DEVELOPMENTS IN BANKING AND FINANCIAL LAW: 2006-2007

THE SUBPRIME MORTGAGE CRISIS

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I. Staff Introduction

The collapse of the subprime mortgage market that began in mid- to late-2007 was one of the most significant economic events in nearly a century, and it will likely be some time before the extent of its effects can be accurately assessed. The following pieces—which attempt to summarize, evaluate, and scrutinize this complex crisis—were written with the ground moving under the writers' feet, as is all timely commentary. These articles do not reflect events occurring much beyond late October 2008, and of course significant events have occurred since.

Nevertheless, our hope is that this commentary will benefit the reader—including one many years removed from 2007—in two main ways. First, by presenting the reader thorough and detailed analysis that remains salient, and, second, that the articles here act as a window into the debates, confusion, fog, guesses, and mistakes of a tumultuous time. We hope you agree.

II. Overview of the Subprime Mortgage Market

A. Introduction

There are three common types of mortgages: prime, alt-A, and subprime.[1] Prime mortgages are for those with good credit, while Alt-A mortgages are for those who have good credit but fail to verify their income or have high debt-to-income ratios.[2] A subprime mortgage is made to high-risk borrowers who typically have poor credit histories.[3]

The "life" of a subprime mortgage is similar to other mortgages. First, a borrower works with a broker or a lender to get a home loan.[4] To determine which type of loan is appropriate, lenders use loan risk grades based upon past payment behavior, history of bankruptcy, debt-to-income ratios, and income verification.[5] The mortgage amount is determined by the borrower's credit score and the size of the down payment.[6] The lender funds the loan via credit from an investment bank and then sells the loan to the investment bank.[7] The investment bank then "packages" or "pools" the loans into securities backed by these pools of mortgages.[8] Finally, the investment bank sells the loans to investors,[9] such as hedge funds. Investment banks sort their loans by risk. Higher-risk mortgages tend to lead to the most defaults, but they also offer the highest return.[10] Investors purchase loans based on how much risk they are willing to endure to maximize return.[11]

The problem with the subprime mortgage market is that lenders, borrowers, and investors underestimated the underlying

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[1] Sumit Agarwal & Calvin T. Ho, *Comparing the Prime and Subprime Mortgage Markets*, CHI. FED. LETTER, Aug. 1, 2007, at 1.
[2] *Id.* at 2.
[3] Edmund L. Andrews, *Bill Allowing Mortgage Lawsuits Expected to Stir Fierce Opposition*, N.Y. TIMES, Oct. 23, 2007, at C1.
[4] Michael Hudson, *Debt Bomb—Lending a Hand: How Wall Street Stoked the Mortgage Meltdown—Lehman and Others Transformed the Market for Riskiest Borrowers*, WALL ST. J., June 27, 2007, at A1.
[5] Agarwal, *supra* note 1, at 1-2.
[6] *Id.* at 2.
[7] Hudson, *supra* note 4, at A1.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*

mortgages' default rates.[12] Moreover, even these sophisticated investors failed to predict a fall in housing prices, and in particular one that would leave many borrowers with negative equity—the situation where one owes more than their home is worth.

B. A Brief History of the Subprime Market

The subprime mortgage market gained significance in the late 1970s with the invention of mortgage-backed securities.[13] This innovation allowed mortgages—illiquid assets—to be traded like stocks and bonds.[14] Until the mid-1990s, however, mortgage-backed securities were made up of mainly loans to borrowers with good credit.[15] Investment banks found that they could securitize riskier loans to borrowers with poorer credit by pooling loans together to diversify the risk.[16]

Several factors contributed to the rapid growth of the subprime mortgage market in recent years. First, investors relished the high-yielding securities produced by the high interest rates accompanying these loans.[17] Second, the advent of securitization led to mortgage originators joining the brokerage industry, and soon unregulated non-banking organizations joined into the new lucrative practice.[18] The distancing of borrowers from lenders along with the introduction of unregulated companies eventually led to lower lending standards.[19] In 2006, "more than thirty-seven percent of subprime loans were made without verification of borrowers' incomes."[20] Additionally, new technology made it cheaper and easier for lenders to facilitate subprime mortgages.[21] Lenders are now able to more quickly collect information on prospective

[12] Tracy Coenen, *Commentary: A Look at the Subprime Mortgage Problem*, WISC. L.J., Aug. 27, 2007, at 1, *available at* 2007 WLNR 1688090.
[13] Roger Lowenstein, *Subprime Time*, N.Y. TIMES, Sept. 2, 2007, at 11.
[14] *Id.*
[15] Hudson, *supra* note 4, at A1.
[16] *Id.*
[17] *Id.*
[18] Lowenstein, *supra* note 13, at 11.
[19] *Id.*
[20] Vikas Bajaj, *For Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007, at C1.
[21] Ben S. Bernanke, *The Subprime Mortgage Market* (2007), http://www.federalreserve.gov/newsevents/speech/Bernanke20070517a.htm.

borrowers and are better equipped to use this information to determine rates and underwriting standards, and to manage risks.[22]

Furthermore, the Federal Reserve cut interest rates during the 2001 recession, thus providing easier credit to lenders, which allowed them to expand their lending capabilities to a more diverse pool of borrowers, such as those with poor credit.[23] Specifically, lenders began offering "2/28" subprime loans which carry adjustable interest rates that remain low for the first two years—a "teaser rate" —but then jump several percentage points.[24] The obvious assumption underlying such adjustable-rate-mortgages was that housing prices would continue to rise indefinitely. Lenders made subprime loans at an exponential rate.[25] By 2006, originations of subprime mortgages rose to $600 billion, up from $160 billion in 2001.[26] That figure equates to "twenty percent of all mortgage originations in 2006, up from six percent in 2002."[27]

C. The Subprime Mortgage Meltdown

Until recently, delinquency rates[28] on subprime mortgages remained low.[29] Rising home prices[30] over the past few years gave borrowers options to avoid foreclosure if they fell behind in payments: borrowers could easily refinance to obtain more affordable payments or build up home equity, allowing them to sell back their home to pay off the principal.[31]

When home prices stopped rising in August 2006, however, such options evaporated and borrowers began defaulting on their

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[22] *Id.*
[23] Greg Ip & Jon Hilsenrath, *Debt Bomb: Inside the 'Subprime' Mortgage Debacle—Seeds of Excess: How Credit Got so Easy and Why It's Tightening—Responses to S&L Mess, Asian Crisis, Tech Bust All Fed Into the Boom*, WALL ST. J., Aug. 7, 2007, at A1.
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] Agarwal, *supra* note 1, at 2.
[28] Deborah Blumberg, *Subprime-Mortgage Woes are Ties to Home Prices*, WALL ST. J., June 13, 2007, at B10A ("[D]elinquency rate is defined as the percentage of subprime loans that are delinquent for more than sixty days.").
[29] Ip, *supra* note 23, at A1.
[30] *Id.*
[31] Blumberg, *supra* note 29, at B10A.

loans at an alarming rate.[32] At the end of 2006, over 2.6 million home loans were either past due or in foreclosure, forty percent of which were subprime loans.[33] This equates to thirteen percent of all subprime loans being delinquent, up from ten percent during the previous few years.[34] This has led to twice as many foreclosures during the past two years than in prior years.[35] It is predicted that this trend will continue as more subprime mortgages are adjusted to even higher interest rates and home prices continue to fall.[36] Over $330 billion in subprime loans are at risk of going into default in the near future,[37] which could result in 1.7 million households losing their homes to foreclosure.[38]

Although the subprime meltdown is affecting the entire nation,[39] subprime woes are most pronounced in areas of the country with low home-price appreciation[40] and a slow local economy.[41] For example, areas hit by Hurricane Katrina in 2005 have suffered from home-price depreciation and have a higher-than-average delinquency rate.[42] It is suggested that borrowers in poor housing markets do not have the same alternatives to default (e.g. refinancing, equity build-up) as those in stronger housing markets.[43] Several states in the Seventh Federal Reserve District are experiencing economic difficulties, leading to even more subprime lending in those regions.[44] All five Midwestern states in that district have higher-than-average delinquency rates on mortgages, with Michigan nearly seven percent above the national average with respect to defaults on subprime mortgages.[45]

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[32] Ip, *supra* note 23, at A1.
[33] Bajaj, *supra* note 20, at C1.
[34] Agarwal, *supra* note 1, at 3.
[35] *Id.*
[36] Bajaj, *supra* note 20, at C1.
[37] *Myths Spun By Lax Lenders*, N.Y. TIMES, July 10, 2007, at A20.
[38] Steve Lohr, *Loan by Loan, the Making of a Credit Squeeze*, N.Y. TIMES, Aug. 19, 2007, at BU1.
[39] *Id.*
[40] Blumberg, *supra* note 29, at B10A.
[41] Agarwal, *supra* note 1 at 1
[42] Blumberg, *supra* note 29, at B10A.
[43] *Id.*
[44] Agarwal, *supra* note 1 at 1, 4.
[45] *Id*. at 4.

D. The Key Players

By the mid-1990s, increases in technology had allowed lenders to expand subprime mortgage lending.[46] Soon, Wall Street firms started pouring money into subprime mortgages. Investment banks such as Credit Suisse, Morgan Stanley, Lehman Brothers, Bear Stearns, Merrill Lynch, Greenwich Capital, UBS, Bank of America, and Deutsche Bank Securities began purchasing whole loans from lenders and securitizing them.[47] The investment banks then sold the loans to investors. For example, in 1995 Lehman Brothers began backing First Alliance Mortgage's subprime lending group.[48] Lehman lent about $500 million to First Alliance to support subprime lending and sold $700 million in bonds backed by First Alliance customers' loans. First Alliance has since collapsed.[49] As banks became aware of the insatiable demand for these loans, they relaxed their standards to meet this supply.[50] Even when the Federal Reserve raised short-term interest rates, lenders continued to lend and borrowers continued to borrow regardless of the risk involved.[51] When home prices stopped rising, borrowers became unable to refinance their mortgages and delinquency rates skyrocketed.[52]

Borrowers, mortgage originators, investment banks, and their investors are now paying for their laxity. Many of the top mortgage lending companies have suffered large financial losses. Countrywide Financial Corporation, one of the largest, has faced tough financial consequences in recent months due to its active role in subprime lending.[53] Countrywide's stock has dropped almost fifty percent and the company has been racing to borrow $11.5 billion from banks because it can no longer sell or borrow against loans it has made.[54] Nearly twenty-five percent of Countrywide's subprime loans are

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[46] Bernanke, *supra* note 21.

[47] Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2062 (2007).

[48] Hudson, *supra* note 4, at A1.

[49] *Id.*

[50] Lowenstein, *supra* note 13, at 11.

[51] *Id.*

[52] *Id.*

[53] Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, at C1.

[54] *Id.*

delinquent, up from fifteen percent at the same time last year.[55] Another large subprime lender, New Century Financial Corporation, filed for bankruptcy protection in April of this year after its subprime borrowers began falling behind in payments.[56] Wall Street firms forced New Century to buy back some of its poorly-performing loans and the mortgage company could not cope with the financial hit.[57] In July 2007, Wells Fargo, the second-largest mortgage lender in the country, announced that it would close its sub-prime wholesale lending business in the wake of the financial difficulties of other mortgage lenders.[58]

The situation is no better for investment banks and their investors. Some of the largest investment banks in the world have announced losses tied to the U.S. subprime mortgage market in recent weeks. Citigroup, the nation's largest bank, estimates its third-quarter profit will drop sixty percent after losses of more than $3 billion. Those losses are attributed to underperforming mortgages.[59] Other large banks, Bear Stearns and Credit Suisse, recently announced that it will lay-off several hundred employees each as a result of the mortgage crisis.[60]

Many of these banks' investors are also citing financial losses. In recent months investment firm Bear Stearns has announced large losses in its hedge fund fueled by investments in risky bonds.[61] Swiss-bank UBS announced huge losses and shut down a hedge fund after a $123 million loss tied to the U.S. subprime mortgage market.[62]

In addition to the potential for high returns, high ratings given by credit-rating agencies such as Standard & Poor's ("S&P"), Moody's Investors Service, and Fitch Ratings encouraged investors to put money into risky subprime securities. Investors commonly rely on these agencies to accurately assess the risk of investing in

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[55] *Id.*
[56] Ip, *supra* note 23, at A1.
[57] *Id.*
[58] *Wells Fargo to Limit Subprime Lending*, N.Y. TIMES, July 27, 2007, at C4.
[59] Madlen Read, *Citigroup Warns of 60% Drop in Earnings; Loss Blamed on Loans, Subprime Mortgages*, TORONTO STAR, Oct. 2, 2007, at B06.
[60] *Bear Stearns and Credit Suisse Announce More Layoffs*, N.Y. TIMES, Oct. 4, 2007, at C3.
[61] Matthew Goldstein, *Bear Stearns' Subprime Bath*, BUS. WEEK ONLINE, June 12, 2007, *available at* 2007 WLNR 11031266.
[62] *Id.*

such debt.[63] Critics of the ratings agencies claim that the agencies initially rated mortgage-backed securities too high and then failed to lower the ratings quickly enough when those assets began to deteriorate.[64] Some claim that the agencies "were vulnerable to conflicts of interest because they were paid by the investment firms whose bonds they rate."[65]

Federal and state regulators have also played an important role in the subprime mortgage market. One possible culprit factor in the crisis has been the lowering of lending standards over time, and some suggest that both federal and state regulators are partly to blame for the current crisis.[66] And yet regulators are often constrained by either a lack of jurisdiction or lack of resources. Half of the new subprime mortgages in 2005 were originated by companies without federal supervision, and another quarter were only indirectly supervised by the Federal Reserve.[67]

State regulators often find themselves without the same resources as federal regulators and thus cannot properly supervise sub-prime lending.[68] For example, in California, the state regulator has twenty-five examiners to supervise over 4,800 state-licensed lenders whereas Wells Fargo has twelve federal examiners assigned to it alone.[69] Some critics argue that even when federal regulators have enforcement authority, they are too slow to respond to increasingly risky lending practices and are quick to protect federally regulated banks from litigants.[70] Some blame the philosophy of recent Republican administrations—which have stressed that the government should rely on efficient markets, prudent lenders, and well-educated borrowers, to prevent risky lending—as being inadequate.[71]

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[63] *Debt-Rating Firms Subpoenaed*, CHI. TRIB., Oct. 27, 2007, at BU3.
[64] *Id.*
[65] *Id.*
[66] Greg Ip & Damian Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown—States, Federal Agencies Clashed on Subprimes as Market Ballooned*, WALL ST. J., Mar. 22, 2007, at A1.
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*

E. Possible Remedies for the Subprime Crisis

In response to pressure from Congress, in June 2007, the Federal Reserve and several other banking regulators enacted new, stricter standards to apply to federally regulated mortgage lenders.[72] The new guidelines require lenders to verify borrowers' incomes, increase the amount of notice given to borrowers before payment amounts increase, and provide clearer disclosures in mortgage forms.[73] Fines and other penalties result from lenders' non-compliance with the new regulations.[74]

Several weeks after such new standards were implemented for federally regulated lenders, state banking regulators followed suit.[75] The new state standards mimic the federal ones, requiring income verification and clear and balanced statements about the risks of a loan in all advertisements and oral statements.[76]

The Federal Reserve has repeatedly lowered interest rates in an attempt to prevent subprime lending from causing a widespread economic recession.[77] The Federal Reserve cut the rate from 5.25 percent to 4.75 percent in September,[78] and again to 4.5 percent in October,[79] in the hopes that doing so would encourage economic growth by lowering borrowing costs for consumers and businesses.[80] Even though the markets have rallied and seen significant gains since the cut took effect, critics continue to argue that such cuts "only encourage American dependence on easy credit."[81]

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[72] Lawyers USA Staff, *Bank Regulators Issue New Subprime Lending Guidelines*, S.C. LAW. WKLY., July 30, 2007.
[73] *Id.*
[74] *Id.*
[75] Robert Schroeder, *State Regulators Follow Federal Subprime Mortgage Crackdown*, THOMSON FIN. NEWS, July 17, 2007.
[76] *Id.*
[77] *Fed Cuts Interest Rate in Effort to Fend Off Recession*, CHI. TRIB., Sept. 19, 2007, at 16.
[78] *Id.*
[79] E.S. Browning, *No Tricks From the Fed: Stocks Rally*, WALL ST. J., Nov. 1, 2007, at C1.
[80] *Fed Cuts Interest Rate*, *supra* note 79, at 16.
[81] *Id.*

F. Conclusion

During the last decade there has been a rapid expansion of subprime lending. When the housing boom came to a halt in 2006, subprime lending got ugly. All of the players in the subprime market —borrowers, mortgage lenders, investment banks, investors, and regulators—have felt the negative consequences their risky practices. As foreclosures continue to skyrocket and many financial institutions post large financial losses, recovery is uncertain.

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III. Historical Overview of State and Federal Regulation of Mortgage Lending

Although modern mortgage regulations are significant, mortgage law has deep common law roots that stretch back more than four centuries.[1] Federal regulation of the residential mortgage industry has sharply increased during the second half of the twentieth century, and with the expansion of federal regulation federal preemption of state law has become prevalent.[2]

The development of the subprime mortgage market in the 1990s expanded availability of mortgage credit to low-income and high-risk consumers, many of whom would previously have had difficulty qualifying for mortgage credit.[3] Subprime borrowers typically have high existing levels of debt, provide little equity, or have a history of repayment problems.[4] Not surprisingly, with the rise of this class of borrower, loan defaults have rapidly increased.[5]

A. Historical Regulation of Mortgage Lending

The twentieth century has seen several major pieces of federal legislation. The Truth-In-Lending Act ("TILA") of 1968 protects borrowers by holding lenders accountable for their loans by requiring clear disclosure of terms in lending agreements.[6] The Civil Rights Act of 1968 included the Fair Housing Act ("FHA"), which, among its many effects, prohibited housing discrimination by lenders and real estate companies.[7] The Equal Credit Opportunity Act ("ECOA") of 1974 provided that banks evaluate only a borrower's

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[1] Morris G. Shanker, *Will Mortgage Law Survive?*, 54 CASE W. RES. L. REV. 69 (2004).

[2] Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption*, 56 CONSUMER FIN. L.Q. REP. 78 (2002).

[3] Gregory Elliehausen & Michael Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, 29:4 J. OF REAL EST. FIN. & ECON. 411 (2004).

[4] *Id.*, at 417.

[5] Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved With Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S. C. L. REV. 473, 553-554 (1999-2000).

[6] Truth-In-Lending Act, 15 U.S.C. § 1601 *et seq.* (1968).

[7] Fair Housing Act, 15 U.S.C. § 3605 *et seq.* (1968).

creditworthiness and not his or her ability to repay debt.[8] In addition, ECOA stipulated that lenders give specific reasons for denying credit.[9] The Fair Credit Reporting Act ("FCRA") of 1992 was another large step in federal regulation of mortgage lending, as it regulated all dissemination of credit information.[10]

The Act with the most profound effect on the eventual surge in subprime lending was the Community Reinvestment Act ("CRA") of 1977, which was inspired by feelings among community groups that many banks and thrifts were not responding to the credit needs of their communities.[11] The CRA was aimed at eliminating discriminatory lending practices such as redlining, requiring banks to attempt to meet their community's credit needs, and encouraging lending to low-income individuals.[12]

By threatening depository institutions with severe penalties for failing to advance credit to meet the needs of low-income individuals,[13] the CRA has caused more credit to be lent in low-income neighborhoods.[14]

The Home Ownership and Equity Protection Act (HOEPA) of 1994 is typical of modern federal regulatory attempts to curb "predatory" lending practices, which can include coercive and deceptive acts that aim to get borrowers to agree to unfair or abusive loan terms.[15] A common predatory practice is to offer a subprime loan with prepayment penalties that do not allow borrowers to pay off the loan early, thus it becomes difficult for borrowers to pay the loan off early. Often coupled with the prepayment penalty is the requirement of a "balloon" payment, which requires a disproportionate final payment which often lead to repayment trouble.[16] HOEPA classifies mortgage loans with high interest rates and fees as potentially predatory. For these loans HOEPA requires additional disclosures

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[8] Equal Credit Opportunity Act, 15 U.S.C. § 1691 *et seq.*
[9] *Id.*
[10] Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.*
[11] Douglas D. Evanoff & Lewis M. Segal, *CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending*, 20 ECON. PERSP., Nov. 1996, at 19, 21.
[12] *Id.* at 19.
[13] Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 340-341 (1993).
[14] Evanoff & Segal, *supra* note 12, at 29.
[15] Elliehausen & Staten, *supra* note 3, at 411.
[16] Terry Pristin, *A Warning on Risk in Commercial Mortgages*, N.Y. TIMES, May 2, 2007, at C11.

and imposes limitations on balloon payments, negative amortization, advance payments, interest rates, and prepayment fees.[17]

The Federal Deposit Insurance Corporation's Regulation Z is another significant federal predatory lending restriction. Section 32 of Regulation Z imposes threshold tests for fees and requires additional disclosures during the lending process. HOEPA and Regulation Z also generally prohibit the practice of making unaffordable loans.[18]

Despite a dearth of early efforts at the state level, some states have also attempted to regulate predatory lending. Most state and municipal predatory lending laws do not prohibit prepayment penalties, but rather impose disclosure requirements or threaten litigation toward lenders who make high-cost mortgage loans.[19]

In 1999, North Carolina introduced the first statutory scheme—besides the federal one—for regulating predatory or "high-cost" mortgage lending.[20] North Carolina's model adopted threshold-based lending regulations.[21] The law included several important limitations: a subprime lender could no longer contract for the right to call the loan before default, lock a borrower into a balloon payment, create a payment schedule that would cause the principal balance to increase (a "negative amortization"), or contract for an increase in the interest rate after a default.[22]

The marked decrease in predatory lending in North Carolina in response to this legislation suggests that this approach has been effective, which is particularly important with the increased availability of mortgage credit to low-income and high-risk consumers during recent years.[23] Since North Carolina passed this scheme in 1999, twenty-three states have adopted some form of threshold-based anti-predatory lending initiative.[24]

The New York Banking Department largely followed North Carolina's lead with its Part 41 Regulations.[25] The city of Chicago

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[17] Lampe, *supra* note 2, at 79.
[18] *Id.*
[19] *Id.* at 84.
[20] Elliehausen & Staten, *supra* note 3, at 412.
[21] Therese G. Franzen & Leslie M. Howell, *State and Local Predatory Lending Issues and Developments*, 59 BUS. LAW. 1179 (2004).
[22] Mansfield, *supra* note 6, at 566.
[23] Elliehausen & Staten, *supra* note 3, at 412.
[24] Franzen & Howell, *supra* note 21, at 1180.
[25] Lampe, *supra* note 2, at 81.

also followed suit in section 2-2-440 of its Municipal Code, which included a two-tiered threshold test requiring that lenders not be "predatory," and requiring lenders to provide detailed information and make a "no predatory lending" pledge in connection with any bid for Chicago city business.[26]

In the past few years, state predatory lending laws, ordinances, or regulations have been considered in at least thirty-five states, with more likely to follow. In addition to North Carolina, comprehensive state statutes or banking regulations have been enacted in New York, Texas, Connecticut, Massachusetts, Illinois, Pennsylvania, and the District of Columbia.[27]

Federal preemption of state law has had profound effects on the behavior of local mortgage lending. Preemption of state mortgage law has, overall, been a by-product of the federal government's efforts to create and maintain a nationwide streamlined credit flow. A significant expansion of federal preemption came with the enactment of the Alternative Mortgage Transactions Parity Act of 1982 ("AMPTA"), which set the stage for lenders to take advantage of preemption that eliminated state limits on charges such as prepayment fees.[28]

B. What regulatory changes took place to encourage subprime lending?

Early on, subprime home equity lenders began aggressively marketing subprime loans as convenient ways to consolidate consumer debt with added tax deductibility benefits and low rates.[29] Fair lending enforcement during the period prior to the 1990s was generally unaggressive. Typically, only the most blatant discrimination was detected.[30] Several market factors developed in the 1980s and 1990s that combined to create a large subprime mortgage industry.[31] These included increased home equity lending in general, the growth of non-depository lenders, and the development of a market for mortgage-backed securities.[32]

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[26] *Id.at 82.*
[27] *Id.*
[28] *Id.* at 78.
[29] Mansfield, *supra* note 6, at 556-557.
[30] Evanoff & Segal, *supra* note 12, at 20.
[31] Mansfield, *supra* note 6, at 520.
[32] *Id.*

Four congressional acts in particular greased the wheels for subprime lending to take off. The first was the Community Reinvestment Act of 1977, discussed above. The CRA gave lenders incentives to make loans to low-income and poor-credit borrowers.[33]

The second was the Depository Institutions Deregulation and Monetary Control Act ("DIDMCA") of 1980, which enabled lenders to charge higher interest rates to borrowers with low credit scores.[34] It applied only to first mortgage loans on residential property, and deregulated interest rates, points, finance charges, and other loan charges for all federally regulated lenders.[35] The DIDMCA, which was adopted in an era of high market rates for conventional mortgages, preempted state usury ceilings in most loans secured by a first lien on the borrower's home.[36]

Not long after DIDMCA was adopted, second mortgage lenders began to use it to charge an unlimited amount of interest on loans (provided they took a first lien on the borrower's home). Many lenders began to cast second mortgage loans as expensive first-lien loans.[37] Subprime lenders now take advantage of DIDMCA to charge unlimited interest rates on nonpurchase loans secured by the borrower's residence and often through the simultaneous refinancing of the original mortgage loan.[38] A number of states have opted-out of DIDMCA, and some recent cases have focused on possible state law overrides.[39]

The third congressional act that set the stage for the current subprime crisis was the AMTPA of 1982, which enabled the use of variable-rate loans and balloon payments.[40] Balloon loans are common among subprime loans, as is the situation where borrowers are discouraged from paying their loans off early through the use of prepayment penalties. Both of these arrangements were generally regulated by state law until the state regulation was preempted by the

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[33] Community Reinvestment Act, Pub. L. No. 95-128, 91 Stat. 1111.

[34] Depository Institutions Deregulation and Monetary Control Act, Pub. L. No. 96-221, 94 Stat. 132.

[35] Lampe, *supra* note 2, at 85.

[36] Mansfield, *supra* note 6, at 476.

[37] *Id.* at 511-512.

[38] *Id.* at 542.

[39] Lampe, *supra* note 2, at 85.

[40] Alternative Mortgage Transaction Parity Act, Pub. L. No. 97-320, 96 Stat. 1469.

AMTPA.[41] Only six states have opted out of the AMTPA.[42] The fourth congressional act was the Tax Reform Act of 1986, which eliminated the interest deduction for consumer loans, but retained the mortgage interest deduction.[43] This encouraged increased mortgage lending as the preferred method of consumer borrowing.[44]

This increase in market share of mortgage lending was the first step in the emergence of the subprime market, which was followed by a significant increase in the number of home loan mortgage brokers along with an increased role for non-depository mortgage lenders.[45] Among the non-depository lenders who took a new role in the consumer financial services market in the late 1980s and 1990s were lenders that specialized in lending to borrowers previously unable to get credit.[46] Thus, the number of subprime lenders making subprime mortgage loans dramatically increased as some mortgage lenders ventured into the subprime market.[47]

Several factors contributed to the growth of the subprime market in the 1990s. First, in a market of rising asset prices (like homes), subprime lending was highly profitable. Second, low-income individuals who owned their own homes provided a new market for subprime lenders. Third, the easy availability of unsecured credit, such as credit cards, and the lack of health insurance among such borrowers caused some families to tap into their home equity to pay their bills. Fourth, securitization (grouping loans into loan pools which are sold by investment banking firms as securities) broadened the market for buyers by both diversifying and allocating risk.[48]

C. The Subprime Players

Much of the blame for the subprime crisis has fallen on the lenders. Loan specialists contributed to the crisis through predatory lending practices and profit maximization loopholes. Underpinning much of the subprime boom was the rapid growth of a secondary

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[41] Mansfield, *supra* note 6, at 556.
[42] Lampe, *supra* note 2, at 85.
[43] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.
[44] Mansfield, *supra* note 6, at 522.
[45] *Id.* at 526.
[46] *Id.* at 527.
[47] *Id.* at 529.
[48] *Id.* at 531

market for mortgages, in which lenders packaged loans as securities and sold them to other investors. That spread the risk, and increased demand for new loans. Because liabilities were thinly spread, lenders became more concerned with making and selling loans than with the risk of holding them, and investors proved less adept at gauging the risks than had been expected.[49] Mortgage brokers deserve some of the blame for seeking personal profits, and in doing so, directed borrowers to accept unaffordable loans. Also, brokers encourage investors to back securities bundles without properly verifying the strength of the portfolios.

The government has been charged with encouraging the development of the subprime debacle through "liberalizing" legislation like the Community Reinvestment Act, which has indirectly encouraged depository institutions to lend to borrowers with insufficient credit.[50] Many also feel that the Federal Reserve, which sets interest rates, may have allowed the housing bubble to rise too high for long to prop up the economy, and thus deserve some of the blame for the market's subsequent collapse. And borrowers also are blameworthy, primarily because so many of them entered into bad loan arrangements, often with eyes wide-open.[51]

D. Likely changes to the state and federal regulation of mortgage lending

Overall, there is a rising level of concern in Congress about the level of regulation in the mortgage lending industry. Supporters of government oversight will point to turmoil in the credit markets as a reason to bolster regulation of the mortgage industry.[52] Possible bills in both houses of Congress would expand homeowner

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[49] James R. Hagerty, Kara Scannell & Sarah Lueck, *Congress Takes Up Mortgages*, WALL ST. J., Sept. 6, 2007, at A7.

[50] Evanoff & Segal, *supra* note 12.

[51] Some state legislatures have tried assigning liability to borrowers in the past. For example, Georgia passed a law in 2002 that extended liability to a loan's end buyer, but after mortgage underwriters and credit-rating organizations essentially boycotted Georgia loans, the legislature voted in 2003 to weaken the buyers' liability. Hagerty, Scannell & Lueck, *supra* note 50.

[52] Jonathan Peterson, *Mortgage Mess Echoes In Congress*, L.A. TIMES, Sept. 4, 2007.

protections to cover more subprime loans and crack down on prepayment penalties.[53]

Some lawmakers urge a broader role for Fannie Mae and Freddie Mac, the two large federally chartered mortgage finance companies.[54] A potentially controversial proposal is to raise the current limits of approximately $700 billion on mortgage portfolios held by the two companies. Some Federal Reserve officials feel that too big a role for Fannie and Freddie will disturb the soundness of the entire housing market, while proponents feel that removing the caps will infuse the system with billions of necessary dollars that might enable many to refinance their debt.[55]

Not surprisingly, the future looks different from the lenders' perspective. Lenders warn that a government overreaction to these problems could backfire and dry up credit at a time when it is sorely needed and putting loans out of the reach of worthy borrowers.[56]

Overall, the aggressive marketing of subprime loans to lower income and minority groups has sparked wide interest in increased regulation of predatory lending.[57] However, there is a lack of standardization between states when it comes to anti-predatory lending laws, and streamlined federal anti-predatory lending legislation is likely several years away.[58] Representative Barney Frank (D-Mass) continues to advocate for a range of borrower protections, including placing mortgage brokers under the supervision of federal regulators and holding investors in mortgage-backed securities partially responsible for problems that may arise with loans they own.[59] Certainly, Congress faces growing pressure to approve at least some changes, given the depth of the financial problems, the emotional toll on families facing foreclosure, and the undesirability of the status quo.[60]

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[53] Hagerty, Scannell & Lueck, *supra* note 50.
[54] *Id.*
[55] Peterson, *supra* note 54.
[56] Peterson, *supra* note 54.
[57] Elliehausen & Staten, *supra* note 3.
[58] Franzen & Howell, *supra* note 22, at 1192.
[59] Peterson, *supra* note 54.
[60] *Id*.

E. Conclusion

Government regulation of mortgage lending has been marked by a relatively recent expansion from traditional common law and state statutory regulation to a large-scale federal administrative structure that preempts state law. Some recent congressional acts immediately made widespread positive impacts, while others may have set the stage for the recent subprime crisis.

In the early 1980s, the DIDMCA and the AMTPA arguably set in motion the beginning of the current crisis by enabling lenders to access more borrowers who were prone to potential default, and by allowing for more creative packaging of subprime mortgages with other securities. In the early twenty-first century and through the onset of the crisis, blame has fallen on most of the major participants in the domain of mortgage lending: the mortgage brokers, the lenders, the regulators and the borrowers themselves. The future for mortgage lending regulation is unclear: at the very least, however, the subprime crisis has created a political environment where the public is hungry for action. It remains to be seen how far this appetite for increased regulation goes.

Jeffrey Russell[61]

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[61] Student, Boston University School of Law (J.D. 2009).

IV. Historical Changes Within the Credit and Investment Markets

Historically, the mortgage market has suffered from illiquidity: home mortgages, being specific to particular homes and owners, have not traded as freely as, say, stocks.[1] The federal government first sought to increase access to home financing during the Great Depression, in part through the creation of government-sponsored enterprises ("GSEs") to purchase mortgages, thus allowing lenders to immediately reinvest their capital.[2] It was not until the 1970s, however, that secondary mortgage market activity "began in earnest" with the sale of publicly issued mortgage-backed securities ("MBSs").[3] Soon private entities began to issue MBSs.[4] This supply of capital for prime mortgages opened up the possibility of financing subprime mortgages on a large scale for the first time. State-chartered mortgage banks took advantage of this untapped market.[5] Changes in capital requirements for federally chartered depository institutions encouraged them to securitize mortgages they held.[6] Prospective changes may yet increase this incentive with respect to subprime loans.

A. The Historical Mortgage Market

Historically, in the United States, a conventional mortgage market functioned as a prospective homebuyer's primary source of home equity credit. This prospective homebuyer approached a mortgage lender and the two parties typically completed the transaction by themselves.[7] At the time, down payments constituted a higher percentage of the total value of the property and repayment periods were much shorter than they are today.[8] Unfortunately, a majority of

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[1] Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2193 (2007).
[2] *Id.* at 2195.
[3] David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. L. REV. 985, 1006 (2006).
[4] *Id.* at 1008.
[5] *A Special Report on the World Economy: On Credit Watch* ("Special Report"), THE ECONOMIST, Oct. 20, 2007, at 26.
[6] *Id.*
[7] Peterson, *supra* note 1, at 2192-94.
[8] *Id.* at 2192.

lenders waited years to recover their capital and to reinvest it in new mortgages.[9] Mortgages' long-term nature historically left lenders with difficulty acquiring capital.[10] Another problem with the historical mortgage market is that the lender usually shouldered the risk of his investment alone. And lenders tended to hold geographically concentrated portfolios of mortgages, thus concentrating their risk exposure.[11] Lenders had two basic means to protect themselves from the risk of mortgage default: "[I]nitially, through a review process before granting the credit, and thereafter through a continuous monitoring and servicing process."[12] In fact, thrifts developed largely because commercial banks avoided the mortgage market on account of these liquidity and risk problems.[13]

Nevertheless, creative early mortgage lenders looked to investors for assistance, particularly for access to capital. The practice of selling whole loans and participations in loans began in the mid to late nineteenth century.[14] During the 1880s, some private mortgage companies issued bonds secured by mortgages.[15] A significant number of investors purchased mortgage participations and syndications during the 1920s.[16] These investments collapsed in the 1930s,[17] however, when homeowners defaulted on half of all single-family mortgages.[18] States passed emergency legislation in order to salvage billions of dollars in these mortgage pools.[19] These early experiments drew on the same principles that underlie the modern practice of securitization.

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[9] *Id.* at 2193.
[10] *Id.*
[11] JAMES A. OCAMPO & JUAN M. ROSENTHAL, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 8 (1988).
[12] *Id.* at 6.
[13] Peterson, *supra* note 1, at 2192.
[14] CHRISTINE A. PAVEL, SECURITIZATION: THE ANALYSIS AND DEVELOPMENT OF THE LOAN-BASED/ASSET-BACKED SECURITIES MARKETS 3 (1989).
[15] Peterson, *supra* note 1, at 2193.
[16] Andrew Lance, Note, *Balancing Public and Private Initiatives in the Mortgage-Backed Security Market*, 18 REAL PROP. PROB. & TR. J. 426, 430 (1983).
[17] *Id.*
[18] Peterson, *supra* note 1, at 2194.
[19] Lance, *supra* note 16, at 430.

B. The Development of the Publicly Issued Mortgage-Backed Security

The current secondary market for MBSs was born of federal government policy. When mortgage lending slowed during the Great Depression, the federal government responded with four main initiatives to increase home financing's availability. First, Federal Home Loan Banks loaned money to thrifts to supplement deposits as a source of capital.[20] Second, the Home Owners Loan Corporation used taxpayer money to buy mortgages held by financially distressed families and then refinanced those loans.[21] Third, the National Housing Act of 1934 established the Federal Housing Administration (FHA), which issued insurance to mortgage lenders.[22] The result benefited consumers: down payments shrank and repayment periods rose.[23] Finally, in 1938 Congress chartered the Federal National Mortgage Association ("Fannie Mae"), a government-sponsored enterprise, to purchase FHA-insured loans so that lenders could immediately recoup and reinvest their capital.[24] Fannie Mae's stated objective is to "expand the flow of mortgage funds in all communities, at all times, under all economic conditions, and to help lower the costs to buy a home."[25]

Secondary mortgage market activity did not immediately rise to its current prominence; the market remained relatively modest for the next three decades. Then the baby boomer generation came of age to purchase homes.[26] The federal government's first steps toward thwarting the expected housing crunch were to create two more GSEs. First, Congress chartered the Government National Mortgage Association ("Ginnie Mae" or "GNMA") in 1968, which was partitioned off of Fannie Mae.[27] Ginnie Mae quickly developed

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[20] Peterson, *supra* note 1, at 2195.
[21] *Id.*
[22] *Id.*
[23] *Id.* at 2195-96; s*ee* Cathy Lesser Mansfied, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 479-80 (2000).
[24] Peterson, *supra* note 1, at 2196.
[25] Fannie Mae, About Fannie Mae, http://www.fanniemae.com (follow "About Fannie Mae" hyperlink) (last visited Nov. 5, 2007).
[26] Peterson, *supra* note 1, at 2200.
[27] *Id.* at 2198.

a pass-through MBS.[28] Second, the Emergency Home Finance Act ("EMFA") created the Federal Home Loan Mortgage Corporation ("Freddie Mac") in 1970.[29] Freddie Mac performs functions similar to those of Fannie Mae.[30]

GSEs serve two main functions, both of which they have been actively engaged in since the 1970s. First, GSEs issue and guarantee residential MBSs.[31] Second, they purchase mortgages and residential MBSs for their own accounts.[32] As a result, GSEs promulgated buying guidelines significantly influential to mortgage lenders.[33] In addition to these primary functions, Fannie Mae and Freddie Mac offered a successful swap program.[34] These GSEs provided agency certificates secured by diversified loan portfolios in exchange for whole loans from mortgage lenders.[35]

The primary reason mortgage lenders sold the loans they originated to GSEs is that securitization ameliorates the stubborn liquidity and risk problems traditionally posed by the mortgage market. Access to the capital markets provides a "new and less expensive funding source for original lenders."[36] As a result, "credit securitization enables a strong loan originator or servicer to expand its volume of business without expanding its capital base in the same proportion."[37] Moreover, the ability to originate more loans carries with it the ability to diversify these loans.[38] These tremendous potential gains are offset only by administrative costs.[39]

These publicly issued MBSs enjoyed immediate popularity[40] for the same reasons any investment does: "they offer buyers

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[28] PAVEL, *supra* note 14, at 3-4 (observing that the origin of securitization is usually traced to this point and describing the GNMA pass-through).
[29] 12 U.S.C. §§ 1451-1459 (2000).
[30] Peterson, *supra* note 1, at 2198.
[31] Reiss, *supra* note 3, at 1009.
[32] *Id.*
[33] *Id.*
[34] PAVEL, *supra* note 14, at 62.
[35] Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1385 (1991) (footnote omitted).
[36] PAVEL, *supra* note 14, at 13.
[37] OCAMPO & ROSENTHAL, *supra* note 11, at 14.
[38] PAVEL, *supra* note 14, at 13.
[39] *Id.* at 12.
[40] To be more specific, this popularity was largely among institutional investors. Cong. Budget Office, *Effects of Repealing Fannie Mae's and*

relatively safe and highly liquid investments with yields higher than those of comparable Treasury securities."[41] Moreover, securitization allows some investors to hold assets otherwise unavailable to them because of legal barriers or the large size of the transaction.[42] These investment tools also offer cash flow on a timetable attractive to some investors.[43] Through the use of real estate MBSs avoid double taxation that plagues some other investment tools.[44] Finally, these instruments also may derive some of their success from a mistaken assumption that they are guaranteed by the full faith and credit of the United States government.[45] In fact, only the Ginnie Mae pass-through boasts this guarantee.[46] In 1977 the savings and loan industry finally sold more mortgages than it purchased.[47]

C. The Development of the Privately Issued Mortgage-Backed Security

Publicly issued MBSs only realized the benefits of securitization to the extent possible under GSE buying guidelines.[48] However, nonconforming loans remained limited to a traditional mortgage market model until private issuers followed the GSEs'

Freddie Mac's SEC Exemptions 3 (2003) ("About 85% of the trades in that market are made by 85% of the investors; the retail market is negligible."), *available at* http://www.cbo.gov/ftpdocs/41xx/doc4199/05-06-03-GSEs.pdf.

[41] *Id.*

[42] Shenker & Colletta, *supra* note 35, at 1383.

[43] Lance, *supra* note 16, at 428 ("MBSs have particular appeal to individuals and institutions whose income needs more closely parallel the monthly, rather than quarterly, cash flow offered by MBSs. Because pension funds are expected [to grow in size], attracting pension funds to capital hungry sectors of the economy has been a primary concern of financial regulators.")

[44] Lynnley Browning, *I.R.S. Looks at Mortgage Securities*, N.Y. TIMES, Oct. 7, 2007, at CI.

[45] Cong. Budget Office, *supra* note 40, at 4.

[46] While considering state tax implications of these guarantees, the Supreme Court found that "[t]here is uncontradicted evidence in the record supporting the conclusion that GNMA's guarantee is responsible for the ready marketability of these securities." *Rockford Life Ins. Co. v. Ill. Dep't of Revenue et al.*, 482 U.S. 182, 185 (1987).

[47] Mark J. Riedy, *Where Will the Money Come From?*, 465 ANNALS AM. ACAD. POL. & SOC. SCI., 14, 18 (1983).

[48] *See* Fannie Mae, *Historical Conventional Loan Limits* (Dec. 2006), *available at* http://www.fanniemae.com/aboutfm/pdf/historicalloanlimits.pdf.

lead. In 1977, Bank of America and Salomon Brothers first issued "a security where outstanding loans were held in trust, with investors as beneficiaries."[49] But the 1970s witnessed inflation and interest rate volatility that left the mortgage industry hesitant to break new ground. As late as 1983, a mortgage-industry representative labeled the dearth of capital a "crisis."[50] The industry "sorely lack[ed] money to meet potential demand."[51] The federal bailout of the savings-and-loan industry of 1989, however, prompted development. To comply with new—stricter—capital requirements, savings-and-loan institutions sold loans and MBSs.[52]

Two legislative developments during the 1980s facilitated the development of the privately issued MBS. In 1984, Congress passed the Secondary Mortgage Market Enhancement Act (SMMEA).[53] The SMMEA "was designed to enable private issuers of mortgage securities to compete effectively with government-related agencies, which had come to dominate the market, by removing some of the legal impediments to issuing private mortgage-backed securities."[54] And the Tax Reform Act of 1986 allowed taxpayers to deduct interest paid on loans secured by a home while prohibiting deduction of interest paid on consumer loans.[55] This stimulated demand among consumers for home equity loans,[56] and mortgage lenders turned to securitization to provide the capital necessary to meet this need.

Of course, private issuers were also at work devising methods that would reduce securitization's risks and increase its efficiency. To lessen risk, it was necessary to reduce the uncertainty resulting from the investors' inability to assess the creditworthiness of the underlying loans. This concern led to the introduction of rating agencies and credit enhancements.[57] This greater availability of information in turn allowed for a pricing system that more

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[49] Peterson, *supra* note 1, at 2200.
[50] Riedy, *supra* note 47, at 15.
[51] *Id.* at 17.
[52] Paulette Thomas, *Thrifts Speed Asset Reduction to Meet Rules—New Capital Requirements Triggered $13.4 Billion of Sales During August*, WALL ST. J., Oct. 24, 1989, at E1.
[53] Peterson, *supra* note 1, at 2198.
[54] Shenker & Colletta, *supra* note 35, at 1385 (footnote omitted).
[55] Mansfield, *supra* note 23, at 522.
[56] *Id.*
[57] Peterson, *supra* note 1, at 2204; Reiss, *supra* note 3, at 1012-16; PAVEL, *supra* note 14, at 32-35.

accurately reflected the present value of the investment.[58] In addition, they began to employ special purpose entities to avoid the costs that the Bankruptcy Code imposes on direct secured lending.[59] Finally, the development of risk- and term-partitioned securities allowed investors greater choice in the amount of risk they assumed.[60] In 2005 the dollar value of privately issued MBSs exceeded that issued by GSEs.[61]

D. The Emergence of a Secondary Market for Subprime Mortgages

The development of a secondary market for prime mortgages made possible a primary market for subprime mortgages. Before the 1990s, mortgage lending was almost exclusively the province of traditional bank and thrift depository institutions.[62] Independent mortgage companies, however, eventually came to dominate the subprime mortgage lending market.[63] But these companies lack the capital available to large banks and thrifts through their depository functions, and so the independent companies could not pursue subprime lending on a large scale until the advent of securitization.[64] Mortgage bankers sell an overwhelming majority of the mortgages they originate, distinguishing them from thrifts.[65] Thus, while prime

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[58] Peterson, *supra* note 1, at 2201-02.

[59] Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1658 (2004).

[60] *Id.* at 2202-03.

[61] Fannie Mae, *A Statistical Summary of Housing and Mortgage Finance Activities* 14 (2007), *available at* http://www.fanniemae.com/ir/pdf/resources/housingmortgage.pdf.

[62] Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLA. L. REV. 295, 312 (2005).

[63] *Id.* ("In 2001, HUD estimated that there were 178 institutions that *primarily* engaged in subprime loan originations. Of that group, fifty-nine percent were independent mortgage companies (mortgage bankers and finance companies), twenty percent were nonbank subsidiaries of bank holding companies, only ten percent were federally regulated banks and thrifts, and the remaining ten percent were 'other types of financial institutions.").

[64] *See* Mansfield, *supra* note 35, at 531-32 ("This led the Federal Reserve to comment, '[m]ost subprime lenders place heavy reliance on securitization of their loans to fund their operations.'").

[65] PAVEL, *supra* note 14, at 55.

mortgages existed for decades before the advent of securitization, subprime lending has depended on securitization from the outset in a "chicken-or-egg-like scenario."[66]

Market forces provided incentive for independent mortgage companies to take advantage of the opportunity securitization offered them. From their position between borrowers and investors, mortgage companies culled servicing fees.[67] They did this while passing along the credit risk to investors better capable of handling it.[68] Moreover, they acted with the minimum possible regulatory burden after "shop[ping] around" for the most favorable rules.[69] Given the "contraction in the pool of borrowers with no blemishes in their financial portraits" at the time this market developed, there was a ready audience for their services.[70]

Government policy that encouraged low-income and minority homeownership also have contributed to the growth of the subprime mortgage market. In the mid-1990s, GSEs began buying the most highly rated subprime loans[71] for the express purpose of increasing access to financing for low-income and minority homebuyers.[72] In addition, efforts to comply with federal affordable housing policy, including the Community Reinvestment Act of 1977 ("CRA"),[73] "dovetail[ed] fortuitously" with the increase in subprime lending.[74] The CRA requires an institution to make efforts to "meet[] the credit needs of its entire community, including low- and moderate-income neighborhoods[,]" before a federal regulating agency can approve an application for a substantial business change or expansion.[75] Therefore, the tremendous growth in interstate banking during the 1990s rendered CRA requirements very

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[66] Dennis Hevesi, *Giving Credit Where Credit was Denied*, N.Y. TIMES, June 8, 1997, at R1.
[67] Manfield, *supra* note 35, at 532.
[68] Special Report, *supra* note 5.
[69] *Id.*
[70] Hevesi, *supra* note 66.
[71] Katherine C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2095 (2007).
[72] Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending: Minority Home Ownership May Increase*, N.Y. TIMES, Sept. 30, 1999, at C2.
[73] 12 U.S.C. §§2901-2906 (2000).
[74] Hevesi, *supra* note 66.
[75] 12 U.S.C. § 2903 (2000).

important during this time period.[76] Mortgage lending is part of the assessment, looking at geographic distribution of loans and characteristics of the borrower.[77]

The investment banks' financial innovation amplified market incentives for the creation and sale of subprime mortgage-backed securities. Investment banks have utilized the following strategies to protect investors from credit and litigation risk: structured finance,[78] deal provisions,[79] third-party insurance guarantees[80] and senior/ subordinated debt structures.[81] More recently, large securities firms have begun to acquire subprime lending companies.[82] This "vertical integration" allows broker-dealers to avoid competition for the purchase of loans.[83] As recently as 2005, demand exceeded supply for subprime mortgage-backed securities.[84]

E. Capital Requirements' Effects on the Secondary Market for MBSs

Unlike the state-chartered mortgage lenders described above, federally chartered banks and thrifts in the market for MBSs are influenced by federal capital requirements. In 1988, the United States adopted the Basel Capital Accord ("Basel I"), drafted by the Basel Committee on Banking Supervision ("Committee") for the twin purposes of enhancing the "soundness and stability" of international banking and increasing uniformity of regulation between countries.[85] Towards this end, Basel I adds risk-based capital requirements to the traditional leverage ratio requirement.[86]

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[76] JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, BANKING LAW AND REGULATION, 187 (3d ed. 2001).
[77] *Id.* at 188.
[78] Engel & McCoy, *supra* note 71, at 2041.
[79] *Id.*
[80] Mansfield, *supra* note 35, at 541 n. 420.
[81] *Id.*
[82] *Mortgage Lending: Subprime Subsidence*, THE ECONOMIST, Dec. 16, 2006, at 33 (stating that Morgan Stanley, Merrill Lynch, Bear Stearns, and Lehman Brothers have each acquired at least one mortgage originator).
[83] *Id.*
[84] Engel & McCoy, *supra* note 71, at 2075.
[85] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* 1 (July 1988), *available at* http://www.bis.org/publ/bcbsc111.pdf?noframes=1.
[86] MACEY, MILLER & CARNELL, *supra* note 76, at 280-82.

A bank must retain more capital per dollar of asset held in an ordinary mortgage than in a MBS.[87] To reduce the cost of compliance with Basel I, banks have moved a large number of mortgages off of their balance sheets by securitizing them.[88]

Thus, on an operational level, Basel I may be too blunt an instrument to effectively account for risk. Basel I imposes a "risk-based 'one-size fits all' minimum capital requirement,"[89] and it lumps together all first-mortgage loans without distinguishing between prime and subprime mortgages.[90] The distinction Basel I does draw, between on- and off-balance-sheet assets, is faulty.[91] On a more fundamental level, the structure of Basel I may be problematic because it fosters incentives contrary to its goal of promoting sound banking practices. Banks have "increased, rather than diminished, the riskiness of their loan portfolios" in response to Basel I.[92] Moreover, Basel I may have indirectly accelerated us towards the current crisis because it is partly responsible for the fact that MBSs are in the hands of investors likely to immediately sell them. Were it not for Basel I, banks might have retained control of the investment until the market reaction subsided.[93] Nevertheless, given that the nature of the current subprime market correction falls outside the scope of capital protection, it would be unfair to place too much blame on Basel I.[94]

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[87] David Wessel, *New Bank Capital Requirements Help Spread to Capital Woes*, WALL ST. J., Aug. 30, 2007, at A2.

[88] Special Report, *supra* note 5.

[89] Eric Y. Wu, Recent Development, *A. Basel II: A Revised Framework*, 24 ANN. REV. BANKING & FIN. L. 150, 151 (2005) (citation omitted).

[90] MACEY, MILLER & CARNELL, *supra* note 76, at 283.

[91] *See* Gillian Tett, *FT Report—World Economy 2007: Questions Hard to Answer*, FT REPORTS, Oct. 17, 2007, at 4 ("But this year it emerged that banks have not always transferred as much risk as it seemed. Some of the assets held in off-balance-sheet vehicles . . . are now unexpectedly coming back onto the banks' balance sheets.").

[92] Michael R. King & Timothy J. Sinclair, *Private Actors and Public Policy: A Requiem for the New Basel Capital Accord*, 24 INT'L POL'Y SCI. REV. 345, 350 (2003). *See* Special Report, *supra* note 5 ("[T]he rules give banks an incentive to sell on their least risky securitised assets while keeping the riskiest ones (since both have the same capital charge, but the riskier ones earn more).").

[93] Wessel, *supra* note 87.

[94] Special Report, *supra* note 5 ("[C]apital adequacy rules are designed to protect a bank from insolvency. But during the summer, the volume of

In 1999, the Committee issued the first version of the Revised Basel Capital Accord ("Basel II"), which has not yet been implemented in the United States. A large part of the Committee's stated goal was to draft capital requirements that would be "significantly more risk-sensitive."[95] Under Basel II, a subprime mortgage would likely bear a different capital requirement than a less risky prime mortgage.[96] Thus, this might reverse prior incentives to sell less risky loans while retaining riskier ones and result in greater incentive to securitize subprime mortgages. However, Basel II would not significantly change incentives already in place regarding prime mortgages.[97]

Nevertheless, the prospective implementation of Basel II does not necessarily portend substantive changes in the secondary market for subprime MBSs: "[A]round half of all subprime loans had nothing to do with traditional banks . . . ."[98] And Basel II would affect even few loans because "only a small number of large, internationally active U.S. banking organizations would be required to use the framework."[99]

F. Conclusion

This exploration of the secondary mortgage market's history sheds light on not only how that market developed, but also why it did so. Indeed, securitization "draws its lifeblood not from regula-

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defaulting subprime mortgages was trial compared with banks' capital. The main problem was not insolvency; it was illiquidity.").

[95] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* 3 (July 2004), *available at* http://www.bis.org/publ/bcbs107.pdf?noframes=1.

[96] *See id.* at 12-167 (delineating calculation of minimum capital requirements).

[97] Some analysts even predict it will have a negative impact on these MBSs. Wu, *supra* note 89, at 155 (citation omitted).

[98] Special Report, *supra* note 5.

[99] Press Release, Federal Reserve Board, Banking Agencies Announce Publication of Revised Capital Framework and Describe U.S. Implementation Efforts (June 26, 2004) *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040626/default.htm. Other smaller banks will have the option of continuing to comply with Basel I or implementing Basel IA, a modified standard that "would use loan-to-value ratios to determine the risk weights for most residential mortgages." *Fed Proposes a Choice on Basel Capital Rules*, WALL ST. J., Dec. 6, 2006, at B8.

tory arbitrage but from the way it handles risk. In this respect, it is fundamentally more efficient than conventional lending."[100] Thus, incentives drove the development of the MBS as an investment tool. The MBS market provided mortgage lenders, investment banks, credit rating agencies with fees and it offered investors liquid, highly (though likely too highly) rated investments, often bearing a GSE guarantee. But there is no doubt that, for this market, even more change is on the way.

Jennifer Cummins[101]

[100] OCAMPO & ROSENTHAL, *supra* note 11, at 5 (emphasis omitted).
[101] Student, Boston University School of Law (J.D. 2009).

V. Public Commentary on the Subprime Crisis and its Causes

Historically higher default rates show that "there is a greater risk associated" when lenders provide subprime loans to borrowers with relatively poor credit."[1] Yet, "subprime lending is not intrinsically dangerous, unsafe or reckless."[2] When conducted consistently with reasonable underwriting standards that account for the risk, subprime lending "can be as safe, profitable, and beneficial."[3] But for the reasons discussed below, subprime lending has become overrun with excess and abuse, thus resulting in borrowers receiving inappropriate loans. Consequently, borrowers have defaulted in large numbers and are suffering foreclosure. Some commentators predict that twenty percent of subprime loans issued in 2005 and 2006 will go into default.[4]

A. Expansion of Subprime Lending

1. Increase in the availability of credit

An increase in the availability of capital for subprime loans led to the expansion of the subprime industry. The Federal National Mortgage Association ("Fannie Mae"), and Federal Home Loan Mortgage Corporation ("Freddie Mac"), purchase mortgages on the secondary mortgage market.[5] Initially, they only purchased low-risk loans,[6] but by the mid-1990s, Fannie Mae began using credit-scoring technologies to price individual loans based on multiple risk factors, thus expanding "the pool of borrowers to whom such credit was available."[7] This increased the capital available to lenders to make subprime loans.

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[1] Tracy Coenen, Commentary, *A Look at the Subprime Mortgage Problem*, WIS. L. J., Aug. 27, 2007, *available at* 2007 WLNR 16808090.
[2] Thomas P. Vartanian, *Bank Regulators' Statement on Subprime Lending a Roadmap to Potential Enforcement Actions*, 26 BANKING & FIN. SERV. POL'Y REPORT 4, Apr. 2007, at 4.
[3] *Id.*
[4] LexisNexis, *Subprime Lending: An Update of the Issues and Approaches,* Aug. 2007, at 22, *available at* LEXIS, Pub. 052.
[5] *Id.* at 20-21.
[6] Douglas G. Baird, *Symposium: Consumer Bankruptcy and Credit in the Wake of the 2005 Act: Technology, Information, and Bankruptcy*, 2007 U. ILL. L. REV. 305, 312 (2007).
[7] *Id.* at 312-313.

Securitization also greatly increased the availability of capital for subprime loans. "As low interest rates fueled a lending boom to borrowers with weak credit, banks looked for new ways to package those loans, so they could sell more."[8] To offset the risk, lenders bundled mortgages together into asset-backed securities,[9] and lenders then sold these securities to investment banks.[10] Investment banks broke them down further into securities that the rating agencies were willing to rate as AAA, low-risk investments.[11] This provided lenders with excess capital, which they could "lend to those who ordinarily would be denied credit."[12] Thus, securitization created a market for subprime mortgages, increasing the availability of such credit.

Initially securitization was seen as "a way to achieve the laudable goal of boosting home-ownership."[13] But securitization created two main problems. First, it made things difficult for borrowers to amend their loan agreements if they could not afford the monthly payments. Historically, lending banks often offered to modify a loan's terms so that the borrower could afford the monthly payments.[14] A loan modification helped borrowers keep their homes and was more profitable to the bank than foreclosure, especially in a weak housing market.[15] But with securitization, usually the bank or broker that issued the loan does not retain control of it. In general, a loan pool is sold to a special purpose vehicle, usually in the form of a trust:[16] "a trustee bank oversees [the trust's] operations on behalf of investors" in accordance with a pooling and servicing agreement.[17]

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[8] Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1.
[9] *Id.*
[10] Paul Krugman, *Workouts, Not Bailouts*, N.Y. TIMES, Aug. 17, 2007, at A23.
[11] *Id.*
[12] Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 410 (2007).
[13] Adam Bryant, *The Unforgivingness of Forgetfulness*, N.Y. TIMES, Aug. 19, 2007, at WK1.
[14] Krugman, *supra* note 11.
[15] Krugman, *supra* note 11.
[16] Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2045 (2007).
[17] Gretchen Morgenson, *More Home Foreclosures Loom as Owners Face Mortgage Maze*, N.Y. TIMES, Aug. 6, 2007, at A1.

The agreement "determines what a servicer can [and cannot] do to help distressed borrowers."[18] It requires that any loan modifications be in the investor's best interest.[19] To this effect, it limits the percentage of loans that may be modified, the "frequency with which a loan can be modified [and/]or dictate[s] a minimum interest rate."[20] Thus, if a borrower's loan was securitized, even if the a loan amendment is allowed, it is usually restricted, and often not in the *borrower's* best interest.

Second, the risks involved with subprime loans do not magically disappear when they are securitized.[21] Securitization shuffles the risky subprime mortgages into bigger pools.[22] In theory, subprime lending accounts for the increased risk of default by charging higher interest rates and other fees based on the risk involved.[23] Securitization then diversifies that risk so that investors are less likely to suffer losses.[24] But one still must understand how much total risk exists in the market and in the pool. The full extent of the risk of recent subprime lending only became apparent when borrowers actually defaulted more than had been expected, because many had received inappropriate loans. Further, while not the subject of this article, the Securities and Exchange Commission is investigating rating agencies due to the rating agencies' high rating of mortgage-backed securities, and a possible conflict of interest since rating agencies are paid by the investment companies that issue the securities.[25]

2. Increased marketing of exotic loans

Market factors influenced the marketing of more exotic subprime loans. As interest rates increased in 2004, prime borrowers did not refinance as much.[26] To reverse the decline in loan

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[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] Bryant, *supra* note 14.
[22] *Id.*
[23] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 126 (2007). *See* LexisNexis, *supra* note 5, at 4 (interest rates and loan fees for subprime loans are higher than for prime loans).
[24] Engel, *supra* note 17, at 2057.
[25] Editorial, *More to Blame*, BALTIMORE SUN, Oct. 2, 2007, at 8A.
[26] LexisNexis, *supra* note 5, at 16.

originations, lenders and brokers began aggressively marketing more exotic forms of subprime loans, including ARMs and interest-only loans.[27] ARMs have a very low initial fixed interest rate, sometimes called a "teaser" rate, which resets to a higher adjustable rate after a specified period of time, often "resulting in 'payment shock' for the borrower."[28] Interest-only loans delay payment of the loan's principal by initially only requiring the borrower to pay interest.[29] "As a result [of increased marketing], from 2003 to 2005, the subprime share of all mortgage loan originations rose from 7.9 percent to 20 percent."[30] However, the resulting mortgages were characterized by "lax underwriting standards, abusive lending practices and some cases of outright fraud."[31]

B. Unscrupulous Lending Practices

Lenient underwriting standards that failed to asses a borrower's ability to pay fueled the current crisis.[32] Increased competition in the subprime market caused mortgage brokers to employ more lenient credit standards.[33] Interest-only loans and ARMs were generally marketed to borrowers expecting a dramatic increase in income, with fluctuations in income, or investors trying to maximize cash flow.[34] "Subprime borrowers, however, generally do not fit any of these criteria."[35] Many subprime borrowers only qualified for their loans because of lax underwriting based on stated incomes or low teaser rates.

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[27] Robert M. Jaworski, *The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis*, Aug. 2007, at 1, *available at* LEXIS.
[28] LexisNexis, *supra* note 5, at 17.
[29] LexisNexis, *supra* note 5, at 17 n.8.
[30] LexisNexis, *supra* note 5, at 16.
[31] Edmund L. Andrews, *Fed Trims Its Forecast For Growth*, N.Y. TIMES, July 19, 2007, at C1.
[32] Testimony of Richard H. Neiman, Superintendent of the New York State Banking Department, Before the New York State Assembly Committees on Banks, Consumer Affairs and Protection, Housing, and Judiciary Oversight, Analysis and Investigation, Fed. News Service, May 29, 2007, *available at* 2007 WLNR 14058300 [hereinafter Neiman Testimony].
[33] LexisNexis, *supra* note 5, at 18.
[34] Stuart T. Rossman, *Selected Hot Topics in Auto, Mortgage and Subprime Lending*, 12 ANN. CONSUMER FIN. SERVICES LITIG. INST. 41, 52 (2007).
[35] *Id.*

Stated-income mortgages are easily abused because they do not require documentation to prove income.[36] Instead, the mortgage company simply accepts the borrower's stated income as true.[37] Stated-income mortgages are useful in situations in which the borrower's income is not reflected on a W-2, such as when someone is self employed.[38] The Office of the Comptroller of the Currency, however, estimated that nearly fifty percent of subprime loans are stated-income loans.[39] "It seems unlikely that all of these borrowers could not document their income, since most certainly receive W-2 tax forms . . . ."[40] A stated-income mortgage allows borrowers to inflate their income to receive a larger loan.[41] Further, brokers sometimes encouraged borrowers to inflate their income.[42] "According to the Mortgage Asset Research Institute, up to 90 percent of stated income loans were overstated."[43] Thus, stated income mortgages caused many borrowers to receive larger loans that they could not afford.

Further, underwriting of many subprime loans did not reflect all relevant credit factors. Underwriting considers a borrower's ability to repay the loan.[44] Underwriting should analyze all relevant credit factors, including the borrower's ability "to adequately service the debt."[45] However, many lenders underwrote ARMs based only

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[36] Coenen, *supra* note 1.
[37] *Id.*
[38] *Id.*
[39] Neiman Testimony, *supra* note 33.
[40] *Predatory Lending and Home Foreclosures: Hearing Before the S. Comm. on Banking, Housing, and Urban Affair*s, 110th Cong. (2007), Congressional Testimony via FDCH, February 8, 2007 [hereinafter Eakes Testimony] (testimony of Martin Eakes, Chief Executive Officer of Self-Help Credit Union and the Center for Responsible Lending), *available at* 2007 WLNR 2411713.
[41] Coenen, *supra* note 1.
[42] Coenen, *supra* note 1.
[43] *Hearing on Possible Responses to Rising Mortgage Foreclosures Before the H. Comm. On Financial* Services, 110th Cong. (2007) (testimony of Rep. Marcy Kaptur), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:36817.pdf.
[44] Rossman, *supra* note 35.
[45] Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,573 (2007).

on the low teaser rate.[46] Thus, the loan was based on the borrower's ability to repay the loan assuming that the teaser rate continued for the life of the loan, "not on the possible maximum payments."[47] This method of underwriting did not account for the risk of interest rates increasing.[48] Further, lenders did not inform the borrower that they did not qualify for the probable higher future payments.[49] Thus, when the loan reset and monthly payment increased, many borrowers could no longer afford the payments.[50] Consequently, underwriting of many subprime loans did not accurately reflect the borrower's ability to repay the loan.

Further, approximately seventy percent of subprime loans also contain high prepayment penalties that sometimes trap borrowers in mortgages they cannot afford.[51] Prepayment penalties initially equal several monthly payments and decline annually during the penalty period.[52] Acceptance of the prepayment penalties is just "one piece of paper that a borrower signs in a stack of 50 papers."[53] Borrowers are unable to process all of the loan terms.[54] "Typically they focus on simple price terms, such as the monthly payment amount, and ignore other potentially onerous terms, like prepayment penalties."[55] Further, many subprime borrowers would not understand the penalties even if they read them.[56] Borrowers think they can make higher payments or refinance later, but prepayment penalties often make refinancing impossible.[57]

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[46] Rossman, *supra* note 35, at 52; Eakes Testimony, *supra* note 38 ("[L]enders routinely qualify borrowers for loans based on a low interest rate when the cost of the loan is bound to rise significantly . . . .").
[47] McCoy, *supra* note 24, at 146.
[48] Rossman, *supra* note 35.
[49] *Id.*
[50] McCoy, *supra* note 24, at 146.
[51] Geraldine Fabrikant, *A Home Loan Trap*, N.Y. TIMES, Sept. 13, 2007, at C1 (quoting Senator Chris Dodd, Sept. 2007).
[52] *Id.*
[53] *Id.* (quoting Melissa A Huelsman, predatory lending attorney); Engel, *supra* note 18, at 2080 ("[W]hen the final loan terms are presented to borrowers at closing, essential terms [such as prepayment penalties] are often obscured in the shuffle of complicated loan papers.").
[54] Engel, *supra* note 17, at 2080.
[55] *Id.*
[56] Fabrikant, *supra* note 53 (quoting Melissa A Huelsman, a predatory lending attorney).
[57] *Id.*

Instead of issuing subprime mortgages based on verifiable underwriting standards, many subprime mortgages were underwritten on a presumption that real estate prices would continue to rise and that the increased value of the collateral would fix any future increased payments or foreclosure problems.[58] Lenders, secondary market purchasers, and borrowers believed that home values would continue to rise, and that interest rates would remain low or decrease further, "enabling borrowers to refinance before their loans reset."[59] Further, low teaser rates and little or no initial payment encouraged many people to buy homes.[60] Renters realized the opportunity to turn their rent check into a mortgage payment, and homeowners viewed the increased value of their home as an investment opportunity.[61]

As real estate prices continued to rise, buyers took out larger mortgages to buy homes. By minimizing initial monthly payments, subprime mortgages allowed borrowers to get a larger loan.[62] Further, stated-income mortgages allowed borrowers to overstate their income.[63] This resulted in borrowers receiving larger mortgages than they could afford. Also, many subprime loans required no down payment or very low monthly payments, resulting in negative amortization, causing the loan's principal to *grow* during the introductory period.[64] Thus, homeowners had little or no equity in their homes.[65] Therefore, when monthly rates increased, refinancing was difficult and many homeowners suffered foreclosure.[66]

The downturn in the real estate market brought lenient underwriting standards to light. The presumptions underlying many loans proved incorrect: interest rates rose and home values fell. As interest rates rose, borrowers with ARMs or who tried to refinance

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[58] Vartanian, *supra* note 3.
[59] Jaworski, *supra* note 28, at 2.
[60] Bryant, *supra* note 14.
[61] *See* Bryant, *supra* note 14.
[62] McCoy, *supra* note 24, at 146.
[63] Coenen, *supra* note 1.
[64] Negative amortization occurs when the loan principal increases. In many subprime loans, low introductory monthly payments were less than the interest accrued on the loan each month. Thus, each month the unpaid interest was added to the loan's principal, and the loan principal was larger at the end of the introductory period than when the loan was issued. McCoy, *supra* note 24, at 144.
[65] Coenen, *supra* note 1.
[66] *Id.*

could not make the higher monthly payments. Further, prepayment penalties meant that borrowers could not refinance right away. The downturn of the real estate market caused many borrowers' homes to decline in value during the prepayment penalty term; once the term expired, refinancing was impossible.[67] Foreclosures were up eighty-seven percent in the period from June 2006 to June 2007.[68] And the weak real estate market meant that mortgage companies often lost money on foreclosures.[69] Consequently, unscrupulous lending practices and the downturn in the real estate market left borrowers with loans they could not afford, hurting borrowers *and* lenders.

1. Lack of consumer protection

Lack of adequate consumer protection fueled the crisis.[70] "[S]ubprime lending tends to involve minority, elderly, moderate-to-lower income or unsophisticated persons whose need for credit makes them vulnerable to overreaching lenders."[71] Securitization provided capital to lenders, thus allowing many "small, thinly capitalized, [*less heavily regulated*] lenders and brokers . . . to enter the subprime market."[72] A high percentage of subprime loans "were made by state-licensed lenders and subsidiaries of federally regulated banks that operate with limited federal regulation."[73] Thus, loan originators were not highly constrained by consumer protection laws. Further, even federal regulation did not adequately protect borrowers, resulting in many borrowers receiving loans that they did not understand and could not afford.

Traditional federal mortgage disclosure rules are ineffective for subprime loans. Subprime lending uses risk-based pricing to

[67] Fabrikant, *supra* note 53.
[68] The Associated Press, *Banking Regulators to Increase Scrutiny of Subprime Lenders*, N.Y. TIMES, July 18, 2007, at C2.
[69] Coenen, *supra* note 1.
[70] Jonathan Peterson, *Congress Eyes Lending Rules: Sponsors in the House and Senate Prepare Bills to Provide Borrowers with More Protections*, L.A. TIMES, Sept. 6, 2007, at 3 (quoting Allen Fishbein, Director of Housing and Credit Policy for the Consumer Federation of America).
[71] LexisNexis, *supra* note 5, at 3; McCoy, *supra* note 24, at 143 (stating that subprime borrowers generally tend to be less educated and less knowledge-able about the mortgage market than prime borrowers).
[72] Engel, *supra* note 17, at 2041.
[73] The Associated Press, *supra* note 69.

determine the cost of the loan.[74] Risk-based pricing of subprime loans results in "multiple prices for the same loan."[75] But federal disclosure laws allow lenders to advertise their best rates, without disclaimers stating that availability depends on creditworthiness.[76] Thus, many "advertisements are tantamount to affirmative misrepresentations" for most subprime borrowers who will not qualify for the advertised rates.[77] Lenders are allowed to advertise teaser rates without stating how high interest rates might go when they reset.[78] As a result, lenders can entice borrowers to apply for loans that, in general, are much more expensive than advertised.

Disclosure laws do not protect borrowers who are enticed by misleading advertisements. Disclosures that lenders must provide are either insufficient to educate borrowers on the terms of the loan or long and complicated and overwhelm borrowers.[79] Also, in general, even if a lender discloses the terms early in the process, the lender can change the terms until closing with no advance notice to borrowers.[80] Thus, many borrowers do not understand the loan they receive, or the loan is more expensive than they expected. Mortgage brokers have been accused of predatory lending because they marketed exotic loans to borrowers for whom the loans were not a good fit.[81]

C. Outlook

Borrowers, lenders, investment banks and investors will continue to feel the effects of improper subprime lending for a number of years. Estimates show that almost two million subprime ARMs will reset to higher rates in 2007 and 2008.[82] Thus, foreclosures and defaults are not going to go away overnight. The high default rate and consequent losses to mortgage backed securities often surprised investors, who were unaware of the extent of the risks

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[74] McCoy, *supra* note 24, at 126.
[75] *Id.*
[76] *Id.* at 129.
[77] *Id.* at 124.
[78] *Id.* at 130.
[79] *See id.* at 132-34.
[80] *Id.* at 138.
[81] Jaworski, *supra* note 28, at 2.
[82] LexisNexis, *supra* note 5, at 22.

due to the securities' high ratings and complexity.[83] Further, the interconnectedness of financial markets caused investors to reassess and reevaluate the risk in all sectors of the market, thus affecting the global economy.[84] While not the subject of this article, Congress, the Federal Reserve, state legislators and other agencies are taking steps to regulate brokers and increase consumer protections to curb the abusive lending practices that fueled the crisis.

D. Conclusion

"[A]n overinflated housing market, zealous mortgage brokers, homebuyers eager to cash in on the craze (and clueless about the fine print) and . . . credit-rating agencies that valued bonds backed by subprime mortgages" all played a role in the subprime crisis.[85] Securitization, along with Fannie Mae and Freddie Mac's purchasing of subprime loans created a secondary market for subprime mortgages, thus increasing the capital available for these loans. Low interest rates and a booming real estate market, encouraged many borrowers to seek bigger mortgages. And lax underwriting standards, unscrupulous lending practices and inadequate consumer protection laws caused subprime borrowers, who tend to be less educated, to take out loans that they did not understand and could not afford. Thus, a larger than expected percentage of subprime borrowers have, and will continue to default on their loans, affecting borrowers, lenders, market purchasers of subprime loans, and the economy as a whole.

Carolyn Rucci[86]

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[83] *See* Anderson & Timmons, *supra* note 9.
[84] *Legislative and Regulatory Options for Minimizing and Mitigating Mortgage Foreclosures: Hearing Before the H. Comm. on Financial Services*, 110th Cong. (2007) (testimony of Henry M. Paulson, Jr., Treasury Secretary), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/testimony_-_paulson.pdf.
[85] Baltimore Sun Editorial, *supra* note 26.
[86] Student, Boston University School of Law (J.D. 2009).

VI. The Role of Rating Agencies in the Subprime Mortgage Crisis

A. Bear Stearns Implodes and Lights "a Very Dry Field of Risk on Fire."[1]

Bear Stearns, rated as the best risk manager among United States brokerage firms in 2006,[2] made a disclosure in June 2007 that lit the subprime market brushfire: Bear admitted that two of its hedge funds—which held nearly $16 billion in subprime securities[3] —were "fac[ing] a sudden wave of withdrawals by investors, the hedge-fund equivalent of a run on the bank."[4] To quell the pullouts Bear Stearns announced that it would lend one of its two faltering funds "up to 3.2 billion dollars to conduct an orderly liquidation."[5] Unfortunately, Bear's reassurances had little effect, as a third Bear Stearns fund—also heavily invested in subprime mortgages—"had to suspend redemptions as investors sought to get out even though there was no evidence the fund was in trouble."[6]

Financial giant Bear Stearns was thus paying $3.2 billion to save a $10 billion fund: "[t]hat's thirty-two cents on the dollar."[7] How could a highly sophisticated investment bank's mortgage portfolio, ninety percent of which was composed of securities with AA or AAA ratings,[8] collapse so quickly?

B. Securitization

"What do you get when you cross a Mafia don with a bond salesman? A dealer in collateralized debt obligations (C.D.O.'s)—someone who makes you an offer you don't understand."[9] In hindsight, the ratings assigned to C.D.O.'s by the major ratings

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[1] Nelson D. Schwartz and Vikas Bajaj, *How Missed Signs Contributed to a Mortgage Meltdown*, N.Y. TIMES, Aug. 19, 2007.
[2] *Id.*
[3] Gretchen Morgenson, *When Models Misbehave*, N.Y. TIMES, June 24, 2007 (Hereinafter, "Morgenson I.")
[4] Schwartz, *supra* note 1.
[5] Morgenson I, *supra* note 3.
[6] Floyd Norris, *Modern Finance Suffers Its Version Of Run on the Bank*, N.Y. TIMES, Aug. 10, 2007. (Hereinafter, "Norris I.")
[7] Morgenson I, *supra* note 3.
[8] *Id.*
[9] Paul Krugman, *Just Say AAA*, N.Y. TIMES, July 2, 2007.

agencies like Moody's and Standard & Poor's weren't worth the paper they were printed on. So the question becomes what role these ratings agencies ought to have in today's housing market. The first step of the securitization process happens when a prospective homeowner walks into a bank and asks for a loan. Based on the prospective homeowner's credit-worthiness, a bank will lend her money at a certain interest rate with the home as collateral on the loan. Typically, banks will not make loans to people with poor credit because the risk that such persons will be unable to repay the loan is too great.

Next, the bank bundles up those mortgages and sells them to large brokerage firms (e.g., Bear Stearns, UBS) in the form of debt that is backed by mortgage payments and secured by homes (known as asset-backed securities or ABSs).[10] Enter securitization: "the process by which mortgages are combined, carved up, recombined and carved up again in almost endless permutations to create new forms of debt."[11] The rationale for securitization is that properly reconstituted, the ABS's can be sold in slices or "tranches" which allow the seller of the securitized instruments to divvy up the asset backed securities based on rights of payment so that, at the end of the day, each slice will carry distinct and identifiable levels of risk and return.[12] The ratings for the slices or tranches range from "the supposedly invulnerable (AAA) all the way down to the bottom rung of investment grade and even past that, to a highly speculative unrated slice."[13] The idea is that buyers of these securities can thus identify and select the risk they want, and the brokerage firms will have created risk-free AAA securities out of pools of junk.[14]

In theory, securitization reduces risk through diversification because even if a particular loan defaults, each tranche should remain largely unaffected because of the number of loans it is exposed to, thus spreading that default risk.[15] As securitization spread into the subprime mortgage market, however, it transformed from a tool of risk-reduction into a tool of risk-concealment.[16]

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[10] Bethany McLean, *The Dangers of Investing in Subprime Debt*, FORTUNE, Mar. 19, 2007.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] Krugman, *supra* note 10.
[16] *Id.*

Wall Street realized that it was possible to create AAA-rated securities out of high-risk assets (subprime mortgages) because "the first dollar of income goes to the securities with the highest rating, while the first dollar of loss is assigned to those with the lowest."[17] The finance structures formed from the bottom rung of investment-grade ABS's became known as collateralized debt obligations (C.D.O.'s).[18] The desirability of C.D.O.'s rested on the theory that most subprime mortgages would rarely default, and even if there were defaults, the historic appreciation of home values would mitigate losses because homeowners could borrow against the rising value of their homes in order to make their mortgage payments.[19] It follows then that the bottom layers of a C.D.O., say the first ten or twenty percent, bear all the risk.[20] The higher-rated securities, protected by a cushion of lower-rated risky securities, were supposedly "as safe as a loan to General Electric."[21] These securities received AAA ratings and investors "snapped [them] up . . . because they typically yield more than bonds with the same credit ratings."[22]

These AAA ratings, however, were shown inaccurate with the collapse of the eight-hundred billion dollar market in subprime mortgage-backed bonds.[23] The low level of risk denoted by the high-ratings was artificial. Investors who thought they bought ultra-safe AAA rated securities are subsequently faced large losses. Indeed, estimates of the losses on C.D.O.'s range from $125 billion to $250 billion.[24] And reciprocally, the flood of demand for securities backed by extremely risky mortgages gave arguably too much rope to those prone to hanging themselves by providing loans to low-credit, often jobless, home buyers.

If rating agencies are in the business of predicting the risk of securities, how could they possibly have been this far off in rating C.D.O.'s? Furthermore, why did it take them until the midst of the subprime crisis to start downgrading the highly-rated yet clearly vulnerable securities?

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[17] McLean, *supra* note 11.
[18] *Id.*
[19] Floyd Norris, *Market Shock: AAA Rating May Be Junk*, N.Y. TIMES, July 20, 2007 [hereinafter *Norris II*].
[20] *Id.*
[21] *Id.*
[22] Krugman, *supra* note 10.
[23] *Id.*
[24] *Id.*

C. Evaluating the Hand That Feeds You

Conflicts of interest between the regulator and the regulated have emerged since Congress began investigating how the ratings agencies could have been so inaccurate.[25] Since John Moody introduced credit ratings in 1909 (with railroad bonds), the business model of rating agencies has been simple: investors buy a subscription to receive the agencies' opinions, and the market disciplines agencies as only accurate ratings will create demand.[26] In the 1970's, by which time it was obvious that the agencies' opinions were vital to the functioning of markets and accurate pricing for all kinds of securities, the Securities and Exchange Commission deemed the opinions a "public good" such that issuers would pay to have products rated rather than force investors to buy subscriptions.[27] While the intent was to alleviate the burden on the little guy from having to pay for these opinions, the result was that the agencies' "customers" became the very entities that they were rating,[28] and "[t]hat was the beginning of the end."[29]

Home mortgages are not exactly easy to value, considering that an investor in Nebraska likely cannot travel to New Jersey to inspect the actual real estate in which they are investing; investors "could hardly be expected to scrutinize the underlying mortgages loan by loan."[30] Instead, they put their faith in the rating agencies.[31]

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[25] *Id.* (quoting Senator Robert Menendez).

[26] Jesse Eisinger, *Overrated*, PORTFOLIO, Sept. 2007, *available at* http://www.portfolio.com/news-markets/national-news/portfolio/2007/08/13/Moody-Ratings-Fiasco.

[27] *Id.*

[28] Furthermore, ratings agencies usually get paid after the issue decides to accept the rating and have it published. In effect then, once the rating agency has completed its performance, the issuer can decide to retract its business if it doesn't like the rating. *Rating Agencies Are Under Fire But Little Consensus on Solution*, INVESTOR'S BUSINESS DAILY, Oct. 3, 2007, *available at* http://money.cnn.com/news/newsfeeds/articles/newstex/IBD-0001-20016156.htm.

[29] *Id.* (quoting Joshua Rosner, managing director of Graham Fisher & Co., a New York financial research firm for institutional investors).

[30] Roger Lowenstein, *Subprime Time*, N.Y. TIMES, Sept. 2, 2007 ("The distancing of the borrower from the lender has contributed to the development of lax underwriting standards.").

[31] *Id.*

In addition, the raters developed into advisors to financial institutions, telling them how to put deals together.[32] As the chief operating officer of Moody's explained: "You start with a rating and build a deal around a rating."[33] In the context of subprime mortgage bonds, ratings agencies and issuers have dialogue "back and forth to get the desired tranched ratings."[34] In effect, the credit-ratings agencies "made the market. Nobody would have been able to sell these bonds without the [high] ratings."[35]

For investment banks, obtaining high AA or AAA ratings for subprime securities was important because high ratings create far more demand than do lower ratings.[36] The booming market for subprime mortgage backed securities was a cash-cow for rating agencies and "the agencies knew that if they cracked down too hard, by toughening [rating] standards, it wouldn't be good for business—theirs or their customers.'"[37] Rating agencies spent "a lot of time developing new [structured finance] methodologies"[38] that would allow them to continue doling out high ratings and keep investors in a buying frenzy. "It was enlightened self-interest. They created a huge moneymaker for themselves."[39]

Indeed, rating agencies' profits steadily increased as the market for structured finance burgeoned:[40] In 2006, more than forty percent of Moody's total revenue (nearly $850 million) came from the "rarified business known as structured finance."[41] Moody's has been the "third-most-profitable company in the S&P 500-stock index for the past five years (that's higher than Microsoft and Google) . . . while S&P has profit margins that would put it in the top ten. Moreover, Fitch Ratings . . . has an operating margin above thirty

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[32] Alec Klein, *Ratings Firms Defend Assessment of Loan Securities*, WASH. POST, Aug. 28, 2007.
[33] Eisinger, *supra* note 26 (quoting Brian Clarkson, Moody's chief operating officer).
[34] *Id.* (quoting Joshua Rosner).
[35] Eisinger, *supra* note 26.
[36] *Id.*
[37] *Id.*
[38] *Id.* (quoting Eileen Murphy, the former co-head of structured derivatives for Moody's).
[39] *Id.*
[40] *Id.* ("The value of structured-finance deals hitting the market has grown twenty-seven percent a year for the past four years, to more than three trillion dollars in 2006, from about 1.1 trillion dollars in 2002.")
[41] *Id.*

percent, about double the average for companies in the S&P 500."[42] Arguably, the incentives for rating agencies were backwards, as it was in their interest to produce high-ratings via lax standards because doing so ensured a steady stream of demand for their services.

This incentive structure helps explain why "the rating agencies, which investors rely on to be the prescient cops on the beat, [were] stunningly behind on downgrading mortgage-backed securities and the pools that own them."[43] In late 2005, when raters began to observe borrowers defaulting on their mortgages, "the agencies themselves for a year were putting out warning signs . . . significant reports highlighting the risks, and yet they weren't down-grading. The raters, in effect, were wearing blinders."[44] For example, S&P waited until mid-July 2007 before it decided to downgrade $7.3 billion worth of securities sold in late 2005 and 2006.[45] Investment firm managers lacked answers: "Why didn't [the rating agencies] do this many, many months ago[?]"[46] One possible answer is the agencies' incentive structure.

D. Legislation or Self-Regulation?[47]

Congressional hearings have produced a plethora of proposals to return to the pre-1970's system where ratings agencies were paid by debt investors rather than issuers.[48] Though the simplicity of the solution is appealing, an investor-paid ratings system raises free-rider issues because "ratings will almost certainly leak to the public, so few investors would be willing to pay for the research."[49] Often there is no clear, bright-line distinction between issuers and investors. For example, UBS both issues CDOs and buys the securities for its own trading account. Depending on your point of view,

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[42] *Id.*
[43] Gretchen Morgenson, *Summer School for Investors Is in Session*, N.Y. TIMES, July 29, 2007 [hereinafter "Morgenson II"].
[44] Klein, *supra* note 31 (quoting Joshua Rosner).
[45] Schwartz, *supra* note 1.
[46] *Id.* (quoting Steven Eisman, a portfolio manager at Front Point Partners, an investment firm that had made a major bet against the subprime mortgage market).
[47] *Rating Agencies Are Under Fire, supra* note 27.
[48] *Id.*
[49] *Id.*

which division of UBS pays the agencies' their fees is more or less significant.

There is a growing consensus among raters, investors, and regulators that the subprime mortgage debt market must be more transparent. Moody's has proposed "third-party oversight of the accuracy of loan information and making loan-level performance information available to transaction participants."[50] In addition, Congress is considering whether there should be a mandatory waiting period for working on Wall Street after working for a rater.[51] Because agencies are now subject to SEC oversight, Columbia University law professor John Coffee proposed that "the SEC should calculate default rates for each rating agency and make that information public. [Also,] rating agencies that are especially inaccurate could have their SEC recognition revoked."[52] In whatever form, there must be improvement. As Representative Barney Frank, the Chairman of the House Financial Services Committee, noted, "The fact is the rating agencies didn't do a very good job. They had no way of knowing whether some of the loans were imprudently granted."[53]

F. Conclusion

While it is probably not conceivable to revert back to the pre-1970's model where investors paid rating agencies in order to receive opinions, agencies may see their freedom curtailed. Ratings firms must refocus on their core business; they must dig down to the grassroots to provide accurate ratings and valuations. Rating agencies wield great strength, respect, and importance in the financial markets. But like any other corporation, they will be most amenable to change if their customers demand it. If an agency has a poor record in ratings securities, raters will have to improve or go out of business from regulation or simply poor demand. And, as with much else in the securities markets, greater transparency cures many ills.

Alan Stern[54]

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[50] *Id.*
[51] *Credit Rating Agencies Defend Track Record*, *supra* note 23.
[52] *Id.* (quoting Columbia Law School Professor John Coffee).
[53] Schwartz, *supra* note 1.
[54] Student, Boston University School of Law (J.D. 2009).

VII. Subprime Collapse Turned Credit Crunch

In the summer of 2007, the United States' subprime mortgage market collapse caused a near-freeze in worldwide credit markets.[1] As estimates of subprime exposure and corresponding institutional losses rose, liquidity in the world credit market plummeted, causing interest rates to surge and forcing lenders to reevaluate their risk appetites.[2] This article will examine how the collapse of the subprime mortgage industry in the United States evolved into a global "credit crunch." Part A analyzes the mechanisms by which subprime borrowers' defaults on an individual scale shook the foundation of global credit. Part B studies the immediate effects of the credit crunch felt in both consumer and corporate credit. Part C discusses borrowers', lenders' and regulators' reactions to the credit crunch and to short-term measures designed to alleviate such pressures.

A. Crunchy Collapse

Throughout the subprime boom, loan originators funded mortgages with credit lines secured by the loans themselves, or by selling, securitizing, or servicing the loans.[3] In the spring of 2007, as rising numbers of Americans defaulted on their loans, subprime mortgage products began to lose their value and loan originators' sources of credit dried up.[4] Dwindling availability of funds, combined with the rising number of defaults, caused lenders to demand higher quality borrowers and higher short-term interest rates.[5] These shifts led to a credit crunch within the consumer mortgage market.

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[1] Jenny Anderson, *The Survivor,* NY TIMES, Oct. 28, 2007, *available at* 2007 WLNR 21230437.

[2] John Waggoner, *Rate Cut Could Skew Investing Path Towards Stocks, Gold*, USA TODAY, Sep. 7, 2007, at 3B, *available at* 2007 WLNR 17470053.

[3] Robert S. Friedman & Eric R. Wilson, *The Legal Fallout From the Subprime Crisis*, 124 BANKING L.J. 420, 420 (May 2007).

[4] Cyndia Zwahlen, *Tightened Credit Market Forcing Borrowers to turn to SBA Loans*, CHI. TRIB., Sep. 3, 2007, at 3, *available at* 2007 WLNR 17186611; James P. Miller, *Jobs Data Hint at Recession*, CHI. TRIB., Sep. 8, 2007, *available at* 2007 WLNR 17553244.

[5] Waggoner, *supra* note 2.

Unfortunately, the credit crunch has not remained limited to the home mortgage sector (nor could it).[6] The rapid growth and profitability of mortgage products over the last several decades made attractive investments to many kinds of investors.[7] Two common mechanisms for investment in mortgages or mortgage-based securities are structured investment vehicles ("SIVs") and real-estate-mortgage investment conduits ("conduits"). Both investment vehicles are often set up by banks.[8] Since these vehicles relied on the issuance of commercial paper for a portion of their funding, when the mortgage-backed assets they held soured in the eyes of investors, conduits and SIVs have found themselves unable to secure funding and at risk of needing significant capital bailouts from their sponsoring banks. [9] Since both conduits and SIVs do not appear on balance sheets and the extent of exposure is unknown, banks are "hoarding" capital in the event they need it and not lending it in the commercial debt markets.[10]

B. The Credit Crunch's Immediate Effects

The spread of the credit crunch from the home mortgage industry to the global credit market has had dramatic impacts on market activity. Top Wall Street firms' writedowns of assets have already topped $19 billion, evidencing widespread overvaluation of these nebulous instruments. Furthermore, as more companies announce writedowns and revise previous estimates, that number is expected to rise.[11] Investor confidence has also taken a beating as high profile institutions have failed, including two German banks and two Bear Stearns hedge funds.[12] And on August 9, French bank BNP Paribas froze refunds at three of its funds within a week of releasing

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[6] Peter Eavis, *Think the Credit Crunch is Over? Think Again*, CNNMONEY.COM, http://money.cnn.com (last visited Oct. 17, 2007).

[7] *Down the Drain*, THE ECONOMIST, Sep. 8-14, 2007, at 75-76.

[8] *Id.*; BLACK'S LAW DICTIONARY, "Real-Estate-Mortgage Investment Conduit" (7th ed. 1999).

[9] *Down the Drain*, *supra* note 7.

[10] *Id*.

[11] David Ellis, *$20B Worth of Subprime Pain*, CNNMONEY.COM, http://money.cnn.com (last visited Oct. 7, 2007).

[12] *Down the Drain*, *supra* note 7; Nicola Clark, *Mortgage Crisis Forces Sale of German Bank,* NY TIMES, Aug. 27, 2007, *available at* 2007 WLNR 16674195.

a statement that the subprime meltdown posed no threat.[13] The fact that the subprime menace struck the most sophisticated banks fueled lenders' defensive desires to horde their capital rather or invest it in less risky vehicles rather than to lend it.[14] J.P. Morgan Chase & Co. was able to post better-than-expected profits after writing down $1.3 billion in leveraged buyout commitments, but even with that kind of success, J.P. Morgan's CEO remained cautious about "a lot of risk on the balance sheet."[15]

The credit crunch's effects are being felt in much more direct ways than simply recognition of unrealized losses. Where a $220 million construction loan was secured in December 2006 to finance the Four Seasons Hotel and Private Residences in Denver, Colorado, recent condominium and apartment developers in Denver have faced lenders backing away from their projects or requiring higher rates and different terms.[16]

Purchase and sale activity between corporations, lenders, and investors has also faced setbacks as banks struggle to sell debt from bridge loans made in buyouts.[17] For example, Home Depot was able to finalize the sale of its HD Supply division to several firms only after reducing the sale price by approximately 18% and taking on part of the debt for itself.[18] Following renegotiations after involved lenders demanded better terms, Home Depot insisted in an August 30, 2007 press release that the sale "delivers shareholder value" despite "softness in the financing and residential construction markets."[19] In a similar situation in early August 2007, DaimlerChrysler

[13] *France: Funds Affected by Subprime Loans Reopen,* NY TIMES, Aug. 30, 2007, *available at* 2007 WLNR 16897460.

[14] Conrad de Aenlle, *Avoiding the Credit Storm, by Swimming Midstream,* NY TIMES, Aug. 19, 2007, *available at* 2007 WLNR 16107835.

[15] Grace Wong, *J.P. Morgan Profit Rises Despite Markdown*, CNNMONEY.COM, http://money.cnn.com (last visited Oct. 17, 2007).

[16] John Rebchook, *Financial Market Woes Knock Real Estate Deals,* Denver Rocky Mountain News (CO), Sep. 12, 2007, at 5, *available at* 2007 WLNR 17795006.

[17] Kirk Shinkle, *Will Subprime Woes End the Easy Money That Lifted Market?*, INVESTOR'S BUSINESS DAILY, July 20, 2007, *available at* 2007 WLNR 13911061.

[18] Mark Clothier and Justin Baer, *Home Depot Cuts Supply Unit Price to $8.5 Billion*, Bloomberg.com, http://www.bloomberg.com (Last Accessed Oct. 7, 2007).

[19] *Id.*; News Release, The Home Depot, The Home Depot Agrees to Revised Terms of Sale of HD Supply, Aug. 28, 2007.

AG took on $1.5 billion of debt in order to finalize the sale of its Chrysler division to a private equity firm.[20] Such problems are likely to continue since an estimated $300 billion of debt needed funding at the end of July 2007.[21] On October 16, 2007, Dow Jones reported that bankers sold $2.2 billion First Data Corp. unsecured bonds at an approximate $66 million loss for its underwriters.[22]

Smaller borrowers face an equally challenging credit problem. While the largest mortgage lender by volume in the United States, Countrywide, was able to arrange an $11.5 billion loan from 40 banks in mid-August to continue making housing loans and an additional $12 billion in September, many companies have stopped funding many new loans.[23] Of those lenders still offering home equity and mortgage loans, some are lending only to those with very good credit.[24] Lack of liquidity for personal loans is problematic not only in homebuilding and home-buying, but also for individuals who rely on home equity loans for the capital they need to operate small businesses.

C. Market Reactions: Lenders, Borrowers and Regulators

Lender reaction to the credit crunch has been predictable given the root causes of the problem. Banks and institutional investors are now unwilling to lend money for fear of unknown exposure to souring securities.[25] Illiquid lenders have stopped making new loans altogether and those still operating have tightened their credit criteria for borrowers.[26] Since unwillingness to lend and invest

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[20] Clothier and Baer, supra note 18.
[21] Shinkle, *supra* note 17.
[22] Cynthia Koons, *Banks Sell First Data $2.2 Billion But Still Left With Hefty Chunk,* DOW JONES NEWSWIRES, *available at* CNNMONEY.COM, http://money.cnn.com (last visited Oct. 19, 2007).
[23] E. Scott Reckard, *Countrywide Announces $12 Billion in New Credit Lines,* LA TIMES, Sep. 18, 2007, *available at* 2007 WLNR 17943968; Dina El-Boghdady, *For Mortgage Seekers, It's Back to the Basics,* WASHINGTON POST, Oct. 3, 2007, *available at* 2007 WLNR 19359018.
[24] Sandra Block, *Subprime Woes Ripple Through Credit Markets*, USA TODAY, Aug. 23, 2007, at 3B, *available at* 2007 WLNR 16378717.
[25] Michael Sivy, *4 Bargains That Can Beat the Credit Crunch,* CNNMONEY.COM, http://money.cnn.com (last visited Oct. 19, 2007).
[26] Nell Henderson, *Fed Leaves Key Rate Unchanged,* Washington Post, Aug. 7, 2007, *available at* 2007 WLNR 15199445.

in the commercial credit market is a function of that same fear of exposure, firms have undertaken to alleviate that fear by examining and reporting their potential losses as much as possible.[27] While neither the closing off of credit to high-risk borrowers nor the disclosure of vulnerability have eased the constricted credit climate, both will likely help to restore investor confidence and usher in the return of normal conditions.[28] Indeed some firms may now pick and choose which revalued mortgage-backed securities to buy at deep discounts.[29]

While the crunch persists and borrowers wait for the credit market to return to its former state, many will likely face problems finding financing for both commercial developments and individual needs.[30] Though finding investors will remain difficult, the Federal Reserve released statistics for the week ending on October 3 that saw the first growth in the commercial paper market after seven consecutive weeks of declines.[31] Citigroup, the largest bank in the United States, reported on October 4 that it was negotiating with various private equity firms to sell some of its leveraged loans.[32] These developments and the recent sale of a portion of First Data Corp.'s high-yield bonds further suggests that the worst of the credit crunch—market paralysis—may have passed.[33]

Individual borrowers have not yet been as lucky. Some business owners who would have previously relied on home equity loans to fund their business have been able to turn to loans backed by the Small Business Administration ("SBA").[34] SBA loans have more

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[27] Walter Hamilton, *Merrill Lynch Nets Huge, Unforeseen Security Losses*, LA TIMES, Oct. 25, 2007, *available at* 2007 WLNR 20926834.

[28] Rex Nutting, *How Much Longer Can U.S. Stave Off Recession?*, THOMSON FINANCIAL NEWS, Sep. 8, 2007, *available at* 9/8/07 Thomson Financial News 00:10:00.

[29] Simon Kennedy, *HSBC is Sued Over Subprime Bond Valuation: Report*, THOMSON FINANCIAL NEWS, Oct. 19, 2007, *available at* 10/19/07 Thomson Financial News 10:10:02.

[30] Wayne Ma, *OfficeMax Shares Jump as Profit Report Tops Expectations,* THOMSON FINANCIAL NEWS, Aug. 1, 2007, *available at* 8/1/07 Thomson Financial News 16:56:00; Block, *supra* note 24.

[31] Grace Wong, *Signs of Life for Debt Markets*, CNNMONEY.COM, http://money.cnn.com (last visited Oct. 7, 2007).

[32] *Citi Reported in Talks With KKR to Move Loans*, CNNMONEY.COM, http://money.cnn.com (last visited Oct. 7, 2007).

[33] Wong, *Signs*, *supra* note 31; Koons, *supra* note 22.

[34] Zwahlen, *supra* note 4.

relaxed credit and collateral requirements but are often more expensive than conventional commercial loans or home equity lines of credit.[35] On the home mortgage front, industry experts predict that homebuyers will go "back to basics" and turn to loans insured by the Federal Housing Administration ("FHA") or to private mortgage insurance.[36]

Regulators around the world quickly tried to soften the credit crunch's effects.[37] On August 9, the European Central Bank injected approximately $129 billion into its banking system.[38] On August 10, the Federal Reserve Bank of New York injected $2 billion of liquidity into its banking network.[39] The Bank of England, acting in its capacity as a lender of last resort, twice extended credit of 1.6 billion pounds.[40] In perhaps the strongest expression of its commitment to supporting the liquidity of the credit market, the Federal Reserve ("Fed") slashed its target twice in two months in order to "help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets."[41] In the short run, lower rates tend to "boost liquidity and confidence in financial markets" and the Fed's move in September seems to have effectively done both.[42]

The latest move, orchestrated by the United States Department of the Treasury, was a joint plan between Citigroup, Bank of America and J.P. Morgan Chase to create a $75 billion to $100 billion "super conduit" or "Super SIV" to buy mortgage-backed

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[35] *Id.*

[36] Jeanne Sahadi, *Goodbye Subprime, Hello FHA*, CNNMONEY.COM, http://money.cnn.com (last visited Oct. 19, 2007).

[37] Robert Schroeder, *Banks' Fund to Aid Credit Markets Seen as Modest First Step*, THOMSON FINANCIAL NEWS, Oct. 15, 2007, *available at* 10/15/07 Thomson Financial News 20:44:00.

[38] Mark Landler, *Europe's Central Bank Steals Spotlight From Fed*, NY TIMES, Aug. 14, 2007, *available at* 2007 WLNR 15696088.

[39] Leslie Wines, *Treasurys Post Gains as Stock Market Rally Loses Steam*, THOMSON FINANCIAL NEWS, Aug. 13, 2007, *available at* 8/13/07 Thomson Financial News 19:09:00.

[40] *Barclays Inv BK Chief Insists There is No "Black Hole"—Times*, THOMSON FINANCIAL NEWS, Sep. 2, 2007, *available at* 9/2/2007 Thomson Financial News 06:41:23.

[41] Maura Reynolds, *Federal Reserve Cuts Interest Rates Again*, LA TIMES, Oct. 31, 2007, *available at* 2007 WLNR 21469502.

[42] Nutting, *supra* note 28.

securities from other troubled SIVs.[43] The move is intended "to prevent a sharp sell-off in assets such as mortgage-backed securities, which would send their prices crashing," cause further writedowns by owners of similar securities and "further tighten credit markets and hurt the economy."[44] As eagerly as the plan was embraced by the U.S. Treasury, some non-participating banks and economists fear that the fund comes with significant risks including prolonging the crisis rather than mitigating it.[45]

D. Conclusion

With the beginnings of growth in the commercial paper market and movement in the market for high yield bonds, central bank liquidity boosts may have helped to stave off a more severe or more prolonged credit crunch.[46] Regardless, until the prices of mortgage-backed securities have been re-evaluated and stabilized, cautionary attitudes towards lending and investing will likely keep credit tighter than it was before the meltdown.

Daniel Levin[47]

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[43] *Big Banks Prepping $100B Bailout Fund*, CNNMoney.com, http://money.cnn.com (last visited Oct. 19, 2007).

[44] *Id*.

[45] Christine Harper, *World's Top Bankers Reserve Judgment on $80 Billion SuperSiv*, BLOOMBERG.COM, www.bloomberg.com (last visited Oct. 21, 2007).

[46] *Bernanke Has Warning for Wall Street*, CNNMoney.com, http://money.cnn.com (last visited Oct. 19, 2007).

[47] Student, Boston University School of Law (J.D. 2009).

VIII. Macroeconomic Implications of the Subprime Lending Crisis

At first glance, the "subprime lending crisis" seems to involve only two parties: the borrowers with less than optimal credit and their lenders. A closer look quickly reveals that the rabbit hole runs deeper: the subprime lending phenomenon has caused a significant downturn in the mortgage and financial markets;[1] and the housing downturn and market turmoil caused by the subprime woes threaten to spill over into the larger economy.[2] Under the best of scenarios, the default risk of the subprime loans will remain contained within the housing and financial markets.[3] Under the worst, the problems in those markets will spill over and lead to an economic recession in the United States.[4] The Federal Reserve's recent action and the subsequent market response provide some evidence that the economy may be able to stave off a full-blown recession.[5] And yet, trouble lurks.

A. The Subprime Lending Crisis and the Housing Market

1. Fallout in the Real Estate Industry

Despite the advantages like the giving of homeownership opportunities to people who would not otherwise have them, subprime lending is risky. Subprime lending involves a lowering in lending standards that allows more people to enter the housing market, thereby driving up housing prices.[6] In the current crisis, housing prices early on in the housing boom increased faster than household income, but over time as housing demand cooled, prices

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[1] *Bad-News Bulls; Stockmarkets*, THE ECONOMIST, Oct. 6, 2007.
[2] Edmund L. Andrews, *Few Expect A Panacea In a Rate Cut By the Fed*, N.Y. TIMES, Sept. 3, 2007, at C1.
[3] *See id.*
[4] *See id.*
[5] Doris Frankel, *Wall St's Fear Meter Falls on Strong Jobs Report*, REUTERS NEWS, Oct. 5, 2007.
[6] Andrews, *supra* note 2.

began to fall.[7] The once booming housing market ended as the housing bubble burst.[8]

One key effect of the burst is that houses currently on the market are not selling nearly as quickly as they were during the housing boom.[9] The potential pool of new homeowners previously comprised of subprime borrowers has virtually disappeared,[10] with the natural result being that housing prices have dropped even further.[11] Exacerbating this situation is the unusually high foreclosure rate.[12] Foreclosures are adding houses to the already saturated market, which in turn drives prices even further downward.[13] No one is certain how much housing prices will decrease, though some, like economist Joshua Shapiro, believe that the bottom is "not yet in sight."[14] Given the significant number of defaults currently, the market could see as many as half a million more foreclosures in the near future.[15] Certain areas of the country are expected to feel the effects more than others.[16] Previously "hot" real estate markets such as Florida could see overall declines in housing prices of 40% before the subprime crisis fully shakes out.[17]

Importantly, the saturated real estate market has affected jobs in industries dependent on the health of the real estate market. Though the September 2007 job report indicated an overall growth in the number of new jobs created, a significant number of jobs have been lost in the residential construction industry.[18] In addition, the bottom lines of home-building companies are seriously being affected by the housing downturn.[19] Also, as the construction

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[7] *Id.*
[8] *See id.*
[9] David Leonhardt, *A Slump That's Far From Over*, N.Y. TIMES, Sept. 19, 2007, at C1.
[10] *Id.*
[11] Sudeep Reddy & Michael Corkery, *Housing Chill Grows Worse, Bites Consumers*, WALL ST J., Sept. 26, 2007, at A1.
[12] Leonhardt, *supra* note 9.
[13] Desmond Lachman, *Housing Bubble Bursts into American Elections*, FIN. TIMES, April 18, 2007, at 11.
[14] *See* Reddy & Corkery, *supra* note 11.
[15] Lachman, *supra* note 13.
[16] Leonhardt, *supra* note 9.
[17] *Id.*
[18] Kelly Evans, *U.S. Economy Down, Not Out*, WALL ST. J., October 6, 2007, at A3.
[19] Reddy & Corkery, *supra* note 11.

industry declines, businesses such as The Home Depot, which supply the industry, are bracing themselves for a difficult year.[20] What started as a credit gamble by lenders has resulted in major drops in housing value, and major losses in jobs and profits in industries dependent on the real estate market.

2. Fallout in the Mortgage Industry

The spike in home foreclosures has left many exposed to the risk associated with lending to subprime borrowers. As a result, an increasing number of mortgage lenders are tightening their lending standards.[21] Lending to subprime borrowers has all but ceased, effectively removing a huge segment of borrowers who helped fuel the housing boom.[22] The flow of credit to obtain housing has been cut off to all but the most creditworthy borrowers.[23] This credit constriction, in turn, has caused serious trouble to companies dependent on originating subprime loans as either all or a significant part of their business; the most spectacular example being the failure of New Century Financial.[24] Even industry leaders such as Countrywide Financial Corporation have been seriously affected by this slowdown. Countrywide has had to scale back its lending operations with layoffs of up to 20% of its workforce in response to the subprime crisis.[25] In addition, the lending giant was forced to draw down on an $11.5 billion credit line from Bank of America in September 2007, in addition to having to sell to Bank of America a $2 billion equity stake in the company to weather the crisis.[26] In short, the previously lucrative mortgage lending industry has been battered by the subprime lending crisis.

Another interesting effect of the subprime fallout is the impact on advertising in the mortgage industry. Mortgage adver-

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[20] Angela Moore, *Home Depot Chief Sees More Macro Weakness Into 2008*, DOW JONES BUS. NEWS, Sept. 5, 2007.

[21] Lachman, *supra* note 13.

[22] *See* John H. Makin, *Recession 2008?*, WALL ST. J., Sept. 8, 2007, at A13.

[23] *Id.*

[24] Gerald P. O'Driscoll, Jr., *Our Subprime Fed*, WALL ST. J., Aug. 10, 2007, at A11.

[25] Andrea Chang, *Amgen Details Plans for Job Cuts*, LOS ANGELES TIMES, Sept. 26, 2007, at C2.

[26] Danielle Reed, *WaMu Feels Subprime Pain, but Not as Deeply; Larger Deposit Base, Access to Low Cost Funds Puts it on More Solid Footing than Countrywide*, CHI. TRIB., Sept. 30, 2007, at C8.

tising is big business. Since 2000 alone, companies have spent over $3 billion on mortgage advertising, excluding money spent on online advertisements.[27] As for internet advertising, it is estimated that in the first six months of 2007 alone, mortgage companies have spent over $378 million.[28] Throughout the housing boom, the flashy pop-ups and catchy radio commercials encouraging people to buy a home often specifically targeted subprime borrowers, claiming that borrowing was cheaper than they previously thought possible.[29] The extent to which these ads were deceptive or misleading is a current topic which the Federal Trade Commission is investigating.[30] It will be interesting to observe what effect the current housing slowdown and tightening of credit standards will have on this lucrative advertising business as other areas of the economy continue to deal with subprime issues.

The signals thus far are mixed, but appear to be leaning toward a slowdown in advertising spending. Some major advertisers, such as Quicken, plan to continue their previous level of investments in mortgage advertising, at least through the end of the year.[31] Other major companies, such as Countrywide, have had to scale back significantly their advertising operations in the wake of the strain that the subprime crisis has put on their bottom lines.[32] Also, the market for online advertising space appears to be shrinking due in large part to problems within the financial and lending sectors. The financial services sector is responsible for 16% of all online ads, and mortgage advertising makes up a large percentage of this segment.[33] As some companies scale back their advertising operations, the prices for online ad space may decline.[34] One cannot help but hypothesize that the media coverage of the subprime phenomenon has alerted many prospective borrowers to the potential dangers of subprime loans, and this will in turn lead to a decrease in the effectiveness of those subprime loan advertisements that do still make it to market. The

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[27] Louise Story & Vikas Bajaj, *Even as Industry's Troubles Grow, Mortgage Ads Keep Up the Pitch*, N.Y. TIMES, Aug. 25, 2007, at A9.
[28] *Id.*
[29] *See id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] Richard Waters, *Internet Groups are Braced for Subprime Fallout*, FIN. TIMES, Aug. 28, 2007, at 18.
[34] *Id.*

FTC is also getting involved and is investigating online mortgage advertisers to determine if they violated any federal laws with respect to the content of the ads or with respect to targeting individual groups with subprime options. All of these factors signal that this once booming advertising business will also fall victim to the subprime crisis.

B. The Subprime Crisis and the Financial Services Market

1. Securitization Spreads Risk

To understand how the subprime lending crisis roiled the financial markets, it is first necessary to understand how the subprime risks were spread throughout the markets. Lenders frequently pooled together large numbers of mortgages in order to sell them to investors.[35] Investors then sliced these pools into various exotic investment vehicles such as collateralized debt obligations.[36] On the demand side, investors, seeking a high yield on their investments, invested heavily in these exotic instruments, thus feeding the frenzy[37] Unfortunately, the value of the assets backing these pooled securities began to fall as an increasing number of subprime borrowers defaulted on their loans.[38] Investors who were initially unaware of the relative riskiness of the underlying assets backing their investments were suddenly struck by the massive volatility of their portfolios. By the time investors discovered the true nature of the risk they were carrying, the ripples brought on by rising foreclosures had spread throughout the financial sector.[39]

2. The Financial Markets in Turmoil

As subprime borrowers have been defaulting on their loans, credit in the financial markets has been less available and in some

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[35] Makin, *supra* note 22.

[36] Randall Smith, *Merrill's $5 Billion Bath Bares Deeper Divide*, WALL ST. J., Oct. 6, 2007, at A4.

[37] *See* Carrick Mollenkamp, Edward Taylor & Ian McDonald, *Global Scale: Impact of Mortgage Crisis Spreads—How Subprime Mess Ensnared German Bank; IKB Gets a Bailout*, WALL ST. J., Aug. 10, 2007, at A1.

[38] Makin, *supra* note 22.

[39] *Id.*

cases has dried up completely.[40] Investors are unable to value the exotic securities which are backed by risky subprime mortgages to some extent or another. As a result, the market for such securities is at a standstill.[41] Sellers caught holding such subprime-backed securities are reluctant to sell them at fire sale prices lest they take a large hit, so they hold them, hoping to recover some value.[42] Also, since the risk has penetrated the market so deeply, it is difficult for investors to evaluate such risk.[43] The consequence is that even banks in the business of making loans have been hesitant to lend to some borrowers, as they have no true way of knowing the extent to which the borrower faces subprime exposure with their ultimate investments.[44]

Fortunately, there have been some recent indicators allowing borrowers to assess the extent of the subprime risk remaining in the market. Recently, as Citigroup and Merrill Lynch have begun to write down their portfolios of mortgage-backed securities, investors at last have received some indication of how exposed the major financial players are to subprime risk.[45] Interestingly (and perhaps unfortunately), the write-downs announced by Citigroup and Merrill Lynch have been larger than expected, which has even led to hasty departures of both companies' CEOs.[46]

The effects of the subprime lending crisis on the financial markets have been most glaring in the debt markets.[47] The sting has been particularly painful in such areas as asset-backed commercial paper, leveraged buyouts, and hedge funds. Commercial paper is the primary mechanism that corporations use to meet their short-term financing needs.[48] Commercial paper is debt issued by a corporation directly to investors and typically has a maturation of thirty days or

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[40] Martin Feldstein, *Liquidity Now!*, WALL ST. J., Sept. 12, 2007, at A19.
[41] Smith, *supra* note 36.
[42] *Global Credit Markets Unlikely to Heal Soon-Moody's*, REUTERS NEWS, Sept. 5, 2007.
[43] *See* Feldstein, *supra* note 40.
[44] *Id.*
[45] Smith, *supra* note 36, at A1.
[46] Aaron Lucchetti & Monic Langley, *Perform-or-Die Culture Leaves Thin Talent Pool For Top Wall Street Jobs*, WALL ST. J., Nov. 5, 2007, at A1.
[47] Tom Lauricella, *How Safe is the Soaring Stock Market?*, WALL ST. J., Oct. 6, 2007, at B1.
[48] Virginia B. Morris & Kenneth M. Morris, GUIDE TO MONEY & INVESTING 81 (Lightbulb Press 2005).

less.[49] The key advantage of commercial paper is that it is often cheaper and more efficient to borrow directly from investors than from a bank.[50] As the subprime risk has spread throughout the markets, investors have become fearful that the assets backing some commercial paper issuances may be infected with subprime mortgages.[51] As a result, the market for short-term borrowing is significantly stressed.[52] On the up-side, though, the short-term nature of commercial paper transactions means that in many instances, the short-term holdings will flow quickly through the system and be purged before creating any large-scale problems.[53] Also helpful is that while the commercial paper market remains jittery, other areas of the credit markets appear to be recovering slowly, so that eventually, debt investors likely will be drawn back to investing in other short-term as well as long-term debt.[54]

Another striking area where the subprime crisis has taken its toll is on the once booming leveraged buyout market. Leveraged buyouts allow companies to take control of other companies with cash and substantial amounts of debt.[55] Companies such as Merrill Lynch and Goldman Sachs underwrite huge volumes of debt, sometimes backed by subprime mortgages, to fund their leveraged buyout deals.[56] The arrangement works fine so long as there is a market for the investment banks to unload the bonds these companies underwrite to fund the buyout.[57] As the risks associated with subprime lending have become apparent, the world of the leveraged buyout has taken a hit, as evidenced by Kohlberg Kravis Roberts & Co ("KKR") and Goldman Sachs pulling the plug on their planned $8 billion buyout of Harman International Industries.[58]

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[49] *Id.*
[50] *Id.*
[51] Anusha Shrivastava, *Is There Hope for Commercial Paper?—Level Outstanding Falls By Smaller Amount; Tension Relaxes a Bit*, WALL ST. J., Sept. 14, 2007, at C2.
[52] *Id.*
[53] *Id.*
[54] Editorial, *Virtuous Losses*, WALL ST. J., Oct. 2, 2007, at A16.
[55] Morris, *supra* note 48, at 183.
[56] Shawn Tully et al., *Risk Returns With A Vengeance*, FORTUNE, Sept. 3, 2007, at 50.
[57] *Id.*
[58] *Deals & Dealmakers: Deal Journal/Breaking Insight from WSJ.com*, WALL ST. J., Sept. 25, 2007, at C3.

Also, in an effort to beat typical market performance, many hedge funds invested heavily over the years in assets backed by subprime mortgages.[59] As these assets have declined, so too has the value of certain hedge funds. The biggest hedge fund losses involve most notably the $1.4 billion collapse earlier this year of two Bear Stearns funds that were invested heavily in subprime-related assets.[60]

C. How Housing and Financial Sector Problems Threaten the Economy

1. Housing Sector Threat

The housing sector, which includes residential real estate and construction, is a relatively small portion of the overall economy. When assessing the consequences of the subprime crisis, the best-case scenario is that the subprime problem will be contained mostly within this sector.[61] By most estimates, housing prices will continue to decline through at least next year.[62] Logically, the associated industries, such as residential construction and retail suppliers, would likely continue to feel the effects as well. Certain factors support the theory that subprime fallout will remain relatively contained. First, demand for U.S. exports remains strong, indicating that the manufacturing industry may remain healthy enough to offset the housing drag on the economy.[63] And, second, after the negative job growth report in August 2007, the September report indicated growth of over 100,000 jobs.[64]

But there is a very real possibility that an alternative scenario will materialize: namely, that the problems in the smaller housing sector will spill into the economy as a whole. Even more serious than the effects which have already touched other segments of the economy, serious attention is on consumer spending, which com-

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[59] Tully, *supra* note 56.
[60] *Id.*
[61] *See* Sudeep Reddy, *Fed Sees Limited Housing Fallout—Risks to Broader Economy From Market's Downturn Remain a Top Concern*, WALL ST. J., Sept. 7, 2007, at A2.
[62] Reddy & Corkery, *supra* note 11.
[63] Timothy Aeppel, *Dollar Lifts Exporters, Blunting Housing Bust—Foreign Clients Buoy Hotels, Manufacturers; Splurging at Tiffany's*, WALL ST. J., Oct. 1, 2007, at A1.
[64] Evans, *supra* note 18.

prises over 70% of all economic activity in the United States.[65] Some in the industry are worried that the decline in housing prices caused by the subprime lending problems will have a negative effect on consumers' wealth.[66] As housing prices increased during the boom, homeowners increasingly borrowed against their homes, which in turn increased overall consumption.[67] The now marked decrease in housing prices means that consumer spending may correspondingly decrease, leading some economy-watchers like Alan Greenspan to forecast that such consequences raise the chance of recession to one in three.[68] In addition, the uncertainty about the decline in consumer spending may cut into consumer confidence, prompting consumers to be more cautious in their spending habits as a whole.[69] According to the most recent consumer confidence survey, confidence fell to its lowest level in nearly two years.[70] The net result is that consumer spending will decline drastically, resulting in a significant drop in the largest area of U.S. economic activity. Combined with the drag in the housing market, some economists see a real threat of recession.[71]

2. The Financial Sector Threat

The possible broader economic implications for the financial sector are similar to what may play out in the housing sector. Again, there are two general scenarios, one favorable and the other more troublesome. Under the more favorable scenario, the worst of the recent financial turmoil is behind us and the financial sector will not hinder the growth of the overall economy. The recent write-downs by major Wall Street banks and the subsequent favorable market reaction indicate that the financial sector may have absorbed the brunt of the negative effects already.[72] In addition, banks have been able to find buyers for $9.4 billion in debt to help fund KKR's

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[65] Makin, *supra* note 22.
[66] Evans, *supra* note 18.
[67] Lachman, *supra* note 13.
[68] *Id.*
[69] Kelly Evans, *Politics & Economics: Signs of Weakness Lurk in Retail Sales—Continued Appetite Among Consumers Remains in Doubt*, WALL ST. J., Oct. 13, 2007, at A4.
[70] Reddy & Corkery, *supra* note 11.
[71] Lachman, *supra* note 13.
[72] *Bad News Bulls*, *supra* Note 1.

takeover of First Data, and during the last week of September 2007, Wall Street banks issued $6.2 billion of CDOs.[73] Also important is the presence of a strong global economy and high demand for U.S. exports fueled by a weak dollar, which should keep corporate profits strong.[74]

The more worrisome scenario is that despite the recent upturn in the financial markets, the turmoil may not be behind us.[75] Looking at one factor, such as the large spread between high-yield junk bonds over the yield for Treasury bonds, indicates that investors may still be nervous about bank exposure to subprime mortgages, and have accordingly shifted their confidence away from credit and investment markets to safe government investments.[76] If investors are correct in believing that banks do in fact continue to have greater subprime exposure than previously reported, the credit markets could again freeze, causing banks to hold onto risky assets backed by subprime mortgages with no discernable market onto which to unload these asset-backed investments.[77] All of this may threaten overall liquidity. The net result is that banks will be able to make fewer loans, which may ultimately drag the economy down even further.[78]

D. Conclusion

The subprime lending crisis has had major effects on certain sectors of the economy. The housing market and its related industries are clearly slumping as a result and are likely to continue to do so throughout the next year. The exposure of many financial institutions has resulted in turmoil throughout the markets. While the economy is still growing (albeit at a slower pace), it remains to be seen whether the housing and financial turmoil caused by the subprime lending crisis will ultimately result in a full economic recession.

Christopher Barlow[79]

[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *See* Feldstein, *supra* note 40.
[78] *Id.*
[79] Student, Boston University School of Law (J.D. 2009).

IX. Subprime Mortgage Consumers

Many consumers are learning that the American dream of homeownership—the white picket fenced symbol of financial and personal success—may itself have a price. For ten years, consumers were persuaded that the dream of middle-class comfort was no longer limited to the middle-class.[1] Increased competition for new customers popularized non-traditional mortgage products,[2] generated a new class of prospective homeowners,[3] and drastically increased the average home price.[4] More borrowers qualified for new and/or larger mortgages,[5] and others took out multiple mortgage loans.[6] At the same time, existing homeowners cashed in on their home equity,[7]

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[1] Daniel Gross, *The Spinal Tap Economy*, SLATE, Oct. 18, 2007, http://www.slate.com/id/2176188/fr/flyout.

[2] *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 16 (2007); Nick Timiraos, *Hot Topic: The Subprime Market's Rough Road*, WALL ST. J., Feb. 17, 2007, at A7.

[3] Homeownership rates among those at the demographic margins rose across the board. Among those 35 and under, homeownership rose from 38.6% in 1995 to 42.6% in 2006. Homeownership rates among racial or ethnic minorities rose from 43.7% in 1995 to 51.3% in 2006. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 36.

[4] *See* FREDDIE MAC, THE FREDDIE MAC REPORTER FACT BOOK 42-44 (2007); *see also* Andy Laperriere, *Mortgage Meltdown*, WALL ST. J., Mar. 21, 2007 at A19.

[5] JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 35, 38.

[6] In 2006, 25.4% of homes had either a second mortgage or home equity loan, and 1.1% of homes had both. In 2000, 22.6% of homes had either a second mortgage or home equity loan, and only .4% of homes had both. *Compare* U.S. CENSUS BUREAU, 2006 AMERICAN COMMUNITY SURVEY: FINANCIAL CHARACTERISTICS FOR HOUSING UNITS WITH A MORTGAGE (2006), *with* U.S. CENSUS BUREAU CENSUS 2000 SUMMARY FILE 3—SAMPLE DATA: VALUE, MORTGAGE STATUS, AND SELECTED CONDITIONS (2000).

[7] The amount of cash out home mortgage refinancing is over ten times higher than ten years ago, currently totaling around 244 billion dollars. Additionally, "[t]he amount of home equity outstanding more than doubled from $501.1 billion in 2002 to $1.02 trillion in 2006." INS. INFO. INST. & THE FIN. SERVICES ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2007 (2007), *available at* http://www.iii.org/financial2/mortgage/mortgages.

or took out additional loans "to pay off credit cards, do renovations and maintain an appearance of middle-class fortitude amid a declining local economy."[8]

The recent fallout from the subprime crisis threatens to take some of these borrowers out of their homes.[9] New underwriting and lending standards adopted in response to the subprime market tumble make qualifying for new loans or refinancing existing ones more difficult. Although maintaining consumer confidence is important, eventually someone must settle the tab running on consumer credit. The current subprime crisis indicates that a decade of loose lending practices and increased consumer spending has caught up with us.

A. An Expanding Array of Consumers

The subprime crisis affects a wide range of consumers, including but not limited to subprime borrowers. By definition, subprime applicants are a relatively more likely than normal borrowers to default on their mortgages—as evidenced by their poor credit scores—and they are vulnerable to changes in their financial status.[10] But the subprime lending market created more than just subprime borrowers: it inspired lenders to offer non-traditional mortgages and innovative mortgage products,[11] which gained popularity with a large and diverse group of consumers.[12] Lenders used both subprime and other non-traditional mortgage products to loan large amounts of money to a wide range of consumers on attractive—albeit

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[8] Mark Whitehouse, *Debt Bomb: Inside the 'Subprime' Mortgage Debacle —Day of Reckoning—'Subprime' Aftermath: Losing the Family Home—Mortgages Bolstered Detroit's Middle Class—Until Money Ran Out*, WALL ST. J., May 30, 2007, at A1 [hereinafter Whitehouse, *'Subprime' Aftermath*].

[9] *See* Gretchen Morgenson, *Beware of Exploding Mortgages*, N.Y. TIMES, June 10, 2007, at C3 [hereinafter "Morgenson, *Beware of Exploding Mortgages*"].

[10] *See*, *e.g.* Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007 at C1.

[11] This term refers to unconventional mortgage products, including subprime, adjustable-rate mortgages ("ARM"), and interest-only mortgages. *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 3. These unconventional mortgage products are defined in FREDDIE MAC, *supra* note 4, at 73, 80, 85.

[12] Steve Lohr, *Loan by Loan, the Making of a Credit Squeeze*, N.Y. TIMES, Aug. 19, 2007, at BU1.

introductory—terms.[13] On polar ends of the scale of borrowers are those with excellent credit histories and those with poor credit histories; the subprime crisis most affects those borrowers situated between these two poles.[14] Most of the consumers in the middle were overly optimistic about both their financial security and the future strength of the national economy. Also affected by the subprime crisis are other consumers who, for various reasons, borrowed more than they could reasonably afford.[15] Some were first-time homeowners, inexperienced with the responsibilities that go along with owning such a large asset.[16] Others assumed they could refinance soon after origination, or that a prospective higher income (or a rise in the value of the homes they purchased) would sufficiently counteract future interest rate adjustments that would occur after a fixed period.[17] In most cases, many subprime consumers simply did not realize the future trade-offs connected with the loans they signed—low introductory payments followed by interest rate resets that would lead to much higher future payments.

As the subprime crisis continues to affect credit markets such that additional sources of income continue to dry up, these borrowers suddenly hit by the change in their mortgage rates have few options available to alleviate the impact of higher monthly payments.[18] Many cannot take out new loans to help make their current monthly payments and they no longer qualify under the tighter lending policies which have developed since the credit markets have instituted stricter lending standards.[19] Most consumers have already spent any

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[13] *See* Morgenson, *Beware of Exploding Mortgages*, *supra* note 9. Consumers with good credit typically have a FICO score in the mid-700s or higher, whereas those with poor credit typically have a FICO score lower than 620. *See* FAIR ISSAC CORP., UNDERSTANDING YOUR FICO SCORE (2005).

[14] *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 25-26.

[15] *See* Lohr, *supra* note 12.

[16] *Id.*

[17] *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 2.

[18] *See* Floyd Norris & Eric Dash, *In a Spiraling Credit Crisis, Large Mortgages Grow Costly*, N.Y. TIMES, Aug. 12, 2007, at A1.

[19] *See* Laperriere, *supra* note 4. Examples of tighter lending policies include requiring a higher FICO score, lower loan-to-value rations, larger down payment requirements, heightened documentation requirements, and better value appraisals.

money previously generated from cash-out refinancing, and now have little home equity left.[20] Due to high prepayment penalties, many borrowers are reluctant to find ways to pay off their mortgages, and some borrowers must wait to refinance ARMs at a lower rate.[21]

At worst, those borrowers with subprime loans may lose their homes.[22] Although homeowners may avoid foreclosure through modifying existing mortgages, in some cases it is nearly impossible for to find the holders of their mortgages in order to renegotiate its terms.[23] A vast number of subprime loans were bundled into mortgage-backed securities and then sold into the market to countless private investors.[24] These mortgage securities make it exceptionally difficult to figure out who holds interests in any particular mortgage obligation.[25] Thus with these difficulties, many consumers who would like to refinance cannot do so, and the consequence is that some borrowers must file for bankruptcy to delay foreclosure proceedings,[26] thus choosing tarnished credit scores over the difficult task (and high cost) of investigating who owns what part of their debt.[27]

Those who do not face the prospect of foreclosure face other challenges. At best, these borrowers devote a relatively high percentage of their monthly household income to meet the high mortgage

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[20] Whitehouse, *'Subprime' Aftermath*, *supra* note 8. *But see* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 5-6.

[21] ARMs accounted for 35% of all home mortgage originations in 2004, up from 12% in 1998. The majority of interest-only mortgages, comprising 26% of mortgage originations in 2005 up from 6.3% in 2002, were at adjustable rates. INS. INFO. INST. & THE FIN. SERVICES ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2007 (2007).

[22] Indeed, many already have lost their homes to foreclosure. *See* U.S. DEP'T OF HOUS. & URBAN DEV., U.S. HOUSING MARKET CONDITIONS, 2ND QUARTER 2007 (2007), at 25.

[23] Gretchen Morgenson, *More Home Foreclosures Loom As Owners Face Mortgage Maze*, N.Y. TIMES, Aug. 6, 2007, at A1 [hereinafter "Morgenson, *More Home Foreclosures Loom as Owners Face Mortgage Maze*"].

[24] *See* FREDDIE MAC, *supra* note 4, at 8.

[25] Morgenson, *More Home Foreclosures Loom as Owners Face Mortgage Maze*, *supra* note 23.

[26] Amir Efrati, *What People Can Do if Foreclosure Looms—As Mortgage Woes Mount, Squeezed Homeowners Have Options to Try to Avoid the Worst—From Counseling to the Courtroom*, WALL ST. J., Sept. 6, 2007, at D1.

[27] *See* Bajaj, *supra* note 10.

payments,[28] which leaves many particularly vulnerable to any external impact on their finances.[29] In turn, the increased strain on borrowers' household finances contributes to growing delinquency rates with their already delinquent mortgages,[30] which is just another factor that may contribute to a rise in foreclosure rates in the near future.[31]

B. A Future for Borrowing?

While it is clear that the subprime crisis affects existing borrowers with less than optimal credit, actions taken in response to the current crisis may affect prospective borrowers as well. Lending companies have tightened their policies in response to the subprime crisis by raising the minimum credit score to qualify for loans and lowering the maximum amount applicants can borrow on certain mortgages.[32] As a result, marginally risky prospective borrowers no longer qualify for loans that were previously all but guaranteed.[33] Additionally, with an election year ahead and with the subprime crisis affecting many constituents, state and federal legislators are taking action.[34] States have allocated funds for current homeowners to give them the opportunity to refinance their mortgages at a lower interest rate.[35] In Congress, the House overwhelmingly passed a

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[28] *See* U.S. CENSUS BUREAU, 2006 AMERICAN COMMUNITY SURVEY: PERCENT OF MORTGAGED OWNERS SPENDING 30 PERCENT OR MORE OF HOUSEHOLD INCOME ON SELECTED MONTHLY OWNER COSTS: 2006 (2006).
[29] *See* John Leland, *Housing Costs Consumed More of Paychecks in 2006*, N.Y. TIMES, Sept. 12, 2007, at A14.
[30] U.S. HOUSING MARKET CONDITIONS, 2ND QUARTER 2007, *supra* note 22.
[31] S*ee* Leland, *supra* note 29.
[32] Jane J. Kim, *Finding a Mortgage in Tougher Times—Turmoil in Subprime Market Hits Home as Terms Tighten for Some Borrowers; Better Deals for the Prime Segment*, WALL ST. J., Mar. 22, 2007, at D1.
[33] *See* Norris & Dash, *supra* note 18.
[34] *See, e.g.,* Thaddeus Herrick, *States Aim to Stem Tide of Home Foreclosures With Funds for Refinancing*, WALL ST. J., July 23, 2007, at A2; Edmund L. Andrews, *Democrats Prepare Bills To Tighten Loan Rule*s, N.Y. TIMES, Sept. 6, 2007, at C1. Cynics might note that 2008 is an election year, which may explain both the sense of urgency underlying many initiatives and the reason why many legislators waited as long as they did to take action.
[35] Herrick, *supra* note 34.

similar proposal on the federal level.[36] The upshot of such a legislative response, though, is that although more regulation may better protect consumers' interests in some areas, it also may have the added detriment of decreasing an already dwindling pool of funds available for prospective homeowners.[37]

The damaged housing market means that some prospective buyers looking to enter the market may have little incentive to purchase homes because prices largely still reflect the housing boom's artificially inflated values.[38] At the same time, rather than marketing their homes at a lower price, prospective sellers in many cases opt to refinance their mortgages at a lower rate (if this option is available). Moreover, since home prices are still quite high in some areas, many would-be buyers are discouraged from attempting to purchase homes whose values, while inflated now, may only decrease in the near future when the market corrects itself.[39] All of these factors have combined to create an atmosphere where current homeowners are struggling to hold onto what they have, while prospective homeowners may be completely shut out from the market altogether.

The subprime issues have also led to marked changes in consumer morale and behavior. The changes in consumer behavior over the past year may likely continue into the foreseeable future. On the one hand, prospective sellers may simply stretch their paychecks to meet higher monthly payments rather than lowering their asking price.[40] On the other hand, prospective buyers may save their current income, opting to purchase a home in the future rather than taking on the immediate financial responsibility of homeownership.

Given the financial impact of the subprime crisis on homeowners,[41] one might expect subdued rates of consumer spending.[42]

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[36] Expanding American Homeownership Act of 2007, H.R. 1852, 110th Cong.

[37] *See* Norris & Dash, *supra* note 18.

[38] *See Economic and Housing Market Outlook: September 2007*, Office of the Chief Economist, Freddie Mac, 2007.

[39] *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 2.

[40] *See* U.S. CENSUS BUREAU, 2006 AMERICAN COMMUNITY SURVEY: PERCENT OF MORTGAGED OWNERS SPENDING 30 PERCENT OR MORE OF HOUSEHOLD INCOME ON SELECTED MONTHLY OWNER COSTS: 2006 (2006).

[41] *See id.*; U.S. HOUSING MARKET CONDITIONS, 2ND QUARTER 2007, *supra* note 22.

But one potentially dangerous trend is developing as retail spending remains relatively steady,[43] suggesting that more consumers are supplementing their monthly income with credit cards to make retail purchases.[44] Furthermore, credit card delinquency rates have decreased and mortgage delinquency rates continue to rise, indicating that some consumers hit by subprime rate re-sets may be more eager to pay their monthly credit card bills on time because with higher mortgage payments, they must rely on these credit cards to maintain their household spending.[45] The risk is that the overall market uncertainty and the resulting credit crunch could have a disastrous effect on consumer confidence and hence consumer spending.[46]

C. Consumer Confidence, Spending and Credit

Consumer confidence motivates spending, which is essential to continued economic growth. While the spread of the subprime crisis outside housing and mortgage lending has not yet dampened consumer spending, the potential threat to consumers lingers.[47] As access to credit in the housing market has tightened up, so too may credit outside the housing market tight, which would create spillover effects on general consumption**.**

Earlier this year, steady job markets, income inflation and steady spending rates fueled predictions that the subprime crisis would have little effect on the greater economy.[48] The fact that

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[42] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS (July 18, 2007).

[43] *See Consumer Credit*, FED. RESERVE STATISTICAL RELEASE (Bd. of Governors of the Fed. Reserve Sys., Washington, D.C.), September 10, 2007. *See also* Sudeep Reddy, *Retail Sales Rise 0.3% Despite Tighter Loans*, WALL ST. J., Aug. 14, 2007, at A2; *Economic and Housing Market Outlook: September 2007*, Office of the Chief Economist, Freddie Mac, 2007, *supra* note 38.

[44] Sudeep Reddy & Conor Dougherty, *The Debt-Ometers—How to Read the Subprime and other Consumer-Loan Dials*, WALL ST. J., Aug. 3, 2007, at C1.

[45] *Id.*

[46] Herrick, *supra* note 34.

[47] Keitaro Matsuda, *Will Housing Push Us into Recession?*, ABA BANKING J., Sept. 2007, at 68.

[48] Mark Whitehouse & Mike Spector, *Subprime Fallout May Not Infect Broader Market*, WALL ST. J., Mar. 12, 2007, at A2. *See* Dana Johnson, *The Subprime Credit Crunch*, ABA BANKING J., May 2007, at 64; BD. OF

people have continued to take on more debt while credit flows freely reflects consumers' confidence in their future economic prospects, and suggests some degree of market efficiency.[49] However, shortly after the Federal Open Market Committee (FMOC) predicted that "increases in employment and real wages . . . should be sufficient to sustain further gains in spending,"[50] the Bureau of Labor Statistics reported that employment decreased during the month of August.[51] The softening job situation ignited fears that the subprime market's turmoil would spread to other markets.

At this point, confidence in the markets and steady consumer spending may be dependent on increasing available credit and steadying inflation. Although the FOMC's recent rate cut helps consumers by promoting economic growth,[52] future consumer credit depends on whether the current market stability will benefit consumers, or merely encourage consumers to acquire more debt that they are unable to repay. A consumer credit crisis is on the horizon if consumers continue spending money to maintain a lifestyle beyond their means.

Recent efforts to maintain market stability by infusing the economy with more credit may cause consumers more long-term harm than short-term good. There are some indicators that consumers are acquiring more debt when they can least afford to do so.[53] Further, although subprime lending has all but evaporated, it may be that the recent rate cut could continue to make available easy consumer credit that contributed to the subprime crisis in the first

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GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS (July 18, 2007).

[49] Austan Goolsbee, *"Irresponsible" Mortgages Have Opened Doors to Many of the Excluded*, N.Y. TIMES, Mar. 29, 2007, at C3.

[50] BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS (July 18, 2007).

[51] *Employment Situation Summary,* EMPLOYMENT SITUATION: AUGUST 2007 (Bureau of Labor Statistics, Washington, D.C.), Sept. 7, 2007.

[52] Press Release, Bd. of Governors of the Fed. Reserve Sys., September 18, 2007; *see also Employment Situation Summary,* EMPLOYMENT SITUATION: SEPTEMBER 2007 (Bureau of Labor Statistics, Washington, D.C.), Oct. 5, 2007 (supporting this proposition); Nelson D. Scwartz & Vikas Bajaj et al., *Credit Time Bomb Ticked, but Few Heard*, N.Y. TIMES, Aug. 19, 2007, at A1.

[53] *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 2, at 18-19.

place.[54] The Fed's action, then, may just be putting a band-aid over the larger problem if consumers continue spending money they do not have.

D. Distinguishing Subprime Victims from Market Speculators

Human interest stories pervade media coverage of the subprime crisis, and there are many victims with many stories. For several years, mortgage brokers promised their customers fast and easy money, leaving countless homeowners at the mercy of an unregulated industry with loans which they could not afford. A visible number of people were victimized by brokers who promised low introductory rates or interest-free loans,[55] pointing to reasonable long-term rates, without mentioning that short-term rates would eventually reset to higher rates after a fixed period of time. Furthermore, independently researching the terms of their loans or reading the documents more carefully before signing would not have helped some consumers, who were unfamiliar with mortgage products and policies, and who signed agreements essentially written in a foreign language.

For every one of these victims the subprime crisis has produced, there are other consumers suffering as a result of their own moral hazard. At the other extreme are the wise-guys—those who bought real estate using ARMs or interest-free mortgages, intending to sell the homes at a profit before the interest rate teaser period expired. This behavior contributed significantly to the housing boom, increasing demand for a relatively fixed supply of homes and artificially inflating sales prices and property values as a result. As the housing market has cooled and lending policies have tightened, these consumers are now stuck paying higher rates on overvalued homes in which they never intended to inhabit. With many people at risk of losing their homes, it is hard to feel sorry for this group of speculative consumer-investors.

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[54] *See* Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Housing, Housing Finance, and Monetary Policy, Speech at the Federal Reserve Bank of Kansas City's Economic Symposium (Aug. 31, 2007).

[55] *See* News Release, Fed. Trade Comm'n, FTC Warns Mortgage Advertisers and Media That Ads May Be Deceptive, (Sept. 11, 2007).

[56] Student, Boston University School of Law (J.D. 2009).

In the middle are those who placed too much faith in an ever-upward housing market. The housing boom created a frenzy among prospective buyers, anxious to get a deal before the price of owning a home went even higher. When the economy slowed down, however, some existing homeowners opted to cash in their home equity to supplement their incomes rather than decrease their consumption levels.

E. Conclusion

The subprime crisis is the end-result of a deal that appeared too good to be true, and was. Rising foreclosure and delinquency rates among subprime mortgages indicate the tenuous situation for existing homeowners struggling to keep up with higher interest rates and monthly payments. Until the dust from the subprime crisis settles, anxious lending institutions are reluctant to finance new mortgages for all but the most credit-worthy borrowers, thus decreasing the pool of funds available for prospective buyers. At some point—and hopefully soon—borrowers, lenders, and investors will have to work together to find a solution.

Devra Lobel

X. Globalization of the Subprime Crisis: Foreign Market Effects

Although the extent of the subprime crises's effect on foreign markets has yet to be determined, the globalization of the crisis is a reality[1] for many countries.[2] Investor confidence in U.S. mortgage-backed securities is suffering dramatically as a result of the crisis. From foreign banks to investment companies to businesses trying to close credit-heavy deals, the depth of the U.S.-originated crisis means significant losses to many investments and a decrease in the availability of credit. Consequently, foreign investors will likely look elsewhere away from the U.S. to meet their future investing needs.

A. Foreign Investments in U.S. Mortgage-backed Securities

Foreign investors are estimated to be holding well over $1 trillion of capital directly invested in U.S. agency bonds and U.S. mortgage-backed securities.[3] Included in this figure are funds like those managed by Union Investment Asset Management, whose exposure to subprime assets forced it to temporarily cease redemptions on its $1.4 billion ABS-Fund in August 2007.[4] Only 6% of the fund is exposed to the U.S. subprime market, but the fund manager felt obliged to protect its clients from what it felt were

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[1] Ashok D. Bardhan & Dwight M. Jaffee, *Global Capital Flows, Foreign Financing, and U.S. Interest Rates*, FISHER CENTER WORKING PAPERS, July 2007, at 7, *available at* http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1047&context=iber/fcreue; Joanna Slater & Craig Karmin, *A New World Disorder for Debt Traders*, WALL ST. J., Aug. 10, 2007, at C1; Carrick Mollenkamp, Edward Taylor & Ian McDonald, *How Subprime Mess Ensnared German Bank; IKB Gets a Bailout*, WALL ST. J., Aug. 10, 2007, at A1.

[2] Dailytimes.com, *Bankers Expect Turmoil to Hit Global Growth*, DAILY TIMES, Sept. 11, 2007, http://www.dailytimes.com.pk/default.asp?page=2007%5C09%5C11%5Cstory_11-9-2007_pg5_13.

[3] Bardhan, *supra* note 1, at 7. *See also* Allen Frankel, *Prime or Not So Prime? An Exploration of U.S. Housing Finance in the New Century*, BIS QUARTERLY REVIEW, Mar. 2006, at 68, *available at* http://www.bis.org/publ/qtrpdf/r_qt0603f.pdf.

[4] Sarah Turner, *German Fund Halts ABS Fund on Subprime Woes*, MARKETWATCH, Aug. 3, 2007.

unrealistic market prices for the securities.[5] BNP Paribas Investment Partners faced a similar issue, as it temporarily ceased redemptions on three of its funds.[6] Those funds, BNP's Parvest Dynamic ABS, BNP Paribas ABS Euribor and BNP Paribas ABS Eonia, had a U.S. subprime exposure of 700 million euros as of July 27, 2007.[7]

Apart from these investments, there could be a much heavier stake of foreign investment dollars in the $1 trillion figure, including indirect investments through short-term commercial loans and investments masked by favorable accounting rules which keep subprime investment figures off many foreign corporations' balance sheets.[8] Until there is full disclosure as to who holds these investments, the full extent of the foreign dollars put at risk by subprime crisis will remain unknown.

B. Perspectives on the Impact of the U.S. Subprime Issue on Foreign Countries

Globally, the impact of the subprime crisis has been varied, with the full extent unclear in many countries.[9] Definite impacts have been felt, however, as evidenced by the recent news surrounding the UK's fifth largest mortgage lender, Northern Rock.

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[5] *Id.*

[6] Simon Kennedy, *BNP Suspends Fund Valuations Amid Credit-market Turmoil*, MARKETWATCH, Aug. 9, 2007.

[7] *Id.*

[8] E.g. Slater, *supra* note 1; Mollenkamp, *supra* note 1 ("There is reportedly $2 trillion in short-term commercial loans that were issued via subprime loan collateral."); Siobhan Kennedy, *Embattled Bank Faces SEC Inquiry Over SIVs*, THE TIMES, Nov. 5, 2007, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2806823.ece.

[9] Gregory Zuckerman, James R. Hagerty & David Gauthier-Villars, *Impact of Mortgage Crisis Spreads*, WALL ST. J., Aug. 10, 2007, Dow Jones Chinese Financial Wire at 1; Hungarian News Agency Via Thomson Dialog NewsEdge, *Hungary Growth May Slip Below 1pc, No Impact Seen From Subprime Crisis, City Says*, TMCnet, Sept. 7, 2007, http://www.tmcnet.com/usubmit/2007/09/07/2921258.htm; Dailytimes.com, *Bankers Expect Turmoil to Hit Global Growth*, Daily Times, Sept. 11, 2007, *available* at http:// www.dailytimes.com.pk/default.asp?page=2007%5C09%5C11%5Cstory_11-9-2007_pg5_13.

Northern Rock blames the "global liquidity crisis"[10] for needing the $8.78 billion bailout by the Bank of England.[11] As of August 20, 2007, Northern Rock's direct subprime exposure was valued at ₤75 million, with its indirect exposure via U.S. CDOs at another ₤200 million.[12] Further examples are Scottish Re and Ballyntine Re which both dropped in Fitch Ratings recently due to their reinsurance agreement reserve funds being impacted negatively by subprime investments.[13] Scottish Re released a report just prior to its rating drop that revealed $1.6 billion in subprime exposure.[14] These cases are just a few examples that demonstrate how far the U.S. subprime issue has reached around the world and the impact it has had on different markets.

Not only are corporate entities concerned about the crisis, but many countries are wary of the current state of the U.S. economy and how the U.S. subprime effects are rippling into their own economies.[15] Different countries have mounted different reactions to the subprime crisis. The Bank of Japan's Governor, Toshihiko Fukui, claimed in September that the subprime issue must be carefully monitored to determine the potential economic impact on the Japanese economy.[16] Conversely, the European Union has claimed that its countries will not experience a significant impact from the

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[10] Questions & Answers, *Why Has the Funding Facility Been Put in Place by the Bank of England and HM Treasury?*, NORTHERN ROCK: CORPORATE RELATIONS: YOUR QUESTIONS ANSWERED, http://companyinfo.northernrock.co.uk/corporateRelations/yourQuestionsAnswered.asp.

[11] Joellen Perry & Jason Singer, *Behind U.K.'s Shift on Bank Bailouts*, WALL ST. J., Sept. 19, 2007, at C1.

[12] Northern Rock PLC, Statement on Market Conditions and Trading Update, Sept. 14, 2007, at 2.

[13] Press Release, Fitch Ratings, Fitch Downgrades Ballantyne Re Class A-1 and B Notes; Remain on Rating Watch Negative (Sept. 7, 2007).

[14] Press Release, Scottish Re, Scottish Re Group Limited Provides Additional Disclosure on Subprime and Alt-A Exposure (Aug. 16, 2007) *available at* http://www.snl.com/irweblinkx/file.aspx?IID=4021224&FID=4678253.

[15] Rich Miller, *This Time, U.S. Economic Woes May Have Greater Global Impact*, INT'L HERALD TRIB., Sept. 10, 2007, *available at* http://www.iht.com/articles/2007/09/09/bloomberg/bxecon.php.

[16] NIKKEI net Interactive, *Global Impact Of Subprime Loan Mess Must Be Monitored: Fukui*, NIKKEI INC., (Sept. 14, 2007, http://www.nni.nikkei.co.jp/CF/FR/GATEWAY/rss_news.cfm?URL=/AC/TNKS/Nni20070914D14JFN03.htm&Check=1.

U.S. subprime collapse.[17] The subprime crisis has the potential to impact these countries' future economic strength and it will be interesting to see how their current perception of the crisis will change over the next year as the subprime issue continues to unravel.

C. Overview of Foreign Reactions

1. Canada and Mexico

The countries closest to the U.S., Canada and Mexico, have reacted with mixed approaches to the subprime crisis's effects. To the north, the impact on Canada is unclear. The Bank of Canada believes that the subprime crisis originated from uncertainty in determining the creditworthiness of the complex asset-backed securities that lie at the heart of the U.S. subprime crisis.[18] More specifically, David Dodge, Governor of the Bank of Canada, believes that this uncertainty in the asset-backed market led to "contagion and dislocations in money markets . . . even those markets that have nothing to do with U.S. subprime mortgages."[19] The Bank pinpointed the cause for the subprime crisis as a "classic principal-agent problem: Since the originators were immune from default risk once the loan was securitized and sold, they often lacked the proper incentives to adequately assess the creditworthiness of the borrower."[20] But Dodge believes that market forces will work out the appropriate risk levels and incentives over time, as long as there is more transparency within the markets, and as long as the market creates a role for policy-makers to help regulate the market in more effectively.[21]

In the meantime, The Bank of Canada is monitoring U.S. subprime market conditions and taking appropriate actions as it sees

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[17] Inquirer Money / Breaking News, *Commissioner Sees Little Subprime Impact on EU Growth*, INQUIRER.NET, (Sept. 4, 2007), http://business.inquirer.net/money/breakingnews/view_article.php?article_id=86495.

[18] David Dodge, Governor, Bank of Canada, Remarks to the Vancouver Board of Trade: Turbulence in Credit Markets: Causes, Effects, and Lessons To Be Learned (Sept. 25, 2007).

[19] *Id.*

[20] *Id.*

[21] *Id.*

fit.[22] Governor Dodge has stated that the Bank of Canada is "committed to providing liquidity in support of the efficient functioning of Canada's financial markets."[23] Dodge noted that the U.S. residential housing sector decline, along with recent developments in the financial markets, "implies weaker demand for Canadian exports than had been expected at the time of the July [Monetary Policy Report Update]."[24] The Governor also admitted that there has been a credit crunch which the Bank believes will dampen domestic growth.[25] Despite these predictions, the Bank chose to maintain the overnight rate at 4 1/2 percent, and thus reevaluate the situation in subsequent meetings.[26]

Recently, Governor Dodge addressed the Vancouver Board of Trade regarding the potential impact that the turbulent credit markets could have on the Canadian economy.[27] Two-thirds of the $120 billion asset-backed commercial paper market in Canada is sponsored by the major Canadian banks.[28] The Bank of Canada has confirmed its commitment to providing "global-style liquidity support to its conduits, and investors have every reason to be confident that [Canada's] banks have the capacity to continue to support its conduits as necessary."[29] However, the remaining one-third of this commercial paper market may receive no such liquidity backing, as the paper was only guaranteed if there was a "general market disruption."[30] The backers are mostly international banks that are declining to step in as the paper comes due because they do not see the subprime problem as a general disruption, but rather as a global crisis.[31] Even though the Bank of Canada recognizes that a small unfunded portion of the Canadian commercial paper market

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[22] Press Release, Bank of Canada, The Bank of Canada is Committed to Providing Liquidity; Restores Standard Terms for SPRA (Sept. 6, 2007), *available at* http://www.bank-banque-canada.ca/en/press/2007/pr07-22.html.
[23] *Id.*
[24] Press Release, Bank of Canada, Bank of Canada Keeps Target for the Overnight Rate at 4 1/2 per cent (Sept. 5, 2007), *available at* http://www.bank-banque-canada.ca/en/fixed-dates/2007/rate_050907.html.
[25] *Id.*
[26] *Id.*
[27] Dodge, *supra* note 18.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*

could be seriously affected by the subprime issue, overall, the Bank appears to be optimistic for the future outlook of the Canadian economy in the midst of the U.S. subprime crisis.

Looking to the south, the adverse effects of the subprime collapse do not appear to have spread to Mexico. In fact, Mexico's Finance Minister, Agustin Carstens, claimed that the "U.S. housing slowdown and losses incurred by subprime mortgage lenders won't damp [sic] growth in Latin America's second-biggest economy."[32] Minister Carstens attributed this optimism to the bounce-back from a 1994 financial crisis in Mexico[33] which resulted in a more resilient banking sector that has lessened the potential impact of U.S. economic woes on Mexico's economy.[34] The only potential impact that Mexican officials feel may pose any risk to their economy is the fluctuation of bond yields in the market since such bonds are linked to the Federal Reserve's decisions to cut rates.[35] Rate cuts are a signal to the rest of the world to invest in riskier emerging market assets such as those in Mexico, instead of the safer, veteran U.S. market.[36] For now, Mexico does not appear to be too concerned about long-term implications from the subprime fallout.[37]

2. Emerging BRIC Markets

Regarding the BRIC (Brazil, Russia, India, and China) emerging markets which are "faster growing economies [with] increasingly sophisticated financial product appetites,"[38] the crunch's

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[32] Karla Palomo & Bill Faries, *Mexican Economy Will Weather U.S. Housing Slump, Carstens Says*, BLOOMBERG.COM, (Mar. 19, 2007), http://www.bloomberg.com/apps/news?pid=20601086&sid=aWbzKoFuLfXM&refer=news.

[33] GAO's Report to the Chairman, Committee on Banking and Financial Services House of Representatives, Mexico's Financial Crisis (February 1996) (*available at* http://www.gao.gov/archive/1996/gg96056.pdf).

[34] Palomo, *supra* note 32.

[35] Valerie Rota, *Mexico's Peso Bonds Fall on Speculation the Fed Won't Cut Rates*, BLOOMBERG.COM, Oct. 10, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apfEbM2xwdTg.

[36] *Id.*

[37] Palomo, *supra* note 32.

[38] Suzanne Dence, Wendy Feller & Daniel W. Latimore, *Get Global. Get Specialized. Or Get Out.* IBM BUS. GLOBAL SERVICES, FIN. MARKETS, July 2007, at 4; *see generally,* Dominic Wilson & Roopa Purushothaman, *Dreaming with BRICs: The Path to 2050*, Goldman Sachs Global Econ.

impact has been varied. For instance, in Brazil, the Brazilian Real has reached a 7-year high, becoming stronger than before the U.S. subprime crisis hit and triggered a sell-off in riskier assets.[39] Also, IPOs are up from 14.2 billion reais for 2006 to 23.9 billion reais in 2007, which indicates an increased interest in investing in this emerging market.[40] Recently, Brazil's Central Bank President, Henrique Meirelles, commented on the country's macroeconomic outlook in the midst of the U.S. subprime crisis.[41] Meirelles believes that Brazil's outlook in the wake of the U.S. subprime crisis is stable due to years of taking actions to strengthen its economy.[42] The central bank has taken steps such as improving liquidity, decreasing debt, and boosting exports.[43] Meirelles also noted that the ability to differentiate among the various asset risk levels in world credit markets appears to be improving, but the fear of a U.S. recession is still present, implying that there is still volatility and uncertainty in the health of the world economy in general.[44] Overall, though, Brazil appears very confident in its economic performance as the subprime crisis continues to unfold.

In Russia, the central bank is taking actions to resolve its own the credit crunch resulting from the U.S. subprime problems.[45] Rory MacFarquhar, a Moscow-based economist for Goldman Sachs, stated that the central bank is attempting to resolve these domestic credit issues by decoupling the swap rate from the refinance rate, which should essentially lower the real refinance rate and attract more lenders to the market to increase the domestic credit supply.[46] The Russian central bank lowered and capped its interbank rates, as

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Paper No. 99, Oct. 1, 2003, http://www2.goldmansachs.com/insight/research/reports/99.pdf.

[39] Adriana Brasileiro, *Brazil Real Strengthens Beyond 1.80 Per Dollar, a 7-Year High*, BLOOMBERG.COM, Oct. 11, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJabeO9MMgME.

[40] *Id.*

[41] Adriana Brasileiro, *Brazil Meirelles Says Local Markets Are More Resistant to Risk*, BLOOMBERG.COM, Oct. 8, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=atZh_oFMchTg.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] Torrey Clark & William Mauldin, *Russian Central Bank Lowers Overnight Swap Rate*, BLOOMBERG.COM, Oct. 11, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6V5K.P.K9rU.

[46] *Id.*

well as lowered the minimum reserve rates for lenders in an effort to attract lenders and increase liquidity for Russia's economy.[47] These actions indicate that Russia is monitoring closely the U.S. subprime crisis' impact on its economy, and is taking steps to ensure future economic stability.

In India, most of the reactions to the subprime crisis have been from corporate entities. For example, a major Indian asset management company, Sundaram BNP Paribas Asset Management, released a statement seeking to differentiate itself from the its sister entity, French bank BNP Paribas, which has experienced major financial woes as a direct result of the subprime crisis.[48] The statement highlights Sundaram's perception that the subprime crisis will not likely have a significant impact on India, and any potential impact is simply seen as "sentiment and liquidity flows" that will be followed by "high volatility and corrective phases."[49] And, for its part, Sundaram's long-term and medium-term outlook on the markets remain unchanged.[50] Sundaram has shifted its focus away from U.S. markets and towards the Asian real estate markets, and the company has emphasized the fact that it will not be investing in mortgage-backed securities for the BNP Paribas Global Advantage Fund.[51] These actions are an indication that while there is some interest in monitoring how the subprime crisis will ultimately affect Indian asset management firms and its economy, there is still an overall high-level of confidence in India's economic resiliency despite what is happening in other markets.

In China, the Bank of China reported in October 2007, that 3.8% of its current securities investments, totaling "U.S. $9.65 billion (€7.2 billion), are in subprime asset-backed securities and collateralized debt obligations."[52] Nevertheless, Chinese analysts are optimistic and feel that there is little risk of a severe impact from the subprime crisis because the securities the Bank has invested in were

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[47] *Id.*

[48] Business Line, *Subprime Impact on Equity Markets*, BUS. DAILY FROM THE HINDU GROUP OF PUBLICATIONS, Aug. 19, 2007, http://www.thehindubusinessline.com/iw/2007/08/19/stories/2007081950361000.htm.

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] The Associated Press, *Bank of China Reports Heavy Exposure to Subprime Crisis*, INT'L HERALD TRIB.BUS., Aug. 24, 2007, http://www.iht.com/articles/ap/2007/08/24/business/AS-FIN-China-Banks.php.

all rated at "A" or higher.[53] One of Standard & Poor's credit analysts, Ping Chew, commented that "Asian economies have improved their banking systems, reined in fiscal deficits, brought down external debts, built up foreign exchange reserves and improved their current account balances," leaving them in a good position to weather the storm of the credit crisis without "major reversals."[54] The director of investment research at Ping An Asset Management, Chi Lo, seems to be on the same page, hypothesizing that the direct impact of the subprime exposure seems contained.[55] But, Chi Lo noted that there is fear of an indirect impact due to a potential reduction of Chinese exports to other countries that are affected by subprime risk.[56]

3. "New Frontier" Emerging Markets

Interestingly, it is worth taking note of the existence of a new frontier of emerging markets and how these markets have reacted to the subprime crisis. This next frontier of emerging markets includes countries like Poland, South Korea, Mexico (discussed above), Indonesia, and Turkey. These markets are characterized as having "lower anticipated country risk," accelerated GDP growth, and "heightened sophistication of the financial sector."[57] The outlook from these countries suggests that there may be little concern about the impact of the U.S. subprime crisis on their home markets. For example, Poland seems to be gaining momentum as one of the riskier emerging-market investments, as evidenced by the zloty climbing to a 5-year high.[58] Piotr Kalisz, an economist at Citigroup Inc. in Warsaw, stated that "investors seem to be leaving the recent subprime worries behind and are more willing to take on risk, and the zloty is gaining on this."[59] Similarly, although South Korea's

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[53] *Id.*
[54] *Id.*
[55] *Lo of Ping An Calls Hong Kong's Tax Cuts 'Positive': Video* (Bloomberg.com video broadcast Oct. 10, 2007) (*available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ar3VQHeifd1E).
[56] *Id.*
[57] Dence, *supra* note 38 at 4.
[58] Ewa Krukowska, *Polish Zloty Surges to 5 1/2-Year High on Growing Risk Appetite*, BLOOMBERG.COM, Oct. 11, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aby7rvooBDhQ.
[59] *Id.*

economy is expected to experience a decrease in growth of a 1/2 percentage point for every 1 percentage point drop in U.S. economic growth, South Korea's Vice Finance Minister, Lim Young-rok, still feels that there is low probability that a potential slowdown in the U.S. will result in other negative effects on its domestic economy; and thus the country is not concerned about a financial crisis.[60] As for Indonesia, the country continues to monitor its current economic conditions, and the Indonesian Central Bank has indicated that the domestic economy is continuing to grow despite the U.S. subprime issue.[61] Finally, according to the UN Development Program (UNDP) Administrator, Kemal Derviş, Turkey appears to be in a delicate position currently because its capital-importing economy is experiencing rapid growth.[62] However, if this inflow of money dries up due to global illiquidity resulting from the subprime crisis, Turkey could experience serious damage to its economy.[63] In sum, while these new frontier emerging economies have not yet felt a significant impact from the U.S. subprime crisis, they are continuing to monitor how, if at all, the crisis may impact their economies in the near future.

D. Future Foreign Investment in U.S. Mortgage-Backed Securities

The future outlook of U.S. mortgage-backed securities could be clouded by an overall lack of confidence of financial market participants. Companies managing investment funds may begin avoiding U.S. mortgage-backed securities because they are now seen as poor investment options.[64] Moreover, foreign companies are

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[60] KBS WORLD Radio, *Prolonged Subprime Crisis to Affect Korean Economy*, KBS GLOBAL, Aug. 30, 2007, http://english.kbs.co.kr/news/newsview_sub.php?menu=3&key=2007083023; KBS WORLD Radio, *Subprime Concerns Won't Cause Financial Crisis*, KBS GLOBAL, Aug. 23, 2007, http://english.kbs.co.kr/news/newsview_sub.php?menu=3&key=2007082321.

[61] Yuin Munn Sze Toh, *Asian Policymakers Say Markets Still Unscathed by U.S. Subprime Crisis*, FORBES.COM, Sept. 7, 2007, http://www.forbes.com/markets/feeds/afx/2007/09/07/afx4092406.html.

[62] Today's Zaman, *TURKEY: Turbulence Will Continue, Central Banks Beware, UNDP Head Derviş Said*, SEEUROPE.NET, Sept. 17, 2007, http://www.seeurope.net/?q=node/12333.

[63] *Id.*

[64] Business Line, *supra* note 48.

shying away from deals given the lack of transparency in determining who actually holds significant investments in U.S. mortgage-backed securities.[65] However, it is unclear that the shift in investments is wholly due to the U.S. subprime issue tainting the confidence of foreign investors. It could be that a significant portion of foreign investors are simply seeking out trends in the most desirable investment options by looking to other markets that may have a more attractive return on investment. Determining the actual amount of foreign investments that has shifted due to the subprime crisis is a difficult task, if not impossible, and will no doubt be looked at by many analysts in the future.

The trend theory, recently proffered by IBM Business Global Services Financial Markets, is that investment firms "must get global and get specialized—or get out."[66] The IBM research looked at both the "socio-political environment" and the "ability to connect" of financial markets around the world.[67] The research projected that by 2015 the worldwide investable assets will double to U.S. $300 trillion, quintupling by 2025 to nearly U.S. $700 trillion.[68] Additionally, IBM analysts opine that this huge growth projection means that for an investment firm to stay competitive it must look globally and enter more prospective markets, instead of relying solely on the "tried and true" veteran markets, such as the U.S.[69] On top of a broadened marketplace, IBM's research also forecasts a significant growth in securities-based investable assets.[70] In terms of worldwide

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[65] Ed Shann, *Commercial Markets Watch and Wait for Impact*, HERALD SUN, Sept. 15, 2007, http://www.news.com.au/heraldsun/story/0,21985,22419366-664,00.html; Jennifer Coogan, *Dow, S&P Lose Nearly 3 Pct as Subprime Ills Spread*, REUTERS, Aug. 9, 2007, http://www.reuters.com/article/newsOne/idU.S.N0326786220070809; sgpropertypress.wordpress.com, *Expected Impact of U.S. Subprime Woes on Stock Markets Overblown*, THE STRAITS TIMES, Aug. 29, 2007, http://sgpropertypress.wordpress.com/2007/08/29/expected-impact-of-us-subprime-woes-on-stock-markets-overblown/; Rex Nutting, *Subprime Could Create Global Crisis, Economist Says*, MARKETWATCH, July 26, 2007, http://www.marketwatch.com/News/Story/economist-world-one-hedge-fund-collapse/story.aspx?guid=%7BC9E3B6A4-A22E-43D2-BA2A-EC4A8F61D2E4%7D&dist=TNMostRead.

[66] Dence, *supra* note 38 at 2.

[67] *Id*. at 3.

[68] *Id.* at 1.

[69] *Id.* at 2.

[70] *Id.* at 5.

wealth distribution, securities will surpass currency and deposits as the investment vehicle of choice by the year 2020.[71] In particular, U.S. securities-based investable assets are projected to continue to dominate the markets, both veteran and prospect, in the next 18 years.[72] However, the IBM project also notes that the last six years witnessed a significant drop in the number of IPOs in the U.S. market,[73] quipping that "the proverbial dam has broken: Clients have been test-driving other markets, and the switching costs that historically kept them close to home have largely been overcome."[74] Thus although the U.S. will dominate securities-based investable assets in the near future, recent trends indicate that investors will continue to look elsewhere for other profitable options.[75] Specifically, investors will look to markets that are becoming easier into which to enter and those markets with looser regulatory structures, rather than dealing with the "extensive, rule-based regulations" of the U.S. market.[76]

The other theory that is more likely on peoples' minds is that the U.S. subprime problems will drive investors away from U.S. mortgage-backed securities, and possibly U.S. investments in general. This movement, if it exists, may have already begun. For instance, a Japanese financial services firm, Nomura, announced that it was exiting the U.S. residential mortgage-backed securities market.[77] It reduced its exposure by approximately U.S. $1.9 billion, leaving it with only a $109 million invested in U.S. mortgage-backed securities, and with only $1 million of this parked in subprime assets.[78] The company blamed its exit on poor results in the RMBS

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[71] *Id*.
[72] *Id.* Prospect or emerging markets are defined as "[t]he financial markets of developing economies." Forbes Financial Glossary, *Emerging Markets*, FORBES.COM, http://www.forbes.com/tools/glossary/searchWord.jhtml (as at Oct. 25, 2007). Veteran or mature markets are those of developed economies, such as the U.S. or England.
[73] Dence, *supra* note 38 at 8.
[74] *Id.*
[75] *Id.*
[76] *Id.* at 4.
[77] News Release, Nomura, Nomura Exits U.S. Residential Mortgage-Backed Securities Business, Oct. 15, 2007, http://www.nomuraholdings.com/news/nr/holdings/20071015/20071015.html.
[78] *Id.*

market, but indicated that it would consider investing in profitable U.S. assets in the future.[79]

Another alarming exit figure was released recently by the U.S. Department of the Treasury.[80] On October 17, 2007, The Treasury International Capital System data showed a $69.3 billion exit of foreign investors from long-term U.S. securities.[81] An economist from ING noted that, although "one month never makes a trend," this mass exodus could be troublesome if the market does not see a rebound in the coming months.[82] Whether or not there truly is a trend away from foreign investment in the U.S. remains to be seen. But any such trend will certainly be played out on the global stage, to a crowd of investors, domestic and foreign.

E. Conclusion

Unfortunately, the uncertainty that created the domestic subprime crisis extends into foreign markets, and that uncertainty has had a major impact on not only future foreign investment in U.S. mortgage-backed securities, but also on the global economy. The U.S. subprime crisis has affected not only industrialized and established economies, but it has also had an affect on emerging economies in Brazil, Russia, India, and China, and such "new frontier" emerging economies like Poland, South Korea, Indonesia, and Turkey. The question with these emerging markets is whether the subprime issue will strengthen emerging markets in the long term or thrust them into a bubble that will pop in the coming months when veteran markets work at rebalancing their economies. The short-term evidence of the initial ripple effects from the subprime crisis around the world indicates that many established markets are resilient, which gives emerging economies confidence that they too will be able to deal effectively with any potential subprime impact. But the question remains: What long-term impact will the subprime crisis have? Will reactions to the crisis promote changes in economic

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[79] *Id.*

[80] Dave Shellock, *U.S. Outflow Numbers Leave Investors on Edge*, FIN. TIMES, Oct. 17, 2007, *available at* http://www.ft.com/cms/s/0/eab82e38-7c4b-11dc-be7e-0000779fd2ac.html; *see also generally* U.S. Department of the Treasury, United States Transactions with Foreigners in Long-Term Securities, http://www.treas.gov/tic/ticsec.html (last visited Nov. 4, 2007).

[81] *Id.*

[82] *Id.*

policy that will translate into long-term economic stability or will these changes be short-lived and the subprime crisis will rear its ugly head again in the future? As the world becomes more enlightened on the true impact of the subprime crisis, countries and companies will hopefully continue to act prudently to move the global economy back into pre-subprime balance.

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XI. Impact of the Subprime Mortgage Crisis on the Student Lending Industry

With the market still responding to the impact of the subprime mortgage crisis, Congress and other lawmakers have turned their attention to the student lending industry, as recent state and federal investigations have revealed that numerous private lenders engaged in improper practices.[1] Similar to the subprime mortgage industry and during the same time that the subprime crisis was brewing, student lending institutions utilized arguably predatory lending tactics to encourage private loan borrowing by students.[2] Additionally, these loan providers offered incentives to higher education's financial aid officials to push students to select their loans.[3]

Given the number of students who rely on private loans, investors now fear that student lending will suffer its own financial crisis, as many are wary of placing their money in investments backed by student loans.[4] Just as with subprime mortgages, student loans are pooled together into an asset-backed security and are purchased by institutional investors to generate revenue.[5] The recent crisis in the subprime mortgage industry has prompted concern among investors about the health of asset-backed securities in general, including those backed by student loans.[6] As money is diverted away from these securities, experts fear decreasing availability of funds for future student loans.[7]

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[1] Kevin Drawbaugh, *As Subprime Rages, Strains for Student Loan Debt Securities*, INT'L BUS. TIMES, Aug. 28, 2007, *available at* http://www.ibtimes.com/articles/20070828/student-loans-subprime.htm; Justin Draeger, *Beware Aggressive Marketing of Student Loans*, OR. SENTINEL, Aug. 26, 2007, at A20.

[2] Eric Dash, *Reeling in the College Bound*, N.Y. TIMES, Sept. 2, 2007, at C1, *available at* http://www.nytimes.com/2007/09/02/business/02jabba.html.

[3] *Id*.

[4] Drawbaugh, *supra* note 1.

[5] *Id*.

[6] Jenny Anderson & Heather Timmons, *Why a US Subprime Mortgage Crisis is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1, *available at* http://www.nytimes.com/2007/08/31/business/worldbusiness/31derivatives.html

[7] Drawbaugh, *supra* note 1.

Upon discovering lending institutions' questionable practices, Congress took action to cut subsidies to private lenders and to provide more favorable laws regarding loan repayment. In addition, Senator Chris Dodd of the Senate Committee on Banking, Housing, and Urban Development sponsored a bill to address many of the underlying concerns with student borrowing.[8] Proposed reforms would prevent lending institutions from providing incentives to school officials, focus government agencies' efforts on increasing students' financial literacy, and would mandate disclosure of loan rates and terms to students.[9] Lawmakers and experts are hopeful that these changes will increase students' awareness when borrowing to pay for higher education, which hopefully will in turn reduce loan defaults.[10] Critics, however, worry that Congressional action will hurt student lenders and, subsequently will lead to a shortage available student loan funds.[11]

A. Recent Trends in the Private Student Lending Industry

The dollar amount of student loans issued in 2006 totaled $17 billion, a staggering $13 billion increase in only 6 years.[12] In large part, this is due to the ever-rising cost of higher education.[13] Tuition, fees, and room and board increased 79 percent to $12,796 a year at four-year public colleges and universities, and increased 65

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[8] Press Release, S. Comm. on Banking, Housing, and Urban Affairs, Private Student Loan Transparency and Improvement Act (Aug. 1, 2007), *available at* http://banking.senate.gov/_files/080107_studentlendingsummary1.pdf.
[9] *Id.*
[10] *Id.*
[11] *Another Subprime Scandal*, ECONOMIST, Apr. 12, 2007, *available at* http://www.economist.com/research/articlesBySubject/displaystory.cfm?subjectid=1269867&story_id=9009079.
[12] *Student Paying for College: The Role of Private Student Lending: Hearing Before S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (testimony of Jennifer Pae, United States Student Association) [hereinafter Testimony of Jennifer Pae].
[13] *Student Loan Lenders Creating a New Credit Bubble*, EDUCATION PORTAL, Oct. 4, 2007, *available at* http://education-portal.com/articles/Student_Loan_Lenders_Creating_a_New_Credit_Bubble.html.

percent to $30,367 a year at private institutions.[14] By contrast, consumer prices rose less than 29 percent on average during the same time period.[15]

Despite rising higher education costs, the maximum amount students may borrow through government-backed loans[16] has remained the same for the past four years.[17] As a result, the number of private loan lenders, and the amount of loans they provide, has grown tremendously to fill the gap.[18] In 1995, private student loans accounted for 1.4 percent of the total volume of student loans.[19] In 2005, that number increased to 16.3 percent.[20] Moreover, student borrowing grew from $38 billion in 1995 to $85 billion last year.[21]

C. Similarities between Student Lending and Subprime Mortgage Industries

Private student loan providers market their loans to students directly through multiple channels, often targeting students with a financial need.[22] As with subprime mortgage lenders, many private student loan lenders used aggressive tactics which sometimes crossed the line into the predatory category.[23] Private loan providers employed various techniques, ranging from misleading marketing materials to drive students away from federal student loans, to suggesting that a "student loan tax" existed that would raise current interest rates on federal loans.[24] Some providers even acted as student-aid officers or government agents by offering students printed loan information decorated with school insignias to suggest that the school recommended the loan.[25]

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[14] Marcy Gordon, *High-Priced Student Loans Spell Trouble*, ASSOCIATED PRESS, Oct. 1, 2007, *available at* http://abcnews.go.com/Business/wireStory?Id=3671761.
[15] *Id*.
[16] Examples of government-backed student loans include Stafford Loans or Pell Grants.
[17] *Student Loan Lenders Creating a New Credit Bubble, supra* note 13.
[18] Testimony of Jennifer Pae, *supra* note 12.
[19] Gordon, *supra* note 14.
[20] *Id*.
[21] *Student Loan Lenders Creating a New Credit Bubble, supra* note 13.
[22] Testimony of Jennifer Pae, *supra* note 12.
[23] Draeger, *supra* note 1.
[24] *Id.*
[25] Testimony of Jennifer Pae, *supra* note 12; Dash, *supra* note 2.

College and university financial aid officers even contributed to the effectiveness of such lender efforts by instituting their own strategies to help the industry increase the number of students who borrowed through private loan channels.[26] Private student loan institutions provided incentives to financial aid officials at universities in exchange for recommending them as the preferred lender of choice. The incentives included offering stock in their companies, paying for travel expenses, and even paying for the officials' continuing education requirements.[27] An investigation by New York Attorney General Andrew Cuomo revealed that many officials pushed students towards these lenders regardless of whether the products they offered met student needs.[28]

In addition to employing aggressive marketing tactics, private student lending institutions targeted students viewed as the most vulnerable—those with poor credit history, with parents unable to co-sign on student loans, and those unlikely to be able to repay the loan debt upon graduation.[29] Private student loans are unique in that unlike other loans, they do not have disclosure requirements; thus students may not have an accurate sense of the loan rates and terms of repayment.[30] Additionally, some adjustable rate loans start with a competitive introductory interest rate but later reset to an unpredictably higher rate.[31] In contrast, federally-guaranteed loans have interest rates capped at 6.8 percent.[32] Private lenders defended the high interest rates as necessary, given the risk of providing unsecured loans to borrowers with poor or nonexistent credit histories.[33] These factors together, however, create a fragile framework in which the likelihood of default on private student loans seems remarkably high compared to government-backed or other loan products.[34]

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[26] Kelsey Volkmann, *Students Drown in Debt from Private Lenders*, EXAMINER, Aug. 24, 2007, *available at* http://www.examiner.com/a-897606~Students_drown_in_debt_from_private_lenders.html.
[27] *Paying for College: The Role of Private Student Lending: Hearing Before S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (testimony of Andrew Cuomo, Att'y Gen. of New York).
[28] *Id*.
[29] *Another Subprime Scandal, supra* note 11; Dash, *supra* note 2.
[30] Gordon, *supra* note 14.
[31] *Id*.; *Another Subprime Scandal, supra* note 11.
[32] Volkmann, *supra* note 26.
[33] Gordon, *supra* note 14.
[34] Matthew Sheahan, *Are Buyers Bluffing on Killing Sallie Mae?*, BANK LOAN REP., Sept. 10, 2007, *available at* 2007 WLNR 17683201

D. Impact of the Subprime Mortgage Crisis on Student Lenders

Similar to the subprime mortgage industry, private student loan providers profit by bundling student loans into asset-backed securities (ABS) and selling them to institutional investors as collateralized debt obligations (CDOs).[35] The demand to bundle student loans in this manner grew tremendously in 2006.[36] According to Moody's Investors Services, the market for securities backed by private student loans increased 76 percent, from $9.4 billion in 2005 to $16.6 billion in 2006.[37]

Given the similar investment vehicle, the student lending industry is feeling the impact from the subprime mortgage crisis. In the wake of the subprime mortgage crisis, individuals began to question the stability of the assets underlying their investments, and grew wary of any securities backed by personal debt. Investors have subsequently pulled money from these types of securities, including CDOs backed by student loans.[38] As funds from shareholders are amongst the largest source of funding for private student loans, experts fear that the decrease in investing over time will lead to a reduction in the amount of private loan funding available for students.[39]

Sallie Mae, one of the largest providers of student loans, exemplifies the impact that investor uncertainty is having on the student lending industry.[40] In 2006, Sallie Mae originated $23.4 billion in student loans, representing 27 percent of all student debts in the United States.[41] The company agreed to a buyout by investor group J.C. Flowers & Co., along with Friedman Fleischer & Lowe, a private equity firm, for approximately $25 billion in April 2007.[42]

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[35] *Student Loan Lenders Creating a New Credit Bubble, supra* note 13; Drawbaugh, *supra* note 1.
[36] *Id.*
[37] Gordon, *supra* note 14.
[38] Anderson & Timmons, *supra* note 6.
[39] Drawbaugh, *supra* note 1.
[40] Seahan, *supra* note 33.
[41] *Id.*; Gale Group, *Sallie Mae To Borrow Big For LBO: Student Loan Lender on its Way to Junk Territory*, ASSET SECURITIZATION REPORT, June 18, 2007, *available at* 2007 WLNR 11426129.
[42] Seahan, *supra* note 33.

The purchase would result in J.C. Flowers and Friedman Fleischer & Lowe collectively owning 50.2 percent of Sallie Mae, and Bank of America and JPMorgan Chase each owning 24.9 percent.[43] With decreasing consumer confidence in the credit market and increased scrutiny on the student lending industry itself, however, the investor group now wants to reconsider the terms of the deal. Concerned that Sallie Mae may no longer be as profitable as they once believed, the investors are seeking to cut the price per share and lower the overall value of the deal.[44] Given Sallie Mae's share of the student lending market, uncertainty about its future leads some to believe the entire industry may be headed for a financial downturn.[45]

Despite the Sallie Mae example, and other similarities between the subprime mortgage and the student lending industries, some experts suggest a crash is not imminent in the latter.[46] According to Moody's Investor Services, securities backed by private student loans perform at analyst expectations, and should continue to do so, provided employment and income trends do not worsen.[47] Moody's contends that as the majority of loan holders are currently in school, the current economic situation should not impact these individuals' ability to repay their loans.[48] In contrast, Standard & Poor's noted an increase in the number of student loan delinquencies in the private sector, and the company suggests that it may be too early to tell whether the trend will continue.[49] Such conflicting predictions on the industry's future simply compound investors' skepticism on the overall stability of the student lending market.

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[43] *Id*.
[44] David Wighton & Jane Croft, *Flowers Group Cuts Sallie Mae Bid*, FINANCIAL TIMES, Oct. 2, 2007, *available at* http://www.ft.com/cms/s/0/6f185aae-712f-11dc-98fc-0000779fd2ac,dwp_uuid=d355f29c-d238-11db-a7c0-000b5df10621.html.
[45] Mark Pittman, *Storm Hits Safe Haven for Bonds*, INT'L HERALD TRIB., May 23, 2007, at 13, *available at* 2007 WLNR 9663600.
[46] *No Near-Term Deterioration in US Student Loan Securitization Performance*, FORBES, Oct. 3, 2007, *available at* http://www.forbes.com/markets/feeds/afx/2007/10/03/afx4183898.html.
[47] *Id*.
[48] *Id*.
[49] Seahan, *supra* note 33.

E. Regulatory Response to Student Lending Industry Practices

Following the discovery of the predatory lending tactics employed by private student loan providers, the United States Senate Committee on Banking, Housing and Urban Affairs held hearings in June 2007.[50] Testifying individuals included Andrew Cuomo, who spearheaded the investigation into the close ties between student lenders and financial aid officials, representatives from Sallie Mae and Bank of America, and advocates from higher education agencies, who provided viewpoints on the status of the industry and recommended solutions.[51]

Based on testimonials, Committee Chair Senator Dodd sponsored the Private Student Loan Transparency and Improvement Act. The bill seeks to improve loan disclosures and market transparency, prevent unfair and deceptive industry practices, eliminate conflicts of interests, and promote greater financial literacy for college students.[52] If passed by Congress the bill would, among other things:[53]

1. Require lenders to provide student borrowers a 30-day window to compare loan products and rates;

2. Require lenders to provide students with a 3-day "cooling off" period after consummation of their loan;

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[50] Press Release, S. Comm. on Banking, Housing, and Urban Affairs, Committee Passes Dodd Bill to Help Students Afford College; Haley Chitty, *Senate Banking Committee Examines Private Student Loans*, National Association of Student Financial Aid Administrators, June 6, 2007, *available at* http://www.nasfaa.org/publications/2007/gsenhearing060707.html [hereinafter "Press Release, S. Comm. on Banking, Housing and Urban Affairs"].

[51] Chitty, *supra* note 50.

[52] Press Release, S. Comm. on Banking, Housing, and Urban Affairs, *supra* note 50.

[53] *Summary of Private Student Loan Transparency and Improvement Act as Reported by The Senate Banking Committee*, Consumer Bankers Association, Aug. 2, 2007, *available* at http://www.cbanet.org/files/FileDownloads/StudentLendingFiles/Dodd-bill-summary-08-09-07.pdf.

3. Prohibit revenue-sharing and loan co-branding arrangements between lenders and schools;

4. Prohibit lenders from offering gifts to schools or school employees in exchange for preferential consideration of their private loan products or services;

5. Apply Truth in Lending Act (TILA) consumer protections to all private student loans;

6. Require lenders to provide comprehensive disclosures upon approval of a loan, including the loan's interest rate, type of rate, all fees and finance charges, and the borrower's monthly payment; and

7. Require federal agencies to develop initiatives aimed at improving the financial literacy of college students, designed to grow awareness on the cost, obligations, and rights associated with educational loans and other college debts.

In addition to the recommendations incorporated by the Private Student Loan Transparency and Improvement Act, Luke Swarthout of the United States Public Interest Research Group, recommends that Congress amend bankruptcy laws regarding student loans.[54] Unlike other debts, student loans cannot be discharged by filing for personal bankruptcy, essentially eliminating this safety net for vulnerable borrowers unable to meet the burdens of student loans.[55] Critics of this system advocate changing the law to treat student borrowers as fairly as other debtors by providing them with an avenue to discharge their student loans.[56]

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[54] *Paying for College: The Role of Private Student Lending: Hearing Before S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (testimony of Luke Swarthout, Higher Education Advocate United States Public Interest Research Group) (hereafter Testimony of Luke Swarthout).

[55] Kathleen Pender, *Student Loans and New Law*, SAN FRANCISCO CHRONICLE, Oct. 6, 2005, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2005/10/06/BUGCMF30J11.DTL&type=business.

[56] Testimony of Luke Swarthout, *supra* note 54.

Already, Congress has taken action to address the potential for crisis in the student lending industry.[57] The bill, which has been passed by both the House and the Senate and will likely be signed by the President, will ease the burden on student borrowers by capping graduates' monthly payments at 15 percent of their income and by providing loan forgiveness after 10 years for those who take public-services positions, such as teachers and nurses.[58] In addition, the bill calls for a $20 billion cutback in subsidies for lenders that participate in government-backed loan programs, directing that money instead to boost student financial assistance.[59] Furthermore, the bill would also cut the interest rates on need-based loans in half over four years, to 3.4 percent.[60]

F. Conclusion

Recent discoveries in the student lending industry show a remarkable similarity to the subprime mortgage industry. In both industries, lenders utilized aggressive marketing tactics to target non-traditional loan candidates who often did not have a clear understanding of the terms of the loan or who may have been unable to eventually repay the loan.

Also similar to subprime mortgages, student loans generate revenue for lending institutions by being pooled together into asset-backed securities and purchased by institutional investors. In large part due to the financial instability in the subprime mortgage market, investors have become skeptical of the soundness of securities backed by personal debt, including student loans, and are now less willing to invest in these products.

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[57] Kevin Drawbaugh, *Congress Sends Student Aid Overhaul to Bush*, REUTERS, Sept. 7, 2007, *available at* http://www.reuters.com/article/politicsNews/idUSWBT00751720070907?feedType=RSS&feedName=politicsNews&sp=true.

[58] Diana Jean Schemo, *Congress Approves Student Loans Bill*, N.Y.TIMES, Sept. 7, 2007, *available at* http://www.nytimes.com/2007/09/07/education/07cnd-loans.html?_r=1&oref=slogin.

[59] *Id*.

[60] *Congress Sends Student Aid Overhaul to Bush, supra* note 56.

In an effort to avoid crisis in another financial market and to address concern over practices employed by private student lenders, Congress and President Bush have taken steps to reform the private student lending industry. Whether these reforms will have an impact, however, remains to be seen.

Ami Bhatt[61]

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[61] Student, Boston University School of Law (J.D. 2009).

XII. Predatory Lending's Role in the Subprime Mortgage Crisis

Much of the media coverage of the subprime crisis of 2007 has focused on the role of predatory lending.[1] Subprime lending does not automatically equate to predatory lending, but a great number of the subprime loans which have since gone belly-up contained arguably predatory terms.[2] Many in federal and state government and in the mortgage industry have struggled with the concept of predatory lending because there is no uniform definition that provides guidance.[3] As a consequence, this lack of a clear definition makes it difficult to determine the exact nexus between predatory lending practices and the high foreclosure rates for many subprime mortgage-holders.[4] In fact, the Federal Deposit Insurance Corporation cited this lack of a clear definition as a key problem in fighting predatory lending practices.[5] Nevertheless, all levels of government around the nation are proposing anti-predatory lending legislation.[6] Even though there is a call to stop the practice of predatory lending, proponents disagree about who should take responsibility.[7] Other market observers, including Federal Reserve Chairman Ben Bernanke, worry that increased regulation will focus on the wrong factors and end up hurting consumers more than

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[1] *Tanking Sharky Lenders*, WASH. TIMES, April 15, 2007, at B05.

[2] *Swimming with Sharks: Homeowners Eaten Alive by Predatory Lenders, Investors*, COLORADO SPRINGS INDEP., Feb. 27, 2002, at 11, *available at* 2007 WL 11656292 (hereafter *Swimming with the Sharks*).

[3] *Tanking Sharky Lenders*, *supra* note 1.

[4] Morgan J. Rose, *Forclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices* 1-35 (Policy Analysis Div., Off. of the Comptroller of the Currency, Econ. Working Paper 2006-1), at 2.

[5] *Tanking Sharky Lenders*, *supra* note 1.

[6] Wei Li & Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, CTR. FOR RESPONSIBLE LENDING, Feb. 23, 2006, at 2, *available at* http://www.responsiblelending.org.

[7] *See*, *e.g.*, *Id.* at 2; *Realtor(s) Seek to Protect Home Buyers from Predatory Lending and Educate them on Mortgage Products*, PR NEWSWIRE U.S., Feb. 7, 2007; Nikitra S. Bailey, *Predatory Lending The New Face of Economic Injustice*, 2005 A.B.A. HUMAN RIGHTS 14, at 16; *Tanking Sharky Lenders*, *supra* note 1.

protecting them.[8] Thus, it is unclear what, if any, steps should be taken to curb predatory lending in the mortgage industry.

A. Relationship Between the Subprime Lending Market and Predatory Lending

Subprime mortgages are for borrowers with low credit scores who traditionally represent a higher risk of default.[9] Beginning with the Federal Community Reinvestment Act of 1977, and continued by Congress and the Clinton Administration's encouragement of homeownership in the 1990s, subprime mortgages became a popular and attractive option for many home buyers.[10] Generally, subprime loans have traditionally targeted unsophisticated borrowers with less understanding of the market and who have poorer credit histories or who are first-time homeowners. In practice, this has meant that the poor, minorities, and the elderly are more likely to receive subprime loans than other groups.[11] Given the risk involved with originating these loans (which are, by definition, riskier than prime mortgages), the market found a way to spread the risk associated with these borrowers through securitization.[12] Thus, the presence of unsophisticated borrowers, and the ability of the market to spread the risk of default more evenly through securitization, has made the subprime market an ideal place for predatory lenders to operate.[13]

Though lacking a uniform definition, predatory lending practices are generally found to include the charging of interest and fees beyond what is needed to cover the associated risk of lending.[14]

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[8] Alan Zibel, *No Major Reform This Year Expected on Mortgages*, PITTSBURG POST-GAZETTE, June 8, 2007, at C7, *available at* 2007 WL 10689106.
[9] *Id.* at 2.
[10] Jeff Brown, *There's a Difference: Subprime Good, Predatory Bad*, THE RECORD (N.J.), March 20, 2007, at B04.
[11] Bailey, *supra* note 7, at 15.
[12] *Subprime Hybrid Mortgages: Regulators and Response—Part 1: Hearing on H.R. 1182 Before Subcommittee on Financial Institutions and Consumer Credit*, Comm. On H. Fin. Serv., 110th Congress (Statement of Steve Antonakes, Commissioner, Mass. Div. of Banks) [hereinafter *Congressional Testimony*].
[13] *Id.*
[14] *Subprime and Predatory Lending in Rural America: Mortgage Lending Practices That Can Trap Low-Income Rural People*, 4 CARSEY INST. UNIV.

It also may include lending on the basis of abusive terms and conditions, coupled with a disregard for the borrower's ability to repay the loan.[15] In America, owning a home is a principal source of wealth accumulation and savings for most families. Demographically, minorities are much more likely to receive subprime mortgages than their white counterparts.[16] Though minority homeownership rates have historically been 25 percent below that of white homeowners, the Federal Reserve believes only a fraction of this difference can be explained by differences in income.[17] Predatory practices may account for part of this discrepancy, as predatory lenders take advantage of unsophisticated borrowers who have not had much (if any) prior experience with homeownership or owning large assets.[18]

Predatory lending typically begins with targeted and deceptive advertising aimed at borrowers with weak credit histories.[19] Targeted borrowers are swamped with mail and phone calls offering low introductory interest rates, but which are actually part of a "bait and switch" scheme that normally includes a much higher introductory interest rate on the official paperwork.[20] This advertising practice is at the heart of a number of federal lawsuits currently pending in the Eastern District of New York which claim that such practices are predatory and unfairly target prospective homeowners.[21] These suits focus on the predatory lenders' use of race to market to borrowers, and chide some lenders' "race-conscious outreach strategies" as being violations of the civil rights of the

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OF NH 2 (2006) (hereafter *Subprime and Predatory Lending in Rural America*).

[15] *Id.* at 2

[16] *Swimming with Sharks*, *supra* note 2.

[17] *Id.*; Stacy Kaper, *First Predator Hearing Has Few Clues on Legislation*, AM. BANKER, Feb. 8, 2007, § Washington, at 27, *available at* 2007 WL 2932257; *Subprime and Predatory Lending in Rural America*, *supra* note 14, at 2; *Swimming with Sharks*, *supra* note 2.

[18] Kevin G. Hall, *SUBPRIME LOANS: Mortgage crisis starts with ads Deceptive pitches used to sign up borrowers with poor credit history*, CHARLOTTE OBSVR. (NC), Sept. 3, 2007, at 8A.

[19] Kevin G. Hall, *Ads often target troubled borrowers Already-squeezed buyers and homeowners fall prey to deceptive tactics*, COLUMBIA ST. (SC), Sept. 5, 2007, at a9.

[20] *Swimming with Sharks*, *supra* note 2.

[21] Mark Fass, *Bias Claims Proceed Against Seller of 'Damaged' Homes*, 189 N.J.L.J. 733 (2007).

targeted minorities.[22] The alleged civil rights violations may be part of a larger band of unfair and deceptive practices targeted at minority, elderly and low-income borrowers to engage them with subprime mortgages containing predatory or abusive terms.[23] Although the Federal Reserve Board has had the authority to define and punish unfair and deceptive practices, the fact that it has failed to do so until now has drawn criticism and accusations that such failure has contributed to the current predatory lending problem.[24]

The problem, though, stretches beyond advertising. Borrowers are enticed into committing to loans with low introductory interest rates that quickly re-set to much higher rates after the end of the initial loan period.[25] Up to 80 percent of the current subprime mortgages are "2/28s," which have low two-year introductory interest rates that are followed by upward interest rate adjustments every six months for the next 28 years.[26] Some lenders do not consider a borrower's ability to repay the loan at these higher rates, and after two years borrowers often are unable to make their much higher mortgage payments.[27] Exacerbating the problem of suddenly very high monthly payments, borrowers are trapped in these loans because of prepayment penalties that are assessed if they pay off a loan before a specific period of time has elapsed.[28] This Hobson's choice leads to many borrowers attempting to "flip their loans" by refinancing quickly after their interest rate resets (usually with a net loss because the value of their home has declined relative to the mortgage value and because of prepayment penalties), sell their homes, or risk foreclosure.[29]

Even at the foreclosure stage, homeowners face additional predators who offer to pay the homeowner an amount far below the equity remaining in their home in exchange for a quit-claim deed to the property (assuming there is any equity in the home in the first

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[22] *Id.*
[23] *Swimming with Sharks*, *supra* note 2.
[24] Kaper, *supra* note 17.
[25] Ed Roberts, *Congress Told Subprime Standards Needed*, CREDIT UNION J., Feb. 12, 2007, at 1.
[26] *Id.*
[27] Jonathan L. Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 FORDHAM URB. L.J. 757 (2007).
[28] *Subprime and Predatory Lending in Rural America*, *supra* note 14, at 2.
[29] *Id.*

place).[30] This offer is intended to entice the borrower into believing that the quit-claim deed is an "easy out" to alleviate some of their financial woes, when in fact the borrower loses any chance of keeping their existing equity or in the end, their homes.[31]

B. Predatory Lending Practices and Their Role in the Current Crisis

The limited empirical research conducted on predatory lending practices suggests that the mere existence of a predatory-type feature or practice within the loan process does not mean it will cause foreclosure.[32] Actually, it appears that a loan with an adjustable rate mortgage ("ARM"), as opposed to a fixed rate mortgage ("FRM"), is associated with a greater probability of foreclosure than either long pre-payment periods or balloon payments, both of which are prominent features of predatory mortgages.[33] Also, the downturn in the housing market and the devaluation of homes may be the major factor preventing refinancing, as it traps some borrowers in their subprime mortgages even when they recognize that they face possible foreclosure.[34] The heart of the subprime crisis is that these factors—widespread use of adjustable rate mortgages coupled with the simultaneous cooling of the market— have been multiplied on a grand scale. The sheer volume of mortgages generated over the last few years has flooded the market with subprime mortgages with interest rates that are re-setting at the same time. It is estimated that $362 billion of adjustable-rate subprime mortgages are due to re-set in the coming year,[35] meaning that countless borrowers will start to feel the shock that many homeowners have already experienced.

Thus, the major change in the subprime mortgage market is really just the sheer volume of loans generated, not the percentage of homeowners in foreclosure.[36] Interestingly, even with ARMs flooding the market and contributing to subprime foreclosures,

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[30] *Swimming with Sharks*, *supra* note 2.
[31] *Id.*
[32] Rose, *supra* note 4, at 2.
[33] *Id.* at 5.
[34] Geraldine Fabrikant, *A Home Loan Trap*, N.Y. TIMES, Sept. 13, 2007, *available at* http://www.nytimes.com/2007/09/13/business/13prepay.html.
[35] Ruth Simon, *Rising Rates to Worsen Subprime Mess*, Wall Street Journal Abs., Nov. 24, 2007, at Sec. A1, *available at* 2007 WLNR 23466414.
[36] *Id.*

subprime delinquency *rates* are currently lower than in 2001 and 2002.[37] Currently more than 95 percent of homeowners with subprime mortgages are *not* in foreclosure.[38] It could be, then, that a major problem underlying the subprime lending crisis may simply be easy credit, not predatory lending.[39]

C. Consumer Protection via Regulation of the Subprime Lending Market

Regulators at all levels of government have begun to address the subprime issue and its affect on their constituents. Below is an overview of the major federal and state regulatory responses.

1. Federal Regulation and Legislation

Several members of Congress have pushed for regulation of the subprime lending market and predatory lending practices.[40] Some of the proposed legislation targets specific practices often deemed predatory, such as prepayment penalties and hidden brokerage fees.[41] Much of this legislation, though, focuses on the lack of regulation or supervision of unlicensed lenders, who are in a position that allows them more readily to engage in predatory practices.[42] A bill proposed by Senators Charles Schumer, Robert Casey Jr., and Sherrod Brown, would create a fiduciary duty between both mortgage brokers and non-bank lenders to their borrowers.[43]

[37] Brown, *supra* note 10.
[38] *Id.*
[39] Interview by Gerri Willis with Steve Christ, Senior Analyst and Editor, Wealth Daily, in CNN News (Sept. 8, 2007) [hereinafter *Interview*].
[40] *See*, *e.g.*, *Congressman Cummings Leads Colleagues in Speaking Out Against Predatory Lending Practices in Subprime Mortgage Industry; Introduces Concurrent Resolution Urging Congress to Address Predatory Lending*, ST. NEWS SERV., April 29, 2007; *Schumer Looking to Introduce Suitability Standard*, HOME EQUITY WIRE, April 15, 2007, at 8, *available at* 2007 WL 7198794; *Senators Want 'Fiduciary Duty' for Brokers*, NAT. MORT. NEWS, May 7, 2007, at 3, *available at* 2007 WL 8494485.
[41] Edmund L. Andrews, *Democrats Prepare Bills to Tighten Loan Rules*, N.Y. TIMES, Sept. 6, 2007, *available at* http://www.nytimes.com/2007/09/06/business/06dodd.html.
[42] *Schumer Looking to Introduce Suitability Standard*, *supra* note 40.
[43] *Senators Support Succor for Subprime Borrowers*, HOME EQUITY WIRE, May 15, 2007, at 8, *available at* 2007 WL 9188209.

The same bill would also establish new underwriting standards under the Truth in Lending Act.[44]

Perhaps the most helpful, but most overlooked option in the bill is an overhaul of the existing Federal Housing Administration ("FHA").[45] Created in 1934 to encourage loans to low and moderate-income households by providing mortgage insurance to lenders, the FHA's failure to adapt to the changing market over the years created the vacuum that subprime mortgages now fill.[46] Reformation of the FHA is not directed at curbing predatory lending practices, but if the reforms enable the FHA to compete with predatory lenders, then they may have the desired effect of also stamping out a number of predatory practices.[47]

2. State Regulations

States have been creating anti-predatory lending legislation for years, with North Carolina taking the lead on the issue in 1999.[48] Most recently Maine passed its Homeowner Protection Act, which specifically targets predatory lending practices such as loan flipping and steering borrowers into loans they cannot afford to repay.[49] As state statutes targeting predatory lending practices proliferate opponents argue that lenders will pull out of states with highly restrictive laws, thus decreasing the overall availability of mortgages for would-be subprime borrowers.[50] The recently enacted Home Loan Protection Act in Rhode Island caused an exit of a number of

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[44] *Id.*

[45] Emmet Pierce, *Lending A Hand Bill Would Help Get FHA Back In Mortgage Game*, UNION-TRIB. (San Diego), July 8, 2007, at D1, *available at* 2007 WL 13033394.

[46] *Id.*

[47] *See*, *e.g.*, *Id.*; Dina ElBoghdady, *Bush Plan on Mortgages Highlights Long-Shadowed FHA*, WASH. POST, Sept. 1, 2007, *available at* 2007 WL 17088537.

[48] Richard A. Oppel Jr. & Patrick McGeehan, *Lenders Try to Fend Off Laws on Subprime Loans*, N.Y. TIMES, April 4, 2001, *available at* http://query.nytimes.com/gst/fullpage.html?res=9D07E2DE163EF937A35757C0A9679C8B63.

[49] *Governor Signs New Law to Curb Predatory Lending*, U.S. ST. NEWS, June 11, 2007.

[50] Oppel, *supra* note 48.

out-of-state lenders from that market.[51] While some lenders cite the "emergency regulations" put in place without giving them time to comply as a reason for leaving, it is not likely that any new anti-predatory lending legislation will keep these lenders out of the market permanently.[52]

It seems that this fear of market withdrawal may be misplaced, since about 30 states now have anti-predatory lending laws, and there has been no mass exodus of mortgage lenders from those markets.[53] Rather, studies have found that states with anti-predatory lending laws observe fewer loans with abusive terms, continued access to subprime mortgages, and the same or lower interest rates for subprime mortgages.[54] Local ordinances, like a Chicago city ordinance that prohibits the city from doing business with predatory lenders, are also being put in place to protect subprime borrowers.[55] These local and state laws are arguably stronger than the recently proposed federal regulations, and therefore proponents of state regulation of the mortgage market fear a uniform federal law that preempts state laws will actually weaken consumer protection.[56]

3. What type of regulation is needed?

Anti-predatory regulations have the potential to cause more harm than good by preventing access to loan products that are appropriate for some borrowers.[57] Studies suggest that broad regulatory measures that attempt to restrict or prohibit predatory lending practices will not actually reduce foreclosure rates.[58] Thus the solution to predatory lending is more complicated than merely stamping out "shady" loan terms and lowering the number of foreclosures. Researchers and industry experts recommend increasing disclosure and underwriting guidelines to help educate and

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[51] Lynn Arditi, *Predatory-lending rule blamed for lender exits*, PROVIDENCE J., Jan. 30, 2007. at Bus. & Fin. News.
[52] *Id.*
[53] *Id.*
[54] Li & Ernst, *supra* note 6, at 2.
[55] *See*, *e.g.*, Entin & Yazback, *supra* note 28; Oppel, *supra* note 48.
[56] Oppel, *supra* note 48; *Subprime and Predatory Lending in Rural America*, *supra* note 14, at 5.
[57] *Swimming with Shark*, *supra* note 2; Rose, *supra* note 4, at 28.
[58] Rose, *supra* note 4, at 28.

protect consumers.[59] With the Fed's coordination and guidance, The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators are in the process of creating a national mortgage licensing system to go into effect by January 1, 2008.[60] The national licensing system may help borrowers by focusing on a troublesome and unregulated segment of the lending industry—unlicensed lenders and brokers.[61] It seems with predatory lending practices the best defense may be borrower education and the requirement for simple, understandable language in mortgage disclosures so that borrowers may protect themselves and have adequate disclosure about their obligations.[62]

Along with licensing, some industry experts, such as former governor of the Federal Reserve Edward Gramlich, are calling for better organized supervision of the mortgage industry.[63] The gaps left in supervision by the variety of federal and state regulators overseeing the industry likely helped give rise to the current industry problems.[64] Proper supervision will be necessary to give effect to any new regulations put in place.[65]

D. Conclusion

Predatory lending has had a role in the current subprime mortgage crisis, but it is difficult to determine how significant a role it has played. Even assuming anti-predatory lending statutes had provided some protection for consumers, the current crisis might still have been caused by a mix of easy credit, an extremely large number of borrowers, and securitization in the investment markets.[66] Still, protection against predatory practices may be beneficial to future borrowers, as long as it does not prevent those in need of subprime mortgages from acquiring them. For this reason, a focus on

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[59] *Id.*; *Congressional Testimony*, *supra* note 12.
[60] *Congressional Testimony*, *supra* note 12.
[61] *Id.*; William M. Isaac, *Subprime Loan Reform: Devil in the Details*, AM. BANKER, May 1, 2007, at 2a.
[62] Isaac, *supra* note 61.
[63] Kevin G. Hall, *Misleading ads fuel credit mess*, MIAMI HERALD, Sept. 2, 2007, at E1, *available at* 2007 WL 17145491.
[64] *Id.*
[65] *Id.*
[66] *Congressional Testimony*, *supra* note 12; *Interview*, *supra* note 39; Brown, *supra* note 10.

disclosure, new standards, education and licensing may be of more benefit than restrictive statutes.

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XIII. Overview of Responses, Reactions, and Potential Solutions to the Crisis

The subprime mortgage collapse has caused the bankruptcy of companies who dealt in such mortgages, exceptionally high rates of foreclosure,[1] and a significant tightening in subprime lending standards.[2] As to the cause of the collapse, blame can be placed on many.[3] Some blame home buyers who misstated incomes to qualify for loans.[4] Others point the finger at Wall Street and the securities firms that packaged and sold these risky loans as tradable securities,[5] while others have blamed the agencies that rated these "hard-to-value" securities, along with the hedge funds and other institutional investors seeking to boost their returns.[6] Finally, even others believe individuals who invested in these hedge funds and "hard-to-value" securities must accept some of the blame for the current subprime debacle.[7]

Although disagreement exists concerning the causes, all agree that action must be taken to mitigate the effects of the subprime crisis on the economy and to prevent a full recession.[8] This article reviews the reactions and proposed-solutions to the subprime crisis.

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[1] Kenneth R. Harney, *Subprime Market's Sinking Fortunes*, WASH. POST, Feb. 17, 2007, at F01, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/02/16/AR2007021600813.html.

[2] *See* Bob Tedeshchi, *Ripples from the Subprime Storm*, N.Y. TIMES, Mar. 25, 2007, *available at* http://www.nytimes.com/2007/03/25/realestate/25MORT.html.

[3] *See* Tomoeh Murakami Tse & Carrie Johnson, *Mortgage Mess Unleashes Chain of Lawsuits*, WASH. POST, Sept. 11, 2007, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/09/10/AR2007091002327.html.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] Dawn Kopecki, *What Will Fix the Mortgage Mess?*, BUS. WK., Aug. 28, 2007, *available at* http://www.businessweek.com/bwdaily/dnflash/content/aug2007/db20070828_301854.htm.

A. Federal Reserve Board

The Federal Reserve Board ("Fed") is charged with setting and monitoring economic policy to provide "a safer, more flexible and more stable monetary and financial system."[9] In order to "forestall some of the adverse effects on the broader economy that might arise from the disruptions in financial markets,"[10] the Fed announced, on August 10, 2007, that it was making reserve funding available to counter some of the strains felt in the money markets.[11] The announced goal was to "pump as much money as needed into the financial system to help overcome the ill effects of a spreading credit crunch."[12] That same day, the Fed released $38 billion in temporary reserves into the monetary system, on top of a similar capital infusion the day before.[13] The Fed also cut fees associated with lending Treasury securities and lowered the discount and fed funds rates by 50 basis points each.[14]

While the Fed's direct infusions into the economy have provided temporary relief to the markets, the Fed must also address an interesting phenomenon in formulating its economic plans going forward: the issue of "moral hazard." Moral hazard is defined as the act of "encouraging people to make riskier choices than they otherwise would" because the costs of their behavior will be borne by others.[15] While in the short term it may seem beneficial for the Fed to "bail out" lenders and borrowers and infuse the markets with much-needed capital, such a response might only "encourage

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[9] Governor Donald L. Kohn, at the Conference on New Directions for Understanding Systematic Risk: The Evolving Nature of the Financial System: Financial Crises and the Role of the Central Bank (May 18, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/kohn20060518a.htm (last visited Nov. 3, 2007).

[10] *Subprime Mortgage Lending and Mitigating Foreclosures*, Before the H. Comm. of Fin. Serv., 110th Cong. (2007) (statement of Ben S. Bernanke, Chairman, Fed. Reserve Bd.), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20070920a.htm (last visited Oct. 27, 2007) [hereinafter *Hearings*].

[11] *Id.*

[12] Editorial, *Fed Injects Reserves Into System*, N.Y. TIMES, Aug. 11, 2007, *available at* http://www.nytimes.com/2007/08/11/business/apee-fed.html.

[13] *Id.*

[14] *Hearings* (testimony of Chairman Bernanke), *supra* note 10.

[15] Editorial, *Insurance for the Next Big One*, N.Y. TIMES, Oct. 1, 2007, *available at* http://www.nytimes.com/2007/10/01/opinion/01mon1.html.

excessive risk-taking in the future."[16] In recognition of possibly perverse incentives, Fed Chairman, Ben Bernanke asserted: "[I]t is not the responsibility of the Federal Reserve—nor would it be appropriate—to protect lenders and investors from the consequences of their financial decisions."[17] Unfortunately, Bernanke's seemingly resolute stance appears undermined by his admission that "developments in financial markets . . . have broad economic effects felt by many outside the markets" which the Fed must take into account when determining policy.[18] Given that reality, the Fed faces many difficult decisions.

So far, the Fed has attempted to curtail abusive lending practices by enhancing scrutiny of disclosures under the Truth in Lending Act, increase regulation of mortgage advertising, prescribe new requirements for borrowers to qualify for loans, and require greater transparency in lending by restricting the use of no-documentation loans.[19] While the Fed is now properly responding to the subprime crisis, it must avoid promoting policies that ultimately encourage risky behavior.

B. Regulatory Agencies

1. Legislative Branch Response

Some Congressional leaders believe that the subprime crisis "threatens to displace more Americans than Hurricane Katrina."[20] As such, the crisis has become a Congressional top priority.[21] For

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[16] *Hearings*, *supra* note 10 (testimony of Chairman Bernanke).
[17] Chairman Ben S. Bernanke, at the Economic Club of New York: The Recent Financial Turmoil and its Economic and Policy Consequences (Oct. 15, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20071015a.htm (last visited Nov. 3, 2007).
[18] *Id.*
[19] Press Release, Marsh, Subprime Crisis Raises Claims Risks, Warns Marsh (Aug. 20, 2007), *available at* http://global.marsh.com/news/press/PRSubprimeCrisis20070820.php (last visited Oct. 27, 2007).
[20] Press Release, Rep. Maloney, Congressional Leaders Take Action to Address Subprime Mortgage Crisis: Urge President to Appoint Mortgage Czar, Strengthen Foreclosure Prevention Orgs (Oct. 4, 2007), *available at* http://maloney.house.gov/index.php?option=content&task=view&id=1469&Itemid=61 (last visited Nov. 3, 2007).
[21] *See* Press Release, Rep. Nancy Pelosi, Pelosi and Reid Urge Bush to Take Action to Address Subprime Mortgage Crisis (Oct. 3, 2007), *available at*

instance, on July 12, 2007, Congressman Spencer Bachus, the top Republican on the House Financial Services Committee, introduced legislation to create a national registry and set new standards for mortgage originators.[22] His bill, the Fair Mortgage Practices Act of 2007, represents an attempt to "curb unscrupulous lending and increase consumer protections."[23] As fellow supporter Congresswoman Deborah Pryce put it, the bill endeavors to "better polic[e] the mortgage industry and ensur[e] that borrowers are armed with simplified and transparent information"[24] by (1) empower the Department of Justice to prevent, investigate, and prosecute mortgage fraud; (2) establish licensing requirements for mortgage brokers; (3) help maintain appraiser independence; and (4) increase Federal supervision of State appraisal programs.[25] The bill attempts to ensure greater lender responsibility while maintaining consumer access to credit.[26]

On the other side of the aisle, on October 2, 2007, Senate Majority Leader Harry Reid and House Speaker Nancy Pelosi proposed a solution to slow the increasing rate of home foreclosures.[27] Working in conjunction with the Chairs of the Senate Banking Committee, the House Financial Services Committee, and the Joint Economic Committee, they devised a plan to increase federal funding to prevent foreclosures and to temporarily raise the caps on Fannie Mae's and Freddie Mac's portfolios.[28] In addition,

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http://speaker.gov/newsroom/pressreleases?id=0356 (last visited Nov. 3, 2007) ("We believe this situation demands a serious response commensurate with the magnitude of the threats to individual homeowners, communities and the nation's economy.").

[22] John Poirier & Patrick Rucker, *Republican Lawmaker Introduces Subprime Legislation*, REUTERS (London), July 12, 2007, *available at* http://uk.reuters.com/article/marketNewsUS.

[23] *Id.*

[24] Press Release, Rep. Deborah Price, Predatory Lending Targeted in Fair Mortgages Protection Act (Sept. 18, 2007), *available at* http://www.house.gov/pryce/07%20releases/091807_FairMortgageProtection_OpEd.htm (last visited Nov. 3, 2007).

[25] *Id.*

[26] *Id.*

[27] Press Release, Democrats, Senate, Gov, Senate and House Democratic Leaders Offer Plan to Stem Tide of Home Foreclosure (Oct. 3, 2007), *available at* http://democrats.senate.gov/newsroom/record.cfm?id=284774& (last visited Nov. 3, 2007).

[28] *Id.*

they urged the President to appoint a special advisor to oversee and coordinate the federal response to the subprime crisis.[29] The lawmakers see this bill as an attempt "to help families . . . victimized by unscrupulous lending practices to keep their homes, hold lenders accountable and deploy the resources necessary to prevent the foreclosure crisis from taking a toll on the broader economy."[30]

Other representatives are also involved in developing potential solutions to the subprime crisis. For example, House Financial Services Committee Chairman Barney Frank proposed a bill to promote the mortgage industry's long-term recovery by increasing lender accountability.[31] The Frank bill attempts to hold abusive lenders accountable by providing borrowers a cause of action against the issuers of no-documentation mortgages or other products that borrowers cannot reasonably repay.[32] Congressman Frank believes the proposed bill is not unduly burdensome on lenders because: (1) it protects those who typically adhere to good lending practices or who agree to settle with borrowers out of court, and (2) its most drastic remedies are rescission and costs.[33] Opponents, however, believe the Frank proposal will have the opposite effect.[34] Although acknowledging that the subprime collapse has depressed the economy, opponents nevertheless believe that because the fallout has been "manageable" and subprime loans have "[brought] home-ownership within the reach of many people who otherwise would have been shut out," regulation that might lead lenders to leave the market may be ill-advised.[35] Whether any of these bills will succeed in meeting their goals is unknown. But we can expect the controversy to continue.

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[29] *Id.*

[30] *Id.*

[31] Editorial, *Suing Subprime: A House bill would impose legal liability on the mortgage-backed bond industry*, WASH. POST, Oct. 31, 2007, at A18, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/10/30/AR2007103001952.html.

[32] *Id.*

[33] *Id.*

[34] *See id.*

[35] *See id.*

2. Executive Branch

President Bush also considers resolving the subprime crisis vitally important. On August 31, 2007, he announced a plan to amend Federal Housing Administration ("FHA") policies to assist homeowners endangered by the collapse of the subprime market.[36] His proposal would decrease required payments, increase the size of permissible loans, offer greater flexibility in pricing, and allow an additional 80,000 homeowners with imperfect credit to receive FHA loans.[37] In addition, the President has encouraged lenders to renegotiate with borrowers to avoid default.[38] Importantly, however, the President insists that his program is not a bailout for banks or borrowers,[39] and instead is designed to provide assistance to homeowners at risk of losing their homes.[40] In the President's words, "[t]he government's got a role to play . . . [b]ut it is limited. A federal bailout of lenders would only encourage a recurrence of the problem."[41] Thus, it seems a massive federal bail-out is unlikely to occur under the Bush Administration.

3. Legal Community Response

One commentator, in response to the potential legal fallout of the subprime crisis observed that, typically, "[w]hen something goes badly on Wall Street, people wind up in court . . . the subprime mortgage mess is no exception."[42] Indeed, in the wake of the subprime collapse, numerous lenders have declared bankruptcy and many borrowers have brought lawsuits.[43] For instance, the Massachusetts Attorney General brought suit against Fremont Investment and Loan for alleged predatory lending practices, seeking fines and

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[36] Tom O'Connell, *Bush announces FHA changes to alleviate subprime fallout*, N.M. BUS. WKLY., Aug. 31, 2007, *available at* http://albuquerque.bizjournals.com/albuquerque/stories/2007/08/27/daily32.html?jst=s_cn_hl.
[37] *Id.*
[38] Editorial, *Bush Tries to Calm Markets with Mortgage Plan*, Aug. 31, 2007, *available at* http://www.cnbc.com/id/20521776/.
[39] *See id.*
[40] *See id.*
[41] *Id.*
[42] Tse, *supra* note 3.
[43] NERA, THE SUBPRIME MELTDOWN: A PRIMER NO. 1 (2007), *available at* http://www.mmc.com/knowledgecenter/NERA_SEC_SubprimeSeries_Part1_June2007.pdf (last visited Oct. 27, 2007).

compensatory damages for borrowers.[44] In addition, State Street Bank and Trust Co. was recently sued in Massachusetts federal court in a class action lawsuit seeking compensatory damages, disgorgement of profits, and an injunction permanently enjoining further alleged violations of the Employee Retirement Income Security Act.[45] The suit alleges that "State Street overexposed bond funds to risky subprime mortgages, [thus] creating an inappropriate level of risk out of line with the stated investment objectives of the purportedly stable and predictable funds."[46] Another high-profile lawsuit was filed by the NAACP in federal district court in Los Angeles.[47] That suit alleges that African-Americans received substantially less favorable terms on their subprime loans than similarly qualified whites and that, in so acting, the lenders "engaged in institutionalized, systematic racism, in violation of the Equal Credit Opportunity Act, the Fair Housing Act and the Civil Rights Act."[48]

According to NERA Economic Consulting, an international firm of economists responsible for authoring a multi-part Insight Series, future litigation could potentially include:

1. homeowners' lawsuits against conduits and underwriters claiming predatory lending;

2. conduits' lawsuits against banks claiming improper margin calls and flawed valuation of underlying collateral;

3. various shareholder lawsuits against conduits, accountants, trustees and underwriters of public companies claiming misrepresentations and omis-

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[44] Kimberly Blanton, *Subprime lender sued under predator law: AG accuses Fremont of 'worst practices,'* BOSTON GLOBE, Oct. 6, 2007, *available at* http://www.boston.com/business/globe/articles/2007/10/06/subprime_lender_sued_under_predator_law/.

[45] Ron Zapata, *State Street Faces 2nd Subprime Loss Class Action*, SEC. L. 360, Oct. 26, 2007, *available at* http://securities.law360.com/secure/ViewArticle.aspx?Id=38557.

[46] *Id.*

[47] Bob Tedeschi, *The N.A.A.C.P vs. 11 Lenders*, N.Y. TIMES, Sept. 21, 2007, *available at* http://homefinance.nytimes.com/nyt/article/mortgage-column-by-bob-tedeschi/2007.09.21.mort/.

[48] *Id.*

sions relating to accounting for residuals, as well as claims of bad valuation, poor underwriting standards and issuing false and misleading statements;

4. insurers' lawsuits against conduits alleging poor underwriting and misrepresentations and omissions;
5. investors' lawsuits against trustees claiming breach of fiduciary duty;
6. trustees' lawsuits against conduits and underwriters on behalf of investors claiming fraudulent conveyance and breach of contract related to loan servicing; and
7. individual investors' lawsuits alleging misrepresentations, omissions, bad pricing, and mark-ups and reverse discrimination.[49]

However, since so many parties seem at least partly to blame for causing the subprime collapse, the list of possible legal targets will grow.[50] Despite the threat of lawsuits, sophisticated parties who allege misrepresentation are unlikely to be successful because it will be difficult to prove they did not understand the risks of subprime lending.[51]

4. Investment Community

The investment community has been blamed for causing the subprime crisis by demanding high-risk, high-reward investments in what was previously a largely low interest rate environment.[52]

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[49] NERA, THE SUBPRIME MELTDOWN: A PRIMER NO. 1 (2007), *available at* http://www.mmc.com/knowledgecenter/NERA_SEC_SubprimeSeries_Part1_June2007.pdf (last visited Oct. 27, 2007).
[50] Tse, *supra* note 3.
[51] Editorial, *Bear Stearns to be sued over subprime funds: CNBC*, REUTERS (London), Jul. 20, 2007 *available at* http://www.reuters.com/article/bondsNews/idUSN2027495320070721.
[52] Press Release, Cameron Street, ERATE, Mountain of Sub-Prime Mortgages Primed for Avalanche (2.2 million households could face losing their homes) (July 2, 2007), *available at* http://www.erate.com/sub-prime-mortgage-crisis.htm (last visited Oct. 27, 2007).

According to National Mortgage News, approximately "80 subprime mortgage lenders have gone out of business since December [2006] . . . and [even more have been] cutting back on subprime lending . . . ."[53] In addition to being thought to be a major cause of the subprime crisis,[54] the investment community has taken a substantial financial hit from the collapse.[55] For instance, in February 2007, HSBC Holdings had to set aside $10.6 billion for potential losses associated with home-loan delinquencies.[56] And HSBC Holdings certainly is not alone. After closing two of its hedge funds this summer, which lost $1.5 billion between them,[57] Bear Stearns announced that its third quarter profits had fallen by 62 percent.[58] The third quarter also proved costly for Merrill Lynch, which recently acknowledged its intention to write down $7.9 billion for poor investments and the still declining value of mortgage-backed collateral it employed to raise capital.[59] These examples are dramatic illustrations of the huge dollars at stake for these institutions.

In response to the huge loses already suffered (as well as those threatened), there has been a reduction in the availability of credit and a general tightening of liquidity, thus increasing the cost of bearing credit risk.[60] Some investors, such as Freddie Mac, have announced that they "will cease buying subprime mortgages that have a high likelihood of excessive payment shock and possible foreclosure."[61] Similarly, Bank of America Chief Executive Ken

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[53] Alex J. Pollock, *Subprime Bust Expands*, AM., Aug. 6, 2007, *available at* http://www.american.com/archive/2007/august-0807/subprime-bust-expands.
[54] *See* Press Release, Cameron Street, *supra* note 67.
[55] *See e.g.*, *id.*
[56] Harney, *supra* note 1.
[57] Suzy Jagger & Angela Jameson, *Merrill Lynch Stuns With an $8bn Subprime Hit*, TIMES (London), Oct. 24, 2007, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2729018.ece.
[58] Editorial, *Mortgage woes hurt Bear Sterns*, BOSTON GLOBE, Sept. 21, 2007, *available at* http://www.boston.com/business/markets/articles/2007/09/21/mortgage_woes_hurt_bear_stearns/.
[59] Jagger, *supra* note72.
[60] Pollock, *supra* note 68.
[61] Press Release, Freddie Mac, Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default: Company Also to Develop Model Subprime Mortgages (June 27, 2007),

Lewis recently admitted that there likely will be "some scaling back" and that he "had all of the fun [he] can stand in investment banking at the moment."[62]

Merrill Lynch also illustrates another common response to subprime woes: fire your management. On October 30, 2007, Stan O'Neil, the Chairman and CEO of Merrill Lynch, announced his retirement.[63] Mr. O'Neil's exit was quick and largely unexpected,[64] but his situation is not unique. In July, in the wake of a hedge fund calamity, UBS replaced its Chief Executive, Peter Wuffli, along with other executives.[65] In addition, two of HSBS's top executives, Bobby Mehta, chief executive of its North American operations, and Sandy Derickson, head of the bank's US retail operations, announced their resignations.[66] If the fate of these executives is any indicator, additional heads may roll as the subprime crisis continues to churn.

An interesting proposal for how to best recover from the current subprime crisis has been offered by the Securities Industry and Financial Markets Association ("SIFMA"), an industry trade group representing securities firms, banks, and asset management companies in the U.S., Europe, and Asia.[67] SIFMA believes it is important for future policy changes "to balance consumer protection

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available at http://www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html (last visited Nov. 3, 2007).

[62] David Enrich, *Bank of America CEO Plans Changes to Investment Bank*, MARKETWATCH, Oct. 18, 2007, *available at* http://www.marketwatch.com/news/story/bank-america-ceo-plans-changes/story.aspx?guid=%7B2283D6C9-6E4D-48B8-9F2B-346BE8FB28EF%7D.

[63] *See* Greg Farrell, *Under Fire, Merrill Lynch CEO O'Neal Retires*, USA TODAY, Oct. 30, 2007, *available at* http://www.usatoday.com/money/companies/management/2007-10-30-merrill_N.htm.

[64] *Id.*

[65] *E.g.*, *After UBS Hedge Fund Trouble, Executives Shuffle*, July 5, 2007, *available at* http://money.cnn.com/2007/07/05/news/international/ubs_ceo/index.htm.

[66] Peter Thai Larsen, Saskia Scholtes & Michael MacKenzie, *HSBC Ousts Two Top U.S. Executives*, FIN. TIMES, Feb. 22, 2007, *available at* http://www.ft.com/cms/s/0/c2f953f2-c267-11db-9e1c-000b5df10621.html?nclick_check=1.

[67] *See e.g.*, Press Release, Securities Industry and Financial Markets Association, Financial Industry Associations Call For Balance in Subprime Mortgage Financing Response (June 27, 2007) *available at* http://www.sifma.org/news/47184405.shtml (last visited Nov. 3, 2007).

with the preservation of mortgage credit to qualified borrowers."[68] On the one hand, it fears that "over- or unclear regulation of the subprime mortgage lending market or the imposition of quantifiable liability on lenders or investors will result in less capital availability at higher cost for worthy borrowers."[69] On the other hand (perhaps in an effort to prevent the abuses that caused the current debacle), it supports "clearer consumer disclosure, education and counseling, and the adoption of uniform broker regulation."[70] Thus, it seems SIFMA supports efforts to inform consumers about their obligations and the terms of their loans, while preserving incentives for mortgage brokers to extend credit to borrowers who otherwise might be ineligible. However, this delicate balancing act can only succeed if investment banks and hedge funds learn from past mistakes and adopt procedures to prevent a recurrence of the current crisis.

5. Consumer Rights Advocacy Groups Response

In response to the collapse of the subprime market, many consumer rights' advocacy groups, such as the Center for Responsible Lending ("CRL"), have called for greater regulation of the subprime lending market.[71] In the CRL's view, "the market has failed to learn . . . from the . . . crisis"—indeed, the "mortgage industry continues to churn out risky loans that will likely end up hurting subprime . . . borrower[s]."[72] According to the CRL, the principal problem is that subprime loans were "perfectly legal but . . . guaranteed to produce unacceptable . . . levels of foreclosures."[73] While recognizing that mortgage fraud contributed to the problem, they argue that even if fraud were eradicated from the market, homeowners still will suffer unacceptable numbers of foreclosures if risky loan practices are not abolished.[74]

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[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] Paul Leonard, Op-Ed, *Government Works, Markets Don't*, L.A. TIMES, July 16, 2007, *available at* http://www.latimes.com/news/opinion/la-op-dustup16jul16,0,109331.story?coll=la-opinion-center.
[72] *Id.*
[73] *Id.*
[74] *Id.*

As such, the CLR and others recommend that federal and state officials act to require greater regulation of the subprime market.[75] Specifically, they have called on Congress to pass anti-predatory legislation, including a private right of action, to protect minority and other communities and to ensure that the current troubles affecting the subprime credit market do not recur."[76] They believe the government must step in because the market alone has proved insufficient.[77]

6. Mortgage Industry Response

According to the Mortgage Bankers Association ("MBA"), approximately "550,000 homeowners with subprime loans began a foreclosure process over the last year . . . [and] the number could double in the next couple of years."[78] Despite broad authority over lending regulations, states had left virtually unregulated brokers and mortgage companies.[79] And at this point, now that the subprime issue has morphed into a large economic crisis, some state regulators have still been slow to act because of limited staff and financial resources, and for fear that the cure may be worse: by restricting credit to those in need, regulation could cause lenders to leave the state for more friendly regulatory environments.[80]

However, the trend of state inaction is changing.[81] As the New York Times observed, "[s]tate governments are beginning to take modest action in part because the federal response has been slow."[82] For example, on August 8, 2007, Commissioner Linda A. Watters of the Michigan Office of Financial and Insurance Services ("OFIS") provided regulatory best practices for mortgage originators to follow when offering adjustable rate mortgages on subprime

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[75] *Id.*

[76] Press Release, Housing Wire, Consumer Advocates Seek to Undo BAPCPA Reforms (Apr. 12, 2007), *available at* http://www.housingwire.com/2007/04/12/consumer-advocates-seek-to-undo-bapcpa-reforms/ (last visited Oct. 27, 2007).

[77] Leonard, *supra* note 86.

[78] Clifford Krauss, *States Begin Action on Subprime Lending*, N.Y. TIMES, Aug. 24, 2007 *available at* http://www.nytimes.com/2007/08/24/business/24states.html?pagewanted=1&_r=1.

[79] *Id.*

[80] *Id.*

[81] *See id.*

[82] *Id.*

loans.[83] These practices, which include underwriting standards, management practices, and consumer protection provisions, were devised in the wake of the federal financial regulatory agencies' *Statement on Subprime Mortgage Lending*.[84] The Michigan OFIS's proposal largely echoes the federal statement, but state regulators customized their guidelines "to address issues particular to non-depository mortgage lenders and brokers who originate loans but do not hold them in portfolios."[85] These best practices were designed to cover lenders who fall through the cracks of federal regulation.[86] Indeed, the OFIS believes that to prevent a recurrence of the subprime debacle, there must be "a coordinated effort among federal and state regulatory agencies . . . to provide consistent and effective policy and overall supervision of the mortgage industry."[87]

Connecticut appears to have taken a similar approach to Michigan. Connecticut Department of Banking Commissioner, Howard F. Pitken, believes federal and state regulators must work together to properly supervise and regulate the lending industry and has issued guidelines for underwriting standards, management practices and consumer protection provisions for subprime lenders.[88] For its part, Massachusetts appears to be going beyond Michigan and Connecticut in its efforts to curtail the practices that have led to epic levels of foreclosures.[89] For example, not only will lenders be required to "reasonably believe" a borrower can repay the loan, they will be unable to profit from charging borrowers interest rates higher than those for which they qualify.[90] Although the regulations fail to

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[83] Press Release, Michigan Department of Labor and Economic Growth, OFIS Issues Best Practices for Subprime Mortgage Lending (Aug. 08, 2007), *available at* http://www.michigan.gov/dleg/0,1607,7-154--173619--,00.html (last visited Nov. 3, 2007).
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] Press Release, State of Connecticut Department of Banking, Connecticut Department of Banking Adopts Statement on Subprime Mortgage Lending (July 23, 2007), *available at* http://www.ct.gov/dob/cwp/view.asp?a=2245&q=386828 (last visited Nov. 3, 2007).
[89] Binyamin Appelbaum, *State Toughens Rules on Mortgages: AG Targets High Fees, Unaffordable Loans*, BOSTON GLOBE, Oct. 18, 2007 *available at* http://www.boston.com/business/globe/articles/2007/10/18/state_toughens_rules_on_mortghages/.
[90] *Id.*

define "reasonable belief," they should be able to prohibit obviously offensive loans.[91] Massachusetts appears to be going further than any other state to curb bad lending practices.[92] In the words of Representative Ronald Mariano of Quincy, "[i]f these rules were in place five years ago . . . I think it would have gone a long way toward preventing some of the horror stories that we hear happening in the marketplace now."[93] In sum, most states are attempting to curb deceptive lending practices.[94] Indeed, law-makers in dozens of states have proposed scores of bills to inhibit predatory lending practices and rein in the foreclosure rate.[95] The anticipated result will be increased regulation of subprime lenders, intermediaries assigned to help restructure delinquent loans, and laws prohibiting lenders from making loans that borrowers cannot reasonably repay."[96]

However, some lenders argue that over-regulating the industry is not the answer.[97] Rather, the solution, they argue, lies in punishing only irresponsible lenders:[98] "[r]egulation that significantly hinders the efforts of honest mortgage bankers will only end up hurting consumers . . . [by] further tightening . . . credit, limiting access to capital and giving fewer people a chance at home-ownership."[99] Conversely, some believe that punishing irresponsible lenders would restore the integrity of the industry and punish culpable lenders, while maintaining lower-income individuals' access to credit.[100] As MBA Chairman, John M. Robbins stated "[t]he mortgage lending industry and borrowers would be better served with legislation and regulation aimed at policing bad actors who close loans in bad faith rather than curtailing the use of

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[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *See* Krauss, *supra* note 93.
[95] *Id.*
[96] *Id.*
[97] *See* Peter Henderson ET AL., *Mortgage industry reloads as subprime misery lingers*, BOSTON GLOBE, May 24, 2007, *available at* http://boston.com/news/education/higher/articles/2007/05/24/mortgage_industry_reloads_as_subprime_misery_lingers/.
[98] Robert Camerota, Op-Ed., *Punish Crooks, Don't Over-Regulate*, L.A. TIMES, July 16, 2007, *available at* http://www.latimes.com/news/opinion/la-op-dustup16jul16,0,109331.story?coll=la-opinion-center.
[99] *Id.*
[100] *See id.*

nonprime mortgage products that permit otherwise unqualified applicants to become homeowners."[101] Thus, it seems most in the mortgage industry believe regulations must walk the fine line of maintaining consumer access to credit while discouraging predatory lending practices.

C. Conclusion

With over "two million homeowners nationwide with mortgage payments that are due to skyrocket within the next two years,"[102] finding a solution to the subprime crisis is obviously important. Each group affected by the crisis has responded differently in terms of facing criticism, casting blame, predicting future developments in the market, and proposing solutions. In the end, however, it seems that all parties are partially to blame. There are the borrowers who exaggerated their incomes to qualify for loans,[103] lenders who made imprudent or deceptive lending decisions,[104] investors who deliberately took on excessive risk in hopes of achieving higher rewards,[105] and the lack of state and federal regulation that created an environment where all these bad practices could occur.[106] Many are at fault for the current credit crunch. But the real question is how do we to mitigate the fallout and how do we to prevent this crisis from reoccurring in the future without eliminating financing to those with less than perfect credit? History shall judge our answer.

Gregory Kopacz[107]

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[101] MBA Chairman, John M. Robbins, at the National Press Club's Newsmakers Lunch: MBA chairman: regulate bad actors, not subprime loan products (May 2007), *available at* http://www.allbusiness.com/finance/4504470-1.html (last visited Nov. 3, 2007).

[102] Carolyn Said, *Few Lenders Are Willing to Make Mortgage Modifications, Survey Says*, S.F. CHRON., Oct. 11, 2007, *available at* http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2007/10/11/BUBTSL4IL.DTL&type=business.

[103] Tse, *supra* note 3.

[104] Press Release, Cameron Street, *supra* note 67.

[105] *Id.*

[106] *Id.*

[107] Student, Boston University School of Law (J.D. 2009).