

## The International Impact of the Subprime Mortgage Meltdown

The collapse of the U.S. subprime mortgage market triggered an international financial crisis that now stretches from Norway to China and the Middle East. The final impact of the crisis remains uncertain, with some analysts predicting that total losses will reach \$500 billion or more worldwide.<sup>1</sup>

In the 1970s, the Government National Mortgage Association (Ginnie Mae) developed the mortgage-backed security to shift the risk of mortgage ownership off government books and eliminate housing-program debt.<sup>2</sup> A mortgage-backed security (MBS) in its simplest form represents an ownership interest in a pool of residential mortgage loans from which principal and interest payments are “passed through” to investors.<sup>3</sup> Ginnie Mae and its counterparts The Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac), guarantee the timely payment of principal and interest for the MBSs they issue.

Although Ginnie Mae, Fannie Mae, and Freddie Mac dominated the MBS market for decades, they are limited by the size and quality of the mortgage loans they can purchase and securitize. In recent years, Wall Street banks and others have filled the gap by securitizing large amounts of high-risk, subprime mortgages. Subprime loans are typically made to borrowers who would not qualify for a traditional home loan because they have poor credit ratings or insufficient cash for a down payment. Between 2003 and 2006, Wall Street’s proportion of the MBS market grew from 24% to 57%.<sup>4</sup>

Issuers often packaged MBSs into collateralized debt obligations (CDOs) or similar investment vehicles. These products featured different slices, or “tranches,” of the income stream, with varying amounts of risk depending largely on the order in which each tranche was paid. Senior tranches could receive high ratings because they had the first claim to payment and were thus less risky than junior tranches.<sup>5</sup> These complex securities were sold to investors around the world, including pension funds, hedge funds, municipalities, and insurers. By June 2007, foreign holdings of United States securities totaled about \$9,772 billion, including \$1,472 billion in asset-backed securities, such as those backed by subprime mortgages.<sup>6</sup>

The subprime lending market collapsed in 2007 as the housing market slowed at the same time as hundreds of billions of dollars of subprime loans began resetting to higher rates. Many U.S. homeowners found themselves with homes that were worth less than the outstanding balance on their mortgage loans. The number of delinquent payments and defaults exceeded the expectations of lenders and investors alike, which eroded the value of subprime mortgage-backed investments and dried up credit markets overnight.<sup>7</sup>

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<sup>1</sup> Charles R. Morris, *The Trillion Dollar Meltdown*, xii-xiii (2008).

<sup>2</sup> Randall Dodd, International Monetary Fund, *Subprime: Tentacles of a Crisis*, FINANCE & DEVELOPMENT (Dec. 2007).

<sup>3</sup> *The Handbook of Mortgage Backed Securities* 45 (Frank J. Fabozzi ed. 2006).

<sup>4</sup> Randall Dodd, *supra* note 2.

<sup>5</sup> *Id.*

<sup>6</sup> Press Release, United States Department of the Treasury, Preliminary Report on Foreign Holdings of U.S. Securities At End-June 2007, *available at* <http://www.treas.gov/press/releases/hp853.htm>.

<sup>7</sup> Faten Sabry and Thomas Schopflocher, NERA Economic Consulting, *The Subprime Meltdown: A Primer*, NERA INSIGHTS, SUBPRIME LENDING SERIES, PART I (June 21, 2007).

As CDOs and MBSs lost value, over-the-counter markets for these assets froze. Many hedge funds and other investors also faced margin calls on loans due to the declining value of their collateral.<sup>8</sup>

The result was a tidal wave of damage to financial institutions and investors around the world. By January, financial institutions had announced more than \$135 billion of write-downs and losses.<sup>9</sup> UBS, the largest bank in Switzerland, wrote down more than \$18 billion due to the US housing crisis in 2007 and announced an additional \$19 billion of writedowns in April.<sup>10</sup> In March, Britain's largest bank, HSBC, reported a loss of \$17.2 billion due to its exposure to the US housing crisis.<sup>11</sup>

British lender Northern Rock was among the most visible casualties of the subprime debacle. The bank, which boasts mid-19th Century origins, grew in the last decade by repackaging and selling home mortgage loans as MBSs. Between 2001 and 2006, Northern Rock's profits more than doubled to \$394.5 million pounds (\$850 million). The bank's fortunes suffered a dramatic reversal last year when, in the wake of the subprime mortgage crisis, Northern Rock quickly exhausted its cash reserves and had to appeal to the British government for emergency funding. After news of the bailout reached investors, Northern Rock became the victim of the first run on a British bank since 1866.<sup>12</sup> The panic subsided several days later when the British government guaranteed all of the bank's savings.<sup>13</sup> Northern Rock was nationalized in February for an undetermined period of time after the government rejected two private takeover bids.<sup>14</sup> Britain's Financial Services Authority admitted in March that it had not adequately supervised Northern Rock and announced reforms designed to improve the monitoring of financial institutions.<sup>15</sup>

German banks have also been particularly hard-hit by America's housing crisis. Last fall, a consortium of German banks stepped in to rescue IKB Deutsche Industriebank, which, prior to the subprime crisis, held an estimated \$20 billion in mortgage-backed securities in two off-balance sheet structured investment vehicles.<sup>16</sup> Despite infusions of capital, losses at IKB have continued to grow. In March, the bank predicted that it would need a fourth government bailout, in addition to the approximately \$14 billion in aid it had already received.<sup>17</sup> Several other German banks have announced large losses, including HSH Nordbank, which had a \$946.3 million bad debt provision by the end of December, Commerzbank, which took a \$1.1 billion write-down in February, and Deutsche Bank,

<sup>8</sup> Dodd, *supra* note 2.

<sup>9</sup> Julia Werdigier, *Trading scandal diverts attention from Societe Generale's subprime losses*, INTERNATIONAL HERALD TRIBUNE, Jan. 29, 2008, available at <http://www.iht.com/articles/2008/01/29/business/loss.php>.

<sup>10</sup> BBC News, *UBS doubles sub-prime writedowns*, April 1, 2008, available at <http://news.bbc.co.uk/2/hi/business/7323809.stm>.

<sup>11</sup> BBC News, *HSBC in \$17bn credit crisis loss*, available at <http://news.bbc.co.uk/2/hi/business/7274385.stm>.

<sup>12</sup> Richard Tomlinson and Ben Livesey, *The Northern Rock Story*, BUSINESSDAY, March 20, 2008, available at <http://business.theage.com.au/the-northern-rock-story/20080320-20nt.html>.

<sup>13</sup> BBC News, *'Savers Return' to Northern Rock*, available at <http://news.bbc.co.uk/2/hi/business/7000035.stm>.

<sup>14</sup> Lionel Laurent, *Northern Rock Nationalized*, FORBES.COM, Feb. 17, 2008, available at [http://www.forbes.com/2008/02/17/northern-nationalize-bank-markets-cx\\_1l\\_0217northernrock.html](http://www.forbes.com/2008/02/17/northern-nationalize-bank-markets-cx_1l_0217northernrock.html).

<sup>15</sup> Robert Barr, Associated Press, *Regulator Takes Blame for Northern Rock*, available at <http://www.wtop.com/?nid=111&sid=1247833#>.

<sup>16</sup> Peter Gumbel, *Subprime on the Rhine*, FORTUNE, Sept. 4, 2007, available at [http://money.cnn.com/magazines/fortune/fortune\\_archive/2007/09/03/100172459/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2007/09/03/100172459/index.htm).

<sup>17</sup> Oliver Suess, *IKB Seeks Fourth Bailout After Subprime Loss Widens (Update 4)*, BLOOMBERG.COM, March 20, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601100&sid=aQJqEIJVz.Q&refer=germany>.

which stated in April that it expected to record losses of \$3.9 billion for the first quarter of 2008.<sup>18</sup> Also in April, the prime minister of the German state of Saxony resigned due to the fallout from the takeover of regionally-owned Sachsen LB, which only narrowly averted bankruptcy in 2007.<sup>19</sup>

Though Europe has been the site of some of the most dramatic subprime-related losses, the crisis has also rattled banks in the Middle East and Asia. Persian Gulf banks reported \$1.5 billion in subprime losses in March, shortly after Standard & Poor's speculated that the region's banks might be concealing their potential subprime exposure.<sup>20</sup> Bank of China, Ltd. wrote off \$1.3 billion due to its subprime exposure in 2007.<sup>21</sup> Sovereign wealth funds, which invested about \$48.5 billion to Wall Street and European financial institutions in 2007, gave an additional \$24.4 billion in the first two months of 2008, despite having suffered significant losses. Singapore, for example, had watched its investment in Citigroup decline 30% by March 2008, and the value of its investment in UBS fall by 50%.<sup>22</sup>

Among the victims of America's subprime crisis are eight municipalities in Norway, which lost a total of \$125 million through subprime mortgage-related investments. The economic domino effect has also impacted remote Canadian lumber towns, which lost bets about the continued growth of the housing boom, and Mexican villages, which prospered from wages sent home by migrant workers employed in construction jobs that no longer exist.<sup>23</sup>

Speculation about the uncertain impact of the subprime-mortgage meltdown has fueled additional turmoil in financial markets. In Canada, subprime-related anxiety caused a freeze in the \$32 billion market for asset-backed commercial paper in August. Participants were still in the process of restructuring the market in April, with analysts warning that a failure to do so would spell disaster for the Canadian economy.<sup>24</sup>

A growing number of international victims of the subprime crisis have flocked to courthouses, and especially to those in the United States. The influx of cases may be due to a combination of the reputation of American courts for large verdicts, and to the nature of this country's securities regulations.<sup>25</sup> For example, United States investors in

<sup>18</sup> *Investors Plan Shareholder Lawsuit against IKB*, SpiegelOnline, March 17, 2008, available at <http://www.spiegel.de/international/business/0,1518,druck-541906,00.html>; BBC News, *Timeline: Sub-prime losses*, April 2008, available at <http://news.bbc.co.uk/2/hi/business/7096845.stm>.

<sup>19</sup> Brian Parkin, *German State Premier Milbradt Quits After SachsenLB (Update2)*, BLOOMBERG.COM, April 16, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601100&sid=ak8jl2PwAMKo&refer=germany>.

<sup>20</sup> Joel Bowman, *Subprime crisis hits more Gulf banks*, ArabianBusiness.com, March 3, 2008, available at <http://www.arabianbusiness.com/512685-gulf-banks-hit-by-subprime-crisis?In=en>.

<sup>21</sup> Dow Jones Newswires, *Bank of China's Net Rises 31% Despite Subprime-Related Charge*, THE WALL STREET JOURNAL, March 25, 2008.

<sup>22</sup> Daisy Ku, *Funds invest \$24.4bn last two months*, ArabianBusiness.com, March 19, 2008, available at <http://www.arabianbusiness.com/514157-wealth-funds-invest-244bn-last-two-months>.

<sup>23</sup> Anthony Faiola, *U.S. Housing Crunch Hits Canadian Lumber Town*, THE WASHINGTON POST, Feb. 1, 2008; Anthony Faiola, *Subprime Contagion Spreads Worldwide*, THE WASHINGTON POST, Feb. 1, 2008.

<sup>24</sup> Canada Department of Finance, Press Release, Minister of Finance Issues Statement on Restructuring Proposal for Asset-Backed Commercial Paper, March 17, 2008, available at <http://www.fin.gc.ca/news08/08-029e.html>; see also John Greenwood, *Financial Post, ABCP Bailout: Canaccord Capital Buys Out Its ABCP Retail Clients*, National Post, April 10, 2008, available at <http://www.nationalpost.com/rss/Story.html?id=434040&p=1>.

<sup>25</sup> Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 107 (Winter 2008).

France's Societe Generale have filed a class action against the company in the Southern District of New York. The plaintiffs' Complaint includes allegations that Societe Generale misled them about the extent of its subprime exposure, and that they were "shocked" when losses were finally disclosed.<sup>26</sup> German bank HSH Nordbank brought suit in February against Switzerland's UBS in New York state court, alleging breach of contract, negligent misrepresentation, fraud, and breach of fiduciary duty.<sup>27</sup>

Central banks in the United States, Europe and Japan have responded to the crisis through coordinated efforts to inject cash into the market. The three have made numerous cash infusions since August 2007, both to the banking system and to individual financial institutions. In March, central banks announced that more than \$200 billion in additional funds would be available for emergency lending to banks.<sup>28</sup> The fallout from the subprime mortgage crisis has also led to questions about the necessity for heightened regulation of global financial markets. G7 members recently approved a slate of reforms created by that group's Financial Stability Forum. The reforms would, among other things, increase oversight of financial firms, and propose methods for dealing with financial strain.<sup>29</sup>

Subprime-related damage is expected to grow in the coming months. As of mid-February, about \$300 billion of subprime debt remained unaccounted for on balance sheets. Some analysts predict that the next aftershock will come from Japanese investors, who may have taken on a much larger proportion of subprime-backed securities than they have so far disclosed.<sup>30</sup> The coming months promise to bring to light more information on the extent of subprime-related losses, as well as novel regulations and legal actions.

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<sup>26</sup> *Barkett v. Societe Generale, et al.*, Docket No. 1:08-cv-02495-GEL (S.D.N.Y. Filed 3/12/08).

<sup>27</sup> Patricia Hurtado, *HSH Nordbank sues UBS in New York to recoup subprime losses*, BLOOMBERG.COM (Feb. 26, 2008), available at

[http://www.bloomberg.com/apps/news?pid=20601100&sid=alwhG3\\_Mf32M&refer=germany](http://www.bloomberg.com/apps/news?pid=20601100&sid=alwhG3_Mf32M&refer=germany).

<sup>28</sup> BBC News, *supra* note 18.

<sup>29</sup> Klaus C. Engelen, *The post-subprime regulation scramble: the regulators and market players pick up the pieces*, ENTREPRENEUR.COM (Winter, 2008) available at

<http://www.entrepreneur.com/tradejournals/article/176131425.html>; BBC News, G7 passes plan to ease credit woe (April 11, 2008), available at <http://news.bbc.co.uk/2/hi/business/7342419.stm>.

<sup>30</sup> Ambrose Evans-Pritchard, *Japan is the next sub-prime flashpoint*, THE TELEGRAPH, Feb. 13, 2008, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/02/10/ccjapan110.xml>.