

**SUBPRIME MORTGAGE MELTDOWN:
FACTS & FALLACIES
By William M. Isaac***

It's nearly impossible to watch a news show without being assaulted by sensational reports about the subprime mortgage crisis. It's important that we put these problems in proper context and not rush to judgment about solutions.

Fallacies about the subprime mortgage problems abound. I want to address a few of them before looking ahead.

We are in a crisis that threatens the banking system. This is simply false. We're not in a "crisis," and the subprime problems don't pose a threat to the banking system.

There were just over \$1 trillion of subprime loans at September 30, 2007. We don't know for sure what portion of these loans is held in U.S. banks, but a reasonable estimate would be in the \$200 billion - \$300 billion range.

We estimate the potential losses on these assets held by U.S. banks to be roughly in the range of \$30 billion - \$45 billion on a pre-tax basis. Losses of this magnitude will be unpleasant but quite manageable for the industry.

The banking industry has more than \$1.4 trillion in equity capital and reserves. It earned \$146 billion in 2006, *after* taxes and *after* reserving \$29 billion for losses.

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One of our largest banks took losses of roughly \$19 billion on its mortgage-backed securities and was able to raise nearly \$30 billion of new capital in the past two months. A large bank specializing in mortgage lending was snapped up by a much larger bank at a bargain basement price. In short, very sophisticated investors are betting a good deal of money that: i) the subprime lending problems are not nearly as serious as many pundits are saying, and ii) the U.S. financial system is strong.

The banking system is experiencing more problems than any year since 1991. This statement is both technically correct and totally misleading. The banking system since 1991 has enjoyed perhaps the longest period of prosperity in history. Today's problems are nothing compared to the problems in the 1980s and early 1990s.

For example, non-performing loans in banks at September 30, 2007 were less than 6% of bank equity capital and reserves compared to nearly 30% in 1990. Loan and lease charge-offs at banks through the first three quarters of 2007 were 28% of net income versus over 300% in 1990.

Problem banks totaled 65 institutions at September 30, 2007, holding 1/6 of 1% of the industry's assets. This compares to over 1,400 problem banks in 1991, holding 18% of the industry's assets (this was after the failure of nearly 3,000 banks and thrifts during the preceding decade).

It's possible that things will deteriorate, particularly if the economy slides into a recession. But it's difficult to imagine that we will experience a banking downturn resembling the downturn of the 1980s.

The Comptroller of the Currency's rule pre-empting state regulation of national banks was a leading contributor to the subprime mortgage problems. This charge was recently leveled on national television by New York Governor Elliot Spitzer. It's utter nonsense.

The states have never had jurisdiction over national banks. The pre-emption regulation promulgated by the Comptroller of the Currency several years ago did nothing more than codify existing Constitutional law and practice.

The subprime mortgage problems were produced by vast flows of funds from investors throughout the world who purchased mortgage-backed securities, packaged and marketed primarily by non-banks. Most subprime mortgages were originated by some 53,000 mostly unregulated mortgage brokers.

Perhaps if Governor Spitzer had focused his attention on the unregulated mortgage brokers in his state instead of fussing about heavily regulated national banks, he could have had a positive impact on the subprime mortgage markets.

While I don't agree we are in a crisis, we do have a serious problem on our hands, and a lot of people are being hurt by it. What should we do, and what should we not do?

The principal thing we should not do is make matters worse. The bad loans are on the books, everyone is aware of them, and the marketplace is attempting to resolve them.

The biggest problem we have today is that there is almost no funding available for subprime mortgage loans. Government should let the marketplace work and intervene in ways that will: i) enhance the clean-up process, and ii) get funds flowing again.

The recently enacted Mortgage Forgiveness Debt Relief Act, providing income tax relief on forgiven mortgage debt, is a positive step. Another example of useful legislation is the effort underway to revitalize the Federal Housing Administration and restore its role in facilitating mortgage loans to low and middle income families.

A particularly bad idea on the table as I write this piece is a bill that would allow bankruptcy judges to override the contractual terms of mortgages. How can we expect to attract

much needed funding into subprime mortgages while such a radical proposal disrespecting the sanctity of contracts is under serious consideration in Congress?

The Treasury and federal banking agencies are taking a number of important actions. The Federal Reserve has been lowering interest rates and working with the Treasury to enhance liquidity in the financial markets. FDIC Chairman Sheila Bair has been leading the charge on finding ways to help servicers of mortgages work with worthy borrowers rather than having to foreclose.

Comptroller of the Currency John Dugan offered some very constructive views in a recent speech. He urged banks with large concentrations of real estate loans to make sure they have strong risk management systems in place. Importantly, he specifically did not tell banks to pull in their horns and reduce their exposure to real estate.

I'm convinced that the banking crisis of the late 1980s was made much worse than it needed to be because bank examiners forced banks to essentially withdraw from real estate lending. While this reaction might have been understandable in the difficult political climate of that period, it was the wrong medicine at the wrong time. I believe Comptroller Dugan's speech is an indication this lesson has been learned.

We have very competent people in the Federal financial agencies, and we should let them do their jobs. Until we are well on the road to recovery in the financial markets, Congress and the regulators should continue to focus on steps that will get funds flowing. There will be plenty of time to point fingers and deal with improved disclosure and regulation once things have settled down.