The Subprime Lending Crisis - the Perfect Storm?

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Commentary: The Subprime Lending Crisis--the Perfect Credit Storm?

By Alvin C. Harrell

I. Consumer Credit--Too Much Law

The Conference on Consumer Finance Law (in conjunction with the Consumer Credit Law Institute) conducted its annual program on Consumer Credit Law in Dallas on November 8-9, 2007. Years ago your author gave up writing articles to summarize these events, largely because the number, scope, and variety of issues covered at these programs defies a manageable summary discussion. For a sample of the kinds and complexity of the material presented at these programs, pick up any issue of the Quarterly Report; the difference is that each issue of the Quarterly Report focuses on selected areas of interest. Indeed, in contrast to the annual Consumer Credit programs try to cover them all, in a single program and book with roughly twenty hours of presentations in it.

So it has been innumerable, even for the experienced consumer credit specialist. Consumer credit is one of our most complex areas of law, and there is far too much of it to summarize in a twenty-hour program, much less a single article. But in a sense this reflects the almost daily barrage of requests that are attempting to develop or contain an expert in this area of law. This complete and simultaneous understanding of every related issue and development is probably beyond human capabilities, and this creates challenges for in-house counsel, compliance officers, and other financial services executives. Outside counsel and plaintiff lawyers face some of the same problems, though with the luxury of being able to focus on a particular litigation issue.

Lawyers do not always like to admit the difficulty of understanding and complying with this area of law (it goes against the veneer of self-confidence that is essential in any profession--and, after all, there is some benefit to lawyers from the resulting legal chaos), and few outside the profession appreciate the extent of the problem. But the cumulative complexity (and the resultant legal risk) has become unmanageable. Moreover, it reflects a long-term and seemingly inevitable tendency in society towards increasing and more intricate regulation (and, in favor of bad laws), and it is getting worse rather than better.

II. Subprime Meltdown--The Risk Crisis?

One of the participants at Consumer Credit Law 2007 said that she had never before been in a situation where so much media attention is focused on her area of law (and, one might add, where so much is misleading), and she noted that it is very disconcerting. In contrast, your author predicted that the Federal Reserve Board (FRB) would reverse a severe inflationary spiral. Thrifts with fixed-rate loan portfolios yielding around five or six percent were suddenly paying seven to ten percent or more for their deposits--it was a gold rush.

Federal thrift regulators did their part to compound the problem, by continually waiving or reducing capital and reserve requirements, and sometimes even allowing thrifts to pay taxes. This led to "easy" credit, which led to higher loan-to-value ratios (e.g., the "three-year" mortgages), and then to "subprime" mortgages (e.g., the "five-year") mortgages). These in turn led to the housing bubble that eventually burst, leading to a financial crisis that has been described as "the perfect storm."
mortgage meltdown is nothing new. Of course, the causes (and likely the effects) of the 2007 crisis are very different from those of the 1980s. But, as before, the popular media and politicians are getting it all wrong, with adverse consequences for a major portion of the American population. They are simply and wrongly hoping for the media, or those catering to political constituencies. For others, perhaps the brief overview that follows will be helpful.

III. Causes and Effects

In view of the discussion above, it is appropriate to note that the current problems have their genesis in the deep-seated insolvency crisis of the 1980s. This crisis and the media response (including coverage of the large public expenditures necessary to bail out the thrift deposit insurance fund) fueled a public furor against "S&Ls" and "crooks" in the financial industry, and Congress responded with punitive legislation such as the Stibbe Act. This response, together with high and volatile interest rates, income tax increases that adversely affected real estate investment, and regulatory and accounting changes, placed banks in a tight spot, and brought about a new set of problems for the mortgage lending business.

Now, and as before, a severe credit crunch in the late 1980s and early 1990s, as the banking system contracted, the mortgage portfolio started to shrink, and mortgage-backed securities lost their appeal, was primarily the result of two factors—old and new. One was the dramatic decline of traditional mortgage banking and the resulting loss of mortgage-backed securities. The reason was, primarily, a reduction of new financing activity, which was, in turn, a result of relatively low interest rates and prevailing excess of supply over demand in the mortgage market. The other was a reduction in the supply of mortgage-backed securities available for purchase in the market. This was the result of the Federal Home Loan Bank Board (FHLBB) policy.

The FHLBB was the only government agency that could provide new mortgage-backed securities to the market, and the FHLBB policy was to limit the supply of mortgage-backed securities to create an artificial shortage, thus driving up mortgage interest rates and creating a demand for them. This was the result of the Federal Home Loan Bank Board (FHLBB) policy, which was to limit the supply of mortgage-backed securities to create an artificial shortage, thus driving up mortgage interest rates and creating a demand for them.

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IV. So, What Next?

With waves of home mortgage foreclosures and subprime mortgage lending, concerns about the scale of a new credit bubble (circa 1992-2006), Congress, the administration, and the financial regulators have been on the alert. The recent real estate downturn that followed the national confluence of declining subprime mortgage lending in 2006 and 2007, reinforcing new state anti-credit laws (just in time to impede subprime borrowers who needed to refinance their adjustable rate mortgage loans before loan rate spikes)

The states continued to do their part to make matters worse, enacting new "anti-predatory lending" laws seemingly designed to deprive subprime borrowers of any access to mainstream credit sources. Some of the new laws designed to protect consumers from foreclose "scams" also have had the effect of shutting off legitimate alternatives to foreclosure. Public anger over a major crisis is sometimes a prelude to legislative action, yet that is not the best atmosphere for deliberate action, particularly when laws are being made by those who do not understand the issues, and who are then charged with writing policy, in an atmosphere charged with politics and emotion. These are the makings of a perfect credit storm, in which misguided policies convert a temporary market cycle into a long-term economic disaster.

Aitch writing, the award for the worst and most counterproductive legislative proposal goes to the Illinois Senate, where a recent bill by John Kirkland, Frank and his colleagues, for their sponsorship of HR 3915. This commentary is not the place for a detailed discussion of this proposal, and your author recognizes that features of HR 3915 are popular in some circles, and are regarded as inevitable by others, including some in the credit industry. It was reported by several financial writers and legislators that even opponents had given up trying to stop this bill, and were focusing instead on protecting their own interests by seeking to shift the most onerous burdens to others obviously not an irrational or uncommon response. At this writing there is hope that better judgement will prevail in the Senate, though to others this seems a long shot; burdening that, the only impediment to a seemingly destined to go nowhere. It seems to the writer, however, that the proposal will be effective in blocking mortgage foreclosures, and will make it more difficult for subprime borrowers to buy a home, refinance or otherwise avoid foreclosure.

V. A Longer-Term Perspective

Economic predictions are notoriously unreliable, but at this writing the subprime credit crisis seems to be spreading to other economic sectors, and the damage appears to be severe. The housing market is suffering a nationwide decline, exacerbated by overbuilding in some markets, the end of a fifteen-year upswing in housing, credit crunch facilitated by FRB monetary policy, and public policies that are cutting off the supply of subprime credit. This FRB is limited in its time response for their failure to foresee the credit crunch of 2007, as noted above, in part due to their failure to recognize that the risk of a long-term credit crunch was not only real, but also likely to be catastrophic. As noted above, most of the recent credit bubbles, beginning with the mid-1990s, some states and federal regulators responded to consumer advocacy concerns about too much credit at too low rates in the 1980s deregulation of credit markets. The expansion of HOEPA, various bank examination procedures, and state anti-predatory lending laws are primary examples. These policy responses imposed new constraints on the availability of subprime credit, but until 2006-2007 this effect was overwhelmed by extraordinary accommodative monetary policy to cushion the blow of disorganization in housing prices. When the FRB began raising interest rates in 2005-2006, simultaneously with a new wave of federal and state initiatives making it more difficult for subprime borrowers to buy a home, refinance or otherwise avoid foreclosure, deficits spread and the housing market that has now been suddenly awoken to the enhanced risks of U.S. mortgage lending, and a rush to the banks. The recent federal legislative proposals to impose additional costs and risks on mortgage lenders and investors probably have frightened the markets for permanent mortgages. As noted, these are the makings of a perfect credit storm at both micro- and macro-economic levels, but even more serious is the risk of a long-term impairment of the U.S. mortgage finance system, including an ever-present risk that
Sixth Federal Preemption?

Of course it is impossible that policy makers may respond with solutions that do not impose, or even that support, an economic recovery. For many in the consumer finance industry, the key to such a solution is federal preemption, which offers a prospect for overcoming the adverse effects of numerous and sometimes contradictory federal and state regulations. As a result, the importance of distinguishing between preemption and regulatory decisions, without serious adverse consequences for consumers and the economy.

The latter perspective has an important place in our legal scheme of things, and is a cornerstone as a court to help correct the consequences of a failure to credit the public policy.

The new Consumer Credit 2007 program was the consumer protection model was essential to the modern legal order. It is not only a matter of whether the consumer credit laws would be constitutional or not. The new regulatory system, to the extent of an accurate combination of consumer protection law in a consummation.

The current federal legislative proposals express the need for a centralized, state law system with federalized-legislation in place and consumer advocacy groups, academics, federal regulators, and law firms, it is time to join this movement.

Other losers from a law like HR 3915 are likely to include those who rely on our state law system of private litigation, which is to be supplanted by the new federal system. Small law firms practice likely will suffer as federal administrative processes increasingly rely on the role of state and federal specialized regulatory counsel and other areas of practice (such as securities law).

VI. Conclusion

So, here are the ingredients for a perfect credit storm: Too much state and federal preemption.
federal law, too much of it misguided, and too much nonuniformity as between types of creditors and states, creating serious legal costs and risks of nonpayment that deter lending and investment; a major downward economic cycle after the bursting of a housing and credit bubble fomented by expansive monetary policies; and waiting in the wings a series of federal legislative and regulatory proposals that threaten to freeze the status quo at the bottom of the cycle, in the process altering the nature of our financial system from a decentralized common law model to that of a federal administrative state.

This will please some within the federal agencies, law firms, and advocacy community that believe that they or their constituencies stand to benefit, and many academics. Large nationwide mortgage lenders and their counsel, and possibly the securitization industry, will embrace the resulting federal preemption of state law. Local lenders, independent mortgage brokers and bankers, many consumers, state agencies, and local counsel will be adversely affected, though perhaps it will not be immediately apparent. If private credit is restricted, as seems likely, the economy as a whole will suffer, and increased public subsidies may be demanded as a substitute for private funding.

Having impaled the private subprime credit system, policy makers can then proceed to address the next national crisis: The inadequate availability of mortgage credit for low- and moderate-income borrowers.

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C. Category 3

The final category of loss mitigation framework includes loans where borrowers are not current on their payments and are already experiencing difficulty making payments at the introductory rate. These borrowers are not eligible for a fast track loan modification. Instead, the servicer will determine an appropriate loss mitigation approach in a manner consistent with the transaction documents. The loss mitigation approach closer to the servicer should be the value of the recoveries to the servicer’s trust and may include loan modification (including a rate reduction and/or principal forgiveness), forbearance, short sale, short payoff, or foreclosure. These borrowers will require a more intensive analysis, including a current DTI analysis, where appropriate, to determine the appropriate loss mitigation approach.

IV. Treatment of Modified Loan Pools

In order not to jeopardize the favorable tax treatment of a securitization of mortgage loans in a REMIC, most typical pooling and servicing agreements only permit modifications if the loan is in default or default is "reasonably foreseeable" or the modification would not be deemed "significant" under U.S. Treasury regulations. While under present law servicers generally could modify a loan if it is reasonably foreseeable that a non-defaulting borrower who is able to pay an introductory fixed rate will be unable to pay the upcoming fully-indexed, adjustable reset rate, the Internal Revenue Service (IRS) has not previously provided any guidance as to what the term "reasonably foreseeable" means, and servicers have been hesitant to modify loans for fear that a modification would not be reasonably foreseeable and would subject the REMIC to entity level taxation or qualification issues.

Sections 861A through 861G of the Internal Revenue Code (the Code) provide favorable federal tax treatment for securitization vehicles that qualify as a REMIC. An entity qualifies as a REMIC only if, among other conditions, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of its assets constitute qualified mortgages and permitted investments. An entity that initially qualifies as a REMIC may cease to qualify if a sufficiently large portion of its qualified mortgages are significantly modified and the modified obligations are not qualified mortgages. However, certain modifications, including changes "occasioned by a default or a reasonably foreseeable default" are not considered significant.

The Code also imposes a tax on REMICs equal to one hundred percent of the net income derived from "prohibited transactions." The disposition of a qualified mortgage is a prohibited transaction unless the disposition is pursuant to the substitution of a qualified replacement mortgage for another qualified mortgage, a disposition incident to the foreclosure, default, or imminent default of the mortgage, the bankruptcy or insolvency of the REMIC, or a qualified liquidation. Note also that IRS regulations provide that an "investment" trust is not considered to be a trust if there is a power under the trust agreement to vary the investment of the certificate holders.

In order to make clear that these provisions would not affect a securitization trust's REMIC status in the event that a servicer modifies loans

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15. (Continued from previous column)

greater than 25 basis points or 3% of annual yield, or exceed the maturity by the lesser of five years or 30% of the original term of the instrument.

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19. (Continued from page 669)