

THE MORTGAGE MELTDOWN AND BASEL II

By William M. Isaac*

The recent liquidity crisis in the mortgage markets, particularly as it relates to subprime loans, raises a number of questions and issues that need to be debated. They range from what to do about the problems to how to prevent such things from happening again.

There is no question that our country is going through a difficult time, as many homeowners are struggling to meet their monthly mortgage payments. Political leaders, quite naturally, want to do something to alleviate the pain – it's almost an involuntary reaction, like breathing.

They need to be very thoughtful before acting, as most steps they might take to interfere with market forces could backfire. They could easily wind up hurting the very people they are trying to help.

Let me give one very current example, which will likely be decided one way or another by the time you read this. The House Judiciary Committee is considering H.R. 3609, the proposed "Emergency Home Ownership and Mortgage Protection Act."

This bill would allow bankruptcy judges – who have no expertise in mortgage lending or in the safety and soundness issues that apply to financial institutions – to reduce the outstanding principal balance of a mortgage loan, extend the terms of the loan, reduce the interest rate, and/or delay the reset of an ARM.

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If private contract terms are no longer considered sacrosanct and can be overridden retroactively, a great deal of uncertainty will be added to an already volatile and illiquid housing market. The interest rates on mortgage loans will almost certainly rise – particularly on subprime loans, which have the highest risk of default.

The neediest borrowers will likely be cut off entirely. And the least deserving borrowers – those who speculated on real estate – will enjoy the windfall of being able to seek reformation of their contract terms in bankruptcy court.

Things clearly went too far in the subprime market in recent years. A fair number of people got mortgage loans that they could not afford.

But let's not lose sight of the fact that a much larger group of people gained access to the American dream of owning their own homes. Not all of them will be able to keep their homes and some will return to renting, but the overwhelming majority will enjoy homeownership for years to come.

The marketplace will sort out who can afford continued home ownership and who cannot. Foreclosure is always a lender's last resort, not by any means the first choice. If we, as a society, want to provide assistance to some owners to help them through this difficult period, it should be in the form of direct aid (*e.g.*, loans or loan guarantees) to homeowners, not through the abrogation of private contracts.

As we look ahead, there are several obvious questions and issues, such as considering whether relatively unregulated mortgage lenders should be subject to federal oversight and whether we should impose federal lending standards. My sense is that such changes are almost inevitable.

A less obvious, but no less important, need is for policymakers to re-consider the recently adopted Basel II capital standards. The crisis in the mortgage markets and the massive losses being taken by some of our largest financial companies demand that bank regulators re-think whether it makes sense to bet the future of our banking system on mathematical capital models that are way too complex and are clearly unreliable.

The theory behind the Advanced Approach under Basel II is that the world's largest banks are too big and complex to evaluate without employing sophisticated mathematical capital models, supplemented by reliance on ratings of the large rating agencies – namely, Moody's, Standard & Poor's, and Fitch. The Advanced Approach was pushed through despite strong objections from most bankers, professional bank supervisors, and bank trade groups.

Implementation costs on the Advanced Approach are already measured in billions of dollars. And guess what? Even before the ink dried on the inter-agency agreement on the Advanced Approach, the mortgage crisis proved that it does not work.

The Advanced Approach assigns a negligible risk rating to residential mortgage loans. It assigns an even lower risk rating to AAA-rated collateralized debt obligations. For those who are keeping track, these are the very assets on which major, highly regarded financial companies, such as Citigroup, have already taken write downs of tens of billions of dollars.

The complaints about the Advanced Approach are not Monday morning quarterbacking. Opponents of the Advanced Approach have been focused from the start on the inability of mathematical models to predict the future with the degree of certainty required to justify betting the banking system on it.

The failures of the models, and of the rating agencies, in the residential mortgage crisis are not the first failures we have seen and will not be the last. Thankfully, the regulators

decided, however reluctantly, to maintain a minimum capital standard, known as the “leverage ratio.” They also built into the Basel II regulations some additional protections against precipitous declines in capital. And they have held open the possibility of allowing the largest banks to use the Standardized Approach.

It is now time for the regulators to recognize the significant flaws in the Advanced Approach and allow all U.S. banks, including the largest, to use the Standardized Approach already available to large banks in other countries.

The Standardized Approach puts assets into a number of buckets based on their perceived risk profile. It does not purport to be a more precise measure of risk than can be delivered by any model, and it does not convey a false sense of precision and security.

The Standardized Approach is more transparent and much easier for all the important users of the information to understand, including boards of directors, bank executives, customers, investors, analysts, the media, and bank regulators. The Standardized Approach is less intrusive than the Advanced Approach and will allow banks more flexibility to manage themselves properly. Finally, the Standardized Approach is much less expensive to implement and maintain and will produce a smaller disparity in capital requirements between large and small banks.

The mortgage banking crisis has already done a great deal of damage to a lot of borrowers and lenders. More pain is likely in store.

But the silver lining is that the crisis has exposed some serious gaps and weaknesses in the regulatory system, which we now have an opportunity to fix before much more serious harm results.