

## **HOW A HOME LOAN SUNK BEAR STEARNS**

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Last Sunday, Bear Stearns died. One of the top investment banks on Wall Street, it was founded 85 years ago and survived two world wars, the Great Depression, numerous financial crises that swept our nation. In 2007, its stock was selling at \$172/share. Last Thursday, the stock was at \$70. By Friday, it fell to \$30. And Sunday night, J.P. Morgan Bank agreed to buy Bear Stearns for just \$2/share .. And only if the Fed Gvt provided \$30 B in guarantees. What happened at Bear Stearns and why should we care?

Well for that we need to look at Tom and Sarah. They were a nice young couple with two kids living in a cramped apartment in Stockton. They dreamed of owning a home but with little money, unpaid student loans, and more than a few late charge card payments.. That home would remain just a dream.... after all their credit score was in the 500's, far too low to qualify for a home loan... that is until the mid-1990s when the lending institutions started changing the rules.

The way the lending system works is like this. A borrower applies to get a loan to buy a home. The Lender checks the borrower's credit, their ability to pay, gets an appraisal of the value of the home, and if all looks good, makes the loan. Now at this point the Lender could sit back and wait to get paid but after a few loans they'd be out of money. So the Lender re-sells the Loan to another tier of Lenders called the Secondary Market which gives money back to the Lender to make new loans. The Secondary Lenders then package up whole groups of loans which they in turn sell to the giant investment companies, such as Bear Stearns. These companies then split up these packages into securities which they then sell on the stock market to individuals, pension plans, and other investors. In theory, these are safe investments because they are secured with the real estate they were borrowed against.

But in the 90's loan brokers realized that 70% of the possible market - people like Tom & Sarah - couldn't qualify for these loans. So someone came up with the bright idea that if they sold these "Subprime" borrowers loans anyway they could charge them more and the increased payments would theoretically cover the increased risk of default. Thus the Subprime Loan was born and the rest, as they say, is history.

You should know that statistically, subprime loans are three times more likely to end up in foreclosure than conventional loans. That is why they didn't catch on quickly. In fact between 1996 and 2004 only 9% of loans were subprime.

But the potential was not lost on home builders who began raising up huge new subdivisions targeting the huge new market of subprime borrowers who could now buy a home. From 2004-06 subprime lending climbed to 21% of all loans creating a feeding frenzy of demand outstripping supply and driving home prices higher and higher. Lenders didn't worry about checking capacity to pay and appraisals were almost irrelevant since climbing home prices would cover all risks. In fact they created new easy entry adjustable loans with low low starting interest rates that even Tom & Sarah could qualify for.

Significantly, Lenders were not strangers to all the problems caused by adjustable loans. But they looked the other way and raked in the new loan fees promising borrowers that they could simply refinance into a fixed rate loan after a year. As a result, Subprime lending reached \$805 b in 2005 with another \$600B in 2006. Home ownership soared to a record 69% ... and yes, Tom and Sarah got their home.

For the big investment firms like Bear Stearns this was a gold mine as they bought up the higher paying loans as fast as they could get them... gaining billions and billions of real estate backed equity in the process.

But was it all real?

Soon enough by mid 2006 and early 2007, the early teaser interest rates gave way to interest rate adjustments, defaults began rising as payment requirements became impossible to meet, and the promised refinancing was nowhere to be found. Tom took on a second job to try to save their home as the stresses began to take a toll on their marriage. Sarah put the kids in pre-school and started cleaning houses. But it was not enough.

As loan defaults started climbing the Secondary Market lenders sought to force the original lenders to buy back these subprime loans. Many of the originators such as New Century went bankrupt and the nations largest, Countrywide, still struggles to hold on while it's value plummeted.

But for Tom and Sarah and thousands like them these market problems were distant and meant nothing to them. They were upside down with debt that they couldn't stop. Soon the default notices came and within months, they were foreclosed upon and returned to a cramped apartment, their credit ruined, and their dreams shattered.

As foreclosures in the Subprime market escalated, prices fell as anxious owners tried to get out. But nervous potential buyers decided to wait things out. The result was more foreclosures, fewer sales, and now foreclosed properties being dumped back on the market at prices often less than 50% of their pre-foreclosure value. This crash of values undermined the security of the loans. Over-encumbered borrowers could not refinance even if they qualified. The Secondary Market had shut off buying any more subprime loans but it was too late. The damage had already been done.

For Bear Stearns, their billions in equity securing the loans quickly became worthless and when word hit the streets, their investors tried to sell off their stock. Bear Stearns used up their available cash as they tried to cover their losses and stay alive. It didn't work and last Sunday they effectively died.

Today, no-one really knows the extent of the damage caused by subprime loans. The surviving big mortgage investment companies are not disclosing how many subprime loans they are holding and it is unclear if even they know the values. Clearly they are staying low and trying to avoid the investor sell-off that brought Bear Stearns down.

Oddly, a new borrower today can get fixed rate loans at 6.1% while the subprime borrowers of two years ago are paying 9.1%. The most risky borrowers are stuck with the most expensive loans. Of course the Lenders could possibly fix the situation by rolling back these subprime rates to today's fixed rates. But they won't do it... perhaps they can't do it because the actual owner of that subprime loan is unknown, the loan having long since been parcelled out in various securities packages.

But for Tom & Sarah it's too late. For the 14,000 employees of Bear Stearns it's too late, and for the millions of small investors who lost everything it's too late. But it's not too late for the thousands of home owners still facing foreclosure if our government will make conditioning financial support for the lenders contingent on rolling back inflated adjustable rates to today's fixed rate levels. Many say this would be a gift to defaulting borrowers. But in reality, if blame is to be assigned, who is worse: the gullible first time borrowers chasing the American Dream or the lending system that created a borrowing system that was doomed to fail.

Unless something is done, then that home loan that brought down Bear Stearns will likely continue to destabilize our economy for several more years to come.