Learning Nothing from History - Financial Institutions Now Repackaging Mortgages in Form of Bonds

August 23, 2021 - When mortgage markets fell apart back in 2008, financial institutions and the federal government did a lot of soul-searching. Well, maybe that isn't the right term. They were looking for someone to pin the blame on. In the end, there were a lot of public statements made by the government, the FED and lenders alike that they never saw the meltdown coming. It was a huge surprise. Even Alan Greenspan, former head of the FED was making such proclamations. Had any of them looked at history, they would have seen in coming, but they would had to go back to the early 1900's and that was apparently too difficult for them. But now, we know quite a bit about what caused the 2008 meltdown, so there really aren't a lot of excuses. Given that, it's a little surprising that mortgage lenders are repeating such recent history.

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Back in February, 2011, the Financial Crisis Inquiry Commission released a report on the root causes of the 2008 crash. We even did a report on it. One of there primary conclusions was that financial derivatives being sold as bonds to investors were a significant driver of the downturn. The way these derivatives work is both simple and devious.

Lenders first make a loan that is higher risk than the government is willing to guarantee. And because it is higher risk, the interest rate on it is higher too. They then divide that loan up into something that's akin to "shares." Then they take a share of that loan, and combine it with shares from other similar loans to make the "derivative." And finally they sell the derivative to another investor.

The theory behind this is that they are spreading the risk. Let's just say that that a borrower stops making payment on their loan. Anyone who owns that loan will take a significant financial hit. But if the loan has been broken up into a derivative, the financial burden that any one investor will feel when the borrower stops paying will be much less. And if every other borrower whose loan is a part of that derivative continues to pay, then the financial hit taken by one non-paying borrower may be completely insignificant to the investor. That's the theory anyway.

But what happened in 2008 tells a different story. Investors finally figured out that they had no say, and no visibility into the loans that made up their derivatives. That meant many derivatives were actually made up completely from high-risk loans. In turn, that meant that when the economy started to turn, investors weren't left with one borrower who wasn't paying their mortgage. They could be holding a derivative that nobody was making payment on. It was worthless. As soon as that became apparent, investors stopped buying derivatives. And when that happened, banks couldn't get the money they needed to make new loans, so the housing market dried up almost completely, and almost overnight.

As we wrote back in 2011, "One of the more interesting conclusions (of the commission) was that "over-the-counter derivatives contributed significantly to this crisis." These derivatives had been illegal in almost every state because they violated state gambling laws. These laws had been known as "bucket shop laws". But in 2000, Congress and the Clinton administration passed and enacted legislation that prevented either federal or state regulators from overseeing derivatives trading. That legislation specifically forbid the states from enforcing laws that had been on their books for nearly the past 100 years. And those laws had been put on the books specifically because near the turn of the last century there had been almost exactly the same kind of trading taking place. That trading also led to a financial crisis. Proof that if you don't know history, you are doomed to repeat it."

Given all of this, along with the fact that 2008 is certainly something that many of us remember vividly, it's more than a little disturbing that companies like J.P Morgan Chase and Goldman Sachs are now issuing mortgage derivatives again. And it is equally disturbing that the FED isn't saying anything about it.

If insanity is doing the same thing over and over again but expecting a different result, then this is totally insane. And it is something that federal regulators needs to step into now and stop. If they don't have the legislative authority to stop it, then they need to start seeking it from congress and the White House. Without some leadership here, we're going to have a repeat of 2008 and it will come sooner rather than later. If history tells us anything, it tells us that.
by Jim Malmberg
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