

**THE SUBPRIME HOUSING CRISIS**  
**Symposium**  
**University of Iowa**

*The Way Ahead: A Framework for Policy Responses*

Kathleen E. Keest  
Senior Policy Counsel  
Center for Responsible Lending<sup>1</sup>

**I. Introduction**

In many respects, events have overtaken this conference. In 2006, CRL released a study that projected 2.2 million foreclosures of subprime mortgages.<sup>2</sup> But by this spring, Credit Suisse projected 6.5 million foreclosures over the next five years, as the housing crisis spread beyond the subprime sector into the larger mortgage market.<sup>3</sup> There is a downward spiral of declining housing prices, which begets defaults and foreclosures, which beget further declines in housing prices. And so it goes.

With this downward spiral continuing, the first and foremost of the needed policy responses is clear: a circuit-breaker to stop the foreclosures. We must arrest the decline in the housing market, and that requires more effective foreclosure prevention efforts than have thus far been put in place. Beyond stabilizing the housing market, restoring balanced rules to govern the market and reforming the ill-functioning oversight system are the next order of business.

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<sup>1</sup> The Center for Responsible Lending (CRL) is a non-partisan, non-profit research and policy organization dedicated to combating abusive financial practices. It is affiliated with the Center for Self-Help, a non-profit community development institution based in Durham, NC, dedicated to increasing wealth-building opportunities for low- and moderate-income and minority families and communities. Self-Help has provided over \$5 billion of financing to 55,000 low-wealth families, small businesses and non-profit organizations in North Carolina and around the country. It offers affordable loans, suited to the needs and circumstances of the borrower, and its losses have been less than 1% per year.

Prior to her work at CRL, Ms. Keest was an Assistant Attorney General in Iowa and Deputy Administrator of the Iowa Consumer Credit Code, and an attorney specializing in credit regulation at the National Consumer Law Center. The views expressed herein are not necessarily those of CRL.

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<sup>2</sup> Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending (December, 2006) (hereafter *Losing Ground*), available at <http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf>.

<sup>3</sup> Credit Suisse, *Foreclosure Trends: A Sobering Reality* (April 23, 2008).

To assure that we have a viable framework for policy responses, it is necessary to understand how we got here. First, we must accurately diagnose the market failures that caused the subprime meltdown, and the regulatory failures that failed to stop it in time. But the crisis has laid bare other foundational cracks in our economy. Most obvious is the systemic weakness it exposed in our financial system. Less discussed in the national conversation so far, but equally important, is the economic state of the American household, which has something to tell us about how and why housing debt came to play such a central role in the American economy. Though in-depth analysis of these issues is not the focus of this symposium, we must at least acknowledge that they are inextricably intertwined with the mortgage crisis.

This paper first discusses the defining traits of the subprime market, and how perverse market incentives maximized risk, rather than minimizing it (part II). It then briefly explains the link between declining housing prices and increasing foreclosures (part III). Part IV gives an overview of the state of the financial health of American households, to place the explosion in housing debt in a larger economic context. Part V then suggests steps that must be taken immediately and in the near-term to stabilize the current situation, and prevent the resurgence of an industry that planted its own seeds of destruction.

## **II. Subprime Lending: Toxic Products and Toxic Practices**

### **A. Defining Terms: Just who or what, exactly, is “subprime?”**

The word “subprime” is typically explained in the press as loans made to “risky borrowers” or people with poor credit. But that definition is less than satisfactory. First, a sizeable portion of borrowers in subprime loans could have qualified for prime loans. According to a Wall Street Journal report, over 60% of subprime loans made in 2006 would have qualified for prime loans with better terms.<sup>4</sup> Even more troubling, the impact of originators steering borrowers to higher-priced loans than that for which they qualify falls more heavily on minority homeowners.<sup>5</sup> Second, as another paper presented at this symposium demonstrates, even less-than prime credit-risk borrowers can manage properly designed and underwritten loans.<sup>6</sup>

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<sup>4</sup> Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A-1 (Dec. 3, 2007).

<sup>5</sup> For most types of subprime loans, African-Americans and Latinos are disproportionately more likely to be steered to higher cost even after controlling for legitimate risk factors. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006), at [http://www.responsiblelending.org/pdfs/rr011-Unfair\\_Lending-0506.pdf](http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf).

<sup>6</sup> Lei Ding, Roberta G. Quercia, Wei Li, and Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, Center for Community Capital, Univ. of North Carolina & Center for Responsible Lending (Working Paper, Sept. 13, 2008).

Yet high failure rates have marked this market from its earliest days – a fact which need not have surprised anyone who took the trouble to examine it. In 2005, CRL began looking at the long-term performance of subprime loans sold on the secondary market. By May 2005, securitized subprime loans originated in years 1998-2000 had already failed at a rate of between 1-in-4 to 1-in-5, and 2003 originations were on a trend line to match 2000 vintage loans, with its 24% failure rate.<sup>7</sup> While at first blush, that may be seen as to be expected in a market that catered to “risky” borrowers, that cavalier response does not withstand scrutiny. As Professor Alan White, who had occasion to see the nature of these loans one by one as a legal services attorney defending foreclosures, observed: “If one-in-five cars collapsed on the road within 4 years, would you blame the drivers, or look for a design flaw?” That so many prime borrowers were in this market, along with the evidence that even subprime borrowers with the same qualifications were able to perform better in other types of loans,<sup>8</sup> indicate that there were indeed design flaws in the market.

Borrower risk, then, is an imprecise – and misleading – definition. (It is misleading because it can lead to mistaken assumptions about what direction policy responses should take.<sup>9</sup>) In fact, not all loans are created equal or give the borrowers an equal chance for success. Certain loan terms and loan products themselves increase the risk of default, irrespective of borrower characteristics. Adjustable rates, prepayment penalties, stated income or low-documentation loans are all associated with increased risk of default. Yet these were the standard products sold in the subprime market. The problem was made worse by “risk-layering” – loading up individual loans with multiple risk features – then capped with increasingly poor underwriting.

<sup>7</sup> Schloemer, et al, *Losing Ground*, note 2, above, at Table 4, p. 13. A failed loan, as used here, is one which was either foreclosed on or “prepaid in distress,” meaning that the loan balance went to \$0 in any given month when it had been listed as in foreclosure, bankruptcy, or real-estate owned by the lender (REO) the previous month.

Origination Year	% foreclosed or distress prepaid by May 2005
1998	20.5%
1999	23.0%
2000	24.0%

In Philadelphia, as early as 2000-2003, subprime foreclosure filings in one neighborhood reached 19% of the housing stock. Ira Goldstein, *Lost Values: A Study of Predatory Lending in Philadelphia*, p. 58 (The Reinvestment Fund, April 2007), available at [http://www.trfund.com/resource/downloads/policypubs/Lost\\_Values.pdf](http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf).

<sup>8</sup> In addition to the UNC paper presented here, note 6, above, FHA loans with similar borrowers also had a better performance record. See *Losing Ground*, note 2 above, at 25.

<sup>9</sup> The recent campaign to identify the cause of the crisis as the Community Reinvestment Act of 1977 is one such effort to misdirect blame. For explanations of how that misses the mark, see, e.g. Speech, Fed. Res. Board Gov. Randall Kroszner, The Community Reinvestment Act and the Recent Mortgage Crisis, (Dec. 3, 2008), available at <http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm>; Daniel Gross, *Subprime Suspects*, Newsweek, October 7, 2008; Michael Barr, Testimony before the U.S. House of Representatives Financial Services Committee, *The Community Reinvestment Act: Thirty Years of Accomplishments, But Challenges Remain* (February 13, 2008).

It was not that these kinds of loans were the product of choice by subprime borrowers.<sup>10</sup> These terms were “supply-side” dictated. Rate sheets from the major subprime lenders that securitized their loans made it abundantly clear that the “default” product (no pun intended) was a 2/28 or 3/27- hybrid ARM: an adjustable rate with a fixed rate and fixed payments for the first two years, then a switch to a “fully-indexed” rate, typically with adjustments every 6 months. Commonly, the initial rate was a “teaser rate” – one lower than it would have been if the rate had been set by reference to the contract’s specified index and margin. Because of the teaser rate, there would be a “payment shock” when the teaser rate expired at the end of two years. Through the second quarter of 2006, hybrid ARMs made up 81% of the subprime loans that were packaged and securitized.<sup>11</sup>

Prepayment penalties were similarly ubiquitous, with a penetration rate of about 70% in 2006, compared to 2% in the prime market.<sup>12</sup> Stated income loans became a staple, even for borrowers who could (and often did) supply W-2s, jumping from 26% in 2000 to 44% in 2005.<sup>13</sup>

Even as late as 2007, as the fragility of the market became indisputable, these risky products and terms were still the mainstays in the market.

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<sup>10</sup> Loan applicants never see the critical documents which have all the relevant pricing information about what each feature costs. The broker or the loan officer is the one who has all that information. In fact, some rate sheets specified that the document should not be shown to the borrower. *See generally* Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, Housing Policy Debate, Vol. 15, Issue 3, p. 503, 509-512 (2004).

<sup>11</sup> *See, e.g. Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 Fitch Ratings Credit Policy (August 21, 2006).

<sup>12</sup> *See, e.g. David W. Berson, Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Banking Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006); Doug Duncan, *Sources and Implications of the Subprime Meltdown*, Manufactured Housing Institute (July 13, 2007) (69.2% penetration rate for 2006 subprime ARM originations). Here, too, the market imposed added risks on minority borrowers through this risk-enhancing loan and costly term. *See* Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending (Jan. 2005), at <http://www.responsiblelending.org/issues/mortgage/research/page.jsp?itemID=28012335>.

<sup>13</sup> Wei Li and Keith Ernst, “Do State Predatory Lending Laws Work?” Housing Policy Debate, Vol. 18, Issue 2 at p. 361 (2007), available at [http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd\\_wei-ernst\\_web.pdf](http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf).

**Table 1: Increased Risk of Foreclosure of Common Subprime Loan Features**

	<b>Increased likelihood of foreclosure<sup>14</sup></b>	<b>Average share of the feature in ten mortgage-backed securities offerings in the first half of 2007<sup>15</sup></b>
ARM	72% (117% for 2003 vintage loans)	77% (90% of which were to reset in 2-3 years)
Prepayment penalty	52%	70%
Stated income or low-documentation	29% (64% for 2003 vintage loans)	37%

Adding to this shaky picture of the subprime sector, there was a jump in the so-called “non-traditional” loans. These are interest-only and payment-option ARMs (POARMs),<sup>16</sup> many of which are classified as Alt-A, rather than subprime.<sup>17</sup> In the past few years, these complex products were poorly underwritten and were mass-marketed to home owners and home buyers for whom they were ill-suited, and by whom they were poorly understood.

These loans, too, were laden with multiple-risk features, particularly the POARMs originated since 2004. Only about 17% of POARMs originated between 2004-07 were fully documented.<sup>18</sup> POARMs with piggy-back seconds were highly

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<sup>14</sup> Schloemer, et al, *Losing Ground*, note 2, above, at p. 21. Unless otherwise stated, the increased odds of foreclosure are those for 2000 vintage subprime loans. The study analyzed the performance of subprime loans originated 1998 – 2004 as of May, 2005. The foreclosure trend line for the more recent years, where the loans had not yet aged, was tracking the performance of 2000 originations. *Id* at p. 12.

<sup>15</sup> Details about the MBS offerings are found in Testimony of Michael Calhoun Before the U.S. Senate Committee on Banking, Housing and Urban Affairs – Subcommittee on Housing, Transportation and Community Development, *Ending Mortgage Abuse: Safeguarding Homebuyers* p. 3, 12-13 (June 26, 2007), available at <http://banking.senate.gov/public/files/calhoun1.pdf>.

<sup>16</sup> Option ARMs allow the borrower to make a payment that is less than the accrued interest during an initial period, commonly five years, with the shortfall added to the loan balance, meaning the loan will “negatively amortize.” Theoretically, the borrower could also choose an interest-only payment, or a payment that would amortize the loan over 15 or 30 years. However, as with the 2-year hybrid-ARMs, these loans tended in recent years tended to be sold on the “low-balled” minimum monthly payments, often deceptively, and with very low teaser rates (1% - 2%) that lasted only a few days or weeks, and with little or no regard for affordability. One judge has called this kind of loan “a booby trap waiting to explode.” *Andrews v. Chevy Chase Bank, FSB*, 545 F.3d 570, 578 (7<sup>th</sup> Cir. 2008)(Evans, J., dissenting).

Monthly payments on interest-only loans (IOs) require payment only of interest accrued for a specified period, then the loan resets to amortizing payments. These loans, sometimes called “deferred amortization mortgages,” can be either adjustable rate or fixed rate.

<sup>17</sup> As is the case with subprime, there is no consistent definition of Alt-A. The term may apply to borrowers with credit scores between ballpark FICO thresholds for prime borrowers (e.g. above 660) and subprime (below 620). *See, e.g.* John G. Dugan, *New Comprehensive OCC Report on Mortgage Performance*, Remarks before the American Securitization Forum, at 5 (June 11, 2008). It may also refer to loans made with limited verification of income or assets. *See, e.g.* Inside Mortgage Finance, *Mortgage Market Statistical Annual: 2008*, Vol. I, p. 1.

<sup>18</sup> *Option ARMs: It's Later Than It Seems*, Fitch Ratings (September 2, 2008), at 5.

concentrated in California, meaning there was no equity cushion at the outset for many borrowers in that state's bubbling market.<sup>19</sup>

To exacerbate matters, the industry virtually abandoned underwriting standards. Adjustable rate loans with teaser payments or rates were underwritten to teaser terms. Inflating incomes and inflating appraisals to get the loan made were commonplace at major lenders – and inflating incomes was easier for “stated income” loans.<sup>20</sup> Underwriting for the non-traditional products was equally weak. By the time federal regulators implemented underwriting standards for those products in October 2006, Countrywide, a top originator of these products, estimated that 80% of its recent POARMs would not meet those standards.<sup>21</sup>

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<sup>19</sup> *Drivers of 2006-2007 Alt-A Collateral Performance*, p. 6, Fitch Ratings (May 7, 2008 (over 60% of piggy-back seconds on POARMs concentrated in California). Since the presence of the second lien meant there was little or no equity in the home to begin with, the negative amortization virtually assured that the home would be underwater, thus precluding any realistic likelihood of refinancing in the absence of appreciation. In other words, lenders making these loans were engaged in “asset-based lending.” This practice – making loans on the liquidation value of the collateral, rather than the ability to make payments from current and expected income and other relevant resources – has long been disfavored by regulators, e.g. 12 C.F.R. §34.3(b)(OCC rule, Real Estate Lending and Appraisals). However, in the bubble markets, it seems that many of these loans were sold based on the *anticipated future* value of the collateral, rather than ability to pay, and regulators failed to move quickly to stop it.

Federal regulators adopted underwriting guidelines for non-traditional mortgages effective in October 2006, but they are “guidance,” not rules with the force of law, *see* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (October 4, 2006). Forty-five states and DC have adopted parallel standards, [http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM\\_State\\_Implement.htm](http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM_State_Implement.htm).

<sup>20</sup> It was not borrower demand that drove the jump in these kinds of loans. Originators were paid more by the secondary market for these kinds of loans, as is discussed in the next section. But this feature also helped make sure that more loans were made, and made faster, as less paperwork was involved. Stated income loans made it easier for lenders and brokers to obscure violations of sound underwriting standards, as lenders did not verify incomes even when they could. Furthermore, though these are often called “liar’s loans,” it was common practice for the originator to do the inflating, even if the borrower were able and willing to provide verification – and often did. One of the allegations made by state attorneys general and banking regulators against Ameriquest, the nation’s top subprime originator for 2003-2005, was that it fraudulently inflated incomes. *See State of Iowa v. Ameriquest Mortg. Co.*, Iowa Dist. Ct. for Polk Cty, CE 53090 (petition filed Mar. 21, 2006) at Para. 16(F). [http://www.state.ia.us/government/ag/images/pdfs/Ameriquest\\_Pet.pdf](http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_Pet.pdf). *See also* Gretchen Morgenson, *Illinois to Sue Countrywide*, New York Times, June 25, 2008; Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times, August 26, 2008. These were not “a few bad apples.” Ameriquest had the largest subprime market share for three years, 2003-05, and Countrywide had the third largest subprime market share in 2006 and 2007, and the largest non-traditional market share in those years. Mortgage Market Statistical Annual: 2008, Vol I, pp. 137-38, 215, 217,219, 221, 223. The jump in stated income loans in the subprime and Alt-A markets must be viewed in this context. As noted above, the share of subprime loans made without full documentation jumped from 26% in 2000 to 44% in 2005 (note 13), and 83% of Alt-A POARMs originated from 2004-2007 lacked full documentation (note 18).

<sup>21</sup> The federal agencies’ guidance instructed lenders to evaluate the borrower’s ability to pay based on the fully-indexed, fully-amortizing payment. *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. 58609, 58614 (October 4, 2006). Countrywide’s estimate from Countywide Financial Corporation, “3Q 2007 Earnings Supplemental Presentation,” October 26, 2007.

Not surprisingly, the recent vintage non-traditional loans are aggravating the self-feeding dynamic of default, foreclosure and continuing housing price decline. One in four payment-option ARMs (POARMs) made between 2004 and 2007 and still outstanding is delinquent already,<sup>22</sup> despite the fact that the scheduled payment resets on these loans are mostly due in 2009-2012.<sup>23</sup> Estimates are that the average payment shock on POARMs could be 63%, with a top range that could double the payments.<sup>24</sup> Hit with payment increases of this magnitude, many of these homeowners will try to refinance the loan, or if worse comes to worse, sell the home. Yet most of these loans are negatively amortizing in the meantime, which will make it harder for them to avoid foreclosure, for the loan itself acts as a weight to sink the home even deeper underwater than declining home prices would take it.

In the mortgage business, default risk comes from three general directions: macroeconomic risks, “borrower” risks, and, as we have seen, product and term risks. Common sense would suggest that lenders purporting to target the “risky borrower” market would minimize their risk by selling the more stable, sustainable products and underwriting to assure that the payments were affordable. Why the market chose instead to push risky products and, for all practical purposes, to stop underwriting, is at the heart of what went wrong. It is critical that we understand this, for if we focus on “risky borrowers” as the crux of the problem, we will be unlikely to design effective policies for the future.

#### B. Perverse incentives drove the market to risky products and practices

One thing must be understood about the subprime lending industry: the dominant business models in this sector never were designed to promote sustainable, healthy lending. The prevailing model instead was to chase growth and the short term profitability it generated. The secondary market gave the lenders a place to sell these loans almost immediately, and the incentives from that back side of the market assured that much of that increased volume would be the wrong *kind* of loan products and terms.

Mortgage originators sacrificed basic underwriting standards to keep up production to feed an increasingly voracious appetite in the secondary market. Even former Federal Reserve Board Chairman Alan Greenspan acknowledged that the demand from investors drove the growth in the subprime market:

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<sup>22</sup> Fitch Ratings, Glenn Costello, *Update on U.S. RMBS: Performance, Expectations, Criteria* (Feb. 2008) at 18.

<sup>23</sup> Fitch Ratings, *Option ARMs: It's Later Than It Seems*, Structured Finance Residential Mortgage Special Report (September 2, 2008) at 5.

<sup>24</sup> Fitch Ratings, *Option ARMs: It's Later Than It Seems*, Structured Finance Residential Mortgage Special Report 1, 5 (September 2, 2008).

And so you had Wall Street’s securitizers basically then talking to the mortgage brokers saying, ‘We’ll buy what you’ve got.’...The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn’t afford. We created something which was unsustainable. And it eventually broke. If it weren’t for securitization, the subprime-loan market would have been very significantly less than it is in size.<sup>25</sup>

As the debt bubble fed the housing bubble, both the subprime and Alt-A markets exploded. Subprime originations grew from \$124.5 billion in 1997 to \$600 billion in 2006.<sup>26</sup> Payment-option ARMs jumped from \$145 billion to \$255 billion in just the three years from 2004 through 2006.<sup>27</sup> The volume of loans purchased on the secondary market more than quadrupled between 2001 and 2007.

**Table 2: Securitization Rates for Subprime and Alt-A<sup>28</sup>**

<i>Year</i>	<i>Rate of MBS issuance</i>	<i>Volume</i>
2001	45.8%	\$98.4 billion
2005	79.3%	\$797.4 billion
2006	81.4%	\$814.3 billion
2007	92.8%	\$432.5 billion <sup>29</sup>

<sup>25</sup> “The Oracle Reveals All,” *Newsweek* (Sept. 24, 2007). See also David Cho, *Pressure at Mortgage Firm Led to Mass Approval of Bad Loans*, *Washington Post* (May 7, 2007) (One bank explained that the pressure worked both ways – they lost business if they exercised too much due diligence. “The entire industry, over time, became more lax . . . . The more [loans] you accepted, the better relationship and the better price you would have. The name of the game was definitely volume.”). See also Structured Finance in Focus, *The Subprime Decline – Putting it in Context*, p. 3, Moody’s Investors Service (March 25, 2008) (“The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market.”) and sources cited in Center for Responsible Lending, *Comments on Proposed Interagency Statement on Subprime Mortgage Lending*, pp. 4-5, notes 11 & 12 (May 7, 2007), available at <http://www.responsiblelending.org/pdfs/Subprime-Statement-CRL-Comment.pdf>. Cf. Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities*, pp. 26-27 (January 2008) (securitization weakens creditors’ incentive to screen the loans they make) available at <http://www2.law.columbia.edu/contracteconomics/conferences/laweconomicsS08/Vig%20paper.pdf>.

<sup>26</sup> Inside Mortgage Finance: *The 2008 Mortgage Market Statistical Annual* Vol. 1 pp. 217, 229. The evidence is that the rapid expansion of the supply of money from securitization drove the bubble. See Atif Mian and Amir Sufi, *The Consequence of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis*, NBER Working Paper 13936 (April, 2008), available at <http://www.nber.org/papers/w13936> (finding that “the expansion in credit supply was driven by a shift in the mortgage industry towards “disintermediation”, which we define as the process in which originators sell mortgages in the secondary market shortly after origination” (p.2)).

<sup>27</sup> Inside Mortgage Finance, *Id.*, at p. 6.

<sup>28</sup> Inside Mortgage Finance: *The 2008 Mortgage Market Statistical Annual* Vol. II, p. 3.

<sup>29</sup> Only \$22.5 billion was sold in 4Q 2007, after the credit crunch began in August, 2007.

The model thus was what Professor Pennington-Cross and his colleagues described at this symposium as “designed to terminate.”<sup>30</sup> Hybrid-ARMs and payment option-ARMs predictably forced many borrowers into refinancing when the payment shock hit. Even fixed rate loans, when written without regard to ability to repay, will generate forced prepayment. Subprime ARM borrowers typically did not even enjoy the usual benefit of an ARM loan – the right to an automatically lower rate in a falling interest rate environment. The initial rate on most subprime ARMs was a contractual “floor,” meaning that if interest rates fell, the borrower would have to refinance to take advantage of that trend.

Beyond the desire to generate a constant flow of new originations, the secondary market also created perverse incentives by paying more for the kinds of products and terms that maximized the originator’s compensation while increasing the cost and risk to the borrower. One telling example: Countrywide’s compensation structure for both brokers and its own in-house loan officers rewarded them most for the riskiest loans, and least for the most stable products: broker commissions were as much as 2.5% for POARMs, 1.88% for subprime loans, but just 1.48% for standard, fixed rate loans.<sup>31</sup>

The result, not surprisingly, was that originators placed homeowners and homebuyers in loans that best served the originators’ interests, rather than the borrowers’. Moreover, those 2/28s and POARMs with their teaser rates and payments had an additional advantage for originators – being able to “low-ball” the cost of the loans made deceptive marketing easy. The incentives are discussed in greater detail elsewhere,<sup>32</sup> but a cursory overview highlights the following:

*Yield-spread premiums (YSPs):* A yield-spread premium is an upward adjustment in the interest rate that the borrower would otherwise pay for his or her loan based on creditworthiness and the loan features. In theory, this upward rate bump reflects the “choice” of the borrower to pay origination fees – primarily brokers’ fees – over time through the rate, instead of financing them upfront as part of loan principal. (Paying upfront costs in cash at closing was virtually non-existent in the subprime market.) However, borrowers typically end up paying both direct fees and a YSP, and there is little reliable evidence for any price trade-off. A CRL study found that subprime borrowers in

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<sup>30</sup> Souphala Chomsisengphet, Timothy Murphy and Anthony Pennington-Cross, *Product Innovation and Mortgage Selection in the Subprime Era*, presented at [The Subprime Housing Crisis: Interdisciplinary Policy Perspectives](#), Univ. of Iowa, October 10-11, 2008 (referring to loans “designed to terminate.”) A former broker confirmed to CRL that applicants were steered to 2/28s to generate repeat business.

<sup>31</sup> See Ruth Simon and James R. Hagerty, *Countrywide’s New Scare – Option ARM Delinquencies Bleed Into Profitable Prime Mortgages*, Wall Street Journal, Oct. 24, 2007. See also Gretchen Morgenson and Geraldine Fabrikant, *Countrywide’s Chief Salesman and Defender*, New York Times, Nov. 11, 2007 (former employee discussing compensation system).

<sup>32</sup> See, e.g. Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis* (Oct. 16, 2008).

fact pay more for brokered loans.<sup>33</sup> Another study found that borrowers generally paid \$1 in yield-spread premiums for between 20 and 35 cents in reduced fees.<sup>34</sup> The premium, in the end, rewards brokers for delivering a higher rate loan to the lender, at least in the subprime and nontraditional markets.

*Prepayment penalties:* Compounding the costly impact of yield spread premiums is the fact that lenders' pricing systems tied them to prepayment penalties. These costly penalties lock borrowers into these loans, imposing a steep "exit tax." Because many lenders limited the yield-spread premiums if there is no or prepayment penalty or a shortened period for the penalty, borrowers were placed into loans with those penalties to maximize the brokers' own compensation. The secondary market, then, gave brokers the incentive to sell loans that cost the borrowers more at both the front and the back end – a higher interest rate on the loan (that would magnify the cost over time) and a prepayment penalty on the back end.<sup>35</sup>

*Stated income:* Here, too, even though many borrowers could (and often did) provide documentation, they were charged as much as 1% or more for no-doc loans.<sup>36</sup> As one now-defunct subprime originator put it, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loan.... What would you do?"<sup>37</sup>

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<sup>33</sup> Keith Ernst, Debbie Bocian, and Wei Li, *Steered Wrong: Brokers, Borrowers and Subprime Loans*, Center for Responsible Lending (April 8, 2008), available at <http://www.responsiblelending.org/issues/mortgage/research/steered-wrong-brokers-borrowers-and-subprime-loans.html>.

According to the Mortgage Bankers Association, mortgage brokers originated the majority (71%) of subprime loans. MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006, available at [http://www.mortgagebankers.org/files/Bulletin/InternalResource/44664\\_September2006-ResidentialMortgageOriginationChannels.pdf](http://www.mortgagebankers.org/files/Bulletin/InternalResource/44664_September2006-ResidentialMortgageOriginationChannels.pdf).

<sup>34</sup> Howell E. Jackson and Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield-Spread Premiums*, 12 Stan. J. L., Bus & Fin. 289, 353 (2007).

<sup>35</sup> For a more complete explanation of the penalty and its interaction with YSPs, see *Comments of the Center for Responsible Lending on the Home Equity Lending Market*, Federal Reserve Board Docket OP-1288, at pp. 11-19 (Aug. 15, 2007) available at <http://www.responsiblelending.org/pdfs/crl-frb-comment-aug-15-2007.pdf>, and *Comments of the Center for Responsible Lending on Proposed Rules Regarding Unfair, Deceptive and Abusive Lending and Servicing Practices*, at pp. 34-42 (April 8, 2008), available at <http://www.responsiblelending.org/pdfs/fed-udap-comments-final-040808.pdf>.

<sup>36</sup> See, e.g. Glenn R. Simpson and James R. Hagerty, *Countrywide Loss Focuses Attention on Underwriting*, Wall Street Journal (April 30, 2008).

<sup>37</sup> Vikas Bajaj and Christine Haughney, *Tremors At the Door – More People With Weak Credit Are Defaulting on Mortgages*, New York Times (Jan. 26, 2007), C1, C4.

Normal theories of competition did not work to drive costs down. There was virtually no transparency to all this pricing complexity.<sup>38</sup> All these rate adjustments were known to the originator, but not to the borrower. Furthermore, with all the risk layering, multiple adjustments would be made for various features, sometimes counteracting each other: some would move the rate up a few basis points, while another (in theory) would move it down. Little wonder, then, that the perverse incentives coming from Wall Street drove the market. And little wonder, too, that the term “subprime” is better defined in reference to the loan than to the borrowers.<sup>39</sup>

### **III. Housing Prices and Foreclosures: Closing the exit ramp for troubled loans**

The abnormally high failure rate of these loans from early on did not cause the industry to hit the pause button. The complex structured finance products on the secondary market side of the business lulled both the lending and securities industries into complacency, thinking that risk had been broadly dispersed, adequately priced, or insured against.<sup>40</sup> Indeed, struggling borrowers looking for the “exit ramp” of refinance, or, if worse comes to worse, sale of the home could mask signs of distress as demand in the origination data, and fit perfectly into the “designed to terminate” business model. In either case, the result was a new loan for a market that wanted new originations, and the industry assumed that rising home values would continue to sustain that cycle. That was the message to borrowers, as well: these products were safe, because they could refinance to a fixed rate, or a lower rate later. But when the value of the collateral outstrips the amount of the loan, lenders will not lend even to creditworthy borrowers – that is, once the irrational exuberance is over, they won’t. Hence the exit ramp closed as the bubble began to deflate.

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<sup>38</sup> See note 10, above. Furthermore, the pricing complexity makes it unclear that adding transparency merely through disclosure would be sufficient. The Federal Reserve Board withdrew its proposal to address the issue of broker compensation and yield spread premiums through disclosure. 73 Fed. Reg. 44522, 44563-65 (July 30, 2008).

<sup>39</sup> The Federal Reserve Board’s recent rules on unfair and deceptive acts and practices define the market in terms of a threshold rate. See 73 Fed. Reg. 44522, 44532-37 (July 30, 2008).

<sup>40</sup> See, e.g. Benjamin Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans?* (April, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1093137](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1093137); Matthew Philips, *The Monster That Ate Wall Street*, Newsweek, p. 46 (October 6, 2008).

A discussion of the developments in the “shadow banking system” that turned the subprime crisis into a global virus is beyond the scope of this paper. The NPR programs Fresh Air and This American Life have had excellent expositions for the general audience on the topic. See (or, to be more precise *listen to*) Fresh Air interviews with Prof. Michael Greenberger, “Our Confusing Economy Explained,” April 3, 2008), <http://www.npr.org/templates/story/story.php?storyId=89338743>, and “Was Adult Supervision Needed on Wall Street:?” (Sept. 17, 2008), <http://www.npr.org/templates/story/story.php?storyId=94686428> This American Life, “Giant Pool of Money,” (May 9, 2008), [http://www.thislife.org/Radio\\_Episode.aspx?sched=1242](http://www.thislife.org/Radio_Episode.aspx?sched=1242). Another helpful explanation is Roger Lowenstein, *Triple-A Failure*, New York Times Magazine, p. 36, (April 27, 2008).

The increasing foreclosure rate on subprime loans in areas of the country that were not part of the housing bubble should have been seen as the canary in the coal mine. States like Ohio, Iowa and some parts of Minnesota, among others, saw high foreclosure rates early.<sup>41</sup> In fact, notwithstanding the oft-repeated statement that subprime lending contributed to an increase in homeownership rates, that market actually was on track to result in a net loss in homeownership when foreclosures (completed or projected) were netted against its first time homeownership gains -- this even *before* the meltdown made foreclosure projections vastly larger.<sup>42</sup> But the continually inflating bubble in certain areas of the country – populous areas -- kept the mutually-reinforcing cycle going: a debt bubble fed the housing bubble.

That brings us to the question of what fed this double bubble. Monetary policy, and interest rates that arguably stayed too low too long come immediately to mind. So, too, does the global glut of money that was looking for a place to park, and ratings agencies that made home-backed securities seem like a good bet. Narrowing the focus just to the subprime mortgage market in isolation, the earlier descriptions of risky products tell us that some origination growth was “serial refinancing”, generated by the business model itself: borrowers, struggling to get out of one burdensome subprime loan, ended up with yet another, or refinanced to take advantage of lower rates that their own “floored” ARM didn’t give them automatically.<sup>43</sup> Push-marketing, steering, and, to be

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<sup>41</sup> Though the mortgage industry tried to attribute high subprime foreclosure ratings to unemployment in the industrial midwest, by concentrating on Ohio and Michigan, that explanation did not withstand scrutiny. Iowa, for example, ranked 3<sup>rd</sup> or 4<sup>th</sup> highest in subprime foreclosure rates in the country from 2004-2006 while its unemployment rate was 12<sup>th</sup> lowest in the country. However, its change in the housing price index from 2001-2006 was just about half the national average (23.6% compared to 55.2%), meaning the exit ramps closed off earlier there. *See generally* Comments of the Center for Responsible Lending on Proposed Interagency Statement on Subprime Mortgage Lending, p. 7-10 (May 7, 2007), [available http://www.responsiblelending.org/pdfs/Subprime-Statement-CRL-Comment.pdf](http://www.responsiblelending.org/pdfs/Subprime-Statement-CRL-Comment.pdf). In Minnesota’s Hennepin County, the unemployment rate declined from 2003 to under 4% in 2006, while foreclosure rates tripled. *Final Report: Predatory Lending Study Group for Attorney General Lori Swanson* (January, 2007), p. 4, [available at http://www.ag.state.mn.us/PDF/Consumer/PredatoryMortgageLendingStudy.pdf](http://www.ag.state.mn.us/PDF/Consumer/PredatoryMortgageLendingStudy.pdf) Even in California, which has – or did then – a low unemployment rate and a “generally healthy economy, observers noted that the foreclosure crisis there was backwards: “Traditionally, people lose their jobs, and then they lose their houses....This time, the foreclosures are happening first – and fast.” David Streitfeld, *Foreclosure pace nears decade high*, LA Times (April 17, 2007).

<sup>42</sup> The subprime market was overwhelmingly a refinance market, not a purchase money market. Even as late as 2006, as the housing bubble inflated in some regions, still only 44% of subprime loans were purchase money. To affect the homeownership rates, the purchase money loans would have to have been made to first-time home-buyers, and a generous estimate is that only 9% of subprime loans went to first time homebuyers. Netting those 1.4 million new homeowners against the 2.2 million or more who have or were projected to lose their homes (as of 2007), the subprime market generated a net homeownership loss of nearly 1 million homes. *Subprime Lending: A Net Drain on Homeownership*, CRL Issue Paper No. 14 (March 27, 2007), [available at http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf](http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf)

<sup>43</sup> *See, e.g. Losing Ground*, note 2, above, at 18. *See also, Case Study in Subprime Hybrid ARM Refinance Outcomes*, Center For Responsible Lending (February 21, 2007)(tracing 106 2/28s made by Option One in Charlotte, NC in the first three quarters of 2004, three-quarters that had refinanced by 2007 refinanced into another subprime loan. ), [available at http://www.responsiblelending.org/pdfs/subprime-outcomes-2\\_.pdf](http://www.responsiblelending.org/pdfs/subprime-outcomes-2_.pdf). *See also* Ira Goldstein, *Lost Values: A Study of Predatory Lending in Philadelphia*, p. 58 (The

sure, a housing bubble, brought in more customers to this market. But there are also more fundamental forces at work – ones that suggest it is too glib to chalk all that borrowing up to rampant consumerism and people “buying more house than they can afford.” While our policy prescriptions in this paper will concentrate solely on the mortgage crisis and mortgage reform, any discussion of policy responses must at least acknowledge the larger context of the long-term erosion of the financial position of American households.

#### IV. The Backdrop: The Household As Economic Engine

##### A. Income growth has not kept pace for most American households

Household spending is a powerful engine in the economy, constituting 70% of America’s GDP.<sup>44</sup> Yet household spending as a pillar of a national economy presents some logical challenges, if income growth does not keep pace. Unfortunately, that has been the case for the majority of Americans as productivity gains have become increasingly concentrated at the top.

Following a half century of decreasing inequality, the last three decades saw a trend to widening income inequality, as the gains have overwhelmingly flowed to the very top part of the top quintile.<sup>45</sup> Over the course of the last twenty-five to thirty years, the real-after tax income gains in the bottom four quintiles have ranged from 6% (bottom) to 30% (4<sup>th</sup>), while the top quintile saw an 80% change and the top 1% saw a 228% gain.<sup>46</sup> Or, to put it another way, the “bottom” 90% saw an average income growth of 83% from 1946 – 76, but only 10% growth from 1976-2007.<sup>47</sup>

**Table 3: Cumulative Percent Growth – Average Household Income**

	“Bottom” 90%	Top 1%
1946-1976	83%	20%
1976-2007	10%	232%

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Reinvestment Fund, April 2007) (discussing rapid refinancing of subprime loans, *available at* [http://www.trfund.com/reource/downloads/policypubs/Lost\\_Values.pdf](http://www.trfund.com/reource/downloads/policypubs/Lost_Values.pdf)

<sup>44</sup> See, e.g. Peter S. Goodman and Amanda Cox, *A Slowdown With Trouble at Every Turn*, A1, New York Times (July 19, 2008); Dean Baker, *Recession Looms for the U.S. Economy in 2007*, p. 9 (Center for Economic and Policy Research, November, 2006)

<sup>45</sup> Ian Dew-Becker and Robert J. Gordon, *Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income*, Discussion Paper No. 5419, Center for Economic Policy Research (January, 2006), [www.cepr.org/pubs/ds/DP5419.asp](http://www.cepr.org/pubs/ds/DP5419.asp). See also Clive Crook, *The Height of Inequality*, p 36-37, *The Atlantic Monthly* (September 2006).

<sup>46</sup> Arloc Sherman, *Income Inequality Hits Record Levels, New CBO Data Show*, Center on Budget and Policy Priorities, (December 14, 2007).

<sup>47</sup> Chye-Ching Huang and Chad Stone, *Average Income in 2006 Up \$60,000 for Top 1 Percent of Households, Just \$430 for Bottom 90 Percent*,” Fig. 2, Center for Budget Policy and Priorities, *updated* October 22, 2008, *available at* <http://www.cbpp.org/3-27-08tax2.htm> (based on the work of Thomas Piketty and Emmanuel Saez)

To put some perspective on where that puts families in terms of actual dollars, the following table shows the 2006 average incomes *within* each quintile, according to census data.<sup>48</sup>

**Table 4: Mean 2006 income by brackets**

	Bottom 5 <sup>th</sup>	Second 5 <sup>th</sup>	Middle 5 <sup>th</sup>	Fourth 5 <sup>th</sup>	Top 5 <sup>th</sup>	Top 5%
Average 2006 income	\$11,352	\$28,777	\$48,223	\$76,329	\$168,170	\$297,405

A recent study of IRS data looked at income gains between 2002 and 2006, which sheds some light on why the majority of American families feel worried about the economy: 75% of all income gains between 2002 and 2006 went to the top 1% of American households – those making more than \$382,600 a year.<sup>49</sup> In the meantime, the median household income, adjusted for inflation, dropped nearly \$1000 from 2000 to 2006.<sup>50</sup>

**Table 5: Distribution of \$863 Billion In Household Income Growth: 2002-2006<sup>51</sup>**

	Aggregate share	Amount of increase per household
Top 1%	\$626 Billion	\$4.2 million
Next 9%	\$195 billion	\$14,651
<b>“Bottom” 90%</b>	<b>\$41 billion</b>	<b>\$304<sup>52</sup></b>

Economic disparities are exacerbated for minorities. Median incomes for minorities remain stubbornly low, notwithstanding gains: \$32,372 for African Americans and \$38,747 for Hispanics, compared to the white median of \$52,375 in 2006.<sup>53</sup>

<sup>48</sup> U.S. Census Bureau, Historical Income Tables, *Mean Household Income Received by Each Fifth and Top 5%*, Table H-3, <http://www.census.gov/hhes/www/income/histinc/h03ar.html>.

By way of comparison, the projected 2008 median federal salary for the DC area is \$90,698, Stephen Barr, *Area Federal Workers Get 4.49% Raise*, Washington Post, D01 (January 5, 2008), <http://www.washingtonpost.com/wp-dyn/content/article/2008/01/04/AR2008010402402.html>. This median is approaching the lower bound for the top quintile in 2006 (\$97,030) U.S. Census Bureau, *Percent Distribution of Households, By Selected Characteristics Within Income Quintile and Top 5%*, Table HINC-05, [http://pubdb3.census.gov/macro/032007/hhinc/new\\_05\\_000.htm](http://pubdb3.census.gov/macro/032007/hhinc/new_05_000.htm). Maryland’s median income was the highest in the nation in 2006, Virginia the 9<sup>th</sup> highest, and DC ranked 16<sup>th</sup>. US Census Bureau, *Income, Earnings, and Poverty Data From the 2006 American Community Survey*, p. 4-5 (August, 2007).

<sup>49</sup> Justin Fox *How the Next President Should Fix the Economy*, 37, 38 TIME (May 26, 2008).

<sup>50</sup> Id.

<sup>51</sup> Scott Lilly, *Understanding Bushonomics: How We Got Into This Mess in the First Place*, at 8- 11, esp. p. 10, Fig. 8 (Center for American Progress, August, 2008) (Lilly, 2008).

<sup>52</sup> In thinking about the challenges facing a “typical” household, it is interesting to compare the census data on household income within quintiles from Table 4 with Lilly, who places the average income for the bottom 90% at just \$30,659 in 2006. Lilly, 2008, *id* at p.9, Fig. 7. (It should be noted that the Census Bureau data for 2006 counts approximately 116 million households, while Saez-Piketty IRS data used by Lilly counts 148 million households, which affects the distribution.)

Compounding the impact of rising income inequality is the fact that households see less predictability as to their financial status. Incomes have become increasingly volatile, which is quite likely to heighten feelings of insecurity.<sup>54</sup> Volatility, of course, can mean that next year could be better – but it also may be worse.

Meanwhile, that slow real-income growth has not been matched by equally slow growth in many of the big-ticket expense items on the expense side of household balance sheets. The longer term pressures from rising costs for health care and health care financing, child care, education, transportation and housing were recently joined by the rising costs in food and fuel.<sup>55</sup> At the same time, the loss of fixed benefit pensions add to the need to save (or invest) more, despite the increasingly tight squeeze between income and expenses. In light of the slow gains on the income side, and increased demands on the expense side of the household ledger, the increased role of debt in American households is unsurprising, if unheralded.

B. Turning to debt and extracting equity: But not to worry – it’s the patriotic thing to do.

The growth in debt should be less surprising in light of that picture of the household ledger for the bottom 90% over the past 30 years. Over about that same period, the debt-to-disposable income ratio of American households more than doubled from 60% in 1980 to 133% in 2007.<sup>56</sup> Ignoring the impact of the top and bottom quintiles, that ratio for the middle three quintiles – for literal middle class America – was 141% in 2004.<sup>57</sup> Overall, aggregate household debt grew from \$734.3 billion in 1975 to nearly \$13 trillion in 2006.<sup>58</sup>

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<sup>53</sup> Census Bureau, *Income, Earnings, and Poverty Data From the 2006 American Community Survey*, p. 3 (August, 2007).

<sup>54</sup> Peter Gosselin, “The New Deal: If America is Richer, Why Are Its Families Much Less Secure?” *Los Angeles Times* (October 10, 2004). See generally Jacob S. Hacker, *The Great Risk Shift* (Oxford Univ. Press 2006).

<sup>55</sup> For general discussions, see, e.g. Lawrence Mishel, Jared Bernstein & Sylvia Allegretto *The State of Working America 2006/2007* (Economic Policy Institute 2007); Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *The Fragile Middle Class*, (Yale Univ. Press 2000).

<sup>56</sup> Dean Baker, *Dangerous Trends: The Growth of Debt in the U.S. Economy*, at 4, Fig 1 (2004); Stephen Roach, *Comment: America’s Inflated Asset Prices Must Fall*, *Financial Times*, January 8, 2008.

<sup>57</sup> Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle Class Squeeze*, p. 21, 24, Levy Economics Institute at Bard College & Department of Economics, NYU, Working Paper No. 502 (June 2007.)

<sup>58</sup> Figures from Federal Reserve Board Flow of Funds Accounts Z.1, Table D.3 (June 5, 2008), <http://www.federalreserve.gov/releases/z1/20080605/z1r-2.pdf>

Over \$10 trillion of that is mortgage debt, which has played an important role in propping up that 70% of GDP that is household spending. Former Federal Reserve Board Chairman Alan Greenspan and a colleague, James Kennedy estimated that cash from equity extraction amounted to an average \$299.6 billion in the years between 1991-2000. That amount more than tripled in the first half of this decade, to an average \$997.4 billion for the period 2000-2005.<sup>59</sup>

While there is a narrative spin about such data that condemns Americans for using their homes “as an ATM” to finance rampant consumerism, the equity extracted also funds college for the kids (increasingly expensive), medical care and health insurance for the family, (also increasingly expensive), and any number of other necessary expenses or sound investments. And it consolidates credit card debt, some of which also funds medical care, gas to go to work and other basic needs.<sup>60</sup> There is no “one-size-fits-all” narrative that marks the face of all the families behind these numbers. That is important to remember, for setting policy with a single stereotype in mind will rarely yield effective results.

The importance of that household spending to the economy may explain why Americans did not turn their equity to liquid without encouragement from the highest quarters of both private finance and public officialdom.

“And low interest rates have encouraged a housing boom here in America – and that’s good, that’s good. Low interest rates mean that people, for example, have got the capacity to refinance their home. .... That’s helped our economy. ... Low interest rates has helped the American citizens. It’s helped them buy a home. It’s helped them refinance if they own a home. It’s put more money in circulation, which is good for job creation. And home ownership is at near-record highs – and that’s good because we need to be an ownership society in America....”<sup>61</sup>

In less direct language than the President, so, too, did “the Maestro” convey the message that extracted equity was smart money.

There can be little doubt that the availability of a ready source of home equity has reduced the costs and uncertainties associated with income volatility, retirement, unexpected medical bills and a host of other life events that can unexpectedly

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<sup>59</sup> Alan Greenspan and James Kennedy, *Sources and Uses of Equity Extracted from Home*, Tbl 2, p. 17 (March, 2007), FRB Working Paper 2007-20. Most mortgages, in effect, recycle old mortgages, as the old loans are paid off with proceeds of new loans, either with the same owner refinancing, or a new buyer paying off the seller’s mortgage. These figures represented an attempt to calculate the new money freed up in the process of selling at a profit, or getting a cash-out refinance or equity loan.

<sup>60</sup> See, e.g. *The Plastic Safety Net*, p. 10 (DEMOS and Center for Responsible Lending, 2005) (7 out of 10 low-and middle-income households used their cards as a safety net.)

<sup>61</sup> Remarks by President Bush on Housing and the Economy, Ruiz Foods, Dinuba, California, October 15, 2003, at <http://www.whitehouse.gov/news/releases/2003/10/20031015-10.html> (visited Dec. 9, 2008).

draw down savings. Home equity extraction may be the household sector's realization of the benefit of a rapidly evolving financial intermediation system.<sup>62</sup>

Unfortunately, household debt is a shaky foundation for a national economy. The equity extraction has come to a screeching halt, down to just \$9.5 billion in the second quarter of 2008.<sup>63</sup> As this symposium is being held in real time, we are just beginning to see the ripple effects into the real economy. Though outside the scope of this symposium, we must come to grips with the fact that America's debt load is not just a matter of a taste for too many flat-screen televisions and bling.

### C. Purchase money mortgages: Was it an Affordable Housing Problem, Not a Credit Problem?

Because the subprime market was primarily a refinance market,<sup>64</sup> this discussion focused first on the role of equity extraction in the economy. But the financial state of the majority of America's household is by no means irrelevant in the purchase money segment of the market. While the bubble inflated, those wages did not, so the disconnect between housing prices and capacity widened. Between 2000 and 2005, real housing prices grew 22%, while median real wages grew 1.7%.<sup>65</sup> In the affected regions, the housing bubble only worsened that disconnect. In 2005, the median home price in California was approximately \$525,000. The income needed to sustain a mortgage at that price was about \$129,000, yet the median income in California then was only half that -- \$60,000, for a shockingly low "affordability index" of 14%.<sup>66</sup>

The housing industry, the mortgage industry, and the securities market all apparently thought that the answer to increasingly unaffordable housing was to provide increasingly unsustainable loans, rather than let demand slow naturally. It is unsurprising, then, that California now suffers from heavy exposure to a lot of poorly underwritten, precarious loans.<sup>67</sup> Without doubt, some people on the buying side decided

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<sup>62</sup> Remarks by Federal Reserve Board Chairman Alan Greenspan to the Annual Convention of the Independent Community Bankers of America, Orlando, Fla., March 4, 2003, <http://www.federalreserve.gov/boarddocs/speeches/2003/20030304/default.htm>

<sup>63</sup> "Q2 2008: Mortgage Equity Withdrawal Plunges to Near Zero," Calculated Risk (October 6, 2008), <http://calculatedrisk.blogspot.com/2008/10/q2-2008-mortgage-equity-withdrawal.html>

<sup>64</sup> See note 42, above.

<sup>65</sup> See Testimony of Eric Stein Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis*, p. 11 (October 16, 2008).

<sup>66</sup> See, e.g. CAR Reports December Housing Affordability Index at 14% (Press release, February 9, 2006), (<http://www.car.org/index.php?id=MzU5Mjg=>) . (Median housing prices and income vary slightly depending on sources and specific reference date used.)

<sup>67</sup> Data from the New York Federal Reserve Bank's interactive mortgage maps indicated at one point recently that California had 56% of all POARMs. Given the weak underwriting, the astonishingly high percentage that were written with stated income, the high LTVs (with a significant number of piggy-back

to try to wait it out, and events have proven them to be the wise ones. Yet it is easy to see that, with each passing year of the home prices climbing, more families might have felt that waiting would only see the possibility of making a purchase get farther out of reach – a purchase that would seem to be a more reliable investment for kids’ college, or for their retirement than the stock market which had so recently burst its own bubble. So on the purchase-money side, too, reacting on the basis of a single stereotype makes it more likely to miss the mark.

The “fundamentals of the economy” have been unsound for a wide swath of American households for some time now. That is one of key public issues confronting us, and one lesson we should draw from the crisis is that we can no longer afford to ignore it. But in the meantime, we must avoid letting the problem worsen, by interrupting the downward cycle of foreclosures and housing price decline, which, in turn, is feeding a recession. Then we must take steps to prevent a recurrence.

### **V: What Now? Policy Responses to the Crisis**

A suggestive phrase has gained currency recently -- “a crisis is a terrible thing to waste.” While clearly the first order of business is to stabilize the housing market by slowing down the foreclosure tide, the crisis also gives us an opportunity to recalibrate a regulatory balance that skewed too far in the direction of deregulation over the last thirty years, and to rethink the design of the recent market incentives that perversely undermined its own stability.

- *Slow down the foreclosures:* We must trip the circuit breaker to stop the downward spiral of foreclosures and declining home values. Efforts to provide meaningful loan modifications on a large-scale basis must be enhanced, and the bankruptcy code should be amended to permit judicially-supervised modification of mortgages on primary residences as a backstop.
- *Reform the origination process and eliminate perverse market incentives:* The next step is to reform the origination and secondary market process to restore basic, common sense fundamentals to the lending process and bring the market incentives into an alignment that enhances, rather than perverts, the sustainability, suitability, and stability of the mortgage market.
- *Reform the regulatory system that badly failed in its oversight.* The philosophy of deregulation created an environment that let this system get out of hand, and the people within the system can and should re-think that philosophy. But it was not just a matter of personnel. There are structural issues in our financial regulatory system that tilt the field toward regulatory laxity, and that must be changed. The first step in that reform is to merge the Office of Thrift Supervision (OTS) into the

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second liens), the negative amortization on these loans, and the low affordability index on the homes, it is easy to conclude that many of these loans made in the middle of this decade were “asset-based lending,” and, as noted above, note 19, even worse were seemingly made based on the *anticipated* value of the asset.

Office of the Comptroller of the Currency (OCC), and curb the latter's overly-aggressive preemption of state law.

A. First Step: Stop the decline by improving bulk loan modification efforts and enacting judicially-supervised modification as a backstop.

This economic crisis started in the housing sector, and we must take effective steps to stop the slide immediately. CRL estimates that some 40.6 million homes will suffer price declines caused by the subprime foreclosures of nearby surrounding homes, to the tune of some \$352 billion.<sup>68</sup> That figure does not factor in the spillover effect from foreclosures in the Alt-A and prime markets, so it is considerably underestimated. Yet to date, the federal policy responses in this regard have been tepid, and conditions have worsened in the meantime.

The most effective and efficient way to interrupt the cycle of price decline, default and foreclosure is to modify the loans on owner-occupied properties to allow them to stay in place, paying their mortgages. That benefits not just the families, but their neighborhoods, their communities, the lenders, and the investors. The federal response so far has been to encourage voluntary loss mitigation efforts by the industry. That has not worked. The number of loans addressed through these efforts has not kept pace with new foreclosures. A working group of state attorneys general and financial regulators working with servicers found in their most recent report that nearly eight of ten seriously delinquent homeowners were not on track for loss mitigation.<sup>69</sup>

Equally troubling is that too much of the loss mitigation that has taken place is not designed to turn these loans into paying loans that are sustainable over the long run. One analysis found that a full 46% of these efforts either did not result in lowered payments or in fact *increased* monthly payments.<sup>70</sup> Such “band-aid” modification efforts will not act as the necessary circuit-breaker, and in fact may make it worse.<sup>71</sup> They are likely to result in re-defaults, which, in turn, undermine efforts for truly meaningful and effective modifications. (As the housing prices continue to decline, the servicers and note-holders may be encouraged to foreclose sooner, rather than later, if they feel that re-defaults, rather than paying mortgages, is the more likely outcome.) Despite evidence that the

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<sup>68</sup> See Issue Brief, *Updated Projections of Subprime Foreclosures in the United States and Their Impact on Home Values and Communities*, Center for Responsible Lending (rev. Aug. 2008), available at <http://www.responsiblelending.org/issues/mortgage/research/updated-projections-of-subprime-foreclosures-in-the-united-states-and-their-impact-on-home-values-and-communities.html>.

<sup>69</sup> Analysis of Subprime Servicing Performance, State Foreclosure Prevention Working Group, Data Report # 3, Sept. 2008, p. 2, available at [http://www.mass.gov/Cago/docs/press/2008\\_09\\_29\\_foreclosure\\_report\\_attachment1.pdf](http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf)

<sup>70</sup> Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, p. 21 (2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1259538](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538)

<sup>71</sup> *Id* at p. 3.

most successful modifications are those where interest rates or principal are reduced,<sup>72</sup> these kinds of effective modifications are lagging.<sup>73</sup>

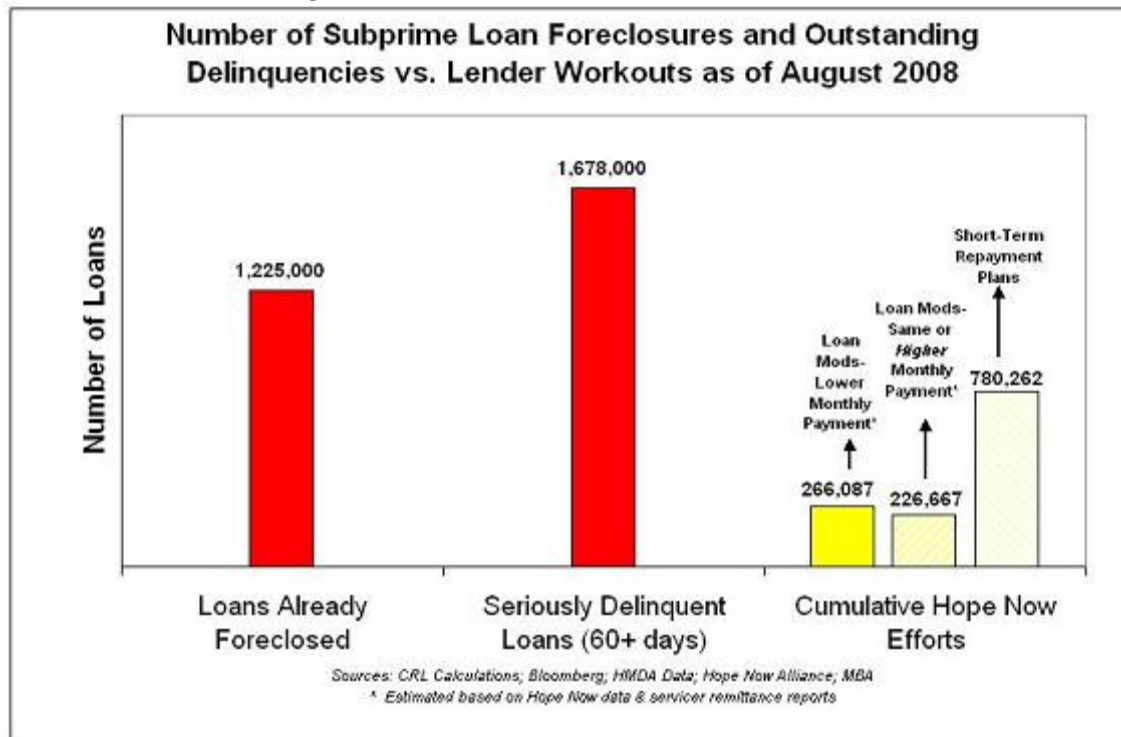
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<sup>72</sup> Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, Oct. 1, 2008, p.2, available at <http://www.credit-suisse.com/researchandanalytics> (stating that these kinds of modifications cut the redefault rate in half).

<sup>73</sup> See, e.g. Alan M. White, *Rewriting Contracts, Wholesale, Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, p. 20 (2008) (only 1.4% of loans in the study had the principal balance reduced.)

**Figure 1: Number of Subprime Loan Foreclosures and Outstanding Delinquencies vs. Lender Workouts as of August 2008**



To be sure, there are a number of hurdles to bulk modifications: contractual barriers in the pooling and servicing agreements that govern the servicing of these loans, and fear of investor lawsuits; the financial incentives for servicers tilt toward foreclosure rather than modifications; and the magnitude of the crisis is simply overwhelming capacity for some servicers. Complicating all these hurdles are the number of second liens on these properties -- first lien holders are not likely to provide meaningful modifications if the result is to put a second lien-holder in a better position.<sup>74</sup> These are not insurmountable, however. There are promising avenues which should be taken in short order.

<sup>74</sup> For more detailed discussion of the structural hurdles, see, e.g. Kurt Eggert, *Comment: What Prevents Loan Modifications*, Housing Policy Debate: Vol. 18, No. 2 (2007); Larry Cordell, et al, *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, Finance and Economics Discussion Series 2008-46.

*Greater use of streamlined bulk modification programs:* The streamlined program that the FDIC developed for IndyMac when it took over the failed bank, aiming to reduce the homeowner's housing debt-to-income ratio at 38%, is being modified for broader use. The agency recently took steps to make the program widely available by releasing "Mod in a Box," that servicers and investors might use to efficiently evaluate loans.<sup>75</sup> A settlement with several state regulators and attorneys general by Bank of America over Countrywide's dubious origination practices adopts a similar tack, though with housing debt-to-income affordability target of 34%. The FDIC program, particularly, will provide an opportunity to see what works best to help avoid foreclosures wherever possible, and allow families to stay in their homes.

*Use TARP authorization to create cost-effective modification programs.* Although the Treasury Department has not yet utilized its authority under the Emergency Economic Stabilization Act (EESA) to facilitate loan modifications, it can use the Troubled Asset Recovery Program (TARP) authority under that Act to do so. CRL's CEO Martin Eakes recently outlined in Congressional testimony a number of ways that TARP authority can be used to establish programs that will more effectively act as the circuit-breaker, and provide more bang for the TARP buck in the process.<sup>76</sup> Briefly, this includes:

- Creating a loan modification guarantee program with an affordability target of 31% (to provide for greater likelihood of success, given the taxpayer-funded guarantee). The guarantee should not kick in until the modification has a demonstrated record that signals long-term affordability, should only apply where initial payments are reduced by a minimum of 10%, and would last for eight years. These conditions would help assure that there is incentive for servicers to make sure it is a sustainable modification. He estimates this could guarantee three million loans, valued at approximately \$600 billion, for just \$50 million of guarantees.
- Paying servicers approximately \$1000 for each qualifying modification, to eliminate the current financial disincentives to meaningful modifications.<sup>77</sup>

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<sup>75</sup> FDIC Loan Modification Program, *available at* <http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf>.

<sup>76</sup> Testimony of Martin D. Eakes Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program* (November 13, 2008), *available at* <http://www.responsiblelending.org/policy/testimony/oversight-of-the-emergency-economic-stabilization-act-examining-financial-institution-use-of-funding-under-the-capital-purchase-program.html>. The testimony identifies some other actions that Congress could take to remove some of the hurdles to modifications.

<sup>77</sup> See sources cited at note 74 for an explanation of the financial disincentives that discourage servicers from cooperating with borrowers to make meaningful modifications.

*Congress should lift the current ban on judicial modifications of loans secured by a primary residence:* A key backstop to all other modification efforts is for Congress to lift the prohibition that precludes bankruptcy judges from modifying loans secured by a primary residence. (Bankruptcy judges already can modify a loan secured by a vacation home in Aspen.) Enacting this change would not necessarily send thousands of homeowners into bankruptcy court, but the simple fact that it is a possibility would encourage greater voluntary participation by servicers and investors still reluctant to do what is necessary.<sup>78</sup>

#### B. Reform the Origination Process and Eliminate Perverse Market Incentives.

The earlier discussion made clear that the financial incentives perversely encouraged the proliferation of the riskiest, most unstable kind of loan products and terms. Meanwhile, there was too little by way of countervailing pressures: too little regulation to curb the appetites those incentives unleashed, and too little legal accountability for the originators who crossed the line in making the loans and for the secondary market that benefited from them for years.

Key principles for reform include:

- Eliminating yield-spread premiums in the subprime and non-traditional loans, and discouraging its abuse in the prime market.

As was discussed earlier, the rationale for yield spread premiums (YSP) historically has been that the premium is a price trade-off -- an alternative way for consumers to pay origination costs. In theory, they can pay them upfront (in cash or financed in the loan amount), or over time through a bump up in the note interest rate. However, YSPs instead became a reward for brokers to steer borrowers to higher-priced, riskier loans, at least in the subprime and non-traditional markets.<sup>79</sup>

Even in the prime market, it is virtually impossible for consumers to assess the value of this feature. Netting out the impact over time of one feature with an upward bump on the rate (the YSP) against another fee also proposed for the loan that is supposed to lower the rate (discount points or a prepayment penalty) requires extraordinary sophistication, even assuming the price adjustments attributable to each was transparent.

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<sup>78</sup> See Testimony of Martin Eakes, note 76, above.

<sup>79</sup> Keith Ernst, Debbie Bocian, and Wei Li, *Steered Wrong: Brokers, Borrowers and Subprime Loans*, Center for Responsible Lending, (April 2008). See also Howell Jackson and Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield-Spread Premiums*, 12 Stan.L.J. Bus & Fin. 289, 353 (2007) (borrowers received 20-35 cents in reduced fees for every \$1 paid in YSP).

To assure that consumers actually get the alleged benefit of YSPs for loans other than subprime and non-traditional mortgages, Senator Chris Dodd's proposed "Home Ownership Preservation and Protection Act" would permit them only where they truly are a substitute for upfront costs, a balanced and sound reform.<sup>80</sup>

- Prohibit prepayment penalties in subprime and non-traditional loans

By imposing this exit tax on homeowners seeking to escape from higher-priced and risky loans, these penalties actually increase the risk that these loans will default. Even when they do not preclude refinancing entirely, they strip equity from these homes. While these fees, too, are purportedly offered as a trade-off for a reduced interest rate, the data indicates that there is no rate benefit.<sup>81</sup>

- Restoring common sense underwriting standards to assure that loans are evaluated for the borrower's ability to repay.

In July, 2008, the Federal Reserve Board promulgated regulations prohibiting unfair and deceptive acts and practices. Among other things, it sets some underwriting ground rules for subprime mortgages, and further requires that income be verified.<sup>82</sup> These common sense standards should be expanded to apply to all non-traditional mortgages, irrespective of whether they are Alt-A or subprime.<sup>83</sup>

- Codifying broker duties to assure that they do not place their own self-interest above that of their clients

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<sup>80</sup> 110<sup>th</sup> Cong., 1<sup>st</sup> Sess, S.2452, § 301, proposing to add new section §129A(e) to the Truth in Lending Act. Presumably Senator Dodd will re-introduce the bill in the 111<sup>th</sup> Congress.

<sup>81</sup> This is explained more fully and illustrated in Center for Responsible Lending, *Comments on Home Equity Lending Market*, p. 11–19 (August 15, 2007), available at <http://www.responsiblelending.org/pdfs/crl-frb-comment-aug-15-2007.pdf>. These penalties are by no means insignificant – they can be thousands of dollars.

<sup>82</sup> See 12 C.F.R. §226.35(b)(1), adopting the standards applicable to high-cost loans found in 12 C.F.R. § 226.34(a)(4).

<sup>83</sup> Federal regulators have adopted underwriting guidelines for non-traditional mortgages, but they are "guidances," not rules with the force of law. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (October 4, 2006). See also State Implementation of CSBS/AARMR Guidance, available at [http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM\\_State\\_Implement.htm](http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM_State_Implement.htm), (reporting that forty-five states and DC have adopted parallel standards).

As the business of loan brokering began to take off, the California Supreme Court had little problem holding that the brokers had a fiduciary duty to their clients, a concept that the industry seemed to adopt – for a while.<sup>84</sup> Over time, however, perceptions diverged, with consumers believing that it is a broker’s job to represent the client’s best interest, while most brokers deny such duties.

Among reforms now more likely in the wake of the crisis is some codification of originator duties, whether it be a fiduciary duty, a duty of good faith and fair dealing, or a list of specific duties.<sup>85</sup> Other options would be to impose a suitability requirement, akin to that in the securities field, or a prohibition against steering a borrower to a higher-cost loan than that for which he qualifies. Some proposals would apply to all originators, whether the lender itself or a third party broker.<sup>86</sup>

- Assuring that homeowners have the ability to vindicate their legal rights

Legal rights atrophy if there is not an adequate system in place to enforce compliance, and as critical as regulatory enforcement is, it is not sufficient. There will never be enough public resources to take effective legal action in relation to the whole universe of players involved in the complex sales, delivery and servicing network that our mortgage credit system has become. It is also unfortunately the case that public enforcement is ill-suited to enforce legal rights on an individual basis. For example, most victims of illegal and predatory loan practices are not aware that they had legal rights violated until they consult an attorney when foreclosure is imminent, but regulators cannot defend foreclosures for individual homeowners. Public enforcement actions are preceded by investigations, which can be quite lengthy. It is small comfort for a harmed consumer to get a share of a settlement distribution years after the family lost the home.

- Assuring that all parties involved in a securitized transaction have their interests aligned to create a stable, sustainable mortgage, by providing for assignee ability.

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<sup>84</sup> Wyatt v. Union Mortgage Co., 598 P. 2d 45 (1979). See generally National Consumer Law Center, *The Cost of Credit* §§ 11.5.4.2, 12.9.2 (3<sup>rd</sup> Ed. 2005). Interestingly, the National Association of Mortgage Brokers at one point seemed to adopt that concept in their Code of Ethics, *id.*, § 12.9.2 at note 686, but it seems to have disappeared, compare [http://www.namb.org/images/namb/Ethics/Code\\_of\\_Ethics.pdf](http://www.namb.org/images/namb/Ethics/Code_of_Ethics.pdf).

<sup>85</sup> Several states have already taken such steps. See, e.g., **Maine** Me. Rev. Stat. Ann. tit. 9-A, § 10-303-1; **New York**, N.Y. Banking Law, § 590-B; **North Carolina**, N.C. Gen. Stat. §53-243.10 - .11; **Ohio** Ohio Rev. Code Ann. Chap.1322.

<sup>86</sup> See, e.g. The proposed “Home Ownership Preservation and Protection Act”, S.2452 110<sup>th</sup> Cong. 1<sup>st</sup> Sess., § 301 (proposing duties applicable to all originators and a fiduciary duty for brokers).

The complex system of structured finance and fancy derivatives undermined market accountability by dispersing risk or insuring against it (or so it was thought.) But there was also insufficient legal accountability. The securitization process made it difficult for a consumer whose legal rights were violated in the course of making the loan to vindicate those rights in a meaningful way. When the faceless trust that owns the note is about to foreclose, those legal rights are worth little if the claims cannot be raised defensively. Brokers are too little capitalized to be able to financially compensate the borrower, or an originating lender may be bankrupt. As a practical matter, for most individuals, simply finding a lawyer willing to fight a two-front legal battle—one to defend a foreclosure and a second to prosecuting the original lender -- would be almost impossible. Even if one did, those two kinds of litigation move at different paces. In many states, the foreclosure would move much faster than separate litigation against the originator, making any later success hollow. For legal rights to be meaningful, when a loan was made in violation of the law, an innocent homeowner must be able to enforce her legal rights against the owner of the loan, whoever or whatever that may be.

As CRL Senior Vice-President Eric Stein recently testified, assignee liability is both an appropriate apportionment of risk between lender and borrower, and an appropriate vehicle to assure that the secondary market actors have enough “skin in the game” to avoid putting their own short-term gains ahead of the long-term viability of the underlying mortgages.<sup>87</sup>

There is an advantage, too, for investors. In the past, the industry strenuously fought even limited assignee liability on the grounds that it would scare investors and “dry up credit.” It is now quite clear, however, that it is a lack of confidence that dries up credit. Events have proven that the interests of consumers and of the end investors are in sync: both want sound, sustainable lending. Properly calibrated assignee liability will help discourage recklessness by encouraging market discipline and bringing much-needed accountability.

### C. Reform the Regulatory System That Failed in its Oversight Responsibilities

The regulatory failures, both on the origination side and the securitization side, are legion, and will properly be the subject of much examination. A thorough exploration of those failures is beyond the scope of this paper. But we can be sure that effective oversight requires tools (in the form of enforceable standards), adequate resources, and, above all, the will. At the federal level, perhaps the most tragic failure was the failure of will. Some of the needed reforms are fairly obvious and would not require a fundamental overhaul of the system. But this may also be a good time to at least examine the possibility of more fundamental structural changes.

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<sup>87</sup> Testimony of Eric Stein, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis*, p. 8-9 (October 16, 2008). See also Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039 (2007); Christopher L. Peterson, *Predatory Structured Finance* 28 Cardozo L. Rev. 2185 (2007).

- Merge the OTS and the OCC to eliminate dysfunctional “charter competition”.

One of the dysfunctional characteristics of banking regulation in this country is that the regulated entities get to choose their own regulator. They can choose between state and federal regulation, and, if they choose federal regulation, they can choose *between* federal regulators. There are obvious pitfalls in this system. The integrity of the “pick-your-regulator” model is further muddled by the fact that funding for the agencies comes from assessments on the entities it regulates.

The result is charter competition, which can lead to regulatory laxity as the agencies compete to become the regulator of choice for large institutions. Merging the two primary federal banking agencies, the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) to avoid this regulatory arbitrage makes sense. Neither of these agencies has distinguished itself in the run-up to this crisis.<sup>88</sup> However, several of the major bank failures – IndyMac and WaMu included – occurred under OTS’ watch. Given this track record, merging the OTS into the OCC is a logical step.<sup>89</sup> But it will be necessary at the same time to reform the OCC’s operations as well. The foremost such reform is to rein in that agency’s overly-aggressive efforts to preempt state laws and state law enforcement.<sup>90</sup>

- Curb excessive preemption: Federal law should establish a floor, not a ceiling

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<sup>88</sup> See, e.g. Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis*, p. 21-24 (Oct. 16, 2008); Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 Temple L. Rev. 1 (2005).

<sup>89</sup> Prior to the crisis, the U.S. Treasury had begun to craft a proposal for regulatory restructuring, which also recommends merger of the OTS into the OCC, and eventually eliminating the thrift charter. U.S. Treasury, *Fact Sheet: Treasury Releases Blueprint For A Stronger Regulatory Structure* [http://www.treas.gov/press/releases/reports/Fact\\_Sheet\\_03.31.08.pdf](http://www.treas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf)

<sup>90</sup> See, e.g. Robert Berner and Brian Grow, *They Warned Us; The watchdogs who saw the subprime disaster coming--and how they were thwarted by the banks and Washington*, Business Week, (Oct. 20, 2008)

In the past fifteen to twenty years, the federal banking regulators have pushed a preemption agenda. Indeed, the OCC preempted Georgia's anti-predatory lending law at the request of National City Bank and its then operating subsidiary First Franklin, and simultaneously proposed sweeping preemption regulations prompted, in part, by increasing state efforts to act on the problem.<sup>91</sup> Ironically, though the OCC vigorously asserted that the national banks and their operating subsidiaries were not engaged in predatory lending, National City Bank and First Franklin are on the roster of lenders taken down by the subprime meltdown. Further, while Countrywide operated under the OCC's watch, it booked \$161 billion in payment option ARMs which, by its own admission, would not meet the interagency guidelines on non-traditional loans that the OCC and the other agencies established, though belatedly.<sup>92</sup>

The evolution of the subprime crisis is good evidence that states as the "laboratories of democracy" is more than a cliché. Being closer to the ground, they were more attuned to the rumblings than was Washington, and many took action. Further, the reforms they have enacted provide a basis for empirical review of the impact of reform proposals, and, to date, they have proven effective.<sup>93</sup> While the federal bar for consumer protection and fair lending standards must be raised, they must set a floor, not the ceiling. States must be free to respond to the next generation of problems as they arise, without waiting for Washington.

- Explore other avenues to assure that consumer protection does not take a back seat in the financial regulatory system

Consumer protection has not been the central focus of the federal banking regulators. Safety and soundness has been their primary focus (though now the centrality of consumer protection to safety and soundness should be unarguably manifest.).

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<sup>91</sup> See 68 Fed Reg. 46264 (Aug. 5, 2003) Preemption Determination and Order (Determining that the Georgia Fair Lending Act does not apply to the national banks and their operating subsidiaries), and 68 Fed. Reg. 46119 (Aug. 5, 2003) Notice of Proposed Rulemaking, Bank Activities and Operations (OCC proposal to preempt the applicability of many state laws to national banks). The timing is explained during the question and answer period during a Congressional oversight hearing. Testimony of Julie Williams, Office of the Comptroller of the Currency, Before the House Financial Services Committee, Subc. on Oversight and Investigations, *Congressional Review of OCC Preemption* (Jan. 28, 2004), oral comments, transcript available at [http://commdocs.house.gov/committees/bank/hba93717.000/hba93717\\_of.htm](http://commdocs.house.gov/committees/bank/hba93717.000/hba93717_of.htm).

<sup>92</sup> Countrywide Financial Corp., "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

<sup>93</sup> See, e.g. Bostic, et al, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. of Econ. and Bus, 47 (2007); Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (Feb. 23, 2006).

Prior to the mortgage market collapse, the Treasury Department had been developing a proposal for restructuring to create a functional regulatory scheme: one regulator each for market stability, safety and soundness, and “market conduct,” the latter to encompass consumer protection.<sup>94</sup> Whether such a fundamental restructuring will seem more or less credible now remains to be seen.

A proposal from Harvard law Professor Elizabeth Warren for a consumer financial products safety commission modeled on the Consumer Products Safety Commission, a regulator that would focus on consumer credit products, has gained attention in Congress. Senator Richard Durbin (D – Ill.) introduced the Consumer Credit Safety Commission Act, S. 3629 this fall which would create a regulator “whose sole focus is the safety of consumer credit products.”

While it is too soon to predict whether radical structural changes will be implemented as a result of the crisis, it is clear that for the first time in decades, there is a will to re-examine the current system that has not served the country well.

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<sup>94</sup> See note 89, above. The regulation of the securities end of the market is beyond the scope of this paper, but the regulatory failures on that end are arguably even more dramatic. See also note 40, above.

## CONCLUSION

The subprime crisis is not “a” crisis. Several long term trends set forces in motion, some as long ago as three decades or more ago. Over the past few years they gained their own momentum before converging into the greatest economic threat since the Great Depression, a phrase we now hear almost daily. Income inequality grew to levels last seen shortly before that same Great Depression, as wages stagnated and expenses mounted for the majority of American households while the safety net began to fray; the country moved from an industrial economy to some sort of post-industrial economy that seems to be still in search of its footing; deregulation of the market place became the norm, and faith in the self-correcting powers of the market came to the fore, while faith in government receded, encouraged by a steady stream of rhetoric. And in the meantime, global markets and “financial innovation” opened pathways for viral infections to spread around the world beyond anyone’s imagination. It does not often happen in history that so many trends come together so abruptly.

These are all root causes, but not all of these root causes are ones that lend themselves to immediate, concrete policy responses. Indeed, some of them are simply life happening: economies always change at some pace, and with varying degrees of dislocation. This paper suggested some modest, but necessary, concrete steps. But as we climb out of this deep hole, hopefully we will step back and think about all that brought us to this point and decide to at least put some of the larger issues back on the public agenda for thoughtful discussion. After all, a crisis is a terrible thing to waste.