple rather than ingenious. In some cases, borrowers who were asked to state their incomes just lied, sometimes reporting five times actual income; other borrowers falsified income documents by using computers."[10]

It should be noted that mortgage applications are usually completed by mortgage brokers, rather than by borrowers, but nevertheless predatory borrowing has taken place.

Soaring/Crashing Home Prices

One of the major reasons for the subprime mortgage crisis is the massive speculative bubble that occurred in housing prices this century. As home prices soared, millions of Americans began to think of their homes as an investment rather than just a place to live. When the stock market crashed in 2000, many looked elsewhere for safer investments. The Taxpayer Relief Act of 1997 had created an interesting possibility in homes. This legislation allows homeowners who have lived in a home as their principal domicile for two of the past five years to sell that home without paying any capital gains. For those filing a joint return, $500,000 of capital gains are not taxed, and for someone filing a single return an exclusion of up to $250,000 is allowed. Homes started to look like a great tax-sheltered investment. Add to this the fact that interest rates were being held down by the Federal Reserve System, and lots of would-be homeowners saw housing as the ultimate investment. Lenders made plenty of money available, much of it to borrowers who historically would not have qualified for a home loan.

House appreciation between 2001 and 2005 was unprecedented. In many Metropolitan Statistical Areas (MSAs), home prices doubled. Those of us from middle Tennessee don't fully appreciate what happened in cities on the east and west coasts. While the average Nashville home appreciated 27 percent over this five-year period, other American cities saw prices explode: Fort Meyers (141%), Ft. Lauderdale (140%), Honolulu (104%), Las Vegas (107%), Los Angeles

(136%), Miami (133%), Phoenix (97%), San Diego (109%), and Washington, D.C. (113%).[11] It is easy to see why homebuyers became home speculators. The most compelling evidence that home prices were greatly overvalued in the U.S. and many other countries was the diverging relationship between house prices and rents. Historically, rents and house prices rise at a similar rate. During the first six years of this century, house prices hit record levels in relation to rents.

Over the past two years, home prices have been plummeting in some parts of the country, especially in those areas that saw the greatest home appreciation—Florida, California, and Nevada. What was once a housing boom has turned into a housing meltdown. The S & P Case-Shiller Home Price national index recorded a 16.6% decline in the third quarter of 2008 compared with the same period a year ago. That eclipsed the previous record of 15.1% set during the second quarter. In the weakest markets, cities such as Phoenix, Las Vegas, and San Francisco have all recorded 12-month losses of 30% or more.[12] Already, 23 percent of homeowners with a mortgage owe more on their loans than their homes are worth, and that figure is estimated to rise to 28 percent by this time next year.[13] According to the real-estate web site *Trulia.com*, about half of all the homes for sale in some cities are repossessed properties that banks have put back on the market.

A *Business Week* cover story article dated January 31, 2008, suggested that as shocking as it might seem, a decline in home prices of 25% would merely reverse the market's spectacular appreciation during the boom. A decline of that magnitude would put the national price level right back on its long-term growth trend line, a quite modest 0.4% a year after inflation.

Whom Should We Blame?

Interesting parallels might be drawn between today's subprime crisis and the Savings and Loan debacle of the mid-1980s. The S & L problem resulted in hundreds of bankrupt savings banks and billions of U.S. taxpayer bailout dollars. The S & L mess was blamed on deregulation of the banking industry, lax oversight, greedy investors and bankers, low bank capitalization requirements, and faulty appraisals. There is undoubtedly plenty of blame to go around this time, too, with some of the same old parties still being involved. Overall, a mix of factors and participants precipitated the current subprime mess. Ultimately, though, human behavior and greed drove the demand, supply, and investor appetite for these types of loans.

Role of Borrowers

Borrowers couldn't turn down easy credit and assumed that housing prices would continue to rise. This encouraged many subprime borrowers to obtain adjustable-rate mortgages (ARMs) they could not afford after the initial incentive period ended. No doubt many borrowers just didn't understand what they were getting into. There is also evidence that some borrowers made fraudulent applications. Many of these may have been investors/speculators who assumed they had nothing to lose and stood a chance of big gains on short-term investments as housing prices continued to soar. By 2005, 40% of home purchases were not primary residences, 28% were purchased by investors, and 12% of the homes bought that year were vacation homes.[14]

Role of Financial Institutions

It can be argued these institutions got greedy. They saw an opportunity to offer an increasing array of higher-risk loans with potentially high rates of return to high-risk borrowers. In 1994 subprime mortgages represented only 5% of total mortgage originations; by 2006 20% of loan originations were subprime.[15] During the 2001-2007 period the risk premium, the difference in interest rates between subprime and prime mortgages, was actually declining. That doesn't sound like a good banking practice. Lenders were also offering increasingly high-risk loan options and incentives. These included interest-only adjustable-rate mortgages and "payment option" loans. Traditional mortgage underwriting standards were not followed, and underwriting standards became quite lax.

Additionally, even though commercial banks did not originate many of the subprime loans directly, they were major participants in the growth of this industry. They provided funding to those who made the loans and often were also investment bankers themselves who packaged the loans into securities. Ultimately, they ended up owning billions of dollars worth of the securities that have lost much of their value.

Role of Securitization

Securitization of mortgages is the process of structuring an investment that acts like a bond and is collateralized by a pool of mortgages. This type of security is often referred to as a mortgage-backed security (MBS). These instruments have been around for almost 40 years. Trillions of dollars of prime mortgages

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have been sold into the secondary market and packaged this way. The secondary mortgage market for prime loans has served a useful purpose. It helped create liquidity in the mortgage loan market. In the recent past, subprime mortgages were also being more actively pooled into MBS's. It is estimated that by 2006, 75 percent of subprime loans were being securitized. It also seems that rating agencies were often assigning investment-grade status to the subprime pools of mortgages.

Role of Investment Banks

During the subprime boom, investment banks bought all of the loans they could pool together and turn into securities. In 2006 the 10 top investment bankers sold mortgage-backed securities with an estimated worth of $1.5 trillion.[16] This figure was only $245 billion in 2000. In order to keep the supply of loans coming, investment bankers increasingly took control of the industry's frontline players. They started by buying small independent mortgage wholesaling firms. Then they made billions of dollars of credit available to subprime lenders. In 2006, the six top investment banking firms paid a total of $2.2 billion to buy subprime shops.

Investment banks bought and sold extremely large volumes of mortgages, worked their sales networks to convince investors to purchase the securities they created, frequently maintained large positions in those securities to profit through proprietary trades, controlled investors such as hedge funds that took positions in these securities, inflated the value of the securities, and then turned around and re-packaged them in new structures to re-start the cycle and generate more revenues. There is little doubt investment bankers fueled the supply of subprime loans to fulfill high levels of demand for which they were primarily responsible. They worked both ends of the deal to "make" this market.

Role of Mortgage Bankers/Brokers

Remember, mortgage bankers don't lend their own money. They simply originate loans for investors who provide the funds. There was a time when the savings and loans originated most home mortgages. That time has passed; today the majority of home loans are made by mortgage bankers and mortgage brokers, not the traditional depository institutions. A study by Wholesale Access Mortgage Research & Consulting Inc. suggests that 68% of all residential loans in 2004 were made by mortgage brokers, with subprime and Alt-A loans accounting for 42.7% of the total loans they made. The mortgage brokers are paid on commission and have an incentive to originate as many loans as they can. Since the loans they originate are sold to others, they don't face much risk if those loans fail. Additionally, mortgage bankers and brokers are not regulated to the same extent as commercial banks.

Role of Mortgage Underwriters

Underwriters decide whether or not a loan meets a lender's accepted lending standards. Historically, borrowers were scrutinized based upon the three C's: **credit** history, **capacity** to repay the loan, and **collateral**. Somehow the old safe way of evaluating loan applications seemed to disappear during the past several years. The underwriting process was streamlined and automated. By 2007, 40% of all subprime loans were generated by automated underwriting. No longer were loans evaluated based on a set of standardized documents that verified employment, income, and collateral. The automated process could make a decision in 30 seconds.

Role of Government and Regulators

The Federal Reserve helped create a climate of easy credit. Even some well-intentioned programs such as the Community Reinvestment Act, which forces banks to lend to otherwise uncreditworthy customers, helped stimulate the use of subprime loans. Some states attempted to prevent the growth of a secondary market in repackaged predatory loans and found that the Treasury Department's Office of the Comptroller of the Currency, at the urging of national banks, struck down such attempts as violations of Federal banking laws. Additionally, actions taken by the Fed back in the 1980s may have also created a "moral hazard." Taxpayers, through the Federal Reserve System, bailed out the savings and loan industry when it collapsed due to real-estate related loan problems. Many mortgage-market participants felt the U.S. government would always step in with a bailout if needed. I guess they were right; the taxpayers of America are once again footing the bill for some outrageous lending/banking practices.

The Securities and Exchange Commission (SEC) has conceded that self-regulation of investment banks was a factor contributing to the crisis. In 2004 the SEC relaxed rules that enabled investment banks to substantially increase the level of debt they were taking on. This action fueled the growth in mortgage-backed securities supporting subprime mortgages.

Role of Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSE) that purchase mortgages, buy and sell mortgage-backed securities, and guarantee nearly half of the mortgages in the U.S.[17] Beginning in the mid-1990s and continuing throughout the crisis and their eventual government takeover in September, 2008, a variety of political and competitive pressures resulted in the GSEs taking on additional risk. In 1995, the GSEs began receiving affordable housing credit for purchasing mortgage-backed securities that included loans to low-income borrowers. This resulted in the agencies purchasing subprime securities. By 2005, HUD directed Freddie and Fannie to provide at least 52% of their mortgage financing to borrowers with income below the median in their area.[18] Even though Fannie and Freddie targeted the lowest-risk loans, they still fueled the subprime market by buying so many MBS's. Between 1994 and 2003, subprime mortgage loan originations surged by 25% per year.[19]

By 2008, the GSEs had borrowed heavily to purchase mortgages and mortgage-backed securities. Their enormous leverage created concerns regarding their ability to make good on their nearly $5 trillion in guarantees and other obligations. In September of 2008, the U.S. government was forced to place the companies into conservatorship, effectively nationalizing them at the taxpayers' expense.[20]

Role of Credit-Rating Agencies

Investors around the world depend on credit-rating agencies to evaluate the risk associated with a wide array of securities. Credit-rating agencies are now under scrutiny for having rated subprime mortgage securities as investment-grade when they should have been aware of the increased risk associated with these loans. The models they used to evaluate risk seem to have assumed that home values can never go down. Another issue associated with the credit-rating agencies is that they are paid to rate securities by the very firms who are creating the investment contracts. This has the appearance, if not the very real possibility, of being a dangerous conflict of interest.

Conclusion

The U.S. faces a deepening foreclosure crisis driven by the rise in subprime mortgages. For years, subprime lenders engaged in a reckless lending spree, marketing the most risky types of loans to the most vulnerable families, many of whom could have qualified for affordable and sustainable loans. The results have driven our country into a recession that is likely to be deep and prolonged. Our country's financial system has been shaken to the core and is being tested in a way not experienced since the Great Depression. Many of the nation's largest and oldest banks and investment banking firms have failed or at the very least been merged into other firms or taken over by the federal government. The national debt continues to pile up as the federal government tries to right the economy and save our financial systems. In a free-market economy, regulation tends to be a nasty word. As a taxpayer, however, I would favor some stronger regulation and oversight of those involved in our country's financial systems. There also appears to be a need for much greater transparency among mortgage and banking system participants. ■

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Notes

1. http://money.cnn.com/2008/11/13/real_estate/foreclosures_october/
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3. http://www.msnbc.msn.com/id/17584725
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