Justice Action Center
Student Capstone Journal
Project No. 07/08-02

The Subprime Mortgage Market Collapse: Causes and Solutions

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THE SUBPRIME MORTGAGE MARKET COLLAPSE: CAUSES AND SOLUTIONS

JUSTICE ACTION CENTER CAPSTONE

RUTH S. USELTON, AMY L. FESTANTE &
CARLOS L. LOPEZ

On Sunday, April 27, 2008, the *New York Times Magazine* published a feature story uncovering the mysteries behind the credit rating agencies' evaluation of mortgage-backed securities ("MBS") and their involvement in the subprime mortgage market meltdown.[1] So many players are involved in this colossal market failure that the *New York Times* could easily devote a feature length article to explain each participant's role in the debacle. In fact, the major print media has published thousands of articles covering the market collapse on a daily basis, and the twenty-four-hour cable news network, CNN, has created a special investigations unit—titled *Inside the Mortgage Crisis*—that centers on the housing market, lending, and the credit crunch affecting low- and middle-income Americans. Most notable among this series is *Busted! Mortgage Meltdown*, in which a former Ameriquest mortgage broker revealed how brokers systematically and intentionally pushed borrowers into mortgages that they could not afford.

The subprime mortgage market collapse has proved so large and complex that three Justice Action Center affiliates chose to research and analyze three distinct aspects of it. In this joint project, Ruth S. Uselton examines the exotic mortgage products and terms that contributed to the foreclosure crisis; Amy L. Festante explains Wall Street's role in securitizing these mortgages and how the MBS market was allowed to spiral out

[1] Roger Lowenstein, *Triple-A Failure*, NY TIMES, Apr. 27, 2008.

of control; and Carlos L. Lopez analyzes the proposals for regulatory reform and legislative attempts to mitigate damages in the wake of this massive market failure.

Today, according the Mortgage Bankers Association, more than nine hundred thousand homes are in foreclosure—up 71 percent from 2007.[2] Forty-two percent of these foreclosures that were started in the fourth quarter of 2007 were subprime adjustable rate mortgages ("ARMs"), and twenty percent were prime ARMs.[3] With more than half of all new foreclosures resulting from this relatively new loan product—aimed primarily at subprime borrowers—which also happened to be a major product fueling the MBS market on Wall Street, there is little doubt that the lenders and rating agencies failed to conduct reasonably adequate due diligence. The fallout from this perfect storm of greed, predatory lending, and oversight failures, will not truly be known for years to come. New foreclosures are certainly on the way, and legislative and regulatory responses are changing every day. This joint Capstone project, however, attempts to piece together the major issues behind the subprime market failure from what is currently known about the loan products used and the process of securitization of those loans.

[2] Les Christie, *Foreclosures Hit All-Time High*, CNNMoney.com, Mar. 6, 2008, *available at* http://money.cnn.com/2008/03/06/real_estate/defaults_continue_climb/index.htm.
[3] Mortgage Bankers Association, Press Release, *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey*, Mar. 6, 2008, *available at* http://www.mbaa.org/NewsandMedia/PressCenter/60619.htm.

Justice Action Center
Student Capstone Journal
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Exotic Loan Products & the Collapse of the Subprime Mortgage Market

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EXOTIC LOAN PRODUCTS & THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET

RUTH S. USELTON*
JUSTICE ACTION CENTER CAPSTONE

I. INTRODUCTION

The collapse of the subprime mortgage market has lead to much finger pointing in Washington and on Wall Street. Some blame the rating agencies for overvaluing these pools of bad loans.[1] Some blame the loan originators for using lax standards to evaluate borrowers' ability to pay and approving clearly bad loans.[2] Others blame the regulators for not sounding alarms soon enough.[3] Still others blame Congress for allowing this problem to metastasize without sufficient regulation and oversight. Ironically, despite the many complex layers of fault, there has been a consistent underlying argument that the borrowers are largely to blame.[4]

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* Ruth Uselton is a 2008 graduate of New York Law School.

[1] *See* Tomoeh Murakami Tse, *Analysts Late to the Alarm; Fallout From Subprime Crisis Casts Scrutiny on Ratings*, WASH. POST, Dec. 13, 2007, at D1 (questioning whether analysts should have foreseen the subprime crisis and whether conflicts of interest could have played a role in this failure).

[2] *See generally* Ann Carrns, *Credit Crunch: Wells Fargo Chairman Concedes Mistakes*, WALL ST. J., Dec. 12, 2007, at C2 (quoting Wells Fargo & Co. Chairman Richard M. Kovacevich as saying that "the widespread industry practice of making 'stated income' or 'low documentation' loans to borrowers with sketchy credit was indefensible").

[3] *See* Editorial, *A Crisis Long Foretold*, N.Y. TIMES, Dec. 19, 2007, at A36 (arguing that the Federal Reserve, the Office of the Comptroller of the Currency, and other regulators willfully failed to heed numerous warnings that the subprime market was headed for collapse).

[4] In early December, 2007, Secretary of the Treasury Henry M. Paulson Jr. stated that "[f]oreclosures are a fact of life" and that the Bush administration's plan to address the foreclosure crisis "will not prevent all foreclosures, nor should it. Some borrowers, particularly those who received loans under the most lax underwriting standards and who haven't even been able to make their initial payments, likely will become renters again." Henry M. Paulson Jr., *Our Plan to Help Homeowners*, WALL ST. J., Dec. 7, 2007, at A17. Mr. Paulson's article emphasizes that the foreclosure crisis is due to borrowers who made bad choices and makes no mention of the predatory nature of home mortgage lending that was fueled by the securitization of subprime loans that Wall Street investors craved. Other experts more brazenly foist the blame on borrowers by stating that "in the end, it simply isn't the government's job to convince people that some financial risks aren't worth taking, or that housing prices can go down as well as up." James R. Barth & Peter Passell, *In Defense of 'Hybrids'*, WALL ST. J., Dec. 6, 2007, at A19 (both authors are senior finance fellows at the Milken Institute).

In quintessential American individualist style, it is easy to blame subprime borrowers for taking out loans that they could not afford and signing documents that they did not understand. Whether it was ignorance or greed that lead borrowers into these risky loans, they created this mess for themselves and they will learn a valuable lesson when all is said and done. This theory sounds harsh, but it is a wonderfully simple explanation, and it allows everyone to sleep easier at night knowing that our financial institutions were not really scheming up predatory products to unleash on the innocent everyday American. Of course, these borrowers were ignorant. Of course, they should have read the fine print. Of course, they should have had representation, or shopped for better loan terms. Yes, this is an easy answer to a very complex problem; unfortunately it is an illusion designed to divert our attention from the true problems lurking behind the subprime market and mortgage-backed-securities ("MBS").

The more difficult answer is that the fundamental source behind the subprime market collapse is the development of exotic mortgage products that were specifically designed to leach equity from vulnerable borrowers.[5] Compounding this problem is the fact that nothing was done to stop these products from wreaking havoc on borrowers—despite warnings from a small but vocal chorus of advocacy organizations.[6]

[5] *See generally* Siddhartha Venkatesan, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGS. & PUB. POL'Y 177, 177 (2004) (discussing the fact that "unethical lenders design predatory loans to exploit financially unsophisticated or unwary borrowers").

[6] Most notably among these advocacy organizations is the National Community Reinvestment Coalition and the many coalition members representing regional and local community economic development organizations. Please visit www.NCRC.org to read the many position papers and studies highlighting the turmoil in the subprime market that NCRC has published over the years.

II. SUBPRIME MORTGAGE PRODUCTS & TERMS

Several new mortgage products have developed to facilitate the MBS market. Many in the financial services sector argue that these products helped hundreds of thousands of people with shaky credit histories become homeowners, and therefore a part of the American dream.[7] In reality, these products were designed to flood the market with mortgages to feed the pools of securities being sold in the secondary markets—with little concern for the borrowers' ability to repay the loan.[8] Far from the savings and loans of yesteryear, which issued loans to help families build equity in a home, subprime lenders seemingly value quantity over quality—originating mortgage loans for the primary purpose of selling them to very eager intermediaries in the secondary market.[9] The products and terms developed to facilitate this process are discussed below.

A. Adjustable Rate Loans (ARMs)

A standard, garden-variety mortgage is a twenty- to thirty-year loan with a fixed interest rate, which allows the borrower to plan for consistent mortgage payments throughout the life of the loan. On the other hand, adjustable rate mortgages (ARMs) usually attract borrowers because they offer a low introductory interest rate for the first

[7] *See*, Yochi J. Dreazen & Christopher Conkey, *Lenders Seek to Guide Subprime-Policy Overhaul*, WALL ST. J., May 21, 2007, at A14 (quoting Steve Bartlett, president of the Financial Services Roundtable, as stating that "[m]any companies made loans that with perfect hindsight we wish had not been made," and that "[t]he underlying motive was to increase home ownership, but mistakes were made on getting there.").
[8] *See* U.S. GEN. ACCOUNTING OFFICE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING (2004) (statement of David G. Wood, Director Financial Markets and Community Investment).
[9] Kevin Connor, WALL STREET AND THE MAKING OF THE SUBPRIME DISASTER 17 (2007) *available at* http://www.northwestbronx.org/wallstreet_subprime.pdf.

year(s) of the loan.[10] However, that interest rate will "adjust" at some point in the future, usually based on a specified index.[11]

When this adjustment happens, if the interest rate increases, borrowers may see a significant increase in their monthly mortgage payments. Determining the payments over the life of an ARM can be difficult, because the rates may fluctuate as they are tied to a constantly changing index.[12] In addition, lenders typically add a cushion to the index rate, called "margin," often based on the borrower's credit score.[13] So the borrower typically pays at least a few percentage points more than the index rate, and borrowers with lower credit scores may pay much more based on the margin added to the index rate. The index plus the margin is called the "fully indexed rate" that the borrower will pay.

For example, see chart below depicting a $200,000 mortgage at an initial 5.5 percent interest rate for the first two years, then a variable interest rate increasing at 2 percent per year (but capped at a 12 percent maximum interest rate):

Payment Number	Interest Rate	Monthly Payment
1-23	5.50%	$1,135.58
24-35	7.50%	$1,386.24
36-47	9.50%	$1,650.95
48-59	11.50%	$1,926.07
60-360	12.00%	$1,995.71

In the above example, note that the total interest paid on this loan will be more than $480,000, whereas a fixed rate loan for the same $200,000 mortgage over 30 years at the same 5.5 percent interest rate will only be a little more than $200,000. Thus, the

[10] *See* Mark Adelson, Nuts & Bolts of Financial Products 2007: Understanding the Evolving World of Capital Market & Investment Management Products: Home Equity ABS Basics, Practicing Law Institute, Feb. 26-27, 2007.
[11] *Id.*
[12] *Id.*
[13] *Id.*

borrower who used the ARM mortgage will pay more than twice as much for her loan if she does not sell or refinance.

In addition, although some ARMs place a cap on the amount the rate can adjust during each adjustment period (e.g. 2 percent), many ARMs allow "carryover." Carryover means that an increase in the index that is more than the cap is carried over and applied to the next year. In other words, if there is a 2 percent cap on interest rate adjustments per year and the index increases by 3 percent, the loan will only increase by 2 percentage points in the current year, but the additional 1 percent will be applied in the following year—even if the index stays fixed or declines.

Clearly, ARMs are complicated products with many variables. Therefore, estimating mortgage payments is difficult and requires the borrower to make assumptions about the movement of interest rates in the future. These variables also make it extremely difficult to compare ARMs if a borrower did want to comparison shop for the best priced loan. Once we dissect these loans and understand their true complexity, it should become clear that borrower ignorance cannot be the sole cause of the colossal failure of so many of these loans.

B. Payment Option ARMs

A Payment Option ARM allows the borrower to choose different payment methods to use each month. For example, the borrower could make a traditional principal plus interest payment, an interest-only payment, or a pre-determined minimum payment (which may be less than the actual interest owed per month). If the borrower is only making interest payments or minimum payments, the principal of the loan will not

be reduced and this leads to more interest payments in the future—creating a very high-cost loan when compared to a fixed-rate mortgage. Often, these payment structures leave the borrower with a "balloon payment" at the end of the loan, because the principal has not been sufficiently reduced or paid off during the life of the loan.

C. Hybrids

So-called 2/28 hybrids are a mixture of a fixed rate mortgage and an ARM. The mortgage will have a fixed interest rate for the first two years of the loan and the remaining twenty-eight years will be subject to variable rates. Often these loans also adjust the interest rate several times per year, which can rapidly increase the borrower's monthly payments. A 3/27 hybrid works in precisely the same way. The mortgage will have a fixed interest rate for the first three years of the loan while the remaining twenty-seven years of the loan will be subject to variable rates.

In addition, many of these hybrid mortgages include prepayment penalties, which charge a fee if the borrower attempts to convert the loan into a fixed-rate mortgage, or tries to repay the loan early by refinancing or selling the home. These fees can be exorbitant (e.g. more than $10,000) and ultimately may force borrowers into staying in higher interest loans because they do not have the cash flow to pay the prepayment penalty—especially in a declining housing market. Thus, borrowers who attempt to make responsible decisions to improve their financial situation are effectively blocked from doing so by prepayment penalties.

D. Interest Only Loans (IOs)

Interest only loans (IOs) allow the borrower to pay only interest (not principal) for a specified number of years (usually three to ten years).[14] After this period, the borrower's payments will substantially increase because they must pay interest and principal. Additionally, the longer the interest only period, the more substantially the borrower's payments will increase when that period is over. This occurs because the borrower will have less time to pay off the principal and therefore payments will be higher. Clearly, borrowers may be attracted to a longer interest only period, because the payments will be lower, but they may not realize the extent to which this will increase their payments in the future. Additionally, these loans are often ARMs, so the interest rate will be variable and sometimes interest rate adjustments will be made during the interest only period of the loan as well.[15]

For example, the chart below depicts a $200,000 mortgage with interest only payments (at 5.5 percent) for the first three years, then interest plus principle payments for the remaining twenty-seven years of the loan with a variable interest rate (increasing at 2 percent per year, but capped at a maximum of 12 percent).

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[14] *See* Mark Adelson, Nuts & Bolts of Financial Products 2007: Understanding the Evolving World of Capital Market & Investment Management Products: Home Equity ABS Basics, Practicing Law Institute, Feb. 26-27, 2007. Despite the seemingly higher risk of interest only loans, these loans accounted for 23 percent of all U.S. mortgage loans for the first six months of 2005 (up 6 percent from the prior six months). Andrew Olszowy, *Alternative Mortgages: Managed Risk or Gamble*, Federal Reserve Bank of Boston, *available at* http://www.bos.frb.org/consumer/spotlight/am.htm (last visited Mar. 9, 2008).

[15] *See generally* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGS. 123, 145–46 (2007) (noting that the "prevalence of I-O and option ARMs in the subprime market suggests that these loans are often underwritten for the wrong reasons. Due to the potential for large payment shock, these products are best suited for borrowers who have large disposable incomes, receive bonuses, or expect their income to rise sharply during the introductory period.").

Payment Number	Interest Rate	Monthly Payment
1-35	5.50%	$916.67
36-47	7.50%	$1,441.47
48-59	9.50%	$1,710.61
60-71	11.50%	$1,990.15
72-360	12.00%	$2,060.85

Notice that payments in the first three years will be a little more than $900 per month. However, when the borrower must begin paying down the principle of the loan in year three, the payments will suddenly jump to nearly $1,500 per month, 46 percent increase. The total interest paid for this $200,000 mortgage will be nearly $500,000.

Even if the terms remained the same, but the variable interest rate increased at only 1 percent per year (rather than 2 percent), the monthly payments will still increase significantly over the life of the loan, as shown below.

Payment Number	Interest Rate	Monthly Payment
1-35	5.50%	$916.67
36-47	6.50%	$1,311.11
48-59	7.50%	$1,438.27
60-71	8.50%	$1,567.19
72-83	9.50%	$1,697.34
84-95	10.50%	$1,828.29
96-107	11.50%	$1,959.64
108-360	12.00%	$2,024.96

At year ten, the borrower's monthly payments will be double what she initially paid for the first three years. Although savvy borrowers might prefer this type of loan—because they plan to sell the property in the first three years or they expect the property to substantially appreciate in a short amount of time—the average homeowner should not be using this type of mortgage product.

E. Prepayment Penalties

As previously mentioned, many ARMs and IO mortgages also charge prepayment penalties to discourage borrowers from paying off loans ahead of schedule.[16] Some penalties only apply to borrowers who attempt to pay off the loan through refinancing, but other penalties may apply no matter what method the borrower uses (including an outright sale of the home). This creates a disincentive for borrowers to sell their homes or refinance for better loan terms, and locks borrowers into bad loans; especially illiquid borrowers who cannot afford the prepayment penalties, which can be several thousands of dollars. In addition, though not considered a prepayment penalty, some ARMs will not allow the borrower to convert the ARM into a fixed-rate mortgage—creating another barrier to borrowers attempting to respond to escalating monthly payments.

F. Balloon Payments

Another highly speculative mortgage product, similar to an IO loan, allows borrowers to pay some interest and principle for a specified term of years, typically five, seven, or ten years. After that term of years is over, the borrower is required to pay the full balance of the loan—this is called a "balloon payment."

For example, the chart below depicts a $200,000 mortgage with an annual interest rate of 5.5 percent (over a thirty-year amortization period), with a balloon payment due after year ten.

[16] *See* Mark Adelson, Nuts & Bolts of Financial Products 2007: Understanding the Evolving World of Capital Market & Investment Management Products: Home Equity ABS Basics, Practicing Law Institute, Feb. 26-27, 2007.

Year	Total Payments	Principal Paid	Interest Paid	Ending Principal Balance
				$200,000.00
1	$13,626.96	$2,694.20	$10,932.76	$197,305.80
2	$13,626.96	$2,846.17	$10,780.79	$194,459.63
3	$13,626.96	$3,006.73	$10,620.23	$191,452.90
4	$13,626.96	$3,176.32	$10,450.64	$188,276.58
5	$13,626.96	$3,355.49	$10,271.47	$184,921.09
6	$13,626.96	$3,544.78	$10,082.18	$181,376.31
7	$13,626.96	$3,744.74	$9,882.22	$177,631.57
8	$13,626.96	$3,955.98	$9,670.98	$173,675.59
9	$13,626.96	$4,179.11	$9,447.85	$169,496.48
10	$178,708.58	$169,496.48	$9,212.10	$0.00

This loan looks like any other mortgage for the first ten years as the borrower makes monthly payments, but the full remaining balance is due after that ten-year period is over. Thus, the total interest on this type of loan can be much cheaper, in this case only about $100,000. However, the life of the loan (ten years) is much shorter than the typical thirty-year mortgage. This type of loan should only be used by borrowers who can afford to make a large lump-sum payment, or borrowers who expect to re-sell the property within the ten year loan period. Any prepayment penalties that might be added to this type of loan should be closely scrutinized, because most borrowers using this type of loan will likely expect to refinance or sell the property before the loan hits the balloon payment. If the borrower cannot afford to pay the prepayment penalty, it will therefore be unlikely that he will be able to afford the balloon payment when it comes due.

G. "No-doc" and "Low-doc" Loans

Typically, a borrower must prove her ability to pay for a mortgage loan by showing past income tax returns, pay stubs, and bank statements. However, lenders/brokers have begun allowing borrowers to apply for loans with little or no

documentation, in exchange for higher fees and higher interest rates on the mortgage. The lender/broker may check the borrower's credit score, but will have no idea whether the borrower has sufficient income and assets to comply with the terms of the loan she is receiving.

H. Computerized Loan Screening

Lenders/brokers now use automated underwriting programs to generate as much as 40 percent of all subprime loans.[17] Interestingly, these programs were designed to help reduce racial discrimination in lending. However, with the increased investor demand for mortgage-backed securities, computerized screening has ultimately facilitated predatory subprime lending, which has been shown to disproportionately affect minority applicants. Computerized loan screening has mainly allowed brokers to take shortcuts in the loan application process, because the programs use a formula (primarily based on credit scores) to determine the risk of the loan. Although these programs typically weed out the most risky borrowers, those on the margins are typically approved without any additional follow up by the broker.[18] Again, due to the perversion of the mortgage market by investors in the secondary market, high volume was emphasized over high quality. The *New York Times* reports that Countrywide Financial, a major subprime lender, used an automated underwriting system to double the number of loans it made in 2004 to 150,000 per month.[19] Opponents of these computerized systems argue that the programs put the credit score on a pedestal allowing other important factors, such as

[17] Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: Not Again!*, 26 AM. BANKR. INST. J. 1 (2007).
[18] Lynnley Browning, *The Subprime Loan Machine*, N.Y. TIMES, Mar. 23, 2007.
[19] *Id.*

income and assets, to be obscured. Use of these programs is just one among many indicators that subprime lenders were looking to make high volume loans, not necessarily high quality loans.

III. RISK-BASED PRICING: THE UNJUST-IFICATION FOR EXOTIC MORTGAGE PRODUCTS

The untold truth is that so-called "risk-based pricing," a term used to justify the higher interest rates and fees associated with exotic mortgage products, has become a proxy for predatory lending and discrimination.[20] The risk-based pricing formula created for mortgage products is seemingly a rational, market-based solution to allow borrowers with weaker credit scores to participate in wealth-building activities (e.g., buying a home or a small business), and therefore became the justification for charging higher interest rates and fees to borrowers with weaker credit histories.[21] The darker side of this methodology, however, hints that risk-based pricing is merely evidence that lenders are leveraging their power over unwitting borrowers in order to maximize profits, with little regard for borrowers' actual creditworthiness.

Thus, borrower credit is only one aspect of the equation—other variables include discrimination and broker compensation linked to churning out high-interest loans.[22] As Wall Street demand for subprime mortgage-backed securities grew, consumer credit

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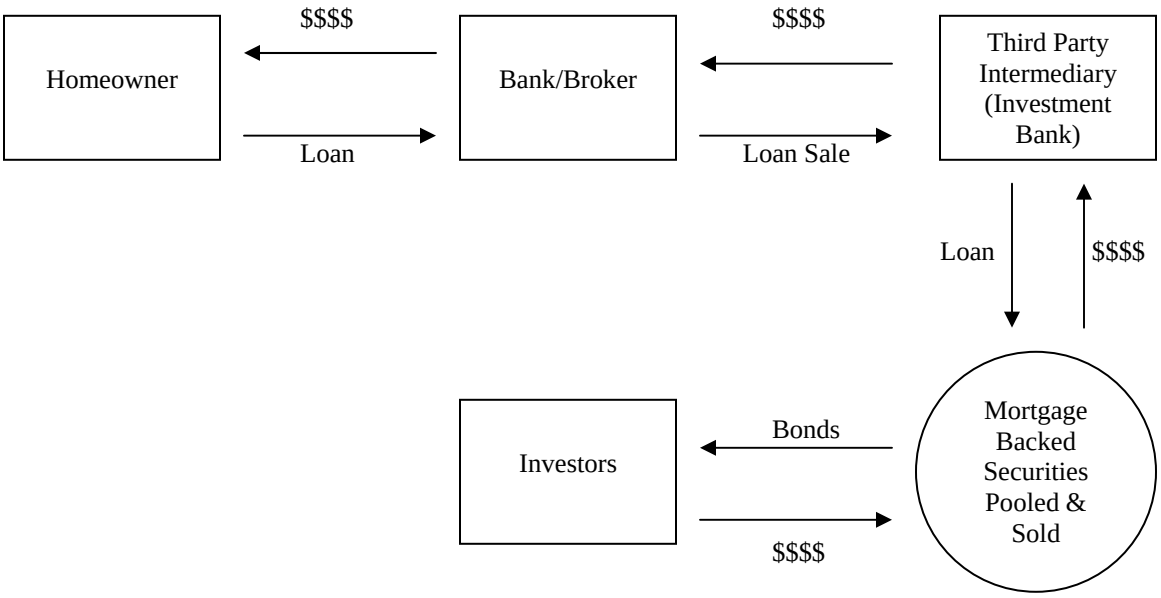
[20] *See generally* Andrew Olszowy, *Alternative Mortgages: Managed Risk or Gamble*, Federal Reserve Bank of Boston, *available at* http://www.bos.frb.org/consumer/spotlight/am.htm (last visited Mar. 9, 2008) (explaining that "some financial institutions have been promoting alternative mortgages as 'affordability' products, potentially misleading consumers about the products' potential costs").

[21] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGS. 123 (2007); Kathleen C. Engel & Patrcia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1273–80 (2002).

[22] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGS. 123, 127 (2007).

scores became less influential in determining who received a subprime mortgage. This became evident as subprime lenders started to generate agreements with investment banks to fund subprime lending—encouraging brokers to flood the market with subprime loans to meet the demands of Wall Street investors.[23] Thus, the forces of supply and demand were corrupted by supplanting investment banks' demands for borrowers' demands. This scenario lead mortgage brokers to prefer a higher volume of loans to quality of loans.[24] Below is a simplistic model of the securitization process, demonstrating each party's role in the process.[25]

Graphical Depiction of the Securitization Process[26]



[23] Kevin Connor, WALL STREET AND THE MAKING OF THE SUBPRIME DISASTER 11 (2007) *available at* http://www.northwestbronx.org/wallstreet_subprime.pdf (explaining that these agreements "encourage lenders to make as many loans as possible, with very little regard to quality").
[24] *Id.*
[25] A more thorough discussion of the process of securitization and the role it has played in the subprime crisis is discussed in the second paper of this series by Amy Festante.
[26] Kevin Connor, WALL STREET AND THE MAKING OF THE SUBPRIME DISASTER 4 (2007) *available at* http://www.northwestbronx.org/wallstreet_subprime.pdf (reprinting the graphic originally produced by Richard J. Rosen, *The Role of Securitization in Mortgage Lending*, The Federal Reserve Bank of Chicago (2007)).

As demonstrated by this diagram, securitization allows banks to re-sell the loans they originate in order to pool them into mortgage backed securities that are re-packaged and sold to investors. These securities became especially lucrative in the subprime mortgage market because of the extremely high interest rates paid by borrowers of these loans, leading to greater returns for investors. An excellent example of the corruption of supply and demand created by this market is that of Lehman Brothers' relationship with a subprime lender, First Alliance. Lehman Brothers' investment bank loaned First Alliance $500 million and packaged $700 million dollars worth of First Alliance loans.[27] In 1999, First Alliance and Lehman Brothers were sued for discriminatory lending practices, but the final judgment which came down in 2003 found Lehman Brothers only liable for 10 percent of the damages (a mere five million dollars).[28] Subprime mortgage securitization boomed after this judgment—rising from $202 billion in 2003 to $401 billion in 2004.[29] Clearly, investment banks took this case to mean that the rewards for subprime mortgage backed securities far outweighed the risks; leading them to encourage brokers to push subprime mortgage products on potential borrowers, regardless of borrower credit worthiness.

In contrast to today's Wall Street driven subprime lending, obtaining a home-mortgage loan in the 1960s and 1970s was a privilege offered almost exclusively to borrowers with strong credit, so lenders had to be competitive and subprime interest rates were unheard of.[30] Today, borrowers are told to shop around for the best rates and to

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[27] *Id.* at 16.
[28] *Id.*
[29] *Id.*
[30] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGS. 123, 125–26 (2007) (explaining that in this market, known as the "prime market," prime borrowers had very narrow differences in credit risk, creating a pass-fail system in which all borrowers with credit scores strong enough to pass received the same interest rate—those who failed simply did not obtain a loan).

make banks compete for their business—but this is a drastic oversimplification of the barriers faced by many borrowers who have either weaker credit scores, or little access to reputable banking facilities, or both.[31] A recent study published by the National Community Reinvestment Coalition found that 21 percent of American households are "unbanked," meaning that they have no relationship with a bank or a credit union.[32] These families are left to deal exclusively with the so-called "fringe banking industry" (e.g., check cashers, pay day lenders, non-bank mortgage brokers, and generally predatory lenders who charge excessive interest rates to anyone who walks in the door).[33] Additionally, subprime lenders typically require a borrower to pay a nonrefundable application fee before the borrower will even learn what their interest rate might be—therefore, shopping for a better loan can be extremely costly for these borrowers if they are expected to pay upfront for each loan application before they are told what the terms might be.[34]

IV. REAL SOLUTIONS & PREVENTING FUTURE LOSSES

Clearly the subprime mortgage market has spiraled out of control—allowing too many exotic mortgage products to exist without consistent, effective regulation to ensure

[31] *Id.* at 123; *see also* NATIONAL COMMUNITY REINVESTMENT COALITION, ARE BANKS ON THE MAP? AN ANALYSIS OF BANK BRANCH LOCATION IN WORKING CLASS AND MINORITY NEIGHBORHOODS 3 (2007), available at http://www.ncrc.org/images/stories/mediaCenter_reports/ncrc%20bank%20branch%20study.pdf (explaining that "[i]n most of the largest 25 metro areas in the US, banks are not located in working class and minority neighborhoods in the same proportions that they are located in wealthy and white neighborhoods").

[32] NATIONAL COMMUNITY REINVESTMENT COALITION, ARE BANKS ON THE MAP? AN ANALYSIS OF BANK BRANCH LOCATION IN WORKING CLASS AND MINORITY NEIGHBORHOODS 3 (2007), available at http://www.ncrc.org/images/stories/mediaCenter_reports/ncrc%20bank%20branch%20study.pdf

[33] *Id.*

[34] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGS. 139–40 (2007).

that they are being offered to buyers who can legitimately afford to repay them. Fortunately, despite the complexity of the mess, there are some relatively simple solutions that can be implemented that would cut to the heart of the problems. Specifically, the mortgage industry must be held to higher standards of documenting borrowers' ability to repay their loans, lenders must provide useful disclosures, and the legislature must ensure expanded and improved loan counseling for all borrowers taking out owner-occupied home-purchase loans.

A. Documentation

The common denominator in the failure of these "exotic" subprime mortgage products is a failure to fit the borrower with a suitable loan that the borrower will realistically be able to repay. Too much emphasis has been placed on credit scores, without factoring in a borrower's income stream, assets, and ability to meet a monthly payment schedule.

Subprime lenders will continue to find new ways to "hide the ball" and create predatory loan products disguised as useful loans, but if borrowers are strictly scrutinized for their true ability to pay off these loans, fewer borrowers will receive such loans. This decrease in availability will curb the overzealous subprime lenders and require other lenders to create more suitable products to meet the needs of borrowers. Strict documentation requirements must be in place for all residential home mortgage applicants. As a corollary, a serious commitment to enforcing these requirements must also be in place at the local, state, and federal level.

B. Disclosure Requirements

Disclosure requirements are already quite significant, and many argue that there is so much disclosure that borrowers are too overwhelmed to really glean any substance from the loan disclosure documents.[35] Therefore, rather than expanding disclosure requirements, the actual form of disclosure must be reformatted to give borrowers an accurate guide to the loan they are being offered. In addition, borrowers must be educated that the lender/broker is not necessarily a fiduciary, and may in fact have a distinctly adverse interest in the borrower's loan (due to incentivized payment for brokers who lock borrowers into high-interest loans).

The Federal Reserve Board and the Office of Thrift Supervision have created a "Mortgage Shopping Worksheet" that provides a very helpful chart for borrowers to use to compare and contrast mortgages based on selected criteria.[36] The factors included in this worksheet are:

- Mortgage amount,
- Loan term in years,
- Type of loan (e.g. fixed rate, ARM, IO),
- APR (for fixed-rate loans),
- ARM initial interest rate (and how long) and APR,
    - Which index is used to determine the ARM's variable rate,
    - Current index rate,
    - Margin,

[35] Patricia McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007).
[36] Federal Reserve Board & Office of Thrift Supervision, *Consumer Handbook on Adjustable-Rate Mortgages: Mortgage Shopping Worksheet*, *available at* http://www.federalreserve.gov/Pubs/arms/armstext_cover2005.pdf (last visited Mar. 9, 2008).

    - Periodic interest-rate cap,
    - Lifetime interest-rate cap,
    - Minimum interest-rate,
- Payment cap,
- Possibility of negative amortization,
- How much can the balance grow before loan is recalculated,
- Prepayment penalty,
- Balloon payment (estimate of amount and when due),
- Origination fees and charges,
- Monthly payments for first year of loan,
    - Include taxes, insurance, condo fees
- Monthly payments after 12 months (if index rate stays same),
    - …if index rate goes up 2 percent,
    - …if index rate goes down 2 percent,
- Maximum monthly payment after one year,
- Maximum monthly payment after three years, and
- Maximum monthly payment after five years.[37]

It seems reasonable to require all lenders/brokers to provide all of this information in a standardized worksheet that borrowers can use to easily compare loan terms—see a sample worksheet comparing three types of exotic mortgages to a fixed-rate mortgage on page 22.[38] In addition, lenders/brokers should be required to provide this information no

[37] *Id.*
[38] The sample mortgage shopping worksheet provided on the following page does not reflect the loan terms of any individual lenders and is purely the creation of the author of this paper.

later than ten days prior to closing, or preferably sooner. Currently, lenders/brokers may provide this information (or change this information) up until moments before closing—leaving borrowers, who have often already paid substantial application fees, with little opportunity to renegotiate or walk away from the loan.[39]

[39] Patricia McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007).

Sample Mortgage Shopping Worksheet				
	Fixed-Rate	**Exotic 1**	**Exotic 2**	**Exotic 3**
Mortgage amount	$200,000	$200,000	$200,000	$200,000
Loan term (e.g., 15 years, 30 years)	30 years	30 years	30 years	5 years
Loan description (e.g., fixed rate, 3/1 ARM, payment-option ARM, interest-only ARM)	Fixed-Rate	3/27 ARM	IO ARM (3yr Intro Period)	Balloon Payment
BASIC FEATURES FOR COMPARISON				
Fixed-rate mortgage annual percentage rate (APR)	5.50%			
ARM initial interest rate and APR:		4.50%	4.50%	6.50%
How long does the initial rate apply?		3 years	3 years	5 years
What will the interest rate be after the initial period?		Index + 4%	Index + 4%	n/a
ARM features:				
How often can the interest rate adjust?		Annually	Annually	None
What is the index and what is the current rate?		2.50%	2.50%	2.50%
What is the margin for this loan?		4%	4%	4%
Interest-rate caps:				
What is the periodic interest-rate cap?		2%	2%	n/a
What is the lifetime interest-rate cap? How high could the rate go?		12%	12%	n/a
How low could the interest rate go on this loan?		4.50%	4.50%	n/a
What is the payment cap?		$1,886	$2,049	n/a
Can this loan have negative amortization (that is, increase in size)?		No	No	Yes
What is the limit to how much the balance can grow before the loan will be recalculated?		None	None	None
Is there a prepayment penalty if I pay off this mortgage early?	No	Yes	Yes	Yes
How long does that penalty last? How much is it?	n/a	5 yrs ($10,000)	5 yrs ($10,000)	5 yrs ($10,000)
Is there a balloon payment on this mortgage?	No	No	No	Yes
If so, what is the estimated amount and when would it be due?	n/a	n/a	n/a	$202,391 due in 5 yrs
What are the estimated origination fees and charges for this loan?	n/a	n/a	n/a	n/a
MONTHLY PAYMENT AMOUNTS				
What will the monthly payments be for the first year of the loan?	$1,136	$1,013	$750	$1,264
Does this include taxes and insurance? Condo or homeowner's association fees?	yes	yes	yes	yes
If not, what are the estimates for these amounts?	n/a	n/a	n/a	n/a
What will my monthly payment be after the introductory period if the index rate…				
…stays the same?		$1,013	$1,067	n/a
…goes up 2%?		$1,231	$1,311	n/a
…goes down 2%?		$818	$849	n/a
What is the most my minimum monthly payment could be after 1 year?	$1,136	$1,013	$750	$1,264
What is the most my minimum monthly payment could be after 3 years?	$1,136	$1,461	$1,570	$1,264
What is the most my minimum monthly payment could be after 5 years?	$1,136	$1,701	$2,049	$16,866

C. Loan Counseling

Loan counseling should be a requirement for all first-time home mortgage applicants—through a local consumer advocacy group or through state/federally funded programs. These loan counseling sessions should be part of the documentation requirement and should be provided by a disinterested party not affiliated with the lender/broker. In this setting, borrowers should have their loan terms explained and see comparisons with fixed-rate and adjustable-rate mortgages. Although this would increase the delay for borrowers applying for mortgages, it would force borrowers to see and better understand their loan terms before they commit to anything. Additionally, this would provide the borrower with access to a truly disinterested party who does not receive any benefit from the loan. This would also be a place where borrowers could receive help in creating a mortgage comparison worksheet, which is likely extremely difficult for the average borrower with little experience reading loan documents.

V. CONCLUSION

There are many factors that contributed to the collapse of the subprime market, but the most primary among these is the predatory mortgage products that were thrust upon too many borrowers. Risk-based pricing is no excuse for the usurious rates and exorbitant fees that were charged to some of the market's least savvy borrowers. As more truths are uncovered through the many hearings and lawsuits that are sure to be brought in the wake of the crisis, the public will undoubtedly learn the predatory nature of these products and the unscrupulous motives behind these loans. Please read the second paper in this series for further discussion of the role that securitization played in

the subprime market collapse, written by Amy Festante. Finally, in the third paper, Carlos Lopez will examine the current legislative solutions that have been proposed to mitigate the current damage caused by the market collapse and to prevent such market failures in the future.

Justice Action Center
Student Capstone Journal
Project No. 07/08-02B

Securitization's Role in the Collapse of the Subprime Mortgage Market

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This paper can be downloaded without charge from:
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SECURITIZATION'S ROLE IN THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET

AMY L. FESTANTE
JUSTICE ACTION CENTER CAPSTONE

INTRODUCTION

The costs of the subprime mortgage meltdown are sweeping the nation, from the homeowners on Main Street to the investment firms on Wall Street. Everyday the news reveals the devastation, the fear, and the uncertainty that people are facing. Millions of homeowners are on the brink of losing their homes, and millions have already faced foreclosure. The victims of predatory mortgage loans are not the only ones that are suffering from reckless lending. Even people with prime credit histories are falling behind on payments for home loans, auto loans and credit card loans. For example, 5.7% of all home equity loans were delinquent or in default in 2007, up from 4.5% in 2006, and 7.1% of all auto loans were delinquent or in default in 2007, up from 6% in 2006.[1] To prevent future losses banks have started to cap home equity loans in areas with falling real estate prices and some credit card companies are reducing lines of credit for risky customers.[2]

With the banks tightening their lending practices, it is now more difficult for borrowers to secure financing to purchase homes. As a result, new home sales have plunged to their lowest rate in over 12 years.[3] When the values of homes were consistently and steadily rising, homeowners felt secure and comfortable borrowing against the equity in their home to finance tuition payments, car payments and vacations. However, because the prices of homes are now

[1] The Associated Press, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. TIMES, Feb. 12, 2008.

[2] *See Id.*

[3] The Associated Press, *New-Home Sales Plunge by 9 Percent*, N.Y. TIMES, Dec. 28, 2007.

falling and credit is difficult to come by, these homeowners are now facing a reduced amount of equity or even negative equity, forcing some to sell their homes reluctantly at a loss.

The broadest result of the subprime crisis is great economic uncertainty. Our nation is on the brink of experiencing stagflation because job growth has slowed, the prospect of growing unemployment is looming, and there are fears of inflation.[4] At the end of 2007 wages grew slower than inflation, so it is not surprising that Americans were exceptionally thrifty during the holiday season, to the detriment of retailers.[5] As predictions of a recession run rampant, it seems as though everyone is experiencing financial stress.

Many people are asking who's to blame for the subprime mortgage meltdown and its accompanying messy consequences? Where should the angry finger be pointed? Multiple theories as to blameworthiness have developed. Some buyers are blaming their real estate agents and have taken it to the next level by bringing suit against them. They are claiming the agent, in fear of losing his commission, concealed information from them that similar homes in the area were selling for less. Brokers are not appraisers and do not have to opine as to value, but those who made valuation statements in the wake of the housing collapse may be receiving letters from attorneys representing angry buyers.[6]

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[4] Stagflation is a macroeconomics term used to describe a period of inflation combined with stagnation (that is, slow economic growth and rising unemployment, possibly including recession). In a stagflation scenario the problems of inflation and slow economic growth co-exist. Recently the Federal Reserve has been cutting the interest rate in an attempt to fix both falling home values and rising consumer prices. This is a difficult task because cutting rates may improve economic growth but it has the effect of stimulating the consumer's purchasing power, which in turn may increase inflation. *See, eg.*, Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/wiki/Stagflation (last visited Apr. 7, 2008).

[5] Peter S. Goodman and Vikas Bajaj, *In the Land of Many Ifs*, N.Y. TIMES, Jan. 2, 2008.

[6] *See* David Streitfeld, *Feeling Misled on Home Price, Buyers Sue Agent*, N.Y. TIMES, Jan. 22, 2008.

With respect to the securities that were backed by the subprime mortgages, former SEC commissioner Joseph A. Grundfest was quoted as saying "Anybody who touched the security in the process of creating or selling it is going to be subject to litigation."[7] New York state prosecutors began investigations into whether Wall Street banks withheld material information from investors regarding the risk factors involved with the subprime loans. The IRS has opened an inquiry into the trusts that are created to issue the mortgage backed securities. The law firm Cadwalader Wickersham & Taft is being sued for malpractice in connection with work it has done in mortgage backed securities.[8] Apparently none of the prestigious and sophisticated institutions involved in the creation and sale of mortgage backed securities were able to foresee the sweeping repercussions of their involvement. As a result, not only did individual homeowners fall victim to the effects of this financial process, the financial institutions themselves eventually fell victim as well.

Foreclosed homes, stingy banks, financial insecurity, finger pointing, investigations and litigation. How did we get to a point where everyone, from the individual homeowner to the multi-million dollar financial institution, is suffering from such devastating economic and non-economic damage? A comprehensive overview of the complex financial process of securitization will help to explain the cause of the current economic crisis.

SECURITIZATION: AN OVERVIEW

Securitization is the process of transforming a liquid[9] asset, such as a residential mortgage, into a tradable security.[10] In residential mortgage backed securities ("RMBS"), the

[7] Lynnley Browning, *Small Law Firm's Role in Bundling Mortgages*, N.Y. TIMES, Feb. 1, 2008.

[8] *Id.*

[9] Liquid is defined as "consisting of or capable of ready conversion into cash." Merriam-Webster Online Dictionary, http://www.merriam-webster.com/dictionary/liquid (last visited Apr. 14, 2007).

creation of the new financial instrument represents an undivided interest in a segregated pool of residential mortgages. This is accomplished by using the following financial structure. The loan originator pools individual loans and then sells the loan pool to a special purpose vehicle ("SPV"), a bankruptcy-remote entity established in the form of a trust by the issuer. The SPV is owned by but legally distinct from the originator. The SPV's only assets are the properties being financed, which the originator sold to the SPV in exchange for the RMBS formed by the proceeds from the mortgages.[11] This transaction is structured in this way for the purpose of isolating the loan pool from the originator. Bankruptcy remoteness boosts the ratings of securitized offerings.

The investment bank for the issuer carves the principal and interest payments into tranches[12] of bonds. Each class of RMBS is a tranche, and the rating agencies rate the credit risk of each tranche separately. Once the investment bank has a rating it will price the RMBS and sell them to investors via public offering or private placement.[13] At issuance the investors are typically paid a fixed coupon[14] and their payments of principal are also based on a fixed schedule. The RMBS tranche system has a senior-subordinate structure under which the junior tranches do not receive principal payments until the senior tranches have been retired or paid off.

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[10] *Webinar: Holding Wall Street Accountable* (David Berenbaum of the National Community Reinvestment Coalition, Oct. 30, 2007).

[11] *Id.*

[12] A tranche is defined as a "division or portion of a pool or whole; specifically an issue of bonds derived from a pooling of like obligations (as securitized mortgage debt) that is differentiated from other issues especially by maturity or rate of return." Merriam-Webster Online Dictionary, http://www.merriam-webster.com/dictionary/tranche (last visited Apr. 14, 2007).

[13] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2048 (2007).

[14] A coupon is defined as "an interest or dividend certificate that is attached to another instrument, such as a bond, and that may be detached and separately presented for payment of a definite sum at a specified time." BLACK'S LAW DICTIONARY (8th Ed. 2004).

As a result, the junior tranches have higher coupons and longer lives. They are also the first to absorb any losses resulting from default. This structure protects the senior tranches from these losses.[15] This tranche system provides investors with a number of options, depending on what levels of risk to which they are willing to be exposed. It follows the general rule that the investors who are the most risk averse get paid first but have lower coupons.

THE PROCESS OF CREATING MORTGAGE-BACKED SECURITIES

The process of creating mortgage-backed securities involves the undertaking of many steps by various parties. Because securitization can be quite difficult to grasp, the following steps provide a basic understanding of the structure. First, the originator (or lender) originates the loans. Next, the originator pools the loans together and the securitization structure is added, as described above. The originator then sells or assigns certain assets to a SPV which is typically a subsidiary of the bank and legally insulated from management. In order to guarantee against loss for the investor, the loan pools then go through credit enhancement[16] (examples of which are discussed further below) and rating agency review. After the rating agency rates the assets, the SPV issues the debt, dividing up benefits and risks among investors on a pro-rata basis. The SPV uses the proceeds from the issuance to pay the loan originator. Over time the borrowers make principal and interest payments which are used to repay the investors.[17]

[15] Engel & McCoy, *supra* note 13, at 2047.

[16] Credit enhancements are financial cushions that can be either internal (provided by the lender themselves) or external (provided by insurers, guarantors and banks).

[17] *Holding Wall Street Accountable*, *supra* note 10.

PLAYERS IN THE RMBS MARKET

The securitization process involves the efforts of several parties. The role of each party, whose respective involvement varies in degree and takes place at certain points of time throughout the process, is described below.

Originator/Lender

The originator/lender issues new loans to borrowers in a process called loan origination. Institutions such as commercial banks, investment banks, insurance companies, and finance companies can all play the role of originator. Before the originator determines and issues the loan amount, it must assess the borrower's ability to make timely payments on a loan. To do this they (1) assess the value of the property and (2) review the creditworthiness of the borrower, which involves looking at past credit performance, current income, and cash reserves.[18]

The originator's counsel works within rating agency guidelines in structuring the transaction and preparing the loan documents.[19] After the originator issues the loan to the borrower and records the debt onto a title, it sets up a SPV and places the loan into the trust. At this point the originator no longer plays an active role in the transaction.[20] As discussed further below, the only obligation the originator retains is a repurchase obligation in the event it breaches a representation in connection with the sale of the loan to the SPV.

In addition to originating the loan in the ordinary course of business, these institutions also purchase and assemble these loans.

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[18] *See* MARIELLE JAN DE BEUR & NAYNIKA CHAUBEY, U.S. CMBS PRIMER 6 (Bear, Stearns & Co. Inc. July 2007).

[19] *Holding Wall Street Accountable, supra* note 10.

[20] JAN DE BEUR & CHAUBEY, *supra* note 18.

SPV/Issuer

The SPV issuer's role in the securitization process is to find willing investors to whom they can issue RMBS. This issuance funds the issuer's purchase of the loans from the originator. The issuer combines the loans into an asset pool and structures the cash flows from the pool into a set of tranches, or bonds, and then sells these bonds as securities to investors. Issuers also play a role in providing liquidity or a secondary market for these securities.[21]

Underwriters/Placement Agencies

The underwriter[22] is a crucial link between the lender and the investor because its task is to understand the collateral by verifying the value of the properties underlying the loan pool.[23] The underwriter usually plays the principal role in structuring the RMBS transaction and they take on the risk of having to sell the securities.[24] If they can not find enough investors to purchase all the securities then they end up having to hold some securities themselves. The underwriter pays the issuer with part of the proceeds they collect from the investors who purchase the securities, and the price difference represents the underwriter's profit.

Trustee

The trustee is usually a bank (or another entity that is authorized to act in such capacity) appointed pursuant to the trust agreement to act as the gatekeeper of the SPV's assets. The trust

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[21] *Id.* at 7.

[22] Securities underwriting is the way business customers are assessed by investment houses for access to either equity or debt capital. This is a way of placing a newly issued security, such as stocks or bonds, with investors. A syndicate of banks underwrite the transaction, which means they have taken on the risk of distributing the securities. *See, eg.*, Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/wiki/Underwriter (last visited Apr. 7, 2008).

[23] KEVIN CONNOR, WALL STREET AND THE MAKING OF THE SUBPRIME DISASTER: HOW INVESTMENT BANKS FUELED THE SUBPRIME BOOM, MADE BILLIONS, AND CAUSED THE CURRENT FORECLOSURE CRISIS 9 (National Training and Information Center, Nov. 2007).

[24] *Holding Wall Street Accountable, supra* note 10.

agreement is the legal document between the trustee and the originator that creates the SPV.[25] The trustee's responsibilities include holding the receivables (loans) and maintaining the mortgage files, collecting payments on the receivables from the borrowers (by way of the servicer) and passing these payments on to the security holders.[26] They are also responsible for providing statements regarding distributions and carrying out trust tax reporting. The trustee holds legal title to the properties underlying the loan pool on behalf of the investors and has a legal obligation to protect their interests. They also are obliged to supervise the servicer (whose role is discussed below) to ensure that they act in accordance with the servicing agreement.[27]

Investor

The investor is the ultimate purchaser of the RMBS. They own the present and future economic value of the assets. The diverse and global institutional investor base includes banks, insurance companies, retirement funds, government sponsored entities ("GSEs"), and others.[28] Each investor has their own preference for risk and return and may choose investments accordingly.

Rating Agencies

The rating agencies enter the securitization process early on and assist in structuring the transaction. The three primary agencies are Moody's Investors Services, Standard & Poor's and Fitch IBCA. Their role is to protect investors, but they are hired by the underwriter to assess and assign credit ratings to the credit quality of pools of mortgages. The rating agencies are considered the "gatekeepers" of RMBS because bonds need to be rated before the issuers and

[25] *Id.*.
[26] *Id.*
[27] *See* JAN DE BEUR & CHAUBEY, *supra* note 18, at 8.
[28] *Holding Wall Street Accountable, supra* note 10.

underwriters can sell them. "The lack of a rating from at least one of the privileged raters, which effectively grant regulatory licenses to institutions that wish to issue securities, is the financial equivalent of a death sentence for a residential mortgage-backed securities offering."[29] The S.E.C. and other government regulators granted these agencies a nationally recognized statistical rating organization status (NRSRO), but they were *not* assigned a reciprocal responsibility to the public. This is a problem because the rating agencies are not held accountable to anyone. Therefore, they can enjoy their privileged regulatory status and their unaccountability up until the investors can no longer rely on them.

Credit ratings are private and purportedly independent opinions about credit. The development of credit ratings for RMBS increased investor confidence in these securities.[30] While these rating are not a legal requirement, most investor's investment guidelines require credit ratings on securities. Ratings range from triple-A (high) to triple-C (low) and they have a major influence on structure and pricing. The rating process begins with the issuer providing the rating agency with relevant information including but not limited to, the issuer's background, strategy, operations systems, and historical performance data. The issuer then explains the deal structure, the nature of the underlying assets, and the operations of the originator of the assets.[31]

The rating agency assessment includes: (1) an evaluation of the risk of RMBS default and likelihood of timely payments; (2) a comparison of the loan pool's characteristics with historical

[29] David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Market*, 33 FLA. ST. U. L. REV. 985, 988 (2006).

[30] *See id.* at 1007.

[31] *See id.* at 1014.

data; and (3) a forecast of the tranche's performance. They do *not* assess the underlying loans or individual borrowers.[32]

The credit ratings are reflective of the agencies' holistic approach to evaluation; they evaluate everything related to credit including (1) the real estate, (2) loan terms, (3) credit support structure, (4) legal structure, (5) pooling effects, and (6) all parties to the transaction. The external factors that are considered include the state of the economy, as well as relevant accounting, legal, tax, regulatory and other external influences. Their evaluation of loss potential includes a consideration of (1) frequency of default along with the severity of loss, (2) pool characteristics, (3) credit enhancement, and (4) deal structure.[33]

After this evaluation and assessment and before rating the securities, the rating agencies provide advisory services to the investment firms on how to package the RMBS so as to gain higher credit ratings.

In addition to their initial ratings, the agencies continue to monitor these transactions and adjust the ratings as credit conditions change. The rating agencies also reevaluate the securities when states pass anti-predatory lending acts, because these measures cause the investors to back away from RMBS.[34] The agencies tend to overestimate credit risk at first, so when they

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[32] This is in contrast to commercial mortgage backed securities ("CMBS") where, "At the loan level, components of a transaction are evaluated in terms of likelihood of payment, implying the capacity and willingness of the borrower to meet the financial commitment in a timely manner, in addition to the provisions of the mortgage." JAN DE BEUR & CHAUBEY, *supra* note 18, at 10. This difference is due in part to the impracticability of assessing the huge volume of residential mortgage loans that make up the pool. On commercial deals, an assessment of the underlying loans is more practical because there are many fewer loans in the pool, and the larger loan dollar amounts for each loan increase the debt concentration risk to levels beyond that of RMBS, making the individual assessments quite necessary. Also, in CMBS there are many additional variables to assess, such as appraisal methodologies, sponsorship, environmental issues, local market issues, tenant issues, and lease issues.

[33] Reiss, *supra* note 29, at 1014.

[34] *Holding Wall Street Accountable*, *supra* note 10.

reevaluate the securities on the secondary market they can upgrade a tranche due to its performance. Traditionally, upgrades outpace downgrades in subprime RMBS. This initial conservative risk assessment by the rating agencies may induce investors to purchase these RMBS because there is a good possibility of a future upgrade.[35]

The criticism of rating agencies is becoming more widespread as people wonder why it has taken them so long to respond to the financial crisis.[36] Critics point to the frequent disagreement in RMBS ratings between the agencies and claim that this is evidence that they fail to provide accurate information.[37] They also claim that the agencies' good reputations are attributable to the power they derive from "their sale of regulatory licenses," or the right to be in compliance with regulation.[38]

The rating agencies face criticism for failure to comply with state and federal antipredatory lending statutes. These statutes are one of the external factors that the rating agencies review when evaluating RMBS loss potential. In particular, they look for assignee liability and damages provisions. "In states where there is both assignee liability and unquantifiable damages, some of the privileged raters have refused to rate transactions containing mortgage loans from such jurisdictions" and this "can effectively shut down the entire mortgage market of a state that passes strong anti-predatory lending legislation."[39] As a result, the rating agencies effectively have a veto over state predatory lending laws. On the federal level, The Home Ownership Equity Protection Act ("HOEPA") places limits on certain practices

[35] *See* Engel & McCoy, *supra* note 13, at 2056.

[36] *See* Joshua Rosner, *Stopping the Subprime Crisis*, N.Y. TIMES, July 25, 2007.

[37] Reiss, *supra* note 29, at 1021.

[38] *Id.*

[39] *Id.* at 1024-1025.

if made in connection with high cost loans.[40] HOEPA abrogates the holder in due course doctrine[41], however, HOEPA's protections only extend to a small part of the mortgage market.[42] The rating agency's interests conflict with the antipredatory lending statutes because the agencies are not held responsible to the public. The agency's guidelines reflect the interests of issuers and investors, and not borrowers. The rating agencies are not interested in reducing the number of predatory loans; rather, they are interested in the growth of the RMBS market because they have a financial stake in it.

The rating agency process is an area of great concern and focus because of the conflict of interest created by the institutional pressure from the issuers and underwriters (who are responsible for paying the agency's fees) on the rating agencies to assign high-quality ratings to RMBS. This is in conflict with the rating agencies' duty to provide objective and independent ratings to investors. Investors should question if it is *their* interests that are really being protected in this process. More oversight is needed in this area, as evident by the recent S.E.C. decision to launch an investigation into whether the rating agencies improperly inflated their ratings of RMBS.[43]

Servicer

The servicer is the party that actually deals with the receivables on a day to day basis, collecting the payments on the mortgages in the trust and transferring funds to accounts controlled by the trustee. In most RMBS transactions the originator acts as servicer. An

[40] 15 U.S.C. § 1639 (1994).

[41] The holder in due course doctrine immunizes investors as good faith purchasers of the mortgage notes. Borrowers that were defrauded by lenders can not hold the investors liable. *See, eg.*, Reiss, *supra* note 29, at 1026. Therefore, the investors are protected, but it is to the detriment of the borrowers.

[42] *See* Reiss, *supra* note 29, at 1024-1025.

[43] *See* Stephen Labaton, *S.E.C. Inquiry Looks for Conflicts in Credit Rating*, N.Y. TIMES, Sept. 27, 2007.

originator with huge servicing operations, such as Countrywide or Wells Fargo, retains servicing because it brings in big revenue. In addition to collecting monthly payments from borrowers, the servicer's responsibilities include (1) monitoring delinquent or problematic loans, (2) deciding between foreclosure or refinance when necessary[44] and (3) reporting information and remitting funds according to the pooling and servicing agreement.[45][46]

Government-Sponsored Entities (GSEs)

The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are both government-sponsored entities that were formed to provide a secondary market for residential real estate loans. The U.S. government acts as guarantor of the loans and therefore Fannie Mae and Freddie Mac can borrow or sell at lower interest rates than private entities. This enabled tens of millions of borrowers to obtain mortgage credit at much lower costs.[47]

Fannie Mae was created in 1938 as a part of FDR's New Deal to raise the levels of homeownership and affordable housing. Its role was to provide private banks, who were discouraged by the Great Depression from making mortgage loans, with money to finance home mortgages. Fannie Mae is a "corporate instrumentality" of the government; it is a quasi-private corporation with stock that trades on the public market. It does not receive a government subsidy and is taxed like any other corporation. Fannie Mae purchases conforming mortgages

[44] *See* CONNOR, *supra* note 23, at 8.

[45] A pooling and service agreement is "a legal contract defining the responsibilities and the obligations of the…servicers in managing a CMBS transaction, including required advances." JAN DE BEUR & CHAUBEY, *supra* note 18, at 199.

[46] *See* JAN DE BEUR & CHAUBEY, *supra* note 18, at 8.

[47] *See, eg.*, Reiss, *supra* note 29, at 1006 and 1010.

from the Federal Housing Administration ("FHA"),[48] pools these mortgages and then issues securities using the pool of mortgages as collateral. Holders of Fannie Mae certificates are guaranteed full and timely payment of principal and interest.[49] Fannie Mae began purchasing subprime loans in 1999 but limited the purchases to the most creditworthy segment of the subprime market in order to adhere to their own buying guidelines.[50]

Freddie Mac is another "corporate instrumentality" of the government. The Federal Home Loan Banks[51] hold stock under the regulatory control of the Department of Housing and Urban Development ("HUD"). Under the direction of the Federal Home Loan Bank Board, Freddie Mac is entrusted to purchase mortgages from savings and loan associations (S&Ls)[52] to enhance their role in and provide liquidity to the secondary market for single family mortgages (i.e. a mortgage not backed by a government agency) and then issue securities using the pool of mortgages as collateral.[53] Freddie Mac began purchasing subprime loans in 1997.[54]

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[48] The Federal Housing Administration was created by Congress in 1934 to provide mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. U.S. Department of Housing and Urban Development (HUD), http://www.hud.gov/offices/hsg/fhahistory.cfm (last visited Apr. 14, 2008).

[49] *See, eg.*, JAN DE BEUR & CHAUBEY, *supra* note 18, at 188.

[50] *See* Reiss, *supra* note 29, at 1011.

[51] The Federal Home Loan Banks are 12 privately-owned regional banks without publicly traded stock . They were congressionally chartered in 1932 to create affordable housing opportunities. They provide stable, low-cost funds to financial institutions for home mortgage, small business, rural and agricultural loans. FHLBANKS: A Nation of Local Lenders, http://www.fhlbanks.com/ (last visited Apr. 14, 2008).

[52] A savings-and-loan association is "a financial institution -- often organized and chartered like a bank -- that primarily makes home-mortgage loans but also usually maintains checking accounts and provides other banking services." BLACK'S LAW DICTIONARY (8th Ed. 2004).

[53] *See, eg.*, JAN DE BEUR & CHAUBEY, *supra* note 18, at 189.

[54] *See, eg.*, Reiss, *supra* note 29, at 1011.

The Emergency Home Finance Act of 1970 allows the GSEs to purchase and securitize "conforming" mortgages.[55] GSEs are limited to purchasing "conforming" loans, which are loans with loan-to-value ratios[56] of 80% or less. They may not buy mortgages with principal amounts greater than an amount set each year.[57] For example, the loan limit for 2008 on a single unit home is $417,000. The 2008 conforming loan limits are identical to the 2007 and 2006 conforming loan limits.[58]

Fannie Mae and Freddie Mac, not private entities,[59] are the dominant purchasers of residential mortgages in the nation's secondary mortgage market. Investors appear to be provided with reassurance and a sense of protection when the securities they are purchasing are endorsed by a government backed entity. The investors in Fannie Mae securities are guaranteed full and timely payment of principal and interest. Fannie Mae's securities are classified as "U.S. agency securities" because Fannie Mae was created and exists pursuant to a federal law that serves the public mission of providing housing to Americans, but these securities are not backed by the full faith and credit of the U.S. Government.[60]

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[55] *See, eg., id.* at 1006.

[56] The loan-to-value ratio is "the principal amount on a mortgage at origination to the current appraised value of the property. The ratio is commonly expressed to a potential borrower as the percentage of value a lending institution is willing to finance. The ratio is not fixed and varies by lending institution, the borrower's credit history, the property type, geographic location, size and other variables." JAN DE BEUR & CHAUBEY, *supra* note 18, at 194.

[57] *See, eg.*, Reiss, *supra* note 29, at 1010.

[58] Fannie Mae, www.efanniemae.com (last visited April 14, 2008).

[59] When the issuer of securities is a private entity, those transactions are referred to as private label/non-agency securitizations.

[60] *See* An Introduction to Fannie Mae, http://www.fanniemae.com/media/pdf/fannie_mae_introduction.pdf (last visited April 14, 2008).

THE POPULARITY OF RMBS

Many of the parties mentioned above became involved in the securitization process because they could derive vast financial benefits from participation. Unfortunately, while these parties were experiencing financial success, it was to the detriment of unsuspecting borrowers.

WHY LENDERS LIKE RMBS

RMBS grew exponentially in the past few years and took the global financial world by storm. These complex and difficult to value assets were risky but reaped high rewards for the lender. In RMBS transactions the lender receives the present value of future cash flows, providing the lender with cash for immediate spending or investment. When the lender sells the rights to the future cash flows to investors, they are passing on the benefits of possible profits but they are also transferring the risk of that profit not emerging.

In general, lenders deem real estate to be good collateral because property in buildings and land needs less monitoring than personal property collateral. However, the individual residential mortgages themselves are not easily tradable because they would require their own extensive monitoring. RMBS help the lender overcome this problem.[61] Technological advances have made it possible to estimate and price the risk of subprime home loan pools. Today lenders securitize almost 80% of subprime mortgages.[62] Because of subprime aggregation, even marginal lenders with low credit ratings are able to obtain financing and borrow funds at better rates because the cash flows these lenders are securitizing are deemed to be quality because of the strength of the underlying collateral and other credit enhancements.[63]

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[61] *See* Reiss, *supra* note 29, at 1005.

[62] Engel & McCoy, *supra* note 13, at 2045.

[63] *See, eg.*, Engel & McCoy, *supra* note 13, at 2065.

Notwithstanding the high rewards, some of these marginal subprime lenders said that the big investment banks encouraged and pushed them to make the risky loans. The subprime lenders claim the investment banks pressured them to loosen their lending standards so that the investment banks could package more loans into securities. However, this was the wrong time to ease credit because interest rates were rising and home prices had reached their peak.[64] The investment banks encouraged the issuance of these risky loans to troubled borrowers because the banks reaped a windfall by packaging them as investments for hedge fund clients.[65] The investment banks pushed for more and more loans to be made as demand for RMBS grew hot, even if the borrowers were not creditworthy. RMBS brought in big revenue so the lenders processed loans as quickly and as often as possible. Therefore, lenders did not mind making "stated income" loans because the lender could process these loans quickly. These are loans where the information provided by borrowers and brokers are not verified by the loan officers with tax returns, pay stubs or other documentation.[66] Simply put, money trumped lending standards. The absence of governmental oversight in this area adds to the power of the investment bank in the securitization process. The investment banks have the power to securitize risky, non-conforming subprime mortgage loans because they are not required to meet GSE underwriting standards.[67]

WHY THE INVESTMENT BANKERS LIKE RMBS: BONUSES

Investment banks operate on a "pay for performance/profit" system. The more net revenue you generate, the bigger your bonus. After the dot.com collapse, collateralized debt

[64] *See* Vikas Bajaj, *East Coast Money Lent Out West*, N.Y. TIMES, May 8, 2007.
[65] *See* Editorial, *Housing and Hedge Funds*, N.Y. TIMES, June 28, 2007.
[66] *See* Bajaj, *supra* note 64.
[67] See CONNOR, *supra* note 23, at 10.

obligations ("CDOs")[68] such as RMBS replaced the tech stocks as the hot products for investment banks to sell to investors. The hot housing market set the background of RMBS as a fast growing sector. The boom in subprime mortgages created pressure on investment bankers to feed the machine; in order for them to take home big bonuses they had to grind out the RMBS transactions. As a result, they focused on quantity, while letting their standards of quality slide. A look at just a few numbers reveals that the growth in the subprime mortgage market did in fact lead to the growth in RMBS. While CDOs were virtually nonexistent 10 years ago, in 2004 CDO issuance amounted to $157 billion and two years later in 2006 it amounted to a whopping $550 billion.[69] A look at the 2006 CEO bonuses for the Wall Street banks who invested in CDOs supports the contention that the growth in the CDOs strengthened revenues. Their bonuses combined amounted to $130 billion. Broken down, the CEO at Goldman Sachs earned $53.4 million, at Morgan Stanley $40 million, at Merrill Lynch $47.3 million, at Lehman Brothers $10.9 million, and at Bear Stearns $14.8 million.[70]

WHY INVESTORS LIKE RMBS

Investors like RMBS because the volume of loans is sufficiently large and homogenous, and this facilitates statistical analysis of the loan pool (history of rates, defaults, delinquencies, and prepayments). The large size of the pool of assets also reduces the likelihood of cash flow interruptions. Investors like how RMBS provides sufficient diversification with respect to geography and socio-economics because this diversification spreads the risk and reduces vulnerability to economic stresses. As previously discussed, the pool of assets provides more

[68] A CDO is "a type of asset-backed security and structured credit product. CDOs are constructed from a portfolio of fixed-income assets." Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/wiki/Collateralized_debt_obligation (last visited April 14, 2008).

[69] CONNOR, *supra* note 23, at 5.

[70] *Id.* at 6-7.

liquidity than the individual underlying assets. Loan pools are transferable and unencumbered. Due diligence costs associated with investing are reduced because this task is delegated to the rating agencies. The rating agencies are capable of evaluating and approving the lenders' basic credit quality standards.[71]

SECURITIZATION AND THE PROBLEM OF ADVERSE SELECTION

Securitization allows lenders to shift the loan performance risk to the investor. How can RMBS investments be successful if securitization enables lenders to sell their worst loans to investors and it blocks the investor's access to data regarding the borrower's credit quality? Why would investors purchase RMBS if they know the lenders are able to fraudulently represent the quality of the loans?

Originators have an incentive to sell their riskiest loans to investors because if they hold onto these loans they are in the position to bear the high risk of default. Before the securitization of residential mortgages grew hot, originators themselves would underwrite, finance the mortgage, service the loan and hold the loan until maturity. With RMBS they have no problems with providing loans to the risky borrowers to whom they would have never lent money if they had to hold the loans themselves. Furthermore, the lenders have less reason to underwrite the loans carefully knowing they will sell them anyway.

Like many other investments, RMBS involve risks that make investors hesitant about investing, but the RMBS tranche system's senior subordinate structure is successful in shifting these risks.[72] In the subsections below, the investment risks are discussed first, followed by the solutions and protections that are available to investors.

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[71] *Holding Wall Street Accountable, supra* note 10.

[72] *See, eg.*, Engel & McCoy, *supra* note 13, at 2054.

Credit Risk

To put the credit risk in context, it is helpful to compare the subprime RMBS to the prime RMBS. Pools of subprime mortgages have a large variance in credit risk covering the entire risk spectrum (A to the weakest D borrowers)[73], whereas prime pools are limited to the most creditworthy borrowers (mostly A), which represents only a narrow band of credit risk.[74] Subprime borrowers have impaired credit and are more likely to miss payments, sending the loan into default. On top of that, lenders make loans that they know borrowers cannot afford, so default is almost a foregone conclusion.

Investors do not have the data on borrower credit quality. As discussed above, any due diligence is limited in scope because the investors depend on the ratings and the senior-subordinate structure to protect them from credit risk, rather than due diligence.[75] Lenders may try to take advantage of this and conceal the credit flaws of subprime borrowers, knowing that investors do not have access to this information.

Prepayment Risk

Investors do not want to face the risk of prepayment. When borrowers pay off their principal before maturity the investor's cash flow is disrupted by (1) accelerating the return of principal and (2) canceling future cash flows from interest payments. Subprime borrowers prepay for two very different reasons. The first is on a voluntary basis; they have improved their credit scores and now want to refinance into prime mortgages to take advantage of lower rates. The second reason for prepayment is involuntary. This happens when they are the victims of

[73] Corporate credit ratings have letter designations, usually with AAA as the highest rating and D as the lowest. For example, Standard & Poor's rating scale is as follows: AAA, AA, A, BBB, BB, B, CCC, CC, C, D.

[74] *See, eg.*, Engel & McCoy, *supra* note 13, at 2050.

[75] *See, eg.*, *id*. at 2060-2061.

"loan flipping," which is when lenders persuade or even force subprime borrowers to refinance their loans repeatedly at short intervals in order to extract high fees. To facilitate this, lenders can structure the original loans so that the borrowers are eventually unable to pay and have to refinance.[76]

Litigation Risk

Investors face the risk that borrowers will sue the SPVs that hold the securitized loans for wrongdoing in the origination of the loans. If the borrower wins large compensatory and punitive damages awards this can have a big impact on the investor's returns.

Protections

Investors are provided with a number of protections to eliminate the aforementioned credit, prepayment and litigation risks.

- The sequential tranches provide investors with options. Investors who are the most risk averse get paid first. These conservative investors will not be offered the high coupons but they are in the best position to avoid risk.

- Investors can rely on diversification to alleviate the risks. The more diverse the pool of subprime loans (with respect to geography, credit risk, prepayment risk, and legal risk), the lower the risk that the investors will suffer losses.[77] For example, even if there are 100 defaults in a pool of 1,000 loans, 900 are still ok and bringing returns to the investor.

- The risk can be shifted through pricing. Investors demand a risk premium in the form of price reduction. This is passed on to the borrower who will be charged higher interest rates and prepayment penalties. For example, lenders steer customers who qualify for prime products towards subprime products which forces them to overpay for credit. These terms generate higher prices when the originator sells or packages them for securitization. Moreover, the prepayment penalties actually push the cost of subprime loans to the lender above their risk-adjusted price paid by the borrower. Prime loans, on the other hand, usually do not have these penalties.[78]

[76] *See id.* at 2051.

[77] *See id.* at 2056-2057.

[78] *See id.* at 2058-2059.

- Investors can purchase credit insurance as a part of an investment.

There are deal provisions that protect investors by shifting the credit risk back to lenders. Although assignee liability is limited by the holder in due course doctrine, many of the representations and warranties made by the mortgage lender about the quality of the loans survive the securitization process and are still enforceable against assignees.[79] The language of these provisions focus on issues of fraud and misrepresentation. The following are examples of these provisions.

- Representations and warranties: The lender warrants that all loans in the loan pool comply with applicable laws such as consumer protection laws.

- Recourse and collateral substitution: This requires the lender to take back loans if specific events occur, such as borrower default, and substitute performing loans for the loans that are going into default. These clauses are common but are not consistently enforced.[80]

- Retention of servicing rights: This should have the effect of causing lenders to be concerned about the borrower's creditworthiness. Servicing costs go up as default risk rises, and under this provision if loans go into default *they* bear the costs.[81] However, it is rare for lenders to retain servicing rights.[82]

- Internal credit enhancements: These come in at least three forms. The first is excess spread, which is the difference between the interest rate received on the underlying mortgage and the coupon on the issued security. When loan payments are in default, the coupon payment can still be made. The second is overcollateralization, which provides a support structure of an underlying loan portfolio with a face value that is larger than the RMBS it backs. Like with excess spread, even when loan payments are in default, principal and interest payments on the RMBS can still be made. The third internal credit enhancement is a reserve account, which is created to reimburse the SPV for losses up to the amount allocated for the reserve.[83]

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[79] *See id.* at 2061-2062.

[80] *See id.* at 2073.

[81] *See id.* at 2063.

[82] *See id.* at 2075.

[83] Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/wiki/Credit_enhancement (last visited Mar. 24, 2008)

- External credit enhancements: These come in at least four forms. The first is surety bonds, which are insurance policies that reimburse the SPV/Issuer for any losses. The second form is wrapped securities, which are insured or guaranteed by a third party. The third party may agree to reimburse the SPV/Issuer for losses up to a specified amount, advance principal and interest, or to buy back any defaulted loans. The third form is a letter of credit, which is when a bank provides a certain cash amount to reimburse the SPV in the event of default for losses up to the allocated credit support amount. The fourth external credit enhancement is a cash collateral account, which is when the issuer borrows the required credit support amount from a commercial bank and then deposits this cash in short-term commercial paper that has the highest available credit quality.[84]

THE LACK OF DUE DILIGENCE

When investors are faced with quick decisions about investments they do not have time to do their own due diligence, and therefore they must rely on the lenders, the rating agencies, and the underwriters. This is notwithstanding the fact that these three institutions do not have the same interests as the investor. In the nonconforming loan market private entities are free to adopt their own internal due diligence standards, and it is questionable whether there is any real self-policing involved. This internal due diligence can be limited to lender compliance with state and federal consumer protection laws. This becomes a problem in the numerous states that do not have strong anti-predatory lending laws. On the other hand, in the conforming loan market the GSEs impose stringent due diligence requirements on the lender. Fannie Mae and Freddie Mac have best practices standards that require substantive screening of subprime loans. Critics argue that both underwriting firms and rating agencies relax their due diligence standards as a response to pressure from the lenders, who may threaten to move their business elsewhere.[85]

[84] Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/wiki/Credit_enhancement (last visited Mar. 24, 2008)

[85] *See* Engel & McCoy, *supra* note 13, at 2070.

HOW THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET IS EFFECTING HOMEOWNERS AND COMMUNITIES

The subprime mortgage loans that generate RMBS harm the borrowers, who usually lack effective bargaining power when dealing with sophisticated institutional lenders. The borrower is sucked into a mortgage that he or she will eventually be unable to afford, and the harmful effects of this situation spread far beyond the individual borrower to the entire community. As homeowner after homeowner must foreclose, the abandoned and deteriorating properties "strain city resources and threaten the vitality and stability of neighborhoods."[86]

The national homeowner vacancy rate, which measures how many vacant homes are ready for sale, rose to 2.8% in 2007. Foreclosure filings rose 75% in 2007 to 2.2 million. Unlike the firms on Wall Street, the mortgage field servicing firms that service foreclosed homes are currently experiencing a booming $1 billion business. Mortgage lenders who are foreclosing on a home often hire these firms. "Lenders faced with growing housing inventories they need to sell are pushing servicers to handle more houses, faster, piling on the pressure."[87] Homeowners may encounter difficulties in selling their homes because they must compete with the sale of foreclosed homes in their neighborhoods, which may offer a more attractive price to buyers.

Homeowners have also experienced the noneconomic effects of the subprime mortgage crisis. As the rates of foreclosure rise, animal shelters are filling to their capacities with abandoned pets. Many evicted pet owners are forced into housing that is not pet-friendly.

[86] *Id.* at 2042.

[87] Gwendolyn Bounds, *For This Niche Industry, Foreclosures Bring a Boom*, WALL ST. J, Feb. 19, 2008, at B1.

Luckily, there are a few shelters that are offering temporary housing for evicted pets until the owners are able to take them back in.[88]

HOW THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET IS EFFECTING THE U.S. ECONOMY AND OTHER NATIONS

Investors are now turning away from RMBS. The securities will go bad as more foreclosures occur and people lose their homes. Ironically, the destructive consequences will even reach the investment banks that created the RMBS.[89]

It is clear that the United States economy is hurting from the collapse of the subprime mortgage market. Investment banks are being stingy about making loans because of the current uncertainty concerning the value of collateral. The loosened lending standards are now a thing of the past, because these banks have stepped up demands for more cash and collateral, sometimes in the form of higher interest rates as they restrict the money they are willing to lend.

Investors do have money, but they don't want to invest it because they are nervous about the uncertainties of RMBS; no one is quite sure what price these securities should be trading at and they do not trust anyone to repay a loan.[90] As a result, liquidity has dried up. The markets have effectively shut down because there are no buyers. The meltdown of the subprime mortgage market has caused a detrimental chain reaction within the financial world. A model of this chain reaction begins with financial institution A, which cannot sell its RMBS to the wary investors, and consequently cannot raise enough cash to make the payment it owes to institution B for borrowed funds. In turn, institution B then does not have cash to pay or to loan to

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[88] *See* Karen Datko, *Pets are becoming victims of mortgage crisis*, Feb. 1, 2008, www.msn.com.

[89] *See* Eric Dash and Landon Thomas Jr., *Credit Turmoil Bruised Most on Wall Street, but Pain Was Not Shared Equally*, N.Y. TIMES, Sept. 21, 2007.

[90] *See* Paul Krugman, *Very Scary Things*, N.Y. TIMES, Aug. 10, 2007 and Jenny Anderson, *Hedge Funds Are Squeezed by Investors and Lenders*, N.Y. TIMES, Aug. 20, 2007.

institution C. The effects of this paralysis has spread to the lender's capability to make more traditional home loans, business loans and even to corporate borrowing for billion-dollar leveraged buy-outs. The meltdown has created a general fear of credit quality coupled with a collapse of confidence.[91]

How the subprime mortgage meltdown has already effected the investment banks

In the last quarter of 2007 there were numerous reports of slowdowns, losses, firings, job cuts, and write-offs. The following are cases in point.

- **Goldman Sachs** experienced a vast slowdown in their RMBS business. In the first nine months of 2006 they securitized $55.2 billion of residential mortgages compared to $22.9 billion in the first nine months of 2007. They only securitized $2.86 billion of residential mortgages during the period of June to August of 2007. In this same period in 2006 they securitized $18.63 billion.[92]

- **Bear Stearns** reported that they were cutting 310 jobs from their mortgage origination units. They announced that they would be making risk management a priority over growth.[93]

- **Merrill Lynch** dismissed two senior executives from their fixed-income division, apparently holding them accountable for succumbing too fast to the credit and buyout boom. They also announced a write down of at least $4 billion.[94]

- **Citigroup** wrote off $5.9 billion in the 3rd quarter, causing profits to drop 60%.[95]

The collapse of the subprime mortgage market in the United States led to a credit squeeze that has even constrained global markets, making it difficult for lenders abroad to raise money.

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[91] *See* Edmund I. Andrews, *Few Expect a Panacea in a Rate Cut by the Fed*, N.Y. TIMES, Sept. 3, 2007.

[92] Bloomberg News, *Holding of Debt Securities Falls Again at Goldman*, N.Y. TIMES, Oct. 11, 2007.

[93] Bloomberg News, *Bear Stearns Denies Need to Seek Cash From Outside*, N.Y. TIMES, Oct. 5, 2007.

[94] Landon Thomas Jr., *2 Executives are Ousted at Merrill*, N.Y. TIMES, Oct. 4, 2007.

[95] *Id.*

The rate that British banks charge to lend pounds to each other has soared.[96] In fact, the Bank of England made money available to Northern Rock, a British mortgage lender, because it had trouble securing loans from other banks who were suffering from the meltdown of the American subprime mortgage market.

In recent years, British mortgage lenders, like their American counterparts, began offering loans that exceeded the value of the properties on which they were secured. This easy availability of credit led to increases in property prices and it also fueled speculation in the real estate market. As with RMBS in the United States, this practice has backfired and the lenders now must suffer through the unfortunate but arguably foreseeable consequences.[97] Northern Rock, whose shares dropped 36% to a 7 year low, had relied heavily on raising money in capital markets. Share prices also dropped drastically for other British lenders. Alliance & Leicester shares fell 31% and Bradford & Bingley shares fell 15%. HSBC Holdings (France), Societe Generale (France) and Deutsche Bank (Germany) shares have also declined.

Writedowns due to subprime securities

2008 has brought a new wave of bad news for Wall Street. RMBS have gone from a lucrative financial product to the reason for massive devaluations. Investors in subprime RMBS are suffering losses, and this brings down the value of the securities. The investment banks that have invested in RMBS must devalue these securities by billions of dollars. This process is called a "writedown." The following are examples of the writedowns that are plaguing Wall Street.

- **Citigroup** reported devastating numbers in January. They announced that they would be writing down $22.2 billion, cutting dividends by 41%, and laying

[96] *See* The Associated Press, *No Bank Bailouts, Briton Says*, N.Y. TIMES, Sept. 24, 2007.

[97] *See* Julia Werdigier, *Official Assurances Fail to Stem Rush of Withdrawals at British Bank*, N.Y. TIMES, Sept. 18, 2007.

off at least 4,000 employees. The bank's revenue had fallen 70% and their net income dropped 83%. They also announced that they appointed a chief talent officer, which was a new position that they created, and that they would be reorganizing the company. Analysts predicted that things could get even worse because Citigroup has "heavy exposure to complex mortgage investments." Talks of a recession has resulted in Citigroup executives setting aside billions of additional dollars to cover future losses on "home equity loans, credit card debt and personal loans."[98]

- **Merrill Lynch** reported that it expected to suffer $15 billion in losses related to mortgage investments that went sour. Merrill, like many other firms, are looking to wealthy foreign governments to raise additional capital[99]

- **JPMorgan Chase & Co**. reported that its fourth quarter profit fell 34% due to exposure to subprime mortgages. The firm's net income had fallen to $2.97 billion, which was down from $4.53 billion one year earlier.[100]

- **Credit Suisse Group** reported that its fourth quarter profit fell 72% due to writedowns for investment banking and money-market funds.[101]

WHAT IS IN THE FORECAST FOR THE FUTURE?

It is "impossible to predict what is going to happen with the American economy because of its size and complex nature combined with the intervention of global finance."[102] Still, the forecast for the near future is dim. On the individual level, the falling prices of homes mean that homeowners can no longer borrow against them, and this tightens consumer spending. In turn, businesses will have to cut back in hiring and in giving raises. The Homeowners earnings will not be able to keep up with inflation, and as a result they will no longer be able to afford their monthly mortgage payments. On the financial institution level, more foreclosures mean more

[98] Eric Dash, *Citi Posts $9.83 Billion Loss; Will Cut Jobs*, N.Y. TIMES, Jan. 15, 2008.

[99] Julia Werdigier and Jenny Anderson, *Giant Writedown is Seen for Merrill*, N.Y. TIMES, Jan. 11, 2008.

[100] The Associated Press, *JPMorgan Joins Banks in Writedowns*, N.Y. TIMES, Jan. 16, 2008.

[101] The Associated Press, *Credit Suisse Profit Down on Writedowns*, N.Y. TIMES, Feb. 12, 2008.

[102] Peter S. Goodman and Floyd Norris, *No Quick Fix to Downturn*, N.Y. TIMES, Jan. 13, 2008.

losses and writedowns for the banks, who in turn will not be able to lend as much money as they would have. This slows economic activity across the globe.

Instead of pointing fingers the focus should be on getting out of this mess and getting the economy moving again. Federal Reserve Chairman Ben S. Bernanke noted, "Developments have prompted banks to become protective of their liquidity and balance sheet capacity and thus to become less willing to provide funding to other market participants." The Federal Reserve has been reducing interest rates since September 2007 to make banks feel more secure, but they remain wary of risky borrowers. The most recent cut in March 2008, a response to the fear of a deep recession, "capped the most aggressive Fed intervention in a quarter-century."[103] Because of our large economy, it will take time to see if the rate cuts will provide the desired boost and if any federal legislation (provided that Washington will be able to agree on fiscal policy in an election year with the White House and Congress controlled by two different parties) will provide a solution. In the interim everyone will continue to feel the strain of the subprime mortgage meltdown. Well, not quite everyone; Bank of America announced that it agreed to pay $4 billion to acquire Countrywide Financial. The deal is expected to close in the third quarter, and as borrowers continue to lose their homes due to Countrywide's loose lending practices, the Chief Executive will be entitled to walk away with an exit package of over $70 million.[104]

[103] The Associated Press, *Fed Officials Worried About Recession*, N.Y. TIMES, Apr. 8, 2008.

[104] Graham Bowley and Gretchen Morgenson, *Bank Agrees to Buy Troubled Loan Giant for $4 Billion*, N.Y. TIMES, Jan. 11, 2008.

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Student Capstone Journal
Project No. 07/08-02C

Solving the Subprime Mortgage Crisis

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New York Law School
Class of 2008

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SOLVING THE SUBPRIME MORTGAGE CRISIS

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I. INTRODUCTION

The summer of 2007 became a flashpoint for a monumental financial crisis that had been simmering for years. Beginning in mid-summer, default rates on home mortgages characterized as "subprime" (those debts owed by mortgagors whose credit risk is considered high compared to average mortgagors) escalated well above the expectations of lenders and above the capability of the markets to absorb without significant disruption. The fall out from the high default rates has been dramatic.[1] Investors have lost hundreds of billions of dollars in a few short months, and millions of homeowners throughout the nation are facing the prospect of foreclosure.[2] The causes of this crisis include unprecedented laxness in lending standards resulting from the rise of securitization of mortgage-backed loans, predatory lending practices, and unwarranted optimism about the housing market in general.

This paper focuses on potential solutions and it explores two broad categories of solutions.[3] They are backward looking solutions that seek to help individual and

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[1] *See The Credit Crunch: Postcards from the Ledge*, THE ECONOMIST, December 19, 2007 (describing the crisis as the "shape-shifting menace that has vexed the world in 2007").
[2] *See id*. (estimating that subprime lenders will default on $200-$300 billion of mortgages).
[3] This paper is the third in a series dealing with the subprime mortgage crisis. The first two papers explore the effect of exotic loan products on the collapse of the subprime market and the role of securitization in the subprime market respectively. *See* Ruth S. Uselton, *Exotic Loan Products & the Collapse of the Subprime Mortgage Market*; Amy L. Festante, *Securitization's Role in the Collapse of the Subprime Mortgage Market*.

institutions already in trouble and prophylactic measures that seek to avert a similar meltdown in the future. Underlying both these approaches must be a rigorous analysis of the current crisis aimed at unwinding complex interrelationships between all the players (e.g. home owners, mortgage brokers, mortgage originators and servicers, investment banks and institutional investors such as hedge funds and pension funds). Only by understanding who the players are and what role they each play can a coherent solution be devised.[4] Efforts at unwinding the crisis into its constituent parts have already begun, but they are likely to be ongoing for some time because of the sheer complexity of the financial products that were created using subprime mortgages as a base, as well as the massive scope of the problem both in terms of dollars and the number of people involved.

However, because people and the overall economy are suffering right now, any action that is taken must be taken based on the imperfect information that is already available. That information suggests that many of the people suffering from the effects of the current crisis are at least partly to blame for their own misfortune.[5] Lenders overly relaxed their lending standards because the rising housing market and the growing securitization industry lulled them into believing that no loan was too risky. Investors bought huge pools of mortgages without conducting due diligence to asses the risk that the mortgages would actually be paid. Some of the home owners who are now facing foreclosure were speculators who purchased multiple investment properties gambling that

[4] Alan S. Blinder, *Six Fingers of Blame in the Mortgage Mess*, N.Y. TIMES, September 30, 2007 (saying "[u]ntil we diagnose what went wrong with subprime, we cannot even begin to devise policy changes that might protect us from a repeat performance").

[5] *See generally*, *id*. Blinder assigns blame to home owners who borrowed recklessly, lenders who sold inappropriate loans to customers, bank regulators who failed to ensure that banks followed sound lending practices, investors who failed to adequately scrutinize their investments in securitized mortgage pools; investment banks who devised inscrutably-complex financial instruments using mortgage pools; and the credit rating agencies who helped create the very credit instruments that they then proceeded to rate.

real estate prices would continue to soar. Other home owners knew that they would not be able to afford their mortgage payments without relying on refinancing two or three years down the road. They too gambled that real estate prices would continue rising so as to ensure their ability to refinance.

Thus, the question is to what extent should the government expend taxpayer resources to rescue people from the consequences of their own irresponsible decisions? Perhaps the answer is that the government should do nothing. Any kind of government bail out would force society in general to bear the cost of poor choices made by these individuals. This may be unfair to taxpayers who chose not to gamble on the real estate market but nevertheless will be forced to shoulder some of the fallout. Further, there is concern that a government bail out would create a moral hazard – that is, a willingness on the part of the government to subsidize the cost of risky behavior may encourage more risky behavior in the future. While it is important to keep these concerns in mind, it is equally important to note that society in general is already bearing some of the cost of this crisis and is likely to continue to do so in the future.[6]

The U.S. economy is headed into recession, if it is not already in one, and the causes of the slowdown have their roots in the subprime crisis.[7] Nowhere is this more apparent than in the credit crunch. Lenders are now reluctant to lend money because of the huge losses they are incurring on subprime loans. Borrowed capital is the lifeblood of the economy and without it everything shrivels up: corporate mergers stall; private equity deals disappear; retailers go bankrupt or are forced to close stores throughout the

[6] *See* William Safire, *On Language: Moral Hazard*, N.Y. TIMES SUNDAY MAGAZINE, April 6, 2008 (quoting Treasury Secretary Henry Paulson as saying "[w]e are very aware of moral hazard …but our primary concern right now … is the stability of our financial system, the orderliness of our markets").
[7] *See Latest Economic Tea Leaves Point to Recession*, N.Y. TIMES, April 18, 2008.

country, etc. The lack of capital also contributes to a worsening of the housing market. Borrowers are having a hard time qualifying for loans because of stricter lending standards. Without eligible buyers, home owners cannot sell the homes they can no longer afford and this leads to foreclosures. Foreclosures drive down the price of housing because too many empty homes in a concentrated area open the door to blight and criminality. In other words, forcing people to suffer from their poor choices to ensure that they will not repeat their mistakes is an important factor to be taken into account in any governmental relief effort, but concerns about the fairness to taxpayers of bailing out investors and lenders are misplaced since taxpayers are going to bear some of the cost one way or another.

With that in mind, let us turn to some specific relief efforts. Section II deals with mitigating the harm that has already occurred (i.e. bailing out people and institutions who are already in trouble). Section III deals with prophylactic solutions to prevent a resurfacing of a similar crisis. The prophylactic solutions focus on a better regulatory system at the national and state level. As with any complex regulatory system, significant tensions exist that need to be resolved. For instance, this regulatory scheme will have to balance the need for clear, nationwide regulation with the need to allow space for the traditional role of state level regulation of home lending. The federal government should not preempt state regulation in this field, but neither should it assume that the states will fix the problems on their own. Another significant tension is that between the need for regulation and an awareness that over-regulation is detrimental because it drives up the cost of loans and reduces their availability.

II. Mitigating the harm

A. Federal Efforts at foreclosure relief

1. The Paulson Plan (Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans of the American Securitization Forum).

In light of the Bush administration's enthusiasm for a laissez-faire approach to the economy, it is not surprising that from the onset of the subprime crisis in mid-summer 2007, the President and his top economic advisors, including current Secretary of the Treasury and former chief of Goldman Sachs Henry Paulson, have stressed their belief that the crisis would be resolved not by governmental action but through efforts led by the lending industry itself.[8] The administration's natural disposition to market-based solutions was bolstered by concerns that governmental action would be seen as a "bail out" for irresponsible lenders and borrowers. Such a bail out, it was thought, might provide some quick fixes in the short term but would ultimately reward lenders and borrowers for their irresponsible behavior and thus encourage more irresponsible behavior in the future. In economic terms, the administration was worried that a government bail out for lenders and borrowers would reduce or eliminate the costs of their actions and thus make those actions economically rational because of their benefits, even potential or uncertain benefits. The same concept, known as moral hazard, is also seen in the insurance industry where it is theorized that insured individuals are more likely to take risks because the potential costs of those risks are borne by the insurer.

[8] *See generally, Bush Faults Easy Money for Volatility*, N.Y. TIMES, August 9, 2007 (noting that President Bush and Secretary Paulson viewed the financial turmoil as a natural adjustment from improvident lending practices and that it would sort itself out).

With a somewhat obsessive worry about being seen as bailing anybody out, Secretary Paulson, with the blessings of President Bush, began talks with members of the lending industry. The talks resulted in an agreement in early December sometimes referred to as the Paulson Plan or Project Lifeline.[9] The Paulson Plan is actually an agreement among members of the mortgage industry on a set of guidelines for dealing with the fallout of the subprime crisis and it is similar to a plan recently implemented in California. The agreement was memorialize by the American Securitization Forum in its Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans. The Paulson Plan focuses on the problem of borrowers with adjustable rate mortgages ("ARMs") which are set to adjust upward. This is a significant group of borrowers because of its sheer size. The Federal Reserve Board estimates that approximately 1.8 million subprime ARMs are expected to reset to higher interest rates in the next two years. Approximately 1.2 million of these loans (two-thirds) are held by borrowers who can afford their current, introductory, rates but will not be able to afford higher payments after their loans reset.

Project Lifeline divides these approximately 1.2 million borrowers into three segments. The first segment is comprised of borrowers who are current on their loan payments, meet credit score thresholds and have sufficient equity in their homes to make them likely eligible for refinancing opportunities. These borrowers would generally be able to refinance their homes without government or industry help except for one of the most pernicious characteristics of subprime loans – prepayment penalties.

[9] *See* American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans, Executive Summary*, December 6, 2007.

Lenders make subprime loans based on the following rationale. Some potential borrowers are ineligible for standard ("prime") loans because of their poor credit history. Nevertheless, some lenders are willing to risk lending to these borrowers as long as the lenders are compensated for the extra risk. As a result, subprime loans have higher interest rates than prime loans. Many subprime loans are structured as ARMs with low introductory rates, known as teaser rates, that later reset to a higher rate. During the introductory period, however, borrowers who make timely payments improve their credit scores. In some cases, improved credit scores and a record of timely payments during the introductory period of the loan cause the borrowers to become eligible for prime loans. These borrowers could then refinance their homes and achieve fixed interest rates that are lower than the adjustable rates of their original loans. This is great for the borrowers, but it deprives the subprime lenders of the benefit of collecting at a high interest rate because of their willingness to take a high risk.

As a result, most subprime loan agreements contain a penalty for prepayment of the loan. The prepayment penalty deters borrowers from refinancing by increasing the amount they must borrow in order to refinance the home. In many cases, the penalty raises the amount needed to a level that either exceeds the borrower's equity in the home or exceeds the refinancing bank's loan-to-value tolerance and therefore makes refinancing impossible. For instance, a subprime borrower (A) who owes $200,000 on a home that is worth $225,000 has $25,000 of equity in the home. If A's credit score has improved during the two years he has owned the home because he has been diligent with his payments, he may be eligible to refinance into a prime mortgage. A prime lender could lend A $200,000 with which to buyout A's subprime lender. The prime lender

could be confident in making such a loan because of A's improved credit score and because A's home is worth $25,000 more than the loan amount so that the prime lender is protected by the value of its collateral should A default on the loan. However, if A's subprime loan comes with a 5 percent prepayment penalty, he will need to borrow $210,000 to buyout his subprime loan. This amount represents 94 percent of the home's value and it is likely to exceed the prime lender's loan to value tolerance.

Project Lifeline encourages servicers of loans in this segment to structure refinances to avoid prepayment penalties wherever possible. Servicers are also encouraged to take all reasonable steps to encourage or facilitate refinancing for borrowers in this segment.

The second segment addressed in the Paulson Plan is comprised of borrowers who are current on their loans but are unlikely to be eligible for refinancing because of poor credit scores, low or no equity in their homes or a history of delinquent payments. Under the Paulson Plan, these borrowers are eligible for fast-track loan modification which would freeze the interest rate at the introductory level for up to five years. Because these borrowers are current on their loans, freezing the interest rate at the introductory level, which they are already paying, should keep their payments affordable and thus defer or avoid foreclosure.

The third segment is comprised of borrowers who are not current on loan payments at the existing introductory rate and do not qualify for refinancing. Project Lifeline does little more than pay lip service to the importance of lenders working with these borrowers on a loan-by-loan basis. But, Project Lifeline acknowledges that foreclosure is a realistic possibility for borrowers in this segment. In December, a *New*

York Times article estimated that 22 per cent or nearly 400,000 of the 1.8 million ARM loans that are set to adjust upward in the next two years fall into this third segment.

The National Community Reinvestment Coalition ("NCRC"), an association of community-based organizations that promote access to banking services for working families, is ambivalent about the Paulson Plan. The NCRC agrees that the plan is an important step forward in dealing with the crisis, but expressed dismay over the plan's narrow scope and voluntary nature. NCRC has five specific concerns about the Paulson Plan. First, the plan's success is contingent on the ability of servicers to unbundle loans from securitized pools and then adjust them, but the plan does not address what will compel or motivate investors who hold the securitized pools to allow for unbundling and adjustment. In fact, the plan itself states that servicers will not take any action that is prohibited by the pooling and servicing agreements.

As the plan also acknowledges, some of these agreements contain language that bars or limits adjustments to the mortgages contained in them. The NCRC is right to fault this aspect of the Plan, but it should be noted that while respecting the terms of pooling agreements drastically limits the effectiveness of the Paulson Plan, it is also an inevitable consequence of the Bush administration's insistence on industry-led solutions. Obviously, the mortgage industry wants to limit the number of foreclosures because foreclosures are expensive and inefficient. In that regard, the interests of borrowers and lenders are somewhat aligned, but the industry also wants to protect the securitization market because it has been immensely profitable. As a result, the Paulson Plan treads lightly to the benefit of the industry and the detriment of borrowers. But a much more significant reason for the Plan's refusal to interfere with securitization pool agreements is

simple – the mortgage industry must obey the law and cannot change the law even to solve a crisis affecting millions of people and costing hundreds of billions of dollars. Securitization pooling agreements are legally binding contracts. As a result, no amount of industry-led problem solving can make much headway because the laws must be changed and they can only be changed through governmental action.

The voluntary nature of the Paulson Plan presents another problem according to the NCRC. A plan affecting such a large number of people can only be successful if it is consistently applied throughout the nation. But consistency is not realistically possible for a plan that relies on individual lenders to determine how best to reach out to and engage homeowners.

The NCRC also believes that a five-year rate freeze may be insufficient. Realistically, a rate freeze only defers foreclosure for the duration of the freeze unless the borrower can find a way to afford his or her payments after the freeze ends. For most borrowers, the only way to do so is to refinance into a standard fixed mortgage. The Paulson Plan's rate freeze for borrowers in the second segment is premised on the belief that at some point during the rate freeze home values will start to increase, thus making refinancing possible. The NCRC is more pessimistic about the prospects of the housing market over the next five years because many high-concentration foreclosure areas throughout the nation have experienced double digit price declines in housing. As a result, the NCRC believes that the housing market will need longer than five years to recover to the point where borrowers in the second segment will have a realistic opportunity to refinance.

The fairness of the plan is another area of concern to the NCRC. The plan is pragmatic in that it attempts to resolve the crisis as efficiently as possible – albeit with the inherent limitations of voluntary action already discussed. But the plan does not address the fact that many borrowers ended up in this untenable situation as a result of unfair or predatory lending practices. As a result, the plan forces the victims of such lending practices to continue to pay to the extent that they are able and only then is any form of relief provided to them. Not only is this unfair, in the eyes of NCRC, but it is ill-conceived because it treats the crisis as being primarily the result of regional economic downturns and some speculation on house prices when "excessive mortgage broker fees, irresponsible loan products, inadequate underwriting, bloated appraisals, abusive prepayment penalties, and fraudulent servicing practices have been the major contributor to the foreclosure crisis that is sweeping the nation."

Finally, the NCRC faults the Paulson Plan for not addressing the increasing problem of vacant houses. This problem is two-fold. First, an increase in vacant houses in moderate-income neighborhoods compounds the problem of decreasing home values. It does so because it increases the surplus of available houses and because vacant houses tend to attract vandalism and crime. Second, the NCRC is concerned that investors could buy large numbers of vacant houses in hopes that the housing market will recover. This would result in a shortage of moderate and middle-income housing down the road.

As an alternative to the Paulson Plan, the NCRC suggests that the federal government draw on its own history of successfully dealing with complications in the housing market and implement bold solutions in the vein of the Homeowners Loan Corporation or The Resolution Trust Corporation.The Department of the Treasury

reported that as of mid-February 2008 more than 90 per cent of the subprime servicing market and nearly 70 per cent of the entire mortgage servicing industry agreed to participate in Project Lifeline.[10]

2. The Economic Stimulus Act of 2008 and higher limits on loans that can be purchased or guaranteed by Fannie Mae and Freddie Mac

In early 2008, worries about a possible economic downturn fueled by a continuing softening of the housing market, a tightening of the credit markets as a result of the subprime crisis, and increasing default rates on prime loans, prompted the federal government to consider enacting an economic stimulus plan. Initial reluctance by some members of the administration and Congress to a stimulus plan was overcome when Ben Bernanke, chairmen of the Federal Reserve Board, told some members of Congress that he supported a stimulus plan so long as the measures employed to head off a possible recession were quick and temporary.[11] After some debate, a consensus developed that the crux of any stimulus package had to be tax rebates to most Americans in order to spur consumer spending, which is thought to be crucial to heading off a recession.[12] Thus the bill that eventually emerged, the Economic Stimulus Act of 2008 ("ESA"), provided tax rebates of varying sizes for most American families.[13]

However, a lesser publicized part of the bill provided direct assistance to homeowners in the form of a temporary increase in the size of mortgage loans that Fannie Mae and Freddie Mac can purchase or guarantee.[14] This is important because the

[10] *Full HOPE NOW Alliance Adopts Project Lifeline*, Treasury Press Release February 19, 2008.
[11] *Fed's Chairman Is Said To Back Aid to Economy*, N.Y. TIMES, January 17, 2008, A1.
[12] *Tax Rebate or Payment: A Policy Debate*, N.Y. TIMES, January 20, 2008, A18.
[13] Economic Stimulus Act of 2008, Pub. L. No. 110-185; 122 Stat. 613 (2008).
[14] *See* ESA § 201.

nationwide drop in housing values combined with tightening credit standards have made it difficult for home owners to refinance mortgage payments that they can no longer afford in the private sector. Before enactment of ESA, homeowners with so-called "conforming" loans – that is those loans not exceeding the $417,000 cap – still had the option to refinance through Fannie Mae or Freddie Mac. But homeowners with jumbo loans could not do the same. The temporary increase expands the number of homeowners who can refinance their mortgages and therefore avoid foreclosure. The increase applies only with respect to loans originated between July 1, 2007 and December 31, 2008.[15] The actual maximum dollar amount that Fannie Mae and Freddie Mac may purchase pursuant to ESA is tied to the median home prices in the applicable area and the median home prices are to be determined by HUD.[16]

It may seem that the problems of homeowners with jumbo loans are beyond the scope of a series of papers dealing with the subprime crisis, but the reality is that the previous cap on Fannie Mae and Freddie Mac loan purchases was so low that many home owners in metropolitan areas such as New York were ineligible for refinancing through those agencies. For instance, according to the *New York Times,* the median home price in the New York-White Plains-Wayne, New Jersey metropolitan area was $523,300 in the fourth quarter of 2007.[17] Thus, an owner of a median priced home in New York who made a 10 per cent down payment and financed the rest would have a mortgage of approximately $470,000, making him or her ineligible for refinancing through Fannie Mae or Freddie Mac under the pre-ESA limits. What this means is that in areas with high median home prices, non-conforming jumbo loans were not limited to the wealthy. In

[15] *See id.*
[16] *See id.*
[17] *Washington Lends a Hand*, N.Y. TIMES, February 23, 2008, C1.

such areas, the average home owner had a jumbo loan and therefore the average home owner was ineligible for refinancing through Fannie Mae and Freddie Mac.

Further, the interest rates on jumbo loans have always been slightly higher than the rates for conforming loans because of the fact that help from the federal government was unavailable on the former.[18] But the current difference in interest rates is almost a full percentage point. According to the *New York Times*:

> [f]or a high-priced home, 1 per cent can make a big difference. A monthly payment on a jumbo 30-year loan of $729,000 at 7 percent, would be $4,850. Monthly payments on a conforming loan of the same amount, at 6 percent would be $4,371, a $479 difference.[19]

The new limits will mitigate this problem, but it remains to be seen how much effect they will have. The changes in loan limits went into effect in early March 2008. Some experts, like Gus Faucher, director of macroeconomics at Moody's Economy.com, believe "[o]f all the various strategies proposed to help the housing market, … this one has the greatest potential …"[20]

3. The Fed has cut the Federal Funds rate six times since the summer of 2007

In early July 2007, before the default rates on subprime mortgages reached crisis levels, the Fed Funds rate was 5.25%. By late July or early August, high default rates on subprime loans forced many large banks to realize that they had huge exposure to subprime loans and therefore stood to lose billions upon billions of dollars. As a result, many banks sharply curtailed new loans causing a widespread seizure of the credit markets. The credit crunch not only made it difficult for home owners to refinance and

[18] *See id.*
[19] *Id.*
[20] *Id.*

for prospective home owners to get a mortgage in the first place, it also forced several mortgage lenders into bankruptcy and brought the private equity business temporarily to a screeching halt. The Fed responded by initiating a series of cuts in the Fed Funds rate.

The Federal Funds rate is the rate that private banks charge each other on overnight loans and it is controlled by the Federal Open Market Committee, chaired by Ben Bernanke.[21] The Fed cannot literally set the rate of interest by fiat, but the Fed does control the supply of money. So when the Fed wishes to lower the interest rate the Open Market Committee directs the New York Fed to inject cash into the system by lending money to major dealers in government securities.[22] Conversely, to increase the interest rate, the Committee directs the New York Fed to borrow money from major dealers in government securities. Unlike ordinary banks, the Fed has the exclusive power to create new money. If an ordinary bank were to lend money to another bank, there would be no net increase in the money supply, but when the Fed wishes to decrease the Fed Funds rate, it actually issues new money to lend thereby creating a net increase in the money supply.[23] The net increase in money does not directly affect interest rates, but it increases the liquidity of banks and the only thing that banks can do with liquidity is to lend it. As a result, cash-flush banks will tend to offer loans on terms more favorable to borrowers (i.e. at lower interest rates) because the banks' supply of liquidity will be outpacing the demand for liquidity. Generally then the effect of a decrease in the Fed Funds rate is to stimulate the credit markets.

[21] *The Education of Ben Bernanke*, N.Y. TIMES SUNDAY MAGAZINE, January 20, 2008.
[22] *See Id*.
[23] *See Id*.

The first rate cut came in September. The Fed cut the rate to 4.75%.[24] This was followed by another cut in October, which brought the rate down to 4.5%, and again in December, which brought the rate down to 4.25%.[25] In January 2008, the Fed cut the rate by 0.75% – the biggest rate cut ever – bringing it down to 3.5%. Later in January, the Fed cut the rate down to 3%. Finally, in mid-March the Fed cut the interest rate to 2.25% where it remains as of this writing.[26]

The Fed's efforts seem to have averted a complete seizure of the credit markets, which would have had a devastating effect on the U.S. economy. For instance, private equity deals such as leveraged buyouts continue to go ahead, albeit for much smaller sums than prior to July 2007. But the rate cuts do not appear to have done much to alleviate home foreclosures. The problem is that the softening of the home market, which began long before the credit crunch, has continued. As home values continue to drop, they will eventually fall to the point where home owners actually owe more on their mortgages than their homes are worth. This is not disastrous for home owners who can afford their monthly payments and have no intention of selling in the near future, but the consequences are dire for home owners who hold ARMs that are due to reset to a level at which the monthly payments become unaffordable. This group of home owners must refinance or face foreclosure. However, refinancing is not a realistic option when the mortgage exceeds the value of the home. Banks, even those flush with cash due to a series of rate cuts, are unlikely to lend more than the value of the collateral (i.e. the home).

[24] *See* http://www.federalreserve.gov/fomc/fundsrate.htm.
[25] *See Id*.
[26] *See Id*.

4. Modification of mortgages in bankruptcy

The bankruptcy code of the U.S. provides relief for borrowers who are overleveraged while simultaneously providing a fair procedure through which creditors have an opportunity to collect at least some of the debt owed to them. For homeowners, Chapter 13 protection may allow them to restructure their debt in such a way as to allow them to prevent foreclosure.[27] Section 1322(b)(2) of the bankruptcy code establishes the principle that the rights of creditors are subject to modification by a bankruptcy court.[28] Exempted from this principle, however, are creditors whose claims are "secured only by a security interest in real property that is the debtor's principal residence …"[29] In other words, the rights of mortgage lenders are not subject to modification in bankruptcy. At the time the code was enacted, Congress apparently believed that "mortgage lenders [were] performing a valuable social service through their loans [and] needed special protection against modification thereof...."[30] Chapter 13 does allow home owners to cure defaults and then to continue making payments, thus avoiding possible foreclosure.[31] Thus, the protections of Chapter 13 were adequate in a time when most loans were of the conventional, fixed rate kind. But the inability of bankruptcy courts to modify the underlying rights of creditors is a real obstacle at a time when many foreclosures are the result of ARMs that become unaffordable upon reset. For instance, a court is barred from converting an ARM into a fixed rate loan because such action would be a modification of the creditor's rights. Some scholars argue that "[i]t is time to recognize that a

[27] *See* Henry E. Hidebrand III, *Let's Remove Special Bankruptcy Protection for Subprime Mortgages*, 26-7 ABIJ 14 (2007).
[28] 11 U.S.C. § 1322(b)(2).
[29] *Id*.
[30] *Grubbs v. Houston First American Savings Ass'n, 730 F.2d 326 (5th Cir. 1984).*
[31] *See* Hidebrand, *supra* note 27 at 14.

modification to § 1322(b)(2) could facilitate the preservation of a mortgage for the benefit of both the borrower and the lender."[32]

Some members of Congress agree. There are currently two bills in Congress, one in the House and the other in the Senate, that would do away with the § 1322(b)(2) exception for mortgages in some way. The Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, was introduced by, among others, the Chairman of the House Financial Services Committee, Barney Frank. The bill would completely eliminate the mortgage exception and allow bankruptcy courts to modify the rights of mortgage lenders just as they would any other creditor. The Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, was introduced into the Senate by, among others, New York's senior Senator Charles Schumer. This bill would preserve a general exception to the ability of bankruptcy courts to modify the rights of mortgage lenders, but allow courts to modify those rights where, after certain permissible deductions from the borrower's income, he or she has insufficient monthly income to retain possession of the home by curing a default and maintaining monthly payments. In such cases, the bill would allow the court to convert the mortgage into a 30-year fixed-rate mortgage.

Considering the devastating consequences of foreclosure for a home owner, as well as the economic losses that foreclosures impose on lenders, allowing bankruptcy courts to modify mortgages at least in some cases may be an important step in solving the subprime crisis.[33]

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[32] *id*. at 34.
[33] *See id*.

B. Mitigating the harm to investors

As discussed above, the largest single phenomenon that gave rise to explosive growth in the subprime mortgage industry and to its current crisis is the practice of securitizing home mortgages. Securitization is a process whereby a bank or other company that originates mortgage loans bundles hundreds or even thousands of mortgage loans together into pools and either sell the pools outright to investors or issues debt collateralized by pools. Conceptually, securitization is good for the originators and the investors who either buy or lend based on the securitized mortgage loans. When the mortgage loan pools are sold, they are sold for a price that is high enough for the originator to recoup its capital and make a modest profit. However, the price is low enough that the investors buying the pools will ultimately profit when the underlying mortgagors repay their loans (principal debt plus interest). When the mortgage loan pools are used as collateral, they act as a guaranteed income stream for the debtor upon which the lender can take a security interest to ensure against the risk that the debtor will default.

Securitization of mortgage loans became increasingly popular in recent decades as loan originators realized that by employing a securitization business model they could recoup their capital much quicker than they could through the traditional lending model, which required the originator to hold a loan for its entire life. Since most home loans have a term of thirty years, the traditional model of home lending left originators waiting to recoup their capital for decades. By contrast, originators using a securitization model can recoup their capital within days of making the loan. The length of time an originator must wait to recoup its capital is significant because it directly affects the volume of

loans it is able to make. Originators relying on a traditional home lending model are able to make many fewer loans than originators relying on a securitization model because the latter have more free capital. In addition to the profit that originators generate from selling their mortgage loan pools, they also generate substantial profit by charging various origination fees in connection with each new home loan. Therefore, securitization, by freeing up more capital and thereby allowing originators to make more loans, also increases the profitability of originators. This explains why the practice has become so widely popular. In fact, securitization has created a market for mortgage companies such as Countrywide. These mortgage companies rely on the vast amount of capital they are able to generate through securitization in order to make as many home loans as possible. They cannot survive without making a large number of new home loans constantly; therefore they could not exist if they had to rely on the traditional home lending model. The securitization model is also advantageous to borrowers because it increases the volume of home loans being made.

However, the securitization model is premised on one assumption, without which the entire industry would collapse. That assumption is that the underlying mortgagors will pay their debts or at least that the level of defaults will remain within a forecasted range. The importance of this assumption cannot be overstated. Investors buy these mortgage loan pools fully expecting that X number of mortgagors will pay Y dollars over the life of the loans to yield Z return for the investors. Without that assumption, the investors would not buy the mortgage loan pools and originators would be forced to retain their home loans. As a result, many originators would suffer significant losses or even go out of business.

The reliability of this key assumption, at least in situations where mortgage loan pools act as collateral for debt offerings, has been left in the hands of the three credit rating agencies, Moody's Investor Service, S&P, and Fitch Ratings. These agencies serve as gatekeepers by evaluating the risks of debt offerings. When the debt offerings are collateralized by mortgage loan pools, an important element of the credit rating agencies' job is to determine the credit risk of the mortgages comprising the pools. Unfortunately, investors have been surprised recently by losses in investments that received high credit ratings from the agencies. Many of these losses are associated with unexpectedly high default rates by mortgagors. In some cases, the default rates are unexpected because investors did not realize the extent to which the mortgage loan pools they invested in were comprised of subprime loans.

The fact that a substantial number of debt offerings backed by mortgage loan pools containing a high percentage of subprime loans have wreaked havoc in the financial markets over the last six months suggests that regulation is needed to force the credit rating agencies to take their gate keeping role seriously. In a *Wall Street Journal* article, Arthur Levitt, Jr., a former chairman of the Securities and Exchange Committee ("SEC"), described the problem with the credit rating agencies by saying that they "are playing both coach and referee in the debt game."[34] The agencies rate the very same companies that are paying their fees. Because of this, the agencies have a considerable interest in ensuring that the debt offerings of their clients are marketable. That is that the debt offerings receive an acceptable rating. Mr. Levitt compared the conflicts of interest of the credit rating agencies to the conflicts of interest of auditing firms of the Enron era

[34] Arthur Levitt Jr., *Conflicts and the Credit Crunch*, OPED, WALL STREET JOURNAL, September 7, 2007.

scandals. Just as the accounting firms were held to account by Congress, primarily through the Sarbanes-Oxley Act, Mr. Levitt suggested that the credit rating agencies must be held accountable.

A good start, according to Mr. Levitt, is the Credit Rating Reform Act of 2006 ("CRRA").[35] The CRRA is primarily a registration act which requires all "nationally recognized statistical rating organizations (NRSROs)" to register with the SEC. Each NRSRO must describe its procedure and methodology for issuing credit ratings in its application for registration. After the initial registration, all NRSROs must file an annual report with the SEC either certifying that there have been no material changes to their procedures and methodology for issuing credit ratings, or a list detailing the material changes. The CRRA grants the SEC exclusive enforcement authority over any NRSRO that issues credit ratings in contravention of its own procedures and methodologies. But, the act explicitly prohibits the SEC or any state or local government from regulating either the substance of any credit rating or the procedures and methodologies to be used. In other words, the act only goes so far as to give the SEC authority to ensure that the NRSROs obey their own rules. In addition, the act requires that NRSROs establish and enforce a written policy and procedure on managing conflicts of interest.

Mr. Levitt argued that the CRRA is only a first step. In order to address the problem seriously more oversight is needed. For one thing, he noted that the CRRA's prohibition against regulations judging the quality of the standards by which the agencies issue credit ratings is similar to the oversight in place for auditors pre-Enron. Mr. Levitt encouraged Congress to pass legislation that would in his view make the credit rating

[35] Pub. L. No. 109-291, 120 Stat. 1337.

agencies more reliable. First, he noted that the SEC needs the power to set standards for issuing credit ratings and the power to discipline credit rating agencies that deviate from those standards. Next, Mr. Levitt argued that individuals who work for a credit rating agency and help a firm structure a financial instrument should be prohibited from going to work for that firm for at least one year. This proposed rule is similar to a requirement imposed on auditors by Sarbanes-Oxley. Mr. Levitt noted that the rule is necessary in order to foster independence among the employees of the credit rating agencies. Another of Mr. Levitt's suggestions is that transparency in the credit rating industry be increased by requiring companies who are issuing debt to disclose any services a credit rating agency has provided in connection with the issuance and rating including any consulting or structuring of the transaction and the amount of fees related to those services that were paid to the credit rating agency.

Mr. Levitt also said that holding credit agencies liable for "malfeasance that is more than mere negligence" would be advantageous. He admitted, however, that this suggestion is more controversial than his other suggestions because the credit rating agencies are likely to claim that their ratings are a form of constitutionally protected speech. Mr. Levitt discounted this argument however, because he claimed that any First Amendment claim based on ratings of structured financial products that the agencies themselves helped to create would be very weak.

Since the credit rating agencies play a pivotal role in ensuring the reliability of the unique operational assumption that allows the securitization industry to function (that debtors will pay their debts), oversight along the lines suggested by Mr. Levitt is crucial

to restoring the integrity of an industry whose health is vital to the overall health of the U.S. and world economies.

Mr. Levitt's article made one final commonsense observation that merits discussion. Investors themselves, especially large institutional investors, should consider this summer's financial crisis as a wake up call for them to play more of an active role in evaluating the risks of their investments. The credit rating agencies offer a guide, not a stamp of approval.

III. Preventing a resurfacing of the subprime crisis

A. Federal efforts

A central concern among advocates for home owners has been that weak federal legislation might be enacted. Advocates fear that a weak federal law would be worse than no federal action because any federal legislation in this area could preempt state laws that in some cases, especially in states like New York and California, already provide strong protection for borrowers. A recent bill introduced by the chair of the Senate Banking Committee, Sen. Christopher Dodd (D-Conn.) has allayed some of the fear. The proposed Homeownership Preservation Act of 2007 ("HPA")[36] provides strong protection for borrowers and, critically, it contains a clause that explicitly precludes federal preemption.[37] Courts are instructed that the bill and regulations promulgated under it are to be deemed supplemental to relevant state laws and are "not to be interpreted as preempting state laws that provide equal or greater protection."[38] HPA's strong protections for borrowers and lack of preemption have won it the endorsement of the

[36] S. 2452.
[37] *See* HPA § 801(b).
[38] *Id*.

NCRC, which in an email to its members noted that "[t]his legislation offers the most meaningful protections yet. It includes some of the strongest language we have seen and incorporates a number of significant provisions NCRC members and allies called for."

The bill divides borrowers into three broad groups and provides certain protections on a categorical basis. Title III of HPA includes all home loan borrowers and it imposes certain duties on mortgage originators[39] and mortgage brokers.[40] Mortgage originators, under the HPA framework, are charged with five affirmative duties. They are to safeguard and account for any money handled for the borrower; to follow reasonable and lawful instructions from the borrower; to act with reasonable skill, care, and diligence; to act in good faith and with fair dealing in any transaction, practice, or course of business in connection with the originating of any home mortgage loan; and to make reasonable efforts to secure a home mortgage loan that is appropriately advantageous to the borrower, considering all of the circumstances, including the product type, rates, charges, and repayment terms of the loan.[41] In addition, HPA prohibits originators from "steering" borrowers into loans that are more expensive than the least costly loan for which a particular borrower qualifies.[42] In cases where an originator does not offer the loan that is the least costly for a particular borrower, the originator is required to disclose the fact to the borrower and indicate that other originators may offer such a loan.

[39] The term "mortgage originators" is defined in § 2 of HPA as "any creditor or other person, including a mortgage broker, who, for compensation or in anticipation of compensation, engages either directly or indirectly in the acceptance of applications for home mortgage loans, solicitation of home mortgage loans on behalf of consumers, negotiation of terms or conditions of home mortgage loans on behalf of consumers or lenders, or negotiation of sales of existing home mortgage loans to institutional or noninstitutional lenders. It also includes any employee or agent of such person."
[40] The term "mortgage broker" is defined in § 2 of HPA as "a person who, for compensation or in anticipation of compensation, arranges or negotiates or attempts to arrange or negotiate home mortgage loans or commitments for such loans, refers applicants or prospective applicants to creditors, or selects or offers to select creditors to whom requests for credit may be made."
[41] *See* HPA § 301(a).
[42] *See* HPA § 301(c).

These duties, particularly the duty to make efforts to secure a loan that is "appropriately advantageous to the borrower" attempt to address what is perceived to be one of the underlying causes of the subprime crisis – a lack of attention on the part of lenders to the ability of borrowers to pay back their loans. Apathy on the part of lenders resulted from the nature of the securitization business because most loans are no longer kept on the books of the originator. Instead they are securitized and sold in bundles to investors.[43]

In addition to imposing affirmative duties on mortgage originators, HPA also explicitly requires that originators base their determination that a potential borrower can afford a loan on documentation of a potential borrower's ability to pay back the loan.[44] For example, mortgage originators must verify all of a potential borrower's sources of income by examining his or her tax returns, payroll receipts, bank records, or other appropriate documentation.[45] The originator's determination must also be based on the borrower's debt-to-income ratio.

The affirmative duties imposed on mortgage brokers are more succinctly stated but, in some sense, even stricter than those imposed on originators. For instance, HPA deems a fiduciary relationship to exist between a broker and borrower in every home mortgage loan.[46] In essence, a fiduciary duty means that all brokers are required to use the utmost good faith in dealing with borrowers and to put the interests of borrowers above all other interests, including the broker's own interest.[47] HPA also requires that

[43] *See generally,* Festante, *supra* note 3.
[44] *See* HPA § 301(d).
[45] *See id.*
[46] *See* HPA § 301(b).
[47] *See id.*.

brokers clearly disclose to all borrowers the total compensation that a broker would receive from each of the loan options presented to a borrower, as well as any other information that could materially affect a borrower's ability to obtain his or her intended benefit from the loan.[48]

A second category of borrowers is described in Title I of HPA. These are borrowers with "high-cost mortgages." A high-cost mortgage is defined to mean, for a first mortgage, a consumer credit transaction secured by a principal dwelling where the annual percentage rate ("APR) of interest will exceed the yield on U.S. Treasury securities having comparable periods of maturity by more than 8 per cent at the time the transaction is consummated.[49] For a junior mortgage, the term is applicable where the APR exceeds the applicable yield on U.S. Treasury securities by more than 10 per cent. Alternatively, whether a home loan is a high-cost mortgage can be determined with reference to the total points and fees payable in connection with the loan. For a loan of $20,000 or more, a high-cost mortgage is one where the applicable total points and fees exceed 5 per cent of the total loan amount.[50] For a loan of less than $20,000, a high-cost mortgage is one where the applicable total points and fees exceed the lesser of 8 per cent of the total loan or $1,000.[51]

Since the protections of Title III of HPA are applicable to all home loans, the protections for borrowers with high-cost mortgages supplement the already significant baseline protections afforded to all borrowers. The first and most controversial protection offered by Title I is that it prohibits prepayment penalties in connection with high-cost

[48] *See id.*
[49] *See* HPA § 101(a).
[50] *See id.*
[51] *See id.*.

mortgages.[52] As discussed above, prepayment penalties play an important role in whether or not a borrower is able to refinance his or her mortgage. As a result, elimination of, or curtailment of, prepayment penalties has been a cornerstone of advocacy policy for groups like NCRC.

Another pernicious "exotic" loan technique that advocacy groups have decried is the balloon payment. A loan with a balloon payment requires a series of, typically affordable, payments, but then requires a large payment that far exceeds the other payments. Balloon payments can cause a borrower to default on his or her loan either because the balloon payment was not clearly disclosed so that it comes as a surprise or because the borrower erroneously believed that he or she would be able to refinance the mortgage before the balloon payment became due. HPA does away with balloon payments for high-cost mortgages by prohibiting, in most cases, any scheduled payment that is more than twice as large as the average of all other previously scheduled payments.[53]

HPA contains several other specific protections for high-cost mortgages such as prohibiting the acceleration of debt by the lender except in cases of default or breach of a material provision of the loan[54] and prohibiting structuring a loan with the deliberate aim of avoiding the requirements of HPA.[55] But more significantly, HPA prohibits mortgage originators from making a high-cost mortgage loan that involves refinancing a pre-existing home mortgage loan unless the new loan will provide a "net tangible benefit" to the borrower. This final protection for borrowers with high-cost mortgages underscores

[52] *See* HPA § 102(a).
[53] *See* HPA § 102(b).
[54] *See id.*
[55] *See id.*

the main thrust of HPA, which is to require mortgage originators and brokers to put the best interests of borrowers above their own best interests.

The final category of borrowers that are afforded special protection by HPA are subprime borrowers. The protections for such borrowers are laid out in Title II. A subprime mortgage loan is defined to mean a home mortgage loan in which the APR exceeds the greater of two thresholds.[56] The first threshold is called the Treasury security rate spread. Under this threshold a home mortgage loans is subprime if the difference between the APR on the loan and the yield on U.S. Treasury securities with comparable rates of maturity exceeds 3 per cent on a senior loan or 5 per cent on a junior loan. The second threshold is called the conventional mortgage rate spread. Under this threshold a home loan is subprime if the difference between the APR on the loan and the annual yield on conventional mortgages is equal to or greater than 1.75 percentage points for senior loans or 3.75 percentage points for junior loans.[57]

HPA imposes a general requirement on originators to determine whether or not a particular borrower has an ability to pay a given subprime or other nontraditional loan prior to entering into the transaction.[58] To that end, HPA lays out a series of factors that an originator must consider when determining a borrower's ability to pay. These factors include the borrower's income, the borrower's credit history, the borrower's other debt payments and obligations, and the borrower's current employment status, as well as other factors.[59] Interestingly, HPA contains a rebuttable presumption that the loan was made without regard to payment ability if at the time the loan was made the total monthly debts

[56] *See* HPA § 2.
[57] *See id.*
[58] *See* HPA § 201(a).
[59] *See id.*.

of the borrower exceeded 45 per cent of the borrower's total monthly gross income.[60] Title II also bars prepayment penalties on subprime loans and imposes the same net tangible benefit requirement as Title I with respect to subprime loans that refinance a home mortgage loan.

B. State efforts

1. The Nationwide Mortgage Licensing System (NMLS)

Forty-two states, including New York, have indicated their intent to require individual mortgage loan originators to be registered with the state and certified to conduct business. According to Richard H. Neiman, the New York Superintendent of Banks, New York's participation in this effort "is a testament to our commitment to reducing mortgage fraud and identifying individuals who attempt to evade enforcement by simply migrating across state lines."[61] Of the forty-two states, fifteen plan to use the NMLS online system to register and track mortgage loan originators.[62] Seven of these states have already enacted legislation mandating the use of NMLS. New York is one; article 12-E of the New York Banking Law went into effect on January 1, 2008 requiring all new applications for certification as a mortgage loan originator to be processed through NMLS.[63] Mortgage loan originators who were previously certified must begin transferring their certification information onto NMLS. In addition to registering with NMLS, mortgage loan originators are required to submit supplementary documents

[60] *See id.*
[61] NYS Banking Department press release Dec. 19, 2007.
[62] *See* http://www.stateregulatoryregistry.org/NMLS/AM/Template.cfm?Section=Participating_States1.
[63] *See id.*

directly to the Banking Department. These documents include fingerprints, credit history, and other documentation related to financial and criminal history.[64]

The New York law instructs the superintendent to determine if the "general character and fitness and the education qualifications of the applicant are such as to warrant belief that the applicant will engage in mortgage loan originating honestly, fairly, and efficiently."[65] The superintendent is to make this determination based on one or more of four grounds.[66] These include whether the mortgage loan originator has been convicted of certain crimes involving an activity which is a felony involving theft or fraud.[67] In addition, the superintendent may refuse to issue a certification if the mortgage loan originator has had a similar authorization revoked by banking regulators in another state.[68] The superintendent may also decide not to issue a certificate to managers or employees of entities who had certifications revoked by regulators in other states.[69]

In principle, NMLS would facilitate the superintendent's task by centralizing relevant information about applicants. However, because only seven states are currently using NMLS, its benefit will be limited for the foreseeable future. As the database grows, so will its usefulness, but New York need not wait for other states to implement the system before beginning to reap the benefits. Article 12-E mandates that by 2010 the transition to NMLS be completed. Therefore, in a few short years banking regulators in New York will have all the registration information for every mortgage loan originator in the state at their disposal in one centralized database. Regulators in other states could also

[64] *See* NY CLS Bank § 599-c (2008); 3 NYCRR § 420.4; 3 NYCRR SP MB § 107.
[65] NY CLS Bank § 599-c(2).
[66] NY CLS Bank § 599-c(3)(a).
[67] *See id.*
[68] *See id.*
[69] *See id.*

benefit significantly from New York's transition to NMLS. States that intend to participate in NMLS but have either not yet begun or not yet completed their transition to the system will still have access to the database, which means that regulators in those states will be able to gauge the reliability of prospective mortgage loan originators coming to their states from New York. Considering the sheer number of banks and individual mortgage originators that operate in New York – with estimated aggregate assets in excess of $1.8 trillion[70] – regulators from other states will benefit greatly by having access to NMLS.

2. HALT Task Force

In March 2007, then Governor Spitzer created an interagency task force charged with halting abusive lending transactions. HALT is chaired by Superintendent Neiman and on December 13, 2007 he testified before the state senate and gave an update on its progress.[71] Neiman said that HALT's first priority was the collection of data to begin quantifying the level of the problem in New York. Specifically, HALT has so far identified patterns in higher-cost or subprime lending in New York; the rate of delinquency for subprime products statewide; and the counties most impacted by escalating foreclosures.[72]

In order to identify patterns in subprime loans, HALT examined so-called "higher-cost" loans, which are those where the APR exceeds the rate on the treasury security of corresponding maturity by 3 per cent for a first lien and 5 per cent for a subordinate lien. Such loans account for less than 30 per cent of all loans statewide, but

[70] New York Banking Department press release December 19, 2007.
[71] Testimony of Richard H. Neiman on "Subprime Mortgages and Foreclosures in New York" before the Committee on Banks, New York State Senate, December 13, 2007 (Hereinafter Neiman Testimony).
[72] *See id.* at 2.

the number is increasing. According to Neiman, in 2005, higher-cost loans accounted for 25.04 per cent of new loans but by the end of 2006 the number had crept up to 27.87 per cent.[73] Although the increase appears marginal, it is expected to increase. Moreover, higher-cost loans are not evenly distributed among categories of borrowers. Neiman noted that HALT's research confirmed several external studies finding that minority borrowers and minority communities receive higher-cost loans at a disproportionate rate.[74] For instance, statewide for every one borrower in a neighborhood with a low minority population who obtained a higher-cost loan in 2006, two borrowers in high-minority neighborhood received a higher-cost loan. In some counties the disparity was even greater. In Westchester County the disparity was more than 4 to 1; in New York County the disparity was almost 4 to 1; and in Kings County the disparity was almost 3 to 1.[75] According to Neiman, a big concern with disparities such as these is "whether overqualified minority borrowers are being discriminated against and steered into higher-priced loan products."[76]

HALT also examined the delinquency rates on subprime loans in New York and compared those rates to the delinquency rates on subprime loans throughout the country. With respect to fixed rate subprime loans, New York fared slightly better than the national average with 6.28 per cent of these loans being more than ninety days past due compared with 6.61 per cent nationwide. However, with respect to subprime adjustable rate mortgages, New York's delinquency rate was almost two full percentage points

[73] *See* Neiman Testimony at 2.
[74] *See id*. at 3.
[75] *See id*. at 3-4.
[76] *Id*. at 3.

higher than the national average (17.59 per cent for New York compared with 15.63 per cent nationwide).[77]

Finally, HALT examined the foreclosure rates in New York and compared them to nationwide rates. The percentage of subprime fixed rate mortgages in New York that were in foreclosure was 3.39 while the nationwide rate was slightly lower at 3.12. The percentage of subprime ARMs in foreclosure was 13.25 while the nationwide rate was 10.38.

The significantly higher rate for delinquencies and foreclosures for ARMs is especially disturbing, according to Superintendent Neiman, because more than 25 per cent of New Yorkers with subprime ARMs had FICO scores of 660 and above, which indicates that they may have qualified for more affordable, fixed-rate loans.[78]

Unfortunately, HALT predictions, as well as national predictions, indicate that the subprime meltdown will continue to worsen in waves over the next several years as more and more ARMs reset to higher interest rates. HALT proposed some potential legislative solutions to this problem, but there are also several steps that HALT recommends for individuals who are facing imminent foreclosure. The first and most crucial step is for a delinquent borrower to contact his or her lender or servicer as quickly as possible.[79] The servicer or lender is in a position to modify the loan and is often willing to negotiate a workout arrangement that will not only prevent foreclosure but will preserve the borrower's credit history. Second, troubled borrowers should contact the New York State Banking Department in order to speak with specially trained staff who can help

[77] *See id.* at 3-4.
[78] *See id*. at 5.
[79] *See id.* at 7.

borrowers file a complaint against their lenders or refer borrowers to appropriate service providers.[80]

HALT also recommends that troubled borrowers contact certified housing counselors who can provide advice on options and resources for dealing with debt.[81] Borrowers should also obtain independent legal advice, according to HALT. This is so because an attorney can review a borrower's loan documents to ensure that the loan does not violate any anti-predatory lending laws.[82]

In addition to these general suggestions for troubled borrowers, HALT has engaged in more detailed outreach and consumer counseling initiatives.[83] For example, HALT has been holding day-long summits across New York to address the unique problems in different regions of the state. In addition, HALT participates in a public service ad campaign organized by a group called NeighborWorks America. HALT also participates with other state agencies in a 40-year fixed rate loan program, which offers loans with low, fixed monthly payments to borrowers, as well as the "Keep the Dream" program, which created a $100 million fund for use in offering refinancing options to eligible subprime borrowers facing a mortgage hardship.[84]

The HALT task force is also working to develop a legislative proposal that would require more in-depth evaluation of a borrower's ability to repay, prohibit certain loan practices, clarify mortgage brokers' duties to borrowers, and further strengthen state

[80] *See id*. For assistance call 1-877-BANK-NYS.
[81] *See id.* A list of certified housing counselors may be obtained at http://www.banking .state.ny.us/legal41ac.htm
[82] *See id*. The New York Bar Association's Lawyer Referral Program can be reached at 1-800-342-3661. The Banking Department may also be able to offer assistance in locating free legal services for borrowers who cannot afford legal fees.
[83] *See id.* at 8.
[84] *See id.* at 9.

enforcement tools.[85] These goals appear broadly similar to those proposed at the federal level through the HPA. Importantly, should HPA become law it will not limit New York's ability to set even higher standards because HPA explicitly does not preempt state action.

[85] *See id.* at 10.

IV. Conclusion

The subprime crisis has affected interests as varied as the capitalization needs of the largest banks in the world on the one hand and the tight monthly budget of middle class families on the other hand. There are few "bad guys" because many of the victims played a role in bringing about their own predicament. For that reason some critics have suggested that the government should take a laissez-faire approach and let the chips fall where they may. However, the scope of this crisis makes such an approach both unwise and politically impossible. The losses from the crisis already number in the hundreds of billions of dollars and they continue to mount. Millions, maybe tens of millions, of foreclosures have already occurred or are looming. As we have seen, the crisis is already causing a slowdown in the U.S. economy. Without some form of governmental action, things could get progressively worse. Moreover, a democratically elected government – composed of individuals who hope to be reelected – simply cannot let so many of its citizens twist in the wind without taking some concrete steps to help.

The proposed solutions discussed above are a good start. Many more solutions are also in the works as this is a very dynamic topic. So long as the government remembers that any proposed solution must attempt to reconcile the interests of lenders, homeowners and taxpayers, as well as balance the need for uniform, clear federal solutions with independent solutions by the states we will be able to put this crisis behind us and hopefully learn from our mistakes.