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Opinion Pages

In defense of the mortgage industry

Once heroes for putting home ownership within reach, the creators of 'non-traditional' mortgages are now being vilified

By Veronica E. Rendon and Jason M. Butler

THERE WAS A TIME, NOT LONG ago, when banks were praised for their innovation in creating subprime and other non-traditional mortgage products. They enabled individuals for whom home ownership was beyond reach to fulfill the American dream, and the growth in home equity was credited with promoting a strong economy. Today, these same products are being blamed for a worldwide credit crisis. The implication is that early market participants understood and intentionally understated the risks attendant to the new mortgage products. The question is whether such criticism is fair.

While the temptation is to accept the negative commentary saturating the press, the reality is that it is difficult to predict the performance of new asset classes. The valuation techniques and cash flow modeling required for new types of loans are extremely complex, and they require making economic assumptions that are difficult to test without actual performance experience, which is only now being obtained. While there may have been isolated instances of abuse in the mortgage industry during the past few years, assuming the worst of all market participants is unjust and uncalled for.

Critics now claim that lenders took advantage of consumers and disregarded prudent underwriting practices to capitalize on a surging housing market; others claim that investment banks and rating agencies misrepresented the expected performance of subprime assets and the risks of investing in bonds backed by a new product with little performance history. The lawsuits are just now being filed, and it appears that many more will follow.

But it is unfair to tar the entire industry for creating innovative consumer financial products. The subprime and non-traditional mortgages originated and securitized during the housing boom were a new asset class tailored to a unique market. After the Internet bubble burst, the rate of U.S. home ownership surged. Many economists attributed that increase to the new and innovative loan products created by the mortgage finance industry.

IT IS UNFAIR TO TAR THE ENTIRE INDUSTRY. THESE MORTGAGES WERE A NEW ASSET CLASS TAILORED TO A UNIQUE MARKET.

Adjustable rate, interest-only and "piggyback" loans, with initial monthly payments lower than traditional fixed-rate mortgages, were tailored for a segment of the market that previously was virtually untapped: those with poor credit, no credit or little cash. The wealthy had long been offered mortgage products with low ini-

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tial payments so they could capitalize on an investment opportunity. Lenders began to offer similar products to a broader range of consumers in light of the escalating housing market, which made these loans less risky since the underlying asset was increasing in value. More consumers qualified for loans to purchase first-time homes than ever before. While there may have been some brokers and originators who oversold their products, it does not appear that there was pervasive fraud perpetrated on consumers. And if there was fraud, it was more likely committed by borrowers overstating their qualifications on credit applications.


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There is also no evidence of large-scale financial fraud in the packaging and securitization of the loans. The performance of subprime and non-traditional loans was and continues to be very difficult to predict. Meaningful performance data are only now emerging through actual experience with the loan products and underlying borrowing base. The additional data, which were not available when the market was initially under way, are resulting in adjustments to predicted future performance and associated present-day value. It is not unusual to adjust expectations as actual performance data are collected and trends are traced and analyzed.

The need to make such adjustments, however, is very different from presuming that the original valuations and underlying assumptions were wrong when made. High rewards and painful corrections are part of the development of any market, and it would be an error to assume widespread impropriety by early market participants.

Indeed, some sophisticated investors are already taking advantage of the "subprime meltdown" as a buying opportunity. With proper review and due diligence, mortgage-backed debt may provide strong investment opportunities in the future, and especially in the current environment, when many are spooked and shying away from the market.

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