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## **Subprime Mortgage Crisis** *Impact, Causes and Solutions for Low-Income Borrowers*

### **Introduction**

Home mortgage foreclosures are at record highs. From 2006 to 2007 foreclosure filings grew 75 percent, leaving more than 1 percent of all households in some stage of foreclosure.<sup>1</sup> Foreclosures in the subprime mortgage market are leading the way. Subprime borrowers entered foreclosure at a rate of 2.43 percent, much higher than the 0.25 percent rate of other borrowers.<sup>2</sup> In the fourth quarter of 2006, about 310,000 foreclosure proceedings were initiated,<sup>3</sup> with subprime mortgages accounting for more than half. The number of foreclosures, particularly among subprime borrowers, is expected to rise in the next few years.

Many of these subprime borrowers are low and moderate income people who live in low and moderate income neighborhoods. As a result, the impact of subprime foreclosures is particularly devastating among the poor. Foreclosure causes families to lose their home and largest asset, and neighborhoods and cities are crippled by lower home prices and lost tax revenue.

The label “subprime mortgage crisis” describes increased foreclosures, falling home prices, and a weakening economy. The roots of the current crisis date back to the increased securitization of mortgages in the mid-1990s and the historically low interest rates in the wake of

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<sup>1</sup> Mike Barris, *Foreclosure Filings Surged 75% In '07 as Subprime Mess Grew*, Wall Street Journal, January 29, 2008, at D3.

<sup>2</sup> Dina El Boghdady and Nancy Trejos, *Foreclosure Rate Hits Historic High*, Washington Post, June 15, 2007, at D1.

<sup>3</sup> Up from an average of 230,000 in the preceding two-year quarterly average. Ben S. Bernanke, Federal Reserve Chairman, Address at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm#f4> (May 17, 2007).

the 2001 burst technology bubble. Additional factors such as government policy, softened lending standards, unregulated mortgage brokers, over reliance on credit rating agencies, and the desire for corporate profits all combined to produce a subprime crisis that has spilled over into the national and international economy.<sup>4</sup>

This paper focuses on the subprime mortgage crisis and its relationship to low-income borrowers, families, and neighborhoods. It examines how and why the current crisis developed, the implications to poor families and neighborhoods, and a solution to help low-income borrowers. Part I explores the nature and landscape of the subprime mortgage market. Part II discusses the impact of the subprime crisis on the poor. Part III discusses the specific political, business, economic, and legal causes of the subprime meltdown. Part IV offers a solution to the problem that assists capable and deserving low-income homeowners avoid foreclosure while resisting an overly broad bailout that would allow lenders and certain undeserving borrowers avoid the consequences of poor decisions.

## **Part I: The Subprime Basics**

Mortgage rates and terms vary for many reasons, including differences in the individual characteristics of borrowers.<sup>5</sup> Differing mortgage rates and terms are put into two main categories—prime and subprime—based on the credit risk and the capacity to repay of potential borrowers.<sup>6</sup> The terms “prime” and “subprime” refer to the credit quality of the borrowers, not the interest rate of the loans. Generally, subprime mortgages are for those borrowers with a

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<sup>4</sup> Maya Jackson Randall and Andrea Thomas, *Paulson: 2008 to Be Difficult Year*, Wall Street Journal, April 13, 2008, available at <http://online.wsj.com/article/SB120800396896310415.html>.

<sup>5</sup> Lenders are primarily interested in the borrower’s credit history. However, characteristics of the mortgage such as “loan-to-value ratio, or attributes of the property that cause the loan to carry elevated credit risk” are also considered. Edward M. Gramlich, Former Governor Fed. Reserve System, Address at the Financial Services Roundtable Annual Housing Policy Meeting, available at <http://federalreserve.gov/boarddocs/Speeches/2004/20040521/default.htm>, (May 21, 2004).

<sup>6</sup> *Id.*

credit score below 620,<sup>7</sup> while borrowers with a score above 620 qualify for prime mortgages.<sup>8</sup> The exact rates and terms of subprime mortgages vary<sup>9</sup> based on credit history, size of down payment, income, and other factors; but subprime loans generally have higher interest rates and less favorable terms than prime loans.<sup>10</sup>

In recent years the subprime market has grown considerably. In 1998 subprime mortgages were 2.4 percent of outstanding home mortgages. By the second quarter of 2006, subprime mortgages were 13 to 14 percent of total outstanding mortgage debt<sup>11</sup> and, in the first half of 2006, accounted for 19 percent of new loan originations.<sup>12</sup> The total amount of outstanding subprime loans is now \$1.3 trillion, up from \$65 billion in 1995 and \$332 billion in 2003.<sup>13</sup>

The rate of foreclosure among subprime mortgages has always been higher than prime mortgages.<sup>14</sup> Over 20 percent of first-lien subprime mortgages end up in foreclosure within 4

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<sup>7</sup> A credit score varies from 300 to 900. The average credit score of a subprime borrower whose mortgage is in the secondary market is 605. Elizabeth Laderman, Federal Reserve Bank of San Francisco (FRBSF) Economic Letter, available at <http://www.frbsf.org/publications/economics/letter/2001/el2001-38.html> (December 28, 2001).

<sup>8</sup> There are many borrowers with credit scores above 620 who have subprime mortgages. Lenders must assess the credit risk of borrowers relative to the size of the mortgage. There is evidence that many borrowers, who otherwise could have qualified for prime mortgages, used subprime mortgages as a way to finance more expensive homes. Rick Brooks and Constance Mitchell Ford, *The United States of Subprime—Data Show Bad Loans Permeate the Nation; Pain Could Last Years*, Wall Street Journal, October 11, 2007, at A1.

<sup>9</sup> The rates and terms of subprime loans are generally less favorable than prime loans and also vary more than prime loans due to different ways subprime lenders assess risk. *Subprime Mortgages*, available at <http://www.bankrate.com/brm/green/mtg/basics2-4a.asp>.

<sup>10</sup> As an example, during the 1998-2001 period, the subprime mortgage rate was 3.7 percent higher than the prime mortgage rate. Laderman, *supra* note 7.

<sup>11</sup> Mortgage Bankers Association (MBA) 2007 Servicing Conference, Mortgage Servicing: Performance Trends and Operational Planning Discussion, available at <http://www.mortgagebankers.org/files/Conferences/2007/Servicing07/Tab18-PerformanceTrends&Operational.pdf>.

<sup>12</sup> Press Release, Mortgage Bankers Association (MBA), *Subprime Mortgage Originations Volume Down in the First Half of 2006* (Oct 23, 2006), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/46043.htm>.

<sup>13</sup> Testimony on Nontraditional Mortgages and Subprime Hybrid Adjustable Rate Mortgages: Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs (March 22, 2007) (statement of Scott M. Polakoff, Deputy Director Office of Thrift Supervision), available at <http://www.ots.treas.gov/docs/8/87131.pdf>.

<sup>14</sup> Roberto G. Quercia, Spencer M. Cowan, and Ana B. Moreno, *The Cost-Effectiveness Of Community-Based Foreclosure Prevention* (December 8, 2005), available at [http://www.fhfund.org/dnld/reports/MFP\\_Full-Report.pdf](http://www.fhfund.org/dnld/reports/MFP_Full-Report.pdf).

years, a rate more than 10 times that of prime mortgages.<sup>15</sup> In the third quarter of 2002, subprime loans had a delinquency rate 5.5 times higher than prime loans and a foreclosure rate 10 times higher than prime loans.<sup>16</sup> Delinquency and foreclosure rates, particularly among subprime adjustable rate mortgages, have accelerated since mid-2005.<sup>17</sup> The delinquencies among subprime adjustable rate mortgages is at 11 percent, more than double the mid-2005 level.<sup>18</sup> Subprime mortgages now account for 60 percent of all foreclosures<sup>19</sup> and in the first quarter of 2007, the percentage of all subprime mortgages in foreclosure was at 2.43 percent, up from 2 percent in the last quarter of 2006.<sup>20</sup>

## Part II: The Subprime Impact on the Poor

The current situation is stark, particularly for low-income homeowners. Subprime mortgages are concentrated among low-income borrowers.<sup>21</sup> In 2002, 10.9 percent of low-

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<sup>15</sup> Roberto G. Quercia, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism: University of North Carolina at Chapel Hill (January, 25, 2005).

<sup>16</sup> The Mortgage Bankers Association of America reports that subprime loans in the third quarter of 2002 had a delinquency rate 5.5 times higher than that for prime loans (14.28 versus 2.54 percent) and the rate at which foreclosures were begun for subprime loans was more than 10 times that for prime loans (2.08 versus 0.20 percent). Souphala Chomsisengphet and Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, Federal Reserve Bank of St Louis Review, Jan/Feb 2006, pg 32, available at <http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf>.

<sup>17</sup> Bernanke, *supra* note 3.

<sup>18</sup> *Id.*

<sup>19</sup> Testimony on Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs, (Feb 7, 2007) (statement of Martin Eakes, CEO, Center for Responsible Lending and Center for Community Self-Help), available at <http://www.responsiblelending.org/pdfs/martin-testimony.pdf>.

<sup>20</sup> Dina El Boghdady and Nancy Trejos, *Foreclosure Rate Hits Historic High*, Washington Post, June 15, 2007, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/06/14/AR2007061400513.html>.

<sup>21</sup> While there is evidence, see note 8, that all income levels used subprime loans, there are still large concentrations of subprime loans among low and moderate income borrowers. Paul Calem, Kevin Gillen, and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, Draft paper, Federal Reserve System, Division of Research and Statistics (October 30, 2002), available at <http://realestate.wharton.upenn.edu/pdf/404.pdf> (“Research to date indicates that there is geographical concentration of subprime mortgages in Census tracts where there are high concentrations of low-income and minority households.”).

income homeowners<sup>22</sup> had subprime mortgages and 16.4 percent of the mortgages in low-income neighborhoods were subprime.<sup>23</sup> The subprime crisis rippled through the broader economy, causing an economic slowdown, which makes it even more difficult for low-income borrowers to make mortgage payments. Housing prices have fallen, giving subprime homeowners little option to sell or refinance, making foreclosure all the more likely. As of March 2007, 490,000 subprime loans were seriously delinquent or in foreclosure.<sup>24</sup> Unfortunately, the situation will likely get worse. An estimated 1.8 million subprime mortgages that are not now in foreclosure have interest rates that are scheduled to increase in late 2007 and 2008, which will undoubtedly produce more foreclosures.<sup>25</sup>

While the subprime problem has affected the broader economy and housing market, increased foreclosures have a specific impact on low-income borrowers and neighborhoods. As a result, the negative economic and social effects of subprime home foreclosures are disproportionately felt in low and moderate income neighborhoods. At the individual level, home foreclosures are devastating: the borrower loses accumulated equity and access to immediate housing, and the negative impact on the borrowers' credit impairs future access to credit, insurance, and rental markets.<sup>26</sup> Moreover, foreclosure can cost a borrower \$7,200 in administrative charges.<sup>27</sup>

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<sup>22</sup> Interestingly, a greater percentage (11.2) of middle-income homeowners had subprime mortgages.

<sup>23</sup> Edward M. Gramlich, Federal Reserve Governor, Address at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois (May 21, 2004), available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm>.

<sup>24</sup> As of the first quarter of 2007, 13.77 percent of all subprime mortgages were delinquent and 5.1 percent were in foreclosure. Patrick Madigan, Iowa Assistant Attorney General, *Overview of The Subprime Foreclosure Crisis* (September 10, 2007), available at [http://www.law.columbia.edu/center\\_program/ag/predatorylend](http://www.law.columbia.edu/center_program/ag/predatorylend).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> Anne Moreno, *The Cost-Effectiveness of Mortgage Foreclosure Prevention*, Minneapolis: Family Housing Fund (1995), available at [http://www.fhfund.org/dnld/reports/MFP\\_1995.pdf](http://www.fhfund.org/dnld/reports/MFP_1995.pdf).

Foreclosures also reduce the individual and social benefits of homeownership. There is evidence that homeownership increases the owner's satisfaction, self-esteem, community involvement, and positively impacts youth behavior.<sup>28</sup> In addition, homeownership provides an asset that can be borrowed against in times of financial need. While the empirical evidence for these benefits is inconclusive,<sup>29</sup> many government policies that encourage homeownership are based on the perceived individual and social benefits of homeownership. The individual and social benefits of homeownership are lost when foreclosure causes homeowners to become renters. In addition, foreclosure itself has a negative psychological impact as individuals and families are removed from a social network and leave a home and neighborhood where they had invested time and money.

Beyond individual hardship, home foreclosures also affect neighborhoods and cities. Home foreclosures can lower surrounding property values. One study of the Chicago area concluded that every foreclosure in a low or moderate income neighborhood lowered surrounding property values by 1.44 percent.<sup>30</sup> This decrease in property values among low and moderate income neighborhoods was 60 percent greater than the decrease in property values a home foreclosure caused in middle and high income neighborhoods.<sup>31</sup>

As forecloses increase, cities and municipalities are hurt by direct costs and lost tax revenue. A 2005 Chicago study calculated that a typical home foreclosure had direct costs—such as court costs, increased policing, building inspections, and increased demand for social

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<sup>28</sup> William M. Rohe, Shannon Van Zandt, and George McCarthy, *The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research*, Joint Center for Housing Studies of Harvard University, Low-Income Homeownership Working Paper Series (October 2001), available at <http://www.jchs.harvard.edu/publications/homeownership/liho01-12.pdf>.

<sup>29</sup> *Id.*

<sup>30</sup> Dan Immergluck and Geoff Smith, *There goes the neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values*, Woodstock Institute (June, 2005). In this study, “surrounding area” is defined as properties within a 1/8 mile radius.

<sup>31</sup> *Id.* The decrease in middle and high income neighborhoods is 0.9 percent.

services—on local government agencies of \$34,000.<sup>32</sup> As property values erode, cities lose tax revenue as the need for government services rises.<sup>33</sup> More foreclosures produce more vacant and abandoned homes, which are targets for vandalism and other criminal activity.<sup>34</sup> Also, general criminal activity such as stealing increases with foreclosures and so does the need for temporary or emergency housing. There is anecdotal<sup>35</sup> and statistical<sup>36</sup> evidence for increased violent crime in the wake of foreclosures. With tax revenues declining, cities have less money to deal with increased criminal activity or to increase temporary and emergency housing.

Finally, increased foreclosures signal businesses and housing developers that a neighborhood is not desirable for investment. This harms neighborhoods in the short-term and long-term as investors do not undertake projects that provide jobs, community infrastructure, and housing price stability.

All of these effects are magnified when, as now, foreclosures are paralleled by a general economic downturn. Deteriorating economic conditions cause increased foreclosures outside the subprime market, which depresses housing prices further as the supply of houses increases. Falling housing prices increase the risk to lenders and results in fewer mortgage originations, reducing the demand for houses and adding to the downward pressure on home prices. Also,

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<sup>32</sup> William C. Apgar, *The Municipal Cost of Foreclosures: A Chicago Case Study* Homeownership Preservation Foundation, Homeownership Preservation Foundation: Housing Finance Policy Research Paper Number 2005-1 (February 27, 2005), available at [http://www.995hope.org/content/pdf/Apgar\\_Duda\\_Study\\_Full\\_Version.pdf](http://www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf).

<sup>33</sup> A separate Chicago study estimated that the cumulative impact of two years of foreclosures on property values exceeded \$598 million, an average of \$159,000 per foreclosure. Dan Immergluck and Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, Housing Policy Debate 17: 57-79, available at [http://www.fanniemae.foundation.com/programs/hpd/pdf/hpd\\_1701\\_immergluck.pdf](http://www.fanniemae.foundation.com/programs/hpd/pdf/hpd_1701_immergluck.pdf).

<sup>34</sup> Haya El Nasser, *Foreclosure crisis has ripple effect*, USA Today, available at [http://www.usatoday.com/news/nation/2008-03-11-foreclosures\\_N.htm](http://www.usatoday.com/news/nation/2008-03-11-foreclosures_N.htm) (last visited April 18, 2008).

<sup>35</sup> *Id.*

<sup>36</sup> Immergluck and Smith. *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, available at [http://www.chicagofed.org/cedric/files/2005\\_conf\\_paper\\_session1\\_immergluck.pdf](http://www.chicagofed.org/cedric/files/2005_conf_paper_session1_immergluck.pdf). (Finding “[a] one-percentage-point (0.01) increase in foreclosure rate...is expected to increase the number of violent crimes in a tract by 2.33 percent, other things being equal.”)

tightening credit standards make it more difficult for low-income renters to take advantage of low interest rates and home prices and become homeowners.

### **Part III: Causes**

The current subprime crisis results from two sets of forces: one set operating on the economy as a whole and one set operating on the particular mechanics of the mortgage market. The increased securitization in the mid-1990s encouraged and enabled lenders to make subprime loans at overly easy credit standards. Simultaneously, the credit risks inherent in subprime loans were masked by low interest rates and appreciating home prices, which allowed subprime borrowers to refinance rather than face foreclosure. As home prices started depreciating, refinancing could no longer mask the credit risk of borrowers, at which time delinquencies and foreclosures began rising.

The expansion of subprime loans first started in the mid-1990s. During this time governments encouraged loans to low-income borrowers, technological improvements made it cheaper and faster for lenders to assess and price credit risk, and the growth of secondary mortgage markets allowed lenders to transfer the risk of subprime loans to investors. Macroeconomic trends before and during the 2001 recession enabled this explosion of subprime loans to continue. Delinquencies among subprime loans increased just before and at the start of the 2001 recession.<sup>37</sup> However, historically low interest rates<sup>38</sup> and appreciating home prices<sup>39</sup> caused this trend to subside. The low interest rates lessened the impact of mortgage rate resets

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<sup>37</sup> Danielle DiMartino and John V. Duca, *The Rise and Fall of Subprime Mortgages*, Federal Reserve Bank of Dallas, Economic Letter, Vol. 2, No. 11 (November 2007), available at <http://www.dallasfed.org/research/ecllett/2007/e10711.html#1>.

<sup>38</sup> During 2001, the Federal Reserve lowered the federal funds rate 11 times, lowering the target rate from 6 percent to 1.75 percent. The rate was further cut in 2002 and 2003, leaving the target rate at 1 percent. Data available at <http://www.federalreserve.gov/fomc/fundsrate.htm> (last visited April 18, 2008).

<sup>39</sup> The median home price rose 24 percent between 2001 and 2004. Data available at <http://www.homemortgagerefinanceblog.com/> (last visited April 18, 2008).



and the combination of low interest rates and appreciating home prices allowed many homeowners to refinance rather than face foreclosure.<sup>40</sup> In 2002, 8 million homeowners refinanced.<sup>41</sup> In 2003, one in every three—15 million total—home mortgages were refinanced.<sup>42</sup>

While some foresaw disaster early on and made billions on the subprime crash,<sup>43</sup> the general trend of increased subprime loans continued even in the face of declining home prices and increased foreclosures that started in 2005.<sup>44</sup> It was not until 2007 that lenders noticed the increasing delinquency rate in the subprime market and tightened lending standards. In the first quarter of 2007 residential mortgages entered foreclosure at a record pace and lenders raised standards on subprime loans as a result.<sup>45</sup> In August 2007, problems in the subprime market finally resulted in industry and economy-wide trauma. The credit markets seized up as investors realized that large sources of liquidity were potential casualties of the subprime fallout. Since August, the economic consequences have intensified, leaving investors uncertain about whether the ripple effects of the subprime crisis will end any time soon. Subprime mortgages, once heavily demanded by investors, are now balance sheet killers and potential sources of corporate disaster.

These above macro-level economic causes combined with the following specific causes:

*Securitization.* Securitization packages large pools of assets and issues the packaged assets as securities to investors on a secondary market. Securitization usually involves an

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<sup>40</sup> The decreased federal funds rate corresponded to a 21 percent drop in mortgage rates from 7.01 percent in the first quarter of 2001 to 5.52 percent in the second quarter of 2003. *An Analysis Of Mortgage Refinancing, 2001-2003*, HUD Office of Policy Development and Research, available at <http://www.huduser.org/Publications/pdf/MortgageRefinance03.pdf>.

<sup>41</sup> Margaret M. McConnell, Richard W. Peach, and Alex Al-Haschimi, *After the Refinancing Boom: Will Consumers Scale Back Their Spending?*, Current Issues in Economics and Finance, Federal Reserve Bank of New York (December 2003), available at <http://www.huduser.org/Publications/pdf/MortgageRefinance03.pdf>.

<sup>42</sup> *Id.*

<sup>43</sup> Gregory Zuckerman, Jenny Strasburg, and Tom McGinty, *Some Traders Win Big*, Wall Street Journal, March 20, 2008, at C1.

<sup>44</sup> DiMartino and Duca, *supra* note 37.

<sup>45</sup> *Id.*

underlying asset that produces an income stream—i.e., credit card receivables, automobile lease receivables, and home mortgages. Large groups of the underlying asset are packaged and sold to investors, who take an interest in the income stream from the asset. Historical rates of default and other sophisticated statistical analyses of the underlying assets are used to estimate the overall risk and price of the packaged assets.

Securitization of subprime mortgages is common, with upwards of 80 percent of subprime mortgages and 50 percent of total mortgages securitized.<sup>46</sup> In a typical subprime securitization transaction, the mortgages are pooled together and transferred from the mortgage originator (a lender or broker) to a legally distinct entity known as a special purpose vehicle (SPV). The SPV, in turn, issues debt securities to investors. The monthly interest and principal payments by the homeowners go to investors according to the particular structure of the securitization. Most homeowners are oblivious to this transaction, as the original servicer of the loan continues to receive the loan payments and service the loan.

Securitization enables and encourages subprime lending. Lenders are willing to make subprime loans—which, by their nature are riskier than prime loans—because securitization allows lenders to shift risk.<sup>47</sup> Once securitized subprime loans are transferred from the lender to a SPV and investors purchase an interest in the securitized loans, the risk of loan default belongs to the investors, not the lender. The lender receives up front payments by the investor when the debt security is purchased. There are, however, structural and contract terms designed to ensure that lenders retain some credit risk and thereby have an incentive to maintain appropriate credit quality in subprime loans. For example, some securitization contracts require lenders to

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<sup>46</sup> Richard J. Rosen, *The role of securitization in mortgage lending*, Chicago Fed Letter (Nov 2007), available at [http://www.chicagofed.org/publications/fedletter/cflnovember2007\\_244.pdf](http://www.chicagofed.org/publications/fedletter/cflnovember2007_244.pdf).

<sup>47</sup> Another important benefit to lenders was shifting the mortgages from their balance sheets to the SPV's. By regulation, banks must keep a percentage of all outstanding loans as capital on reserve. Shifting the mortgages to the SPV's balance sheet allowed banks to free up reserve capital for other investments.

substitute loans in default with performing loans. However, the high demand for subprime-backed securities forced investors to overlook many of these protections, and many other protections did not function as intended.

While the lender is able to shift risk, investors are compensated for and protected from this risk. The structure of the securitization protected investors from legal and credit risk. Securitized investments are divided into tranches, where higher (senior) tranches get paid off before lower (subordinated) tranches, leaving the lower tranches to absorb any losses from borrower defaults. Also, investors want protection from borrower prepayment because a prepaid loan provides less cash flow than a regularly paid mortgage. These concessions to satisfy investors can impact borrowers. Lenders have an incentive to charge higher interest rates and prepayment penalties because those terms command a higher price once securitized. In fact, there is evidence that demands by rating agencies for more investor protections resulted in higher mortgage rates.<sup>48</sup>

While a sophisticated financial transaction, created and executed far removed from low-income neighborhoods, securitization is vital in understanding the roots of the subprime crisis. This transfer of risk discouraged adequate credit screening of loan applicants and encouraged lenders to include prepayment penalties and other “predatory” terms in loan documents. The built-in protections for investors and high profitability ensured high demand for securitized subprime loans. While securitization enabled lenders to offer loans to borrowers who otherwise would not have qualified, securitization also encouraged unfavorable terms to trickle down to the

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<sup>48</sup> Kathleen C. Engel and Patricia A. McCoy, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 75 *Fordham Law Review* 2039, 2057 (March, 2007), available at <http://law.fordham.edu/publications/articles/500flspub7646.pdf>.

mortgage contracts and an excessive supply of loans at easy credit standards that set the stage for a massive increase in foreclosures.<sup>49</sup>

*Credit Rating Agencies.* In the U.S., three primary credit rating agencies—Standard & Poor’s, Moody’s, and Fitch—evaluate the risk associated with different companies and investments. These rating agencies are private, but subject to specific government oversight. The rating agencies analyze companies and particular financial instruments and issue ratings ranging from AAA (the highest quality) to D (the lowest). The ratings represent the risk of a particular company or investment. In many cases the rating agencies gave the highest rating (AAA) to securitized subprime mortgages.

Rating agencies had several conflicts of interest that contributed to the subprime crisis. First, rating agencies generated large fees from securitization deals, both in terms of traditional rating services and in terms of consulting fees on how to structure securitized products to achieve high ratings. Rating agencies are paid directly by the issuer (the company whose product is being rated) to rate and consult on each security. Based on the complexity of securitized deals, rating agencies charged fees twice as high as the fees charged to rate traditional corporate bonds.<sup>50</sup> Moreover, underwriters paid consulting fees to ratings agencies for advice on how to structure securitized subprime mortgages in a manner that would receive a high rating. High ratings ensured greater demand by investors because certain investors are limited by internal

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<sup>49</sup> Atif Mian and Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis*, National Bureau of Economic Research, Work Paper 13936 (January 2008), available at <http://www.nber.org/papers/w13936>.

<sup>50</sup> In 2006, Moody’s earned 44 percent of its revenue from rating structured products, which included subprime mortgages, credit card debt, student loans, and other types of loans. Aaron Lucchetti and Serena Ng, *Credit and Blame: How Rating Firms’ Calls Fueled Subprime Mess—Benign View of Loans Helped Create Bonds, Led to More Lending*, Wall Street Journal, August 15, 2007, at A1.

policy to investments that receive a sufficiently high rating. This need for high ratings gave the rating agencies an institutional incentive to ensure the products received a high rating.<sup>51</sup>

The conflict of interests between generating revenue and offering independent analysis has been noted by many observers, including the rating agencies themselves.<sup>52</sup> In addition to these conflicts of interest during the initial rating stage, rating agencies were slow to downgrade mortgage-backed securities, even as mortgage defaults rose. Rating agencies do not have a financial incentive to rerate securities after the initial rating because they are only paid for the initial rating.<sup>53</sup> The delay in downgrades caused additional harm as more subprime loans were originated, securitized, and traded while rating agency downgrades caught up with market realities.

*Predatory lending.* Predatory lending is a loaded term, with an amorphous definition. In general, predatory lending charges excessive fees or interest rates or uses deceptive or fraudulent lending practices. Predatory lending includes practices outlawed by state and federal laws<sup>54</sup> or a set of terms and practices considered unfair or fraudulent, even if not expressly prohibited by statute. A joint report by the Department of Housing and Urban Development and the

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<sup>51</sup> For example, in testimony before Congress, Professor Joseph R. Mason stated that:

Bloomberg Markets reported in July that: “Corporate bonds rated Baa, the lowest Moody’s investment grade rating, had an average 2.2 per cent default rate over five-year periods from 1983 to 2005, according to Moody’s. From 1993 to 2005, CDOs with the same Baa grade suffered five-year default rates of 24 per cent, Moody’s found.” In other words, long before the current crisis, Moody’s was aware that its Baa CDO securities were 10 times as risky as its Baa corporate bonds. *Hearing on the Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the House the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services* (Sept 2007) (statement of Joseph R. Mason, Associate Professor, Drexel University), available at <http://www.lebow.drexel.edu/PDF/Docs/Mason-Testimonial.pdf>.

<sup>52</sup> See, *S&P’s steps to further manage potential conflicts of interest, strengthen the ratings process, and better serve the markets* (Feb 7, 2008), available at [http://www2.standardandpoors.com/spf/pdf/media/Leadership\\_Actions\\_List.pdf](http://www2.standardandpoors.com/spf/pdf/media/Leadership_Actions_List.pdf).

<sup>53</sup> Mason, *supra* note 51.

<sup>54</sup> Fifty percent of states have anti-predatory lending statutes as well as the federal law, Homeownership Equity Protection Act (HOEPA). See generally, Raphael W. Bostic and Kathleen C. Engel, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, Working Draft (August 7, 2007), available at [http://www.chicagofed.org/cedric/2007\\_res\\_con\\_papers/car\\_44\\_bostic\\_state\\_laws\\_enforcement\\_mechanisms\\_1\\_31\\_07.pdf](http://www.chicagofed.org/cedric/2007_res_con_papers/car_44_bostic_state_laws_enforcement_mechanisms_1_31_07.pdf).

Department of the Treasury defined predatory lending as “deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower’s lack of understanding about loan terms.”<sup>55</sup>

Predatory lending includes practices such as the following:<sup>56</sup>

- (1) *Loan structure.* This includes loans structured so that borrowers are harmed at the expense of lenders and brokers. An example of a loan structure considered predatory is a so-called 2/28 (or 3/27) loan. In the first two years of a 2/28 loan, the borrower pays a low fixed interest rate called a teaser rate. After the first two years, the interest rate adjusts every six months. Typically the interest rate adjusts upwards. Borrowers who cannot continue to make payments under the higher interest rate return to the lender to refinance and receive another teaser rate for another two years. Many lenders qualified borrowers based on the ability to repay under the initial teaser rate. As a result, lenders received large refinancing fees as 85 percent of borrowers were past due on 2/28 loans soon after interest rate adjustments.
- (2) *Rent-seeking.* This includes fees or interest rates that are excessive in relation to the credit risk posed by the borrower. A commonly used example is prepayment penalties, which are more than three times as likely in subprime mortgage terms than prime mortgage terms.<sup>57</sup> Prepayment penalties charge the borrower for paying off the entire loan, usually expressed as a percentage of the outstanding loan amount or a specified number of months of interest. Prepayment penalties make it more costly to refinance.<sup>58</sup> Some suggest that these penalties

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<sup>55</sup> Report available at <http://www.huduser.org/Publications/pdf/treasrpt.pdf>.

<sup>56</sup> Based on the categories developed by Engel and McCoy, *supra* note 48.

<sup>57</sup> Amy Crews Cutts and Robert A. Van Order, *On the Economics of Subprime Lending*, *The Journal of Real Estate Finance and Economics*, 30:2, 167–196, 2005.

<sup>58</sup> *Id.* at 175 (“[F]or many borrowers who took out loans in 1998, there was a strong refi incentive due to falling interest rates... [A]mong subprime loans originated in 1998, 10 percent of loans with prepayment penalty clauses

exist because lenders gave loans that they knew would require refinancing or encouraged repeated refinancing as a means to collect fees.

Others suggest that prepayment penalties are a rational and appropriate response to increased risk. When a borrower prepays a mortgage, the lender must reinvest the funds, which had been expected to produce a certain return, at an uncertain (and possibly lower) interest rate. The risk of prepayment is higher among subprime borrowers because the incentive to refinance is much greater than prime borrowers.<sup>59</sup> Also, as discussed above, loans with prepayment penalties command a higher premium on the secondary market, which gives lenders an economic incentive to include those terms.

(3) *Illegal fraud or deception.* This includes violation of the major consumer protection statutes: Truth in Lending Act (TILA), the Homeownership and Equity Protection Act (HOEPA), and the Real Estate Settlement Procedures Act (RESPA). This also includes violation of state anti-predatory lending statutes.<sup>60</sup>

(4) *Non-transparency, Discrimination.* Other categories of predatory lending include non-disclosure of mortgage prices and terms, mandatory arbitration clauses, and racial or ethnic discrimination in lending.

For years, lenders have been accused of different varieties of predatory lending. Lenders generally have a financial disincentive to engage in predatory lending, as lenders do not profit from defaults; however, in a period of rising home prices lenders are more likely to engage in predatory lending because they can recoup the value of their loans in the event of default.

Securitization has the potential to reduce incentives for predatory lending as investors demand

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prepaid by the thirteenth month after origination, but more than 20 percent of loans without prepayment penalties prepaid within 13 months.”)

<sup>59</sup> The large differences in interest rates between prime and subprime mortgages and within different credit classes of subprime mortgages give borrowers a large incentive to refinance after changes in credit. *Id.* at 173.

<sup>60</sup> *See, Bostic, supra* note 54.

that investment pools are comprised of quality assets. However, the structure of securitization, as discussed above, insulates investors from the credit risk associated with subprime defaults and, instead, encourages less restrictive lending practices.

Predatory lending is difficult to analyze as a cause of the subprime crisis because of its amorphous definition. Some practices are considered predatory by some actors but not others, and the same practice might be predatory in one situation but not another. The pervasiveness and impact of the practices commonly considered predatory should be examined further as a cause of the subprime crisis. For the scope of this paper, it is enough to note that the practices (whether they are predatory or not) such as 2/28 loans and prepayment penalties are strongly related to the subprime crisis.

*Government Policy.* Under the assumption that homeownership confers benefits to individuals, families, and neighborhoods, the government has long encouraged homeownership. Based on the idea that banks should supply the credit needs of the communities in which they are located, the Community Reinvestment Act (CRA) is the best known legislation to encourage lending in poor communities. The CRA requires depository institutions to reinvest deposit funds back into the communities in which they are located. Federal regulators evaluate each institution yearly and assign and publish a rating based on whether the bank is meeting community needs. These ratings and the institution's records are used by federal regulators when deciding whether to approve a merger, a branch opening, or a relocation.

While there is no mandatory quantitative allocation of capital to low-income communities,<sup>61</sup> banks often make quantitative commitments in an effort to improve chances at

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<sup>61</sup> There was a regulatory effort to create quantitative guidance for lending practices. In 1994 HUD Secretary Henry Cisneros developed rules for lenders that encouraged them to increase approval rates for loans to minority applicants by 20 percent within one year. Vern McKinley, *Community Reinvestment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation?*, Regulation, 1994 Number 4, at pg 30.



regulatory approval for a merger.<sup>62</sup> The CRA encourages and rewards allocations of capital to low-income and minority areas, with little regard to whether the loans are sound or not. While banks are now being criticized for too lenient lending standards in poor communities, the incentives created by the CRA encouraged such lending behavior.

Certainly other micro-level causes exist. For example, Federal Reserve Chairman Bernakee suggested that many loan originators are smaller independent brokers, rather than traditional mortgage originators such as a bank.<sup>63</sup> These small brokers are more difficult to monitor and regulate, and were able to insulate themselves from the risk of loans by using securitization. These independent brokers facilitated inconsistent, loose, and abusive lending practices.

#### **Part IV: Toward a solution**

As detailed above, there are many causes of the subprime crisis. A mixture of political, economic, corporate, and legal factors played into the current situation. The appropriate solution requires a balance of mitigating short-term harm in the housing sector, setting the foundation for long-term stability in the housing market and the general economy, and avoiding the moral hazard of bailing out investors and consumers from bad choices. Historically, half of homeowners in foreclosure eventually are displaced from their house.<sup>64</sup> If this trend continues it would result in hundreds of thousands of displaced homeowners, most of whom would be the

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<sup>62</sup> Fleet Financial made a three-year 8 billion dollar commitment to low-income neighborhoods after a settlement related to unfair lending to low-income borrowers; Bank of America made a 12 billion dollar pledge when acquiring Security Pacific Corporation. *Id.* at 29.

<sup>63</sup> Subprime mortgage lending and mitigating foreclosures: Hearing Before the House Committee on Financial Services (Sept 20, 2007) (statement of Ben S. Bernanke, Federal Reserve Chairman), available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20070920a.htm>.

<sup>64</sup> *Id.*

poorest subsection—the subsection least likely to receive a lender mortgage renegotiation—of the subprime housing market.

Before examining an appropriate solution, there is one proposal with bipartisan support that would be counter-productive and inadvisable:

*Changes to Section 1322(b)(2) in the Bankruptcy Code.* As it stands now, Chapter 13 bankruptcy affords an individual, whose debts do not exceed the statutory maximums, an opportunity to pay debts, in whole or in part, according to a court-ordered plan.<sup>65</sup> As long as the debtor and the plan itself meet the statutory criteria, creditors must accept the plan as decided by the court.

Debts are divided into two main categories: secured debts, such as a home mortgage, and unsecured debts, such as a utility bill. With a secured debt, the borrower promises to repay the debt and gives the lender an interest in a piece of property that serves as collateral. If the borrower defaults on the debt, the lender can force the sale of the collateral property to satisfy the debt. With an unsecured debt, the borrower only promises to repay the borrowed amount, without giving any property as collateral. If the borrower defaults on an unsecured debt, the creditor cannot force the sale of any property to satisfy the debt.

When a person seeks Chapter 13 bankruptcy protection, bankruptcy courts are permitted to modify the loan amount and terms of secured and unsecured debts. The bankruptcy code, however, prohibits courts from modifying one particular secured debt, the mortgage on the debtor's principal residence.<sup>66</sup> Prior to the Supreme Court case *Nobelman v. American Sav.*

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<sup>65</sup> There are two types of bankruptcies: liquidation and reorganization. Chapter 13 governs reorganizations for individuals.

<sup>66</sup> The bankruptcy code provides that a Chapter 13 plan may “modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims...” 11 U.S.C. § 1322(b)(2).

*Bank*,<sup>67</sup> some courts held that lenders only had a secured claim in the current market value of the mortgaged property, with the remainder considered an unsecured claim.<sup>68</sup> As a result, in situations where the market value of the house fell below the original loan amount, some courts created plans where lenders had a secured debt in the market value of the property and an unsecured debt in the remaining amount of the loan. The secured debt was protected from court modification;<sup>69</sup> but because it was possible for courts to modify the unsecured debt, lenders often received nothing for the amount of the loan amount above the market value of the property.<sup>70</sup>

Take, for example, a borrower who was given a \$70,000 loan to purchase a principal residence, secured by a lien on the property—in other words, a \$70,000 mortgage. If the borrower later sought and was eligible for Chapter 13 bankruptcy protection, the court could find that the lender’s secured claim was only equal to the current market value of the house, say \$25,000. The court cannot modify the secured claim on a principal residence, but the borrower would avoid foreclosure and only be responsible to repay \$25,000.<sup>71</sup> The \$45,000 unsecured claim—the \$70,000 loan amount minus the \$25,000 current market value—is subject to complete elimination by the court.

In *Nobelman*, the Supreme Court disagreed with this interpretation and held that the bankruptcy code prohibits reducing the secured amount of a mortgage to the current market value. The court conceded that the amount exceeding the current market value of the property was an “unsecured claim component” but stated that it was “impossible” to “reduce the

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<sup>67</sup> *Nobelman v. American Sav. Bank*, 508 U.S. 324 (1993).

<sup>68</sup> Section 506(a) provides that an allowed claim secured by a lien on the debtor's property “is a secured claim to the extent of the value of [the] property”; to the extent the claim exceeds the value of the property, it is an unsecured claim. 11 U.S.C. § 506(a).

<sup>69</sup> 11 U.S.C. § 1322(b)(2).

<sup>70</sup> It is possible under Chapter 13 bankruptcy plans for unsecured creditors to receive nothing.

<sup>71</sup> These are roughly the facts of *Nobelman v. American Sav. Bank*.

outstanding mortgage principal to the fair market value” without modifying the bank’s rights.<sup>72</sup> By reducing the outstanding principal amount, the court is changing contract terms such as interest rates and payment amounts. According to the court, section 1322(b)(2) “prohibits such a modification where, as here, the lender's claim is secured only by a lien on the debtor's principal residence.”<sup>73</sup>

Currently there are several bills in the U.S. House and Senate that seek to change section 1322(b)(2) to the pre-*Nobelman* interpretation and allow bankruptcy courts to modify the terms of principal residence mortgage contracts.<sup>74</sup> The specific provisions of each bill vary in important ways, but the general outcome of each bill is to allow Chapter 13 bankruptcy courts to reduce the outstanding principal on home mortgages to the current market value of the property—a process called “stripping down.”

Currently, under Chapter 13 plans, all secured creditors must be paid within five years.<sup>75</sup> All of the current bills allow courts to modify the duration of mortgages beyond the five year Chapter 13 plan, and in some cases beyond the original duration of the mortgage. These changes in bankruptcy law would treat home mortgage lenders less favorably than other secured creditors who must receive payment within five years. Moreover, it makes more sense to strip down a secured automobile loan, where the automobile is constantly depreciating and unlikely to ever be worth more than the current market value. The strip down of a secured home mortgage deprives the lender of the value of likely future home price appreciation. Even for types of secured creditors where strip downs are permitted (i.e., all secured creditors with an interest other than

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<sup>72</sup> *Nobelman* at 331.

<sup>73</sup> *Id.*

<sup>74</sup> The Emergency Homeownership and Mortgage Equity Protection Act, H.R. 3609, 110th Cong. (2007); Helping Families Save Their Homes in Bankruptcy Act, S. 2136, 110th Cong. (2007).

<sup>75</sup> 11 U.S.C. §1322(d).

the debtor's principal residence), the current bankruptcy code does not allow a strip down unless the loan was made more than 910 days prior to bankruptcy filing.<sup>76</sup>

Strip downs significantly change the risk profile of home mortgages, which will lead to higher interest rates.<sup>77</sup> Strip downs will be more likely when real estate prices are down, leaving lenders with mortgages that are heavily stripped down. Under traditional foreclosure procedures, lenders can wait for the property to appreciate and are thereby more likely to recover the entire loan amount. But if bankruptcy courts can order strip downs, lenders will have to originate and price future loans to account for the probability of large strip downs and unrecoverable loan amounts. As a result, lenders will charge higher interest rates and tighten lending standards. In fact, avoiding higher interest rates was the original rationale for prohibiting bankruptcy courts from stripping down home mortgages.<sup>78</sup>

Strip downs will also lead to a windfall for some debtors. Under the proposed changes, debtors can use Chapter 13 to avoid foreclosure and receive a stripped down mortgage. If a mortgage is stripped down when the market value is less than the outstanding principal amount, any price appreciation in the property thereafter results in equity for the debtor. Because the outstanding principal amount was stripped down during bankruptcy, the lender will be unable to recoup the full value of the principal amount when the house price appreciates. Also, strip

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<sup>76</sup> 11 U.S.C. § 1325(a)(5)(B).

<sup>77</sup> *The Looming Foreclosure Crisis: How To Help Families Save Their Homes: Hearing Before the Senate Committee on the Judiciary* (Dec 5, 2007) (statement of Mark S. Scarberry, Pepperdine University School of Law, Professor), available at [http://judiciary.senate.gov/testimony.cfm?id=3046&wit\\_id=6808](http://judiciary.senate.gov/testimony.cfm?id=3046&wit_id=6808).

<sup>78</sup> Traditionally home mortgage contracts were not subject to revision in bankruptcy court because “exempting mortgage debt from reduction [in bankruptcy] would lower mortgage interest rates and encourage homeownership.” *Options for Responding to Short-Term Economic Weakness: Hearing Before the Senate Committee on Finance* (Jan 22, 2008) (statement of Peter Orszag, Director, Congressional Budget Office), available at <http://www.cbo.gov/ftpdocs/89xx/doc8916/Frontmatter.2.1.shtml>.

downs add costs to a bankruptcy proceeding, which may deter people from filing for bankruptcy.<sup>79</sup>

Bankruptcy law should continue its traditional emphasis on encouraging homeownership by lowering strip down risk to lenders and not attempt to solve the subprime crisis through a case-by-case court ordered solution.

The most appropriate solution will specifically target low-income subprime borrowers who have the ability to continue making payments under modified terms. Taxpayers should not assume the risk of housing speculators or middle-income borrowers who used subprime loans to buy expensive houses, second residences, or speculation property. The borrowers and lenders in this subset of subprime loans should bear the full costs of their risky decisions. Whatever, if any, short-term economic benefit from bailing out these borrowers and lenders is more than offset by the long-term moral hazard of bailing out risky decision-making.

However, preventing foreclosures among low-income borrowers who are able to continue making payments under reasonably reworked mortgages will help individuals, families, neighborhoods, and governments avoid the large costs of foreclosure and the downward spiral of home prices that will negatively affect the housing market and general economic recovery. The appropriate solutions should target this group of borrowers, and follow these guidelines:

1. *Maximize Incentives for Lenders to Renegotiate.* It is expensive for lenders to foreclose and many observers thought that the high cost of foreclosure would encourage lenders to renegotiate mortgages. However, for legal<sup>80</sup> and economic<sup>81</sup> reasons, mortgage servicers

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<sup>79</sup> *High Foreclosures but Low Bankruptcies: Why the Disconnect?* (Sept 12, 2007), available at <http://knowledge.wpcarey.asu.edu/article.cfm?articleid=1472> (last visited April 18, 2008).

<sup>80</sup> Many of the contracts for mortgage service providers limit the amount of authorized loan modification. Alison Vekshin, *Regulators Urge Refinancing of Securitized Mortgages*, Bloomberg.com, Sept 4, 2007, available at [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9wsR\\_gvp6TA](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9wsR_gvp6TA).

<sup>81</sup> Servicers are overwhelmed with the volume of loans that need to be modified. Saskia Scholtes, *Mortgage lenders in subprime 'traffic jam'*, Financial Times, October 3 2007, available at <http://www.ft.com/cms/s/0/b7b4d912-71d5->

apparently are not renegotiating delinquent mortgages at a high rate. This trend is improving, but there is still criticism that not enough renegotiations are occurring. To encourage negotiations, Congress should mandate a 90 day work-out period for all home mortgages currently in default. During this period, lenders should be strongly encouraged to follow the guidance of federal regulators,<sup>82</sup> which focuses on long-term fixes such as converting adjustable rate mortgages to fixed rate and extending the duration of mortgages. Most importantly, Congress should act quickly on the many subprime bills currently under discussion. Mortgage bailout bills like those proposed by Senator Johnny Isakson<sup>83</sup> and Representative Barney Frank<sup>84</sup> are unnecessary, and prolonged debate about these bills will lessen the incentives of lenders and borrowers to renegotiate because of the anticipation of a future government bailout. Congress should send a clear signal that government intervention will be narrowly tailored and not likely to expand over time.

2. *FHASecure*. In August of 2007, the Federal Housing Authority presented the FHASecure plan. The plan targets adjustable rate mortgage (ARM) borrowers who are currently or will soon face a payment reset. The plan allows ARM borrowers to refinance to a fixed rate insured by the FHA. This federal insurance gives an incentive to lenders to refinance. To be eligible for this program, a borrower must (1) have a good credit history

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[11dc-8960-0000779fd2ac.html?nclick\\_check=1](http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070302a1.pdf); Investors in securitized subprime mortgages are not pushing for modification because delayed foreclosures will harm investors more as home prices continue to decline. Vekshin, *supra* note 80.

<sup>82</sup> Federal Reserve Guidelines, available at

<http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070302a1.pdf>.

<sup>83</sup> S. 2566, 110th Cong. (2007). This bill would provide buyers of either a newly constructed house or one that is in foreclosure or default with a one-time, \$15,000 refundable tax credit.

<sup>84</sup> Under the Frank-Dodd plan lenders would reduce the loan amount and refinance the mortgage at a lower interest rate. Refinanced loans would be guaranteed by the FHA, and the lender would have no further credit exposure if the borrower subsequently defaulted. A draft is available at

[http://www.house.gov/apps/list/press/financialsvcs\\_dem/frank\\_158\\_xml.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/frank_158_xml.pdf).

and sufficient income to repay the refinanced mortgage, (2) if delinquent, the delinquency must be due to the interest rate reset, (3) have at least 3 percent equity in the home, (4) have an outstanding mortgage balance of no more than \$362,790, and (5) have an interest rate that either has or will reset between June 2005 and December 2008.

In February 2008, HUD claimed that FHASecure had helped 100,000 homeowners avoid foreclosure.<sup>85</sup> Those numbers have been seriously challenged as grossly misleading,<sup>86</sup> and the program itself challenged because the program only helps those who have good credit, 3 percent equity, and are delinquent because of a mortgage rate reset. However, targeted nature of the program is its advantage. Larger FHA-insured refinancing proposals, such as the Frank-Dodd approach,<sup>87</sup> run the risk of transferring the risk of default of 1 to 2 millions loans to taxpayers and insulating lenders from the consequences of poor lending policies. Moreover, the Frank-Dodd approach will take time to pass and implement, as each mortgage must be individually renegotiated. This rush to renegotiate will crowd out those truly capable and deserving of a renegotiation; and, in the meantime, foreclosures will continue. The FHASecure program combined with the Hope Now alliance (see below) will help those borrowers with the long-term ability to continue making mortgage payments to remain in their homes.

3. *Mortgage Forgiveness Debt Relief Act of 2007*.<sup>88</sup> In December 2007 the President signed a small but important piece of legislation that changed the tax code to allow more favorable treatment of forgiven debt.<sup>89</sup> Prior to this legislation, mortgage debt reduced through mortgage restructuring or foreclosure resulted in taxable income. This

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<sup>85</sup> Press Release, *FHASecure Helps 100,000 Americans Stay In Their Homes*, HUD, February 26, 2008.

<sup>86</sup> *CNBC raises an important question -- is FHASecure a flop?*, (Dec 20, 2007), available at <http://interestrateroundup.blogspot.com/2007/12/cnbc-raises-question-about-whether.html>.

<sup>87</sup> *Supra* note 84.

<sup>88</sup> H.R. 3648, 110th Cong. (2007).

<sup>89</sup> Press Release, *Fact Sheet: The Mortgage Forgiveness Debt Relief Act of 2007*, White House (Dec 2007), available at <http://www.whitehouse.gov/news/releases/2007/12/20071220-6.html>.



legislation allows taxpayers to exclude debt forgiven on their principal residence if the balance of their loan was less than \$2 million.<sup>90</sup> The act applies to debt forgiven in 2007, 2008, or 2009.

Inherent in this legislation is the moral hazard of encouraging homeowners to seek debt relief by walking on mortgages or purposely going delinquent. However, lenders concerned about borrowers seeking debt relief will be encouraged to refinance and many homeowners who legitimately refinanced will receive much needed tax relief.

4. *Hope Now Alliance.* Hope Now is a voluntary alliance of servicers, investors, counselors, and other mortgage market participants ranging from Catholic Charities to the Bank of America. Many troubled homeowners fail to contact their mortgage companies until they are already in foreclosure. Hope Now seeks to reach out aggressively to potentially at-risk, credit-worthy homeowners to help them modify their loans or develop more realistic repayment plans. Hope Now is designed to be a systematic approach with industry-wide standards for eligibility and renegotiation.<sup>91</sup> To qualify for the plan borrowers must have a mortgage that originated between January 2005 and July 2007 and is due for rate reset between January 2008 and July 2010. Since the summer of 2007, the industry overall has reworked over one million mortgages, over 60 percent of which are subprime, to help homeowners stay in their homes.<sup>92</sup> Reworked mortgages include repayment plans (changing the loan duration or monthly payments) and loan modifications (lowering the outstanding principal). Repayment plans are the most

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<sup>90</sup> *Mortgage Workouts, Now Tax-Free for Many Homeowners; Claim Relief on Newly-Revised IRS Form*, Internal Revenue Service (Feb. 12, 2008), available at <http://www.irs.gov/irs/article/0,,id=179073,00.html>.

<sup>91</sup> *Details of the Bush Plan*, (Dec. 7, 2007), available at <http://globaleconomicanalysis.blogspot.com/2007/12/details-of-bush-plan.html>.

<sup>92</sup> Data available at [http://www.fsround.org/hope\\_now/pdfs/Summarypdf-AdobeAcrobatStandard.pdf](http://www.fsround.org/hope_now/pdfs/Summarypdf-AdobeAcrobatStandard.pdf).

common type of reworking, but loan modifications made up 50 percent of the subprime reworks in January 2008.<sup>93</sup>

5. *Credit Rating Agencies.* There are many proposals for improving rating agencies, including better management of conflicts of interest, better training for analysts, better analytical models, and more transparency. These are all helpful changes, but, most importantly, the credit rating agency market needs more competition and the elimination of structural advantages that favor established agencies.

In 1975 the Securities and Exchange Commission (SEC) established the category "nationally recognized securities rating organization" (NRSRO). The SEC and other agencies require financial institutions to hold bonds of certain quality ratings in their portfolios. The NRSRO category designated which companies' ratings could be used. Prior to 2006, the SEC's NRSRO accreditation procedure favored the three primary rating agencies and it was difficult for new agencies to obtain accreditation. In the credit-rating-agency market, NRSRO's had a structural advantage because regulations allowed the financial industry to rely on only NRSRO ratings. With the creation of the NRSRO designation in 1975, the SEC grandfathered in the three primary credit rating agencies. New entrants had to undergo a difficult and opaque accreditation process. This prevented strong competition in the credit agency market.

The credit-agency-rating market needs more competition, which will encourage more innovative, efficient, and reliable rating techniques. The tools for this reform process are already in place. The Credit Rating Agency Reform Act of 2006 (CRARA) called for the SEC to develop a quick and transparent NRSRO accreditation process. In the wake of the

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<sup>93</sup> Press Release, *HOPE NOW: Industry Tops ONE MILLION Loan Workouts Since July '07*, Hope Now Alliance (Mar 3, 2008), available at [http://www.fsround.org/hope\\_now/pdfs/17-28FebruaryRelease.pdf](http://www.fsround.org/hope_now/pdfs/17-28FebruaryRelease.pdf).

calls for increased credit agency rating competition after Enron, two new credit rating agencies were accredited. Currently, there are seven NRSRO's and the passage of the CRARA is likely to produce more entrants. This competition and voluntary changes<sup>94</sup> will improve rating agency products. Attempts to further regulate credit rating agencies should be deferred until the results of increased competition can be analyzed.

*Securitization.* As stated above, securitization enabled and encouraged subprime lending. It is necessary to harmonize the incentives of mortgage originators and investors in securitized products. The built-in risk insulation—such as subordinated tranches—allowed investors (at least they thought) to avoid the consequences of risky mortgages and eased lending standards. The high demand for securitized products combined with the failure of other structural mechanisms—such as investor due diligence and originators maintaining an interest in the securitized product—further encouraged lenders to ease lending standards and caused an explosion of subprime mortgage originations. In sum, neither the originators nor the investors had adequate incentives to appropriately monitor and minimize risk. Changes in the securitization industry need to address this concern.

Given the massive losses caused by subprime investments, market forces should act quickly to harmonize mortgage originator and investor incentives. These market forces are the best solution to the deficiencies in the securitization process. Investors now have a strong incentive to conduct appropriate due diligence on the composition of securitized subprime loan pools to assess risk prior to investing. Investors are also likely to insist on other structural mechanisms that will ensure originators bear appropriate risk. For example,

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<sup>94</sup> For example, Standard and Poor's announced a plan to improve transparency and accuracy of its ratings and has taken steps to implement the plan. See, *Progress Update: S&P's steps to further manage potential conflicts of interest, strengthen the ratings process, and better serve the markets* (April 10, 2008), available at [http://www2.standardandpoors.com/spf/pdf/media/Leadership\\_Actions\\_Full\\_Update.pdf](http://www2.standardandpoors.com/spf/pdf/media/Leadership_Actions_Full_Update.pdf).

investors are more likely to insist that the originator (or underwriter) maintain an unhedged interest in the securitized product, giving the originator an incentive to monitor the risk profile of subprime loans. Investors are also likely to insist on increased representations and warranties by the originator about the quality of the mortgages and work with originators who have adequate capital. There is evidence that the private sector is undertaking such reforms.<sup>95</sup>

Speculators and middle-income borrowers should not be bailed out. Low-income borrowers with the ability to make payments under a reworked mortgage should be given opportunities such as Hope Now and FHASecure. There is, however, a group of low-income borrowers who are not credit-worthy enough to continue making mortgage payments, even under reasonably reworked mortgages. These individuals may need assistance finding and transitioning into rental property. Government policy should shift focus from homeownership to sustainable homeownership. Legal efforts focusing on abusive lending practices are underway, and more are expected.<sup>96</sup> As more information on the extent of abusive lending practices in the subprime market becomes available, appropriate policy measures should be taken, including more uniform regulation of mortgage originators.

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<sup>95</sup> See, *Moody's Proposed Enhancements to U.S. Residential Mortgage Securitizations: Call for Comments* (Mar 25, 2008), available at [http://www.americansecuritization.com/uploadedFiles/Moody's\\_Proposed\\_Changes\\_RMBS\\_3%2026%2008%20\(2\).pdf](http://www.americansecuritization.com/uploadedFiles/Moody's_Proposed_Changes_RMBS_3%2026%2008%20(2).pdf).

<sup>96</sup> Ruth Simon, *Illinois Probes Mortgage Firms*, Wall Street Journal, March 7, 2008, at A3.