Roots of the Financial Crisis

You can track the pain back to one cause, lack of regulation

by Tom Krebs, attorney with Christian & Small

This country's legitimate capital markets have been crippled, the global economy is wavering and nobody seems to know exactly why. It is however rather simple. Just as occurred in 1929, the cause of the 2008 financial crisis was securities fraud. Had it not been for Real Estate Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDO), the credit rating agencies' conflicts of interest might never have occurred. There would have been no reason for the rating agencies' sale of their ratings in an all-out grab for RMBS and CDO market share. Without the funds provided by the issuers of RMBS and CDOs, the mortgage loan originators would never have become the national disgrace that they proved to be; these mortgage loan predators simply would not have had the resources to make their highly questionable Alt-A and subprime loans. Absent the cash from the securitization firms, they would have had no money to lend to the unwary wanna-be homeowners or the gaggle of gamblers betting that they could cash in on ever-increasing home values. With no RMBS offerings or CDO tranches to write credit default swaps against, the derivatives market might never have written its trillions of dollars of credit default swaps and AIG would never have become the colossal failure that it was. Nor would have Lehman Brothers or Bear Stearns failed, as they would not have had too many poorly underwritten mortgages tied to their leveraged balance sheets.

Like some Sisyphusian nightmare, we are seemingly condemned to learn again and again that the sale of securities in the absence of regulatory oversight will end in fraud. It happened in 1929 and it happened again in the financial crisis of 2008.

Investors paid the Wall Street securitization firms who in turn paid the mortgage loan originators who used those funds to make more mortgage loans. In order to meet the demand for AAA rated mortgage-backed securities, securitization firms purchased and then securitized virtually any type of mortgage from any type of mortgage loan originator—all without adequate disclosure to investors. The years 2002 to 2007 were characterized by unfettered and unregulated underwriting of mortgages by mortgage loan originators who saw their profits increase through the transfer of mortgage loan products to securitization firms. The securitization firms, in turn, packaged these mortgages in offerings for investors and retained little of the risk. The mortgage-backed securitization documents used to market the securities to investors did nothing to alert them to the considerable erosion in the quality of the mortgages underlying the mortgage pools.

During 2003 to 2007, it was seldom that any securitization firm reviewed as many as 30 percent of the loans to be sold in their RMBS securities offerings; it was routine that only 5 to 2 percent of the loans sold to investors were subjected to due diligence reviews. The records amassed by Clayton Holdings, Inc. (Clayton), which performed as many as 50 to 60 percent of all the mortgage loan pool due diligence for all securitizations during this period, show that the mortgage loans included within these securitizations seldom met mortgage underwriting standards.

Those failures are surfacing daily in suits brought against securitization firms. In those suits, courts are finding that default rates on home mortgages were woefully understated, loan to value ratios on loans were misstated (often by a factor of 20 percentage points), the percentages of owner occupied properties were materially overstated and the percentage of loans that met underwriting guidelines was grossly overstated. Nowhere was it disclosed that only 54% of the loans met underwriting guidelines. Nowhere was it disclosed that 28% of all loans did not meet underwriting guidelines. How did this come to be?

Following a Congressional mandate in 1984, the SEC extended the coverage of Rule 415 to mortgage backed securities and permitted RMBS to be sold in shelf-offerings so long as the senior tranches of the offering were rated in the four highest grades by SEC recognized rating agencies. In short, SEC Rule 415 is a "shelf registration process" which had been limited to seasoned issuers, companies for which there was already extensive public information on file.

In 1984, the mortgages being securitized were of a much higher quality, had very low default rates and possessed a great deal more uniformity than the mostly subprime mortgages which helped create the financial crisis. In 2003, 2004, 2005, 2006 and 2007, there were 7,138 RMBS offerings registered with the SEC under Rule 415; that is almost four offerings per day. The SEC then had only ten people assigned to RMBS offerings – and these ten folks were from the travel and leisure division of the SEC's Division of Corporations Finance. Even if the SEC staff were inclined to do so, they could not review that many shelf offerings. Thus they did no reviews. Neither did the SEC review Rule 506 private placements of CDO's to "sophisticated investors" and did not review Rule 144A offerings to qualified institutional buyers. There was NO regulation whatsoever of the sale of mortgage-backed securities. It is axiomatic that where there is no regulation, there will be fraud!

No other nation possesses a system of securities markets with the depth and resilience of ours. There are reasons why trust could be placed in our unseen, and often not understood, markets: there were regulators on duty whose function it was to make sure that investors could place their funds into markets that were free from fraud. We learn time and again that self-regulation is a myth. The only way to secure fraud free markets is to have good securities regulation. Then, and only then, will legitimate business flourish in an atmosphere free from fraud. ●