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Banks Stuck With Bill for Bad Loans

By FLOYD NORRIS

If nobody does their job right, and disaster ensues, who should pay for the sins of all?

That is the predicament now confronting the mortgage industry, where it has become clear that many billions of dollars in home loans were sold, guaranteed and rated as safe without anyone bothering to examine whether the loans were made with due regard for the rules.

You can make a case — call it the caveat emptor case — that no one should be able to recover any losses they suffered from loans that went bad. If they had performed even rudimentary checks before the loans were made, sold, rated, insured or securitized, it's very likely that big problems would have been visible before disaster hit. There would have been fewer bad loans and many fewer foreclosures.

That case is not, however, showing any sign of prevailing as legal battles increase in number. Instead, it appears that big banks will be compelled to pay for their own sins as well as the sins of others.

Already the four big commercial banks — [JPMorgan Chase](#), [Bank of America](#), [Wells Fargo](#) and [Citigroup](#) — have taken losses of \$9.8 billion on loans they have repurchased or expect to be forced to repurchase. Moshe Orenbuch, an analyst at [Credit Suisse](#), says he thinks that figure will rise to \$20 billion or \$30 billion before the wave is over. Other analysts think the number could be significantly higher.

Even now, long after we learned just how bad the underwriting standards were, it is surprising to see how bad many of these loans were. In the second quarter, Wells Fargo repurchased \$530 million of mortgage loans. It concluded those loans were worth, on average, a little less than half their face value.

Wells says it has the right to recover some of that from the companies that sold it the loans.

Unfortunately, “due primarily to the financial difficulties of some correspondent lenders, we typically recover on average approximately 50 percent from these lenders,” Wells added in a [filing](#) with the [Securities and Exchange Commission](#).

So far, most of the money the banks have paid has gone to [Fannie Mae](#) and Freddie Mac, which used to be government-sponsored enterprises and now, after the bailouts, are government-controlled. But even though they have collected billions, Fannie and Freddie are getting increasingly frustrated with the banks for what they see as foot-dragging.

Freddie, in its quarterly [report](#) filed this month, said it was now requiring banks “to commit to plans for completing repurchases, with financial consequences or with stated remedies for noncompliance, as part of the annual renewals of our contracts with them.”

A spokesman for Freddie would not say just what those remedies or financial consequences might be. But any bank that wants to keep offering mortgages must have contracts with Fannie and Freddie. Tying the repurchases to contract renewals could be a strong bargaining chip.

The mortgages sold to Fannie and Freddie were supposed to conform to specified requirements. Those requirements did get weaker as the credit bubble intensified — a fact some bankers privately mutter the government now wants to forget — but they were still of higher quality than many mortgages sold into private securitizations.

Those securitizations are the subject of demands for mortgage repurchases made by monoline insurers like MBIA and Ambac, which erred in promising to make the payments if the securitizations did not have enough money from payments by borrowers.

When MBIA began making such claims last year, it seemed a little presumptuous. In its suits, it admitted it did virtually no due diligence to assess the quality of the loans it was insuring. Instead, it said it had relied on the representations and warranties made by banks and brokerage firms that bought the insurance.

“It would be enormously expensive, even if it were logistically feasible, for a credit insurer to investigate the health of these ground-level loans,” MBIA argued in a court filing, adding that if it had done such research, it would have been forced to charge much higher premiums.

Something similar could be argued by almost everyone involved. To cite one example, Credit Suisse, which was sued by MBIA after it guaranteed a securitization of second-mortgage loans that may have been among the worst such loan collections ever, said it had not reviewed the loans either. Instead, it relied on assurances from the firms that made the loans.

Nor did the bond rating agencies do reviews of individual loans before they assigned AAA ratings to securities that in no way deserved them. Conveniently, everyone assumed that the others were telling the truth.

The industry motto could have been, “Since we trust, why verify?”

In decisions that should send alarms through bank boardrooms, MBIA has managed to persuade judges in three cases that it has a strong enough argument to avoid dismissal at an early stage. In a [decision](#) on Credit Suisse earlier this month, a New York judge rejected the bank’s claim that MBIA was a sophisticated party that failed to perform due diligence and thus had only itself to blame.

The prospectus for the deal MBIA insured did have plenty of warnings. There were “Nina” loans (no income, no assets), for which the borrower did not even have to claim having income or assets to get the loan. Some of the loans were made by New Century, a subprime lender that had already gone bankrupt.

Many of the loans left the borrower owing 100 percent of the appraised value of the property, including the first mortgages sold to others. The prospectus even said that the underwriting standards varied and that in some cases even those standards had not been met.

But the judge said that all those warnings, and MBIA's failure to do due diligence, were not enough to let Credit Suisse avoid charges that it made representations and warranties about the loans that were not accurate.

MBIA has persuaded its auditors to let it book \$2.1 billion in receivables from banks, although only one small bank has reached a settlement with the insurer. Other insurers are making similar claims. So are some institutions that purchased bad paper, like some [Federal Home Loan Banks](#).

Of course, some banks are now judgment-proof. One of them is [IndyMac](#), which was seized by the [Federal Deposit Insurance Corporation](#). Unable to get money from the bank, MBIA has now filed suit against its officers (who may still have some insurance) and the underwriters of the securitizations that MBIA guaranteed.

Those underwriters, of course, include some of the big banks that did not fail, like Credit Suisse and JPMorgan Chase. They may have to pay for the sins of their former competitors.

The banks are fighting many repurchase demands, and say they are winning some arguments. The issue is not whether a given loan went bad, of course, but whether it was properly documented and underwritten by the standards that were promised.

The result is that Freddie and Fannie and MBIA and Ambac and the banks are all now going over loans one by one. Had any of them bothered to do that in 2006, 2007 and 2008 — when most of the disastrous loans were made — this tragedy could have been avoided.

But they all thought such care would cost too much and take too long. After all, MBIA charged as little as \$77,500 for each \$100 million of insurance, and you can't hire many financial analysts for that kind

of money. Fannie and Freddie were competing with each other and with the private securitization companies for business, and speed mattered.

Banks richly deserve to suffer for their role in creating this mess. But so do a lot of other players who may well end up being compensated for losses that, to a significant extent, they brought on themselves by not doing the work they should have done.

Floyd Norris comments on finance and economics in his blog at nytimes.com/norris.

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