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Faulty assumptions led to mortgage mess

By Joseph Ganem

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Throughout the unfolding crisis in subprime mortgages, an industry mantra has been repeated over and over: that it is necessary to charge high interest rates to borrowers who are at greater risk of default. The implication is that lenders expect more defaults from subprime borrowers, but the additional money collected from these loans will cover the higher losses.

This reasoning is common in many industries that profit from taking risks. It is the same reasoning that automobile insurance companies use to justify charging higher rates to teenage drivers. In fact, auto insurers have elaborate rate structures based on models that take into account the variations in risk associated with age, gender, ZIP code and past driving history.

These models apparently work because there is no crisis in automobile insurance, with large insurers no longer able to cover their losses. In contrast, the risk models used by the mortgage lending industry have failed spectacularly. The disintegration of a large company such as Countrywide Financial indicates that its executives had no idea of the amount of risk the company had assumed.

What went so wrong with mortgages? Automobile insurers and mortgage lenders make assumptions about the future when they sell their products, but those assumptions are very different. Despite what the salesperson will tell you, everyone knows that an automobile is not an "investment." With few exceptions, automobiles are projected to have a worth of zero in the not-too-distant future. Insurers know that and price their products accordingly.

But houses are always sold as investments. The underlying assumption is that a house will always be worth more in the future. Anyone who has bought a house knows the elaborate charade of numbers the parties sign off on to convince everyone that the risks are small and manageable.

Homebuyers are "qualified" by calculating the fraction of current income needed to make monthly payments. It is assumed that future income will be more, not less. Home appraisers examine the features of the house in relation to "comparables" in the neighborhood and produce an elaborate calculation to show that the buyer is not overpaying. It is assumed that the buyers of the comps did not overpay themselves. Private mortgage insurance is required if the down payment is too low to cover the lender's losses in the event of foreclosure. It is assumed that the insurer knows the default rate when it determines rates for mortgages.

But if market conditions change, these assumptions are no longer valid. A recession can bring job losses, resulting in less income in the future. Home values can fall, rendering the numbers on the appraisals meaningless. The resulting higher-than-expected default rates can bankrupt the insurers. It turned out that the risks to lenders were greater than anyone thought because no one considered the risk that the underlying assumptions behind the homebuying process might change.

Evidently, lenders were no better than homebuyers at predicting the future and understanding the real risks.

But in the ensuing financial meltdown, it is interesting to see the moral framework in which the numbers are presented. Last week, Baltimore sued Wells Fargo Bank, accusing it of predatory lending practices. In response, a spokesman for the Mortgage Bankers Association called the action "counterproductive." Speaking on the NBC News, he said the litigation will ultimately increase costs, which is bad for borrowers.

According to the mortgage industry, borrowers are responsible for fully understanding the terms of the loans that they sign; they should know the risks. Meanwhile, it was reported that Angelo R. Mozilo, CEO of Countrywide Financial, stands to receive as much as $115 million in severance pay if his failed company is acquired by Bank of America.

No comment, so far, from the mortgage industry on the cost to customers of his severance package.

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