The New York Times
nytimes.com

PRINTER-FRIENDLY FORMAT
SPONSORED BY
JULY 1

September 30, 2007

ECONOMIC VIEW

Six Fingers of Blame in the Mortgage Mess

By ALAN S. BLINDER

SOMETHING went badly wrong in the subprime mortgage market. In fact, several things did. And now quite a few homeowners, investors and financial institutions are feeling the pain. So far, harried policy makers have understandably focused on crisis management, on getting out of this mess. But soon the nation will turn to recrimination — to good old-fashioned finger-pointing.

Finger-pointing is often decried both as mean-spirited and as a distraction from the more important task of finding remedies. I beg to differ. Until we diagnose what went wrong with subprime, we cannot even begin to devise policy changes that might protect us from a repeat performance. So here goes. Because so much went wrong, the fingers on one hand will not be enough.

The first finger points at households who borrowed recklessly to buy homes, often saddling themselves with mortgages that were all too likely to default. They should have known better. But what can we do to guard against it happening again?

Not much, I'm afraid. Gullible consumers have been around since Adam consumed that apple. Greater financial literacy might help, but I'm dubious about our ability to deliver it effectively. The Federal Reserve is working on clearer mortgage disclosures to help borrowers understand what they are getting themselves into. ("Warning! This mortgage can be dangerous to your family's financial health.") While I applaud the effort, I'm skeptical that it will work. If you have ever closed on a home, you know that the disclosure forms you receive are copious and dense. Should we add even more?

Fewer words, and in plainer English, might help, especially if they highlighted the truly important risks. ("In two years, your mortgage payments could double.") But the truth is that there is much to disclose, that complicated mortgage products are, well, complicated, and that people don't read those documents anyway.

It seems more promising to point a finger directly at lenders. Some lenders sold mortgage products that were plainly inappropriate for customers, and that they did not understand. There were numerous cases of unsophisticated borrowers being led into risky mortgages.

Here, something can be done. For openers, we need to think about devising a “suitability standard” for everyone who sells mortgage products. Under current law, a stockbroker who persuades Granny to use her last $5,000 to buy a speculative stock on margin is in legal peril because the investment is “unsuitable” for her (though perfectly suitable for Warren Buffett). Knowing that, the broker usually doesn’t do it.

But who will create and enforce such a standard for mortgages? Roughly half of recent subprime mortgages originated in mortgage companies that were not part of any bank, and thus stood outside the federal regulatory system. That was trouble waiting for a time and a place to happen. We should place all mortgage lenders under federal regulation.

That said, bank regulators deserve the next finger of blame for not doing a better job of protecting consumers and ensuring that banks followed sound lending practices. Fortunately, the regulators know they underperformed, and repair work is already under way.

Regulators also need to start thinking about how to deal with a serious incentive problem. In old-fashioned finance, a bank that originated a mortgage also held it for years (think of Jimmy Stewart in “It’s a Wonderful Life”), giving it a clear incentive to lend carefully. But in newfangled finance, banks and mortgage brokers originate loans and sell them quickly to a big financial firm that “securitizes” them; in other words, it pools thousands of mortgages and issues marketable securities representing shares in the pool. These “mortgage-backed securities” are then sold to investors worldwide, to people with no idea who the original borrowers are.

Securitization is a marvelous thing. It has lubricated the market and made mortgages more affordable. We certainly don’t want to end it. But securitization sharply reduces the originator’s incentive to scrutinize the creditworthiness of borrowers. After all, if the loan goes sour, someone else will be holding the bag. We need to find ways to restore that incentive, perhaps by requiring loan originators to retain a share of each mortgage.

But wait. Don’t the ultimate investors have every incentive to scrutinize the credits? If they buy riskier mortgage-backed securities in search of higher yields, isn’t that their business? The answer is yes — which leads me to point a fourth finger of blame. By now, it is abundantly clear that many investors, swept up in the euphoria of the moment, failed to pay close attention to what they were buying.

Why did they behave so foolishly? Part of the answer is that the securities, especially the now-notorious C.D.O.’s, for collateralized debt obligations, were probably too complex for anyone’s good — which points a fifth finger, this one at the investment bankers who dreamed them up and marketed them aggressively.

Another part of the answer merits a sixth finger of blame. Investors placed too much faith in the rating agencies — which, to put it mildly, failed to get it right. It is tempting to take the rating agencies out for a public whipping. But it is more constructive to ask how the rating system might

be improved. That's a tough question because of another serious incentive problem.

Under the current system, the rating agencies are hired and paid by the issuers of the very securities they rate — which creates an obvious potential conflict of interest. If I proposed that students pay me directly for grading their work, my dean would be outraged. Yet that's exactly how securities are rated. This needs to change, but precisely how is not clear.

SO that's my list of men (and a few women) behaving badly. But as we point all these fingers, let's remember the sage advice of the late and dearly missed Ned Gramlich, the former Fed governor who saw the emerging subprime problems sooner and clearer than anyone. Yes, the subprime market failed us. But before it blew up, it placed a few million families of modest means in homes they otherwise could not have financed. That accomplishment is worth something — in fact, quite a lot.

We don't have to destroy the subprime market in order to save it.

Alan S. Blinder is a professor of economics and public affairs at Princeton and former vice chairman of the Federal Reserve. He has advised many Democratic politicians.

Copyright 2007 The New York Times Company

Privacy Policy | Search | Corrections | RSS | First Look | Help | Contact Us | Work for Us | Site Map