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# A weak economy trampled by battling giants

By Paul McMorrow

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IT'S BEEN more than four years since the subprime mortgage market seized up. The three-year anniversaries of the Lehman Brothers bankruptcy and the nationalization of Fannie Mae and Freddie Mac are weeks away. Time has done little to quell the subprime mortgage crisis. Now, as the crisis moves into its next phase, it's stalking a group of battered Wall Street institutions and promises to be just as destabilizing as the first.

Toxic mortgages brought down the economy, and they are still bedeviling big banks. The 2008 bailout propped up banks' balance sheets, but it didn't flush dangerous loans out of the system. The busted financial instruments are still wreaking havoc. In the meltdown's early days, the culprits were bad loans sitting on banks' own books. Now the problem loans are mortgages that Wall Street banks pooled together and shoved out the door and into investors' hands.

The loans behind Wall Street's latest headache were once the Street's meal ticket. Through perverse financial alchemy, banks compiled poisonous loans, turned them into AAA-rated securities, and sold them off at hefty profits. Poisonous loans exploded into foreclosures that, in turn, made most of Wall Street's mortgage instruments all but worthless. Banks got burned by the slices they kept for themselves, but for the most part, homeowners and securities investors bore the brunt of the ensuing financial losses.

The Federal Reserve once believed that pooling mortgages into bond securities would cure predatory lending, since banks had to swear to the mortgages' condition in paperwork filed with the Securities and Exchange Commission. In practice, mortgage securities encouraged sketchy lending. Drunk on bond fees, Wall Street demanded ever-greater quantities of mortgages. Volume-hungry loan originators handed borrowers mortgages they couldn't hope to pay back. Banks cherry picked high-quality loans to keep on their own books, and got paid to offload the trash to their customers.

Of course, banks didn't characterize their trash as trash, but as stable, well-underwritten, investment-grade gold. It's these representations that are now under fire. Investors are clamoring for their money back, and the multi-billion-dollar tab is swelling every day.

Last week, AIG sued Bank of America, alleging "massive fraud" connected to \$28 billion in soured mortgage securities. The bailed-out insurer is seeking \$10 billion from Bank of America in the biggest mortgage securities claim lodged since the housing bust. AIG is preparing a similar suit against Goldman Sachs - a firm that's also in the sights of Allstate and John Hancock. The federal credit union regulator is currently suing Goldman, the Royal Bank of Scotland, and JP Morgan over toxic mortgage securities, while readying actions against other investment banks. The FDIC is reportedly considering piling on.

A pair of elephants waits just outside the courtroom. Fannie Mae and Freddie Mac have swallowed \$141 billion from the Treasury since they were nationalized. They've lost \$250 billion since 2007. And they were huge buyers of Wall Street's mortgage-backed securities - bonds backed by subprime loans that didn't meet the two companies' own loan standards. Fannie and Freddie gorged on \$690 billion worth of toxic securities during the housing boom, and

have lost \$50 billion on those securities so far. Fannie and Freddie's federal regulator has already sued UBS for \$4.5 billion in bad mortgage securities, and has the rest of Wall Street in its sights.

Trillions of dollars of bad loans went through Wall Street's mortgage bond pipeline, and they've exploded at astounding rates. Deals where half the mortgages went bad are common. One Goldman lawsuit lists a loan pool where 71 percent of the mortgages failed. Wall Street's defense so far - that sophisticated investors should have known what they were getting into - is tantamount to saying that investors should have known better than to believe SEC filings.

It's not a defense that inspires confidence. Wall Street soaked the American populace for everything it had, and then the bankers took their bailouts and bonus checks and slunk off toward the Hamptons. Wall Street titans aren't in jail, but their reckoning is coming to civil courtrooms, and it's going to be brutal. And given how integral these too-big-to-fail institutions have proved to be to the economy's overall health, there's sure to be little enjoyment in the spectacle of bailed-out banks and nationalized financial institutions battling each other over billions.

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