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The Subprime Lending Crisis - the Perfect Storm?

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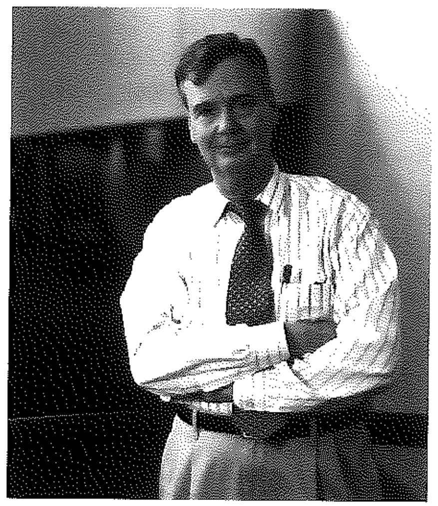
Commentary: The Subprime Lending Crisis--the Perfect Credit Storm?

By Alvin C. Harrell



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I. Consumer Credit--Too Much Law

The Conference on Consumer Finance Law (in conjunction with the Credit Law Institute) conducted its annual program on Consumer Credit 2007 in Dallas on November 8–9, 2007. Years ago your author gave up writing articles to summarize these events,[1] 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*;[2] the difference is that each issue of the *Quarterly Report* focuses on selected areas of interest--in contrast, the annual Consumer Credit programs try to cover them all, in a single program and book with roughly twenty hours of presentations in two days.[3]

To cover all of these issues at a program is a mammoth undertaking and the experience tends to be overwhelming, 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 experience of anyone trying to develop or maintain an expertise in this area of law. A 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 plaintiffs' lawyers face some of the same problems, though with the luxury of being able to focus on individual litigation issues.

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 cummulative 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 (along with a bias in favor of bad laws[4]), and it is getting worse rather than better.[5]

1. The last being Alvin C. Harrell, *Consumer Credit 1997*, 52 Consumer Fin. L. Q. Rep. 104 (1998); and Alvin C. Harrell, *Subprime Lending Developments with Implications for Creditors and Consumers*, *id.*, at 238. An exception is the biannual conference on Teaching Consumer Law sponsored by the University of Houston School of Law, which has a more cohesive scope and is therefore more manageable to describe. *See, e.g.*, Alvin C. Harrell, *Teaching Consumer Law, Part Three*, 10 J. of Consumer & Comm. L. 46 (2007) (latest of three installments in a series describing the issues covered at the Houston program). OK, to be accurate, another exception was a report on the 2004 Chapman University Law Review Symposium on "Responsibility and Reform: Striking a Balance in the Marketplace." But again that program was limited to (four) discrete topics that made the report manageable. *See* Alvin C. Harrell and Kurt Eggert, *Chapman University Presents Consumer Law Symposium on Responsibility and Reform*, 58 Consumer Fin. L. Q. Rep. 214 (2004). Similarly, a report on the Oklahoma City University program commemorating the Twentieth Anniversary of the Penn Square Bank failure was narrowly focused, and therefore not comparable to something like Consumer Credit 2007. *See* Alvin C. Harrell, *Conference Joins Oklahoma City University School of Law in Examining Historic Bank Failure*, 57 Consumer Fin. L.Q. Rep. 75 (2003).

2. Another example is the *Annual Survey of Consumer Financial Services Law. See e.g.*, *Survey*, *Consumer Financial Services*, 62 Bus. Law. 553 (2007).

3. Consumer Credit 2008 is scheduled for November 6–7, 2008 at the Westin Galleria in Dallas, Texas.

4. As ably explained by an Associate Professor of Economics at George Mason University in: Bryan Caplan, *Special Interest Secret*, Wall Str. J., May 12, 2007, at A11 ("The real mystery is why bad policy isn't more popular than it is," given the political dynamics noted in the article). *See also* the same author's book, BRYAN CAPLAN, WHY DEMOCRACIES CHOOSE BAD POLICIES (Princeton Univ. Press 2007).

5. The promulgation and enactment of the Uniform Commercial Code (UCC) in the mid-Twentieth Century is a notable exception to this observation, and one that has greatly contributed to the economic prosperity of the past fifty years. But almost

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So it has become impractical to describe in one short article the numerous issues and developments covered at a program like Consumer Credit 2007. Nonetheless, in contrast to some prior years, it would be fair to say that one set of issues dominated the program in 2007. It was not the usual legal developments (litigation, regulatory developments, state legislation, federal preemption, predatory lending, security interests, data security and privacy, etc.), although these and other issues were discussed extensively and play major roles in the overriding theme. Despite the importance of these issues and developments, the overriding issue at Consumer Credit 2007 was what one attendee called the "perfect storm" of legal, political, and economic factors that have coalesced to threaten the private mortgage finance system. The legal issues discussed at Consumer Credit 2007, and even the "subprime credit meltdown" so widely noted in the media, are a part of this "storm," but, as with the complexity of our law, even an extensive knowledge of these piecemeal issues does not provide the full story.

II. Subprime Meltdown--The Thrift Crisis Redux?

One of the participants at Consumer Credit 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 discomforting. In contrast, your author's perspective has a longer time frame--perhaps one of the few advantages of getting older. Since your author began working in the consumer credit field (as a young teenager, one hastens to add) in 1960, there have been many credit cycles and credit "crunches," each time involving a collapse of collateral values (particularly residential real estate, which is highly sensitive to credit conditions and prone to spasms of speculation and overbuilding when credit is "easy," which leads to periodic boom-and-bust cycles).[6] Sometimes there were two of even three such cycles in a decade, *e.g.*, the 1960s.

Many of these cycles have been accompanied by hysterical and misleading media attention. I still remember my first time--hearing media commentators blame the "Kennedy recession" of the early 1960s on the greed of bankers who had raised interest rates (with nary a word about the effects of monetary policy, inflation, tax rates, or currency flows). And who could forget President Kennedy's "jaw-boning" threats against the steel industry, for raising prices and allegedly causing inflation. Subsequently, the purportedly powerful big steel companies all went broke--how inconvenient for today's media commentators (ah, but there is still the oil industry).

Of course, the granddaddy of all recent credit cycles and media meltdowns was the federal deposit insurance crisis of the late 1980s. The losses were huge, but the causes were fairly simple. In the 1930s Congress mandated a business plan for the thrift industry (borrow short and lend long, at fixed rates, or else). This was a prescription for disaster when interest rates spiked three times in rapid succession beginning in the 1970s, as the Federal Reserve Board (FRB) fought to reverse a severe inflationary spiral. Thrifts with fixed-rate loan portfolios yielding around five or six percent were suddenly paying seventeen percent or more for their deposits--it is hard to make that up on the volume.

Federal thrift regulators did their part to compound the problems, by continually waiving or reducing capital requirements as thrifts careened toward insolvency, sometimes creating fictitious "regulatory capital" accounts, and then encouraging thrifts to further reduce their capital ratios by "growing out of their problems" and diversifying into commercial real estate.[7] A huge swath of the industry went down (in some states the disaster engulfed virtually the entire thrift industry and spread to roughly half of the banks), and the victims included the 1930s-era model of a narrowly-focused thrift industry limited by law to long-term fixed-rate mortgage loans. Most of the surviving thrifts were merged into a small number of large interstate institutions that bear little resemblance to their locally-focused predecessors.

Somehow the popular media missed these clues to the cause of the "thrift crisis," instead focusing on the antics of a handful of thrift "kingpins" and then casually presenting them as the face of the entire industry and the cause of the crash.[8] Many good and innocent people (including borrowers, lawyers, and financial services executives) were ruined in the ensuing media and regulatory jihad against "crooks in the industry," but the public ate it up. The media seemed eager to turn the public into a kind of angry mob, and apparently some people enjoy having a common villain to serve as a target for popular ire and blame. In the case of the thrift crisis, "S&L kingpins" served this role better than the real culprit: fifty years of Congressional mismanagement of thrift industry law, and the actuarial realities of a deposit insurance system.

So, the media and political demagoguery with respect to the 2007 subprime

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from its beginning the relative clarity, simplicity, and uniformity of the UCC was undermined by case decisions and other laws, a problem that is ever-present (and continues today). The difficulties regularly faced by the National Conference of Commissioners on Uniform State Laws (NCCUSL), seemingly the only rational law-making body in the universe, are merely one manifestation of the threat to reason in the law. While the challenges have never been easy, it may well be that the Twentieth Century will come to be viewed as a high water mark for both the uniform law process and a rational rule of law in commercial and consumer transactions.

6. Some analyses of the current credit crisis have noted that it has its genesis in "long-accepted beliefs" that underlie a "prevailing logic: The value of the American home would never fall nationwide, and people would almost always make their mortgage payments." Greg Ip, Mark Whitehouse & Aaron Luccheti, *U.S. Mortgage Crisis Rivals S&L Meltdown*, Wall Str. J., Dec. 10, 2007, at A1. If investors believed this, one wonders what planet they have inhabited over the past 30 years; or, as a colleague opined when this language was brought to her attention: "Apparanently this means that all investment managers are 15 years of age or younger" *See also* Shawn Tully, *Wall Street's Money Machine Breaks Down*, Fortune, Nov. 26, 2007, at 65 (with a cover headline reading: "What were they smoking?").

7. *See, e.g.*, EDWARD J. KANE, THE S&L INSURANCE MESS—HOW DID IT HAPPEN? Ch. 2 (Urban Inst. Press 1989); JAMES R. BARTH, THE GREAT SAVINGS AND LOAN DEBACLE 48-65 (Univ. Press of America 1991); Symposium: *Penn Square Bank-20 Years Later*, 27 Okla. City Univ. L. Rev. 945 (2002); Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 Okla. City Univ. L. Rev. 179, 184-213 (1993).

8. *See, e.g.*, Harrell, *supra* note 7, at 206-213.

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.[9] But, as before, the popular media and politicians are getting it all wrong, with adverse consequences for a number of innocent parties. There is probably no hope 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 deposit insurance 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&L kingpins" and "crooks" in the financial industry, and Congress responded with punitive legislation such as FIRREA.[10] This response, together with high and volatile interest rates, income tax increases that adversely affected real estate investments and collateral values, and fiercely aggressive regulatory enforcement policies, drove many banks and thrifts out of business or into mergers. There followed a vicious cycle of banking failures and consolidations, impaired collateral values, and constrained credit availability, *i.e.*, a "credit crunch." Many predicted that a lack of credit availability for low- and moderate-income consumers would be the next "big thing," and much federal effort was directed at addressing this emerging new problem.

It didn't happen. Instead, after a severe credit crunch in the late 1980s and early 1990s as the banking system contracted, by the mid-1990s subprime consumer credit had begun to blossom, despite the dramatic decline of traditional bank and thrift lending. The reason was primarily the result of two factors--one old and one new. The old factor was FRB monetary policy. The FRB, which put fighting inflation well ahead of saving the thrift industry on its list of priorities in the 1980s, reversed course when the commercial banking industry was threatened. Obviously the health of the banking industry (and particularly the large banks that are regarded as "too big to fail," or TBTF) is of great significance to the U.S. economy (and a direct regulatory responsibility of the FRB). Remembering what happened to the Federal Home Loan Bank Board (FHLBB) when large thrifts began to fail,[11] one can only shudder at the potential fate of the FRB if our large banks start to go down. It is quite possible that the independence of monetary policy in the United States is at risk. As a result, TBTF appears to have been enshrined as national policy of the highest order, and perhaps even a paramount objective in the conduct of monetary policy.

One consequence was the beginning, in the early 1990s, of a fifteen-year cycle of ever-more-accommodative FRB monetary policy. Every subsequent economic crisis resulted in a renewed monetary expansion to address the crisis, which in turn has created pressures for the next crisis, repeating the cycle again and again, each time with a greater monetary expansion. First the FRB saved the banking industry from the fate of the thrifts and addressed the early 1990s credit crunch; then it was the crisis caused by the bursting of the dot.com bubble; then Y2K; the September 11, 2001 terrorist attacks; the Asian currency crisis, etc. Along the way were private equity and hedge fund crises, Japanese banking problems, the Russian debt crisis, unemployment worries and threats of recession, and of course the election cycle. The FRB got us through all of this, but in the process created a fifteen-year credit and housing bubble that was very likely to deflate, painfully, at some point. In 2007, it did.[12]

But along with monetary policy, there was another, relatively new factor that contributed to this cycle: Securitization. With the traditional thrift model gone, and banks both consolidating and retrenching as to the subprime market, the early 1990's predictions of a subprime credit crunch seemed safe. But when the FRB began pushing down interest rates, and the reduction in banking competition left many borrowers "unbanked" and many savings depositors dissatisfied with the yield on bank deposits, mortgage-backed securities offered an attractive alternative. This was capitalism and contract law at their best, filling a need left open as a result of restrictive regulation. There followed an enormous influx of money, from all over the world (as the FRB "exported" its monetary expansion), seeking U.S. mortgage-backed securities, which were regarded as safe

9. *See, e.g.*, Ip, Whitehouse & Lucchetti, *supra* note 6 (comparing various financial crises); and discussion below.

10. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989. *See, e.g.*, Barth, *supra* note 7, Ch. 5; Harrell, *supra* note 7, 213-226; Robert L. Lofts, Donald J. Querio, and Mark C. Jenson, *Financial Institutions Receivership Before and After the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 Consumer Fin. L.Q. Rep. 158 (1991); Ronald W. Stevens, Robert A. Wittie, and Mary Frances Monroe, *The Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990--A Further Expansion of FIRREA's Regulatory Enforcement Authority*, *id.* at 181; Symposium: *Banking Law 1990: FIRREA and Other Banking Developments, Part I*, 44 Consumer Fin. L.Q. Rep. 74 (1990); *id.* Part II, *id.* at 150.

11. The FHLBB no longer exists as such, though its functions live on in the Office of Thrift Supervision (OTS). *See supra* note 10.

12. It is terribly unfair the way the media portrays these issues. It is no wonder the public is so misinformed. Recently your author happened to watch a network television program (almost always a mistake) about Countrywide Mortgage and the housing/credit crisis. The "news" reporter interviewed one person--a disgruntled former Countrywide employee who was fired shortly before the big 2007 layoffs. The former employee revealed that she was "not surprised" by the mortgage crash, given the "lax" lending standards that previously prevailed. Well, of course, after a financial bubble has burst everyone can see that the prices were too high, the lending standards too generous, etc. If we are to have subprime loans to low- and moderate-income borrowers, some will go bad when the market crashes. The former Countrywide employee was treated as though she was revealing an industry secret: that mortgage lenders knew in advance that the markets would crumble and these loans would go bad. It was essentially the S&L "crooks in the industry" pitch all over again. The focus then shifted to Countrywide's founder and CEO, who was said to be under SEC investigation because he sold some of his shares when the market was booming, as his retirement approached. A rational person might think that this is a normal, prudent investment practice, but again it strongly was inferred to be evidence of wrongdoing. Why can't the media consider alternative explanations?

As with the thrift industry crisis of the 1980s, one might come away from this kind of "news" segment with the impression that the mortgage industry is full of crooks who have caused nothing but problems and should be in jail. The relation to economic freedom, credit availability, and the causes of boom-bust cycles, are not mentioned. The apparent purpose of this kind of media exercise is to support massive new federal intervention in the mortgage markets. The above-noted program was presented as investigative news reporting, but made no effort to be fair or accurate. It was one-sided political propaganda, plain and simple, in the guise of objective news reporting. Then again, that is not new, either. *See, e.g.*, Harrell *supra* note 7.

given U.S. real estate values and our traditional contract-based rule of law.

This money poured into the subprime housing market, which offered credit to those who otherwise couldn't get it, and provided attractive yields to investors with the apparent security of real estate and the dispersion of risk provided by securitization.[13] This drove up real estate values and enabled unprecedented numbers of subprime borrowers to become homeowners. It also sucked into the U.S. economy massive home-related imports, supporting a world-wide economic boom, with the proceeds often recycled again into U.S. securities. It was quite a party, while it lasted.

Unfortunately, it didn't, and probably couldn't, at least not without an inevitable adjustment period. It is the nature of cycles that they have a downside as well as an upside. The only questions are when the downsides will occur, for how much, and for how long. With interest rates at unsustainably low levels through-out 2001–2004 and even much of 2005, real estate prices bid to stratospheric levels in many areas, new construction outstripping demand, and the dollar in decline, it was inevitable that the markets would adjust. All it took as a trigger were some modest upward interest rate movements in 2005–2006; soon afterward, it became apparent that the party was over, at least for the time being, and the focus shifted to the likely policy responses (and how damaging they would be). The likely answer: plenty. Home buyers, banks, and investors began to retrench. Housing prices softened, defaults increased, and the cycle began to reverse; institutions that depended on generous investment flows, booming residential housing values, and large loan origination volumes began to suffer seriously.

A related factor should be noted. As the use of securitizations spread in consumer finance, and subprime credit began expanding in the 1990s, consumer advocates began to complain that too much subprime credit was available, to the wrong people, and on the wrong terms. State legislatures and federal banking regulators responded with measures designed to reduce the availability of subprime credit, *e.g.*, by cracking down on "predatory lending." As subprime lending and securitizations continually expanded over the subsequent fifteen years, so did these efforts, creating a companion cycle of new restrictions on subprime lending that increased more-or-less in tandem with the expansion of subprime credit. These cycles were mutually contradictory, and sooner or later were bound to collide.

Securitization (and FRB money policy) diffused the risk and lowered borrowers' interest rates, while increasing the availability of credit, encouraging an expansion of subprime credit at the same time that new laws and regulations were seeking to constrain it. This created an increasing tension between the law and the markets, a contradiction that could not continue indefinitely without a market adjustment. The market for mortgage-backed securities is based on the economic and legal viability of mortgage lending contracts; an ever- increasing tide of measures designed to restrict or impair those contracts will eventually intrude into investor sentiment and risk-premium calculations, despite the dispersion of risk promised by securitization. A surge of anti-subprime credit laws and regulations in 2006 and 2007[14] came just as the other negative factors noted above began to overwhelm the housing, credit, and securitization markets, thereby reinforcing the downward trend. The law of unintended consequences prevailed again; the mass of new laws and regulations purporting to protect consumers has instead compounded the market decline and precluded many consumers from refinancing their loans and saving (or selling) their homes.

By late summer, 2007 the resulting credit crunch was in full swing. With home mortgage finance dependent on world-wide investment flows, factors such as increased investor unease about the safety and value of mortgage-backed securities, concerns about the enforcement of mortgage contracts (including worries about the impact of various state and federal policy initiatives), and the declining value of the dollar coalesced to impair the supply of mortgage credit. The secondary market for these loans largely dried up in the summer of 2007, and the worries (including concerns about the economic ripple effects) soon spread to the commercial paper markets and infected initial public offerings as well. At this writing these markets remain significantly frozen, and FRB efforts to loosen them by reducing interest rates and pumping up the money supply have resulted mostly in a further collapse of the dollar in international currency markets. The FRB is faced with its own "perfect storm": A credit crunch that imperils the financial markets and threatens a recession (and large, TBTF financial institutions), in conjunction with a declining dollar (partly a cumulative result of prior economic rescue efforts) that threatens an international currency crisis and ultimately may limit FRB discretion regarding monetary policy.[15]

13. This was a new kind of "disintermediation," in which investors bypassed traditional financial intermediaries like banks and thrifts, to invest directly in mortgage loans through securitization. *See, e.g.*, Land, *infra* note 35. Unfortunately, one downside of disintermediation is that investors, while earning higher returns, are assuming the credit risks otherwise shouldered by financial intermediaries. In retrospect, these investors underpriced their risk premium--they loaned money too cheaply to compensate for the legal and economic risks. In 2007, many securitization investors suddenly discovered this error.

Another downside of disintermediation is that it reduces the role of central bank monetary policy, as the latter depends on the authority to regulate financial intermediaries and any diminution in the role of those intermediaries necessarily reduces the effects of that regulation. Former FRB Chairman Alan Greenspan has emphasized something like this point, in disclaiming responsibility for the mortgage crisis. *See, e.g.*, Alan Greenspan, *The Roots of the Mortgage Crisis*, Wall Str. J., Dec. 12, 2007, at A19 (arguing that world-wide savings flows generated by the spread of capitalism and increased prosperity led to a global asset bubble that naturally affected U.S. housing and credit markets: "[Such] bubbles cannot be safely defused by monetary policy or other policy initiatives before the speculative fever breaks on its own. There was clearly little the world's central banks could do to temper this most recent surge in human euphoria…."). So much for the popular perception that the FRB can save us from every investment error. On the other hand, former chairman Greenspan also conceded that FRB policy reducing interest rates below 1% may have played some role in creating the bubble: "We will never know whether the temporary 1% federal-funds rate fended off a deflationary crisis….I did fret that maintaining rates too low for too long was problematic." *Id.* For a less charitable view of the role of the FRB, *see* William A. Fleckenstein with Frederick Sheehan, Greenspan's Bubbles (McGraw Hill 2008).

14. *See* any issue of this journal over the past two years for numerous examples.

15. *See, e.g.*, Ethan Penner, *Capital Flight and Other Policy Risks*, Wall Str. J., Nov. 17-18, 2007, at A11.

IV. So, What Next?

With waves of home mortgage foreclosures in the news, in the aftermath of an extended credit bubble (circa 1992–2006), Congress, the administration, and the financial regulators have been under intense pressure to "do something." Federal banking regulators, perhaps shutting the barn door after the horse was already far away, clamped down on subprime mortgage lending in 2006 and 2007,[16] reinforcing new state anti-credit laws (just in time to impede subprime borrowers who needed to refinance their adjustable rate mortgage loans before loan rates spiked).

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.[17] Some of the new laws designed to protect consumers from foreclosure "rescue" schemes also have had the effect of shutting off legitimate alternatives to foreclosure.[18] Public anger over a major crisis is sometimes a prerequisite to legislative action, yet that is not the best atmosphere for deliberative action, particularly when laws are being made by those who do not understand the transactions they are regulating, 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.

At this writing, the award for the worst and most counterproductive legislative proposal goes to Representative Barney 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 speakers at Consumer Credit 2007 that even opponents had given up seeking 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).[19] At this writing there is hope that better judgment will prevail in the Senate, though to others this seems a long shot; barring that, the only impediment to a likely financial disaster is a presidential veto.[20]

Why financial disaster? In a few words, without the benefit of space for a fuller explanation, HR 3915 would permanently shut down much of the mortgage loan origination and funding system that has provided mortgage credit to consumers over the past fifteen years. It is apparent that many existing mortgage brokers are unable to meet the capital, licensing, and compliance/legal documentation requirements in HR 3915, cutting off this source of mortgage credit. These requirements will also force more lenders out of the business, and prevent new competitors from entering it. While others (including some depository institutions and portfolio lenders) think this will benefit them, the impact on the credit and housing markets will be adverse, and this will hurt all mortgage creditors.

Moreover, it is likely that depository institutions increasingly will restrict their lending to prime credit borrowers due to the new lender liability rules (such as the borrower's "best interest" and "ability to repay" standards in HR 3915), which are seemingly designed to provide plaintiffs' lawyers an ever-ready reason to sue or contest foreclosure.[21] Investors have concerns about the prospects for new federal assignee liability rules, assuming there are sufficient volumes of new subprime loans to securitize after many mortgage brokers and originators exit the business.

Clearly the credit markets will shrink and become far more concentrated if HR 3915 becomes law. In effect, the credit crunch will become permanent for many. One speaker at Consumer Credit 2007 opined that if HR 3915 is enacted thousands of mortgage brokers, mortgage banks, lenders, and other mortgage loan originators will be consolidated into twenty or thirty mortgage lenders serving the entire market nationwide. This is the model followed in other countries with centralized financial structures--just take a look around either north or south of our borders (or east and west, for that matter). It is apparently an inherent tendency of centralized political and administrative authorities to encourage consolidation of market participants into a small number of large enterprises (which then work closely with the central authorities, often via "revolving door" or similar arrangements). This is the European model of a comprehensive administrative state, as contrasted to the traditional

16. *See, e.g.*, Symposium: *Regulation of Subprime and Nontraditional Mortgage Loans and Related Issues*, 61 Consumer Fin. L.Q. Rep. 154 (2007).

17. *See id.*, and *supra* note 14.

18. As bad is the problem of "foreclosure rescue" scams is, some solutions are worse. *See, e.g.*, Anna-Katrina Christakis. *Consumer Legislation, Regulation and Litigation Update*, 61 Consumer Fin. L.Q. Rep. 4, 10-11 (2007). The drumbeat for such laws continues in the media, despite the obvious counterproductive effects. *See, e.g.*, Noel Know, *Con Artists Circle Over Homeowners on the Edge*, USA Today, Nov. 9, 2007, at 1B (describing the plight of homeowners facing foreclosure and suggesting that a new wave of laws prohibiting "foreclosure rescue" is the answer).

19. *See, e.g.*, Damian Paletta and James R. Hagerty, *House Passes Bill Curbing Mortgage Brokers*, Wall Str. J., Nov. 16, 2007 at A2. At this writing senior officials at the American Bankers Association (ABA) have opined that "[t]he bill isn't all bad," because it imposes more regulation on mortgage brokers and this may lead more borrowers to rely on federally-regulated depository institutions. *See* Ed Yingling, ABA President, and Diane Casey-Landry, ACB (America's Community Bankers) President, CEO Alert, "Subprime Legislation," Nov. 28, 2007. Sixty-four House Republicans voted for HR 3915, including Alabama's Spencer Bachus (ranking Republican on the House Financial Services Committee). *See, e.g.*, '*Predatory Politics*,' *infra* note 21.

20. The Bush administration proposals to help selected subprime homeowners probably are directed in part at heading off more counterproductive proposals like HR 3915. *See, e.g.*, Henry M. Paulson, Jr., *Our Plan to Help Homeowners*, Wall Str. J., Dec. 7, 2007 at A17. *Cf.* Jesse Jackson, *A Marshall Plan for Mortgages*, *id.*, at A16. *See also* Brian S. Wesbury, *Let's Not Panic and Ruin the World*, *id.*, at A17. *See generally* Michael M. Phillips, Serena Ng and John M. McKinnon, *Battle Lines Form Over Mortgage Plan*, *id.*, at A1; Damian Paletta, Amy Chozick and John D. McKinnon, *Bush to Unveil Aid to Homeowners*, Wall Str. J., Dec. 6, 2007, at A3; Andy Laperriere, *No Bailouts for Borrowers*, Wall Str. J., Dec. 4, 2007, at A21.

As this issue went to press, Treasury Secretary Paulson proposed sweeping revisions to the financial system, seeming endorsing aspects of HR 3915 that would substantially increase the role of federal regulation in the mortgage markets, yet simultaneously (and somewhat disingenuously, it would seem) warning against the dangers of over-regulation. *See, e.g.*, David Ellis, CNNMoney.com staff writer, "Paulson Offers Sweeping Rule Changes," http://money.cnn/2008/03/31/news/economy/paulson_regulation/index.htm?cnn=yes (Mar. 31, 2008); Damian Paletta, Greg Ip and Michael M. Phillips, *Paulson Plan Begins Battle Over How to Police Market*, Wall Str. J., Mar. 31, 2008, at A1; Damian Paletta and Elizabeth Williamson, *Paulson Plan Gets Blasted by Lobbyists and States*, Wall Str. J., April 1, 2008, at A1.

21. *See, e.g.*, Review and Outlook, '*Predatory' Politics*. Wall Str. J., Nov. 27, 2007 at A 18; Bennet S. Koren, *Suitability and HOEPA*. 61 Consumer Fin. L.Q. Rep. 201 (2007).

and more decentralized U.S. model based on common law principles and private judicial remedies within a federal republic. This change is apparently an inevitable consequence whenever an area of law is transferred from state to federal law. But this is not a cure for the credit crunch, it is a codification of it. Whether this is in the public interest and favors consumers is an important question, but one that seems to be of little interest to the media or even in academic journals.

HR 3915 represents a major step in this direction. Its proposed rules requiring federal licensing and registration of mortgage brokers and originators is an obvious example, reflecting a dramatic departure from our traditions of state contract, corporation, and real property law. The scraps thrown to state authorities (allowing them, in some instances, to administer parts of the federal system) do not obscure the impact of this change. Likewise, the federalization of loan underwriting standards in HR 3915 means that loan terms and eligibility will no longer be determined by the states or the parties to the transaction. This is a fundamental departure from our traditional system of state contract and consumer protection law, party autonomy, and diverse and decentralized loan underwriting processes.

There can be little doubt that large numbers of existing mortgage brokers and loan originators will view this new regulatory environment as untenable, resulting in a massive restructuring of the mortgage finance system and a more concentrated mortgage finance industry. And that is before one even considers the impact on creditor liability and credit availability from the codification of various "suitability" and other quasi-fiduciary duties for mortgage lenders.[22] These obviously will be a boon for trial lawyers,[23] at least in the short term, though one wonders whether plaintiff's lawyers have fully considered the implications of the movement away from a decentralized state law, and private litigation environment to a federal administrative system that is likely to carefully guard a small number of large (and influential) creditor institutions.

The result of consolidating thousands of independent mortgage brokers and loan originators into a centralized federal administrative structure can only be a permanent reduction in the availability of private subprime mortgage credit and traditional private remedies. The last time we saw something even hinting at this was when the traditional thrift industry was dismantled in the late 1980s.[24] The result was a severe credit crunch, with widespread and painful economic dislocations, that ended only when the securitization model emerged and became prevalent a few years later. Now, the latter model is under attack. Perhaps some members of Congress would not mind a 2008 repeat of the late 1980s, but surely there is hope that others in Congress and the administration will recognize the economic dangers posed by a solution like HR 3915. If it can be stopped in 2008, it will then be up to a new administration to decide whether it wants an extended nationwide mortgage credit crunch to be a hallmark of its first years in office.

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.[25] The housing market is suffering a nationwide decline, exacerbated by overbuilding in some markets, the end of a fifteen-year credit bubble facilitated by FRB monetary policy, and public policies that are cutting off the supply of subprime credit. This time the FRB is limited in its response by the falling dollar. As noted, the FRB is suffering its own perfect storm.[26]

As also noted above, throughout most of the recent credit bubble, beginning in the mid-1990s, some states and federal regulators responded to consumer advocacy concerns about too much credit being available by chipping away at the 1980's deregulation of credit markets. The expansion of HOEPA, various bank regulatory guidances, and new state anti-predatory lending laws are primary examples.[27] These policy responses imposed new constraints on the availability of subprime credit, but until 2006–2007 this effect was overwhelmed by extraordinarily accommodative monetary policy and the apparent effectiveness of securitization in diffusing these risks. When the FRB began raising interest rates in 2005–2006, simultaneously with a new wave of federal and state initiatives making it even more difficult for subprime borrowers to buy a home, refinance or otherwise avoid foreclosure,[28] defaults spread and the housing market faltered, investors suddenly awoke to the enhanced risks of U.S. mortgage lending, and a rush to the exits ensued. Recent federal legislative proposals to impose additional costs and risks on mortgage lenders and investors probably have frightened the markets further and made matters even worse.[29]

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

22. *See id.*

23. *See, e.g.*, *id.*; *see also* Stuart M. Soft, *The Anti-Mortgage Lending Act*, Wall Str. J. Nov. 10-11, 2007, at A10.

24. *See supra* this text Parts II. and III., and notes 7-10.

25. *See, e.g.*, *supra* note 20; Peter Grant, *Commercial Property Now Under Pressure*, Wall Str. J., Nov. 19, 2007, at A2; James R. Hagerty, *Fannie, Freddie Feel Default Heat*, *id.*, at A14 (noting the spreading impact of the credit crunch); Michael Mandel, *The Consumer Crunch*, Bus. Wk., Nov. 26, 2007, at 057.

26. *See id.*, and this text *supra* at note 15.

27. *See, e.g.*, David Smith, *High Cost Mortgages: The New Lender Liability*, 61 Consumer Fin. L.Q. Rep. 190 (2007); David Smith and Gregg Stevens, *The Impact of TILA on the Debtor-Creditor Relationship*, *id.* at 296. *See also supra* this text at notes 16-18.

28. *Id.*

29. *See supra* this text at notes 19-24. In some states, such as your author's State of Oklahoma, state immigration legislation has worsened matters by driving away undocumented workers (or forcing them into the "underground" economy), thereby creating additional economic problems that include reduced demand in the housing market. *See, e.g.*, Oklahoma HB 1804; Vince Orza, *Find Solutions for Good Problem*, Oklahoman, Dec. 8, 2007, at 13A; Michael McNutt, *Arguments Heat Up Over New Immigration Law*, Oklahoman, Dec. 7, 2007 at 8A.

misguided policy responses will make permanent (or at least extend) an otherwise cyclical downturn. It has happened before, most recently in the late 1980s and early 1990s, when threats to the solvency of the federal deposit insurance funds led to responses that crippled the traditional mortgage finance system and caused real estate prices to crash.[30] But that response was focused in large measure on federal banking law and regulatory policy, and within a few years that federal policy was largely reversed, to a stance favoring credit expansion. State predatory lending laws were unknown, mortgage lending was governed largely by traditional state laws, and the technology revolution together with our state common law system facilitated a boom in securitizations that quickly compensated for the impairment of traditional portfolio lenders.

So, the credit markets have crashed before but, even with a policy response that largely destroyed the existing suppliers of mortgage credit, the markets recovered within a few years under a replacement financial system that fueled more growth than ever. But that replacement system depended on the foundation of state common law.[31] What is different this time is the threat to supercede the underlying state law system that has provided the foundation for each successive resurgence of private mortgage credit.

Thus, neither the 1990's time frame nor that rosy scenario is guaranteed. The experience following the crash of 1929 was far less pleasing, with recovery taking roughly twenty years, and requiring the economic pressures of a world war to dismantle federal restrictions, along with monumental legal reforms such as the UCC. One cannot count on such pressures or reforms, or another technology revolution such as that in the 1990s (and hopefully not the demands of another world war) to bail us out again this time. In history, economic recoveries from public policy disasters are neither inevitable nor reliable. So, this crisis represents a window of longer-term risk, and a potential turning point for American public policy, the legal profession, the consumer, the states, and the entire economy.

For those of us who have observed firsthand the close connections between consumer protection law, credit conditions, and economic prosperity, it may come as a surprise that not everyone appreciates the implications of this relationship, and hence the risks of well-intentioned but misguided public policy. It may even appear to some that public policy and the law can protect consumers by broadly restricting their access to credit, so as to preclude sub-optimal private decisions, without serious adverse consequences for consumers and the economy. No doubt this view is reinforced by the foolish human behavior that we witness nearly every day (which may give rise to a natural urge to "help" others avoid such behavior, by guiding their decisions).

The latter perspective has an important place in our legal scheme of things, and is essential as a counterpoint to help correct the consequences of human error, but it is a view far too narrow to serve as the sole basis for macroeconomic policy or comprehensive legal reform. As former Harvard Professor Thomas K. McCraw noted, the "reason why capitalism arrived so late, only 300 years ago, was a long-standing aversion to credit."[32] That aversion is with us today and has its place, but it can be easily carried too far, even (or perhaps most commonly) in our modern consumer-oriented society. A purely expedient response to the current credit crisis, based on a desire to prevent future credit bubbles by reducing access to subprime credit, will risk a reversal of the positive trends that have facilitated improvements in U.S. living conditions for the past 250 years. Those who want to prevent credit bubbles would do better to look to monetary policy, rather than constraining party autonomy. Otherwise, it is clearly within the power of U.S. policy makers to turn this cyclical credit downturn into a permanent state of affairs, with broad and adverse economic consequences.

VI. Federal Preemption?

Of course it is also possible that policy makers may respond with solutions that do not impede, 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 onerous and nonuniform state legislation. There can be little doubt that such preemption was essential to development of the modern credit card industry, or that the increased role of nationwide mortgage lenders and securitization markets cries out for increased uniformity. At any gathering of credit industry representatives, federal preemption is likely to be treated as the holy grail of policy objectives (and a goal that now seems attainable). For many, the inclusion of broad federal preemption of state law in HR 3915 would make that bill not only palatable, but desirable, no matter what the other implications might be.[33]

Nonetheless, at the Consumer Credit 2007 program there was an understandable ambiguity on the issue of prospective federal legislation. Perhaps among consumer credit lawyers there is a greater understanding of the risks represented by this approach. Of course, the attendees who view HR 3915 as the means to achieve national uniformity through federal preemption were far more favorable and optimistic regarding the proposal, generally conceding the need to accept more federal regulation in order to achieve that goal. Others,

30. In Oklahoma, virtually the entire thrift industry was wiped out, and roughly half of the banks failed. Housing prices fell by 90% in some areas. *See, e.g., supra* notes 7-10 and accompanying text.

31. *See infra* this text and note 35.

32. Thomas K. McCraw, On My Mind, *Just Trust Us*, Forbes, Nov. 12, 2007 at 32. He notes that in the 1790s the U.S. had only three banks; by the 1890s there were 12,000. *Id.* Obviously, the economic consequences were significant.

33. *See, e.g., 'Predatory Politics,' supra* note 21 (noting that 64 house Republicans voted for HR 3915, and that it was actively supported by Alabama Representative Spencer Bachus, ranking Republican member of the House Financial Services Committee, apparently in part because it offers a means to preempt state law).

perhaps reflecting the perspective of the independent mortgage brokers and originators who will not survive in a federal regulatory system, were less sanguine.

No one disagreed when one speaker opined that we are headed toward a European-style centralized administrative state closely supervising a small number of large mortgage providers. Another speaker reported that HR 3915 generally suits the needs of the Wall Street firms that securitize mortgages, imposing as it does most of its burdens on originators. The resulting correlation of interests between consumer groups, federal regulators, large financial institutions, and Wall Street securities firms was evident, and was regarded by several of the program speakers as a politically unstoppable combination.

There was, however, also a recognition that others will be adversely affected by the move from a state-based private law system to a federal administrative structure. The small, independent mortgage brokers and originators who cannot adapt to the compliance-intensive legal environment of a federal regulatory structure are the most obvious example.[34] It should also be noted that the securitization model was effective in substituting for the failed thrift industry model, beginning in the early 1990s, partly because securitization is based on state common law principles[35] and therefore did not require the kind of federal regulatory approvals that will be required for innovation within a comprehensive regulatory structure. In essence, securitization (and the entire subprime credit boom) was possible because the state common law barriers to entry and innovation were very modest. Almost anyone with a computer, some knowledge of contract and mortgage law (or a good local lawyer), and a little capital could set up shop as a mortgage broker or even a mortgage banker. The current federal proposals are expressly designed to change this, *i.e.*, to restrict market entry to only the larger and better-capitalized market participants. No wonder the larger players are willing to pay this "price" in return for federal preemption. Regulation that reinforces the status quo for dominant players in the industry is always a popular political strategy; but innovation, competition, and customer service are the inevitable losers.

Other interests are also at risk. As noted, federalization of loan underwriting standards will mean a reduced role for decentralized, individual lending decisions.[36] The diversity, and diffusion, of separate loan underwriting standards being exercised independently by thousands of independent brokers, dealers, banks, finance companies, credit unions, mortgage bankers, etc., has been a hallmark of the U.S. financial and economic system for hundreds of years.[37] This has distinguished the nature of credit availability in the U.S. from the more restricted access that is common in the centralized financial systems of many other countries. Arguably this has been an essential element of American "exceptionalism" and economic opportunity.

Certainly our decentralized credit system, the result of an almost unique combination of state private law in a constitutionally-limited federal republic, and the economic lifestyle it represents, has been the envy of consumers world-wide for hundreds of years. It was inevitable that this would come under attack as the United States moves to a more centralized federal administrative state. The current federal legislative proposals explicitly seek to replace our decentralized, state-law system with federally-administered, nationally-uniform legal and loan underwriting standards. While this solves many problems for nationwide lenders, and suits the agendas of various advocacy groups, academics, federal regulators, and law firms, it is not clear that it is a pro-consumer development.

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 a federal administrative structure (again, on the European model). Local, small law firm practice likely will suffer as federal administrative processes increasingly replace private judicial remedies, although specialized regulatory counsel and other areas of practice (such as securities law) may thrive. Such a change will involve fundamental shifts in the role of the legal profession. Again it is not clear that this is a pro-consumer agenda. State administrative agencies also will suffer a reduced status and jurisdiction, though a new role as partial administrators of federal law and regulations may soften the economic blow in the short term. Still, the status of independent state agencies (and the legal profession and state courts) will not be the same.

Community banks, thrifts, and credit unions also may be victims, at least to the extent they traditionally extend subprime home mortgage loans. Some federal preemption of state law will extend to all lenders, costing federally-regulated institutions a current competitive advantage. The new federal underwriting restrictions on mortgage lending will apply to banking institutions, likely having a disproportionate impact on small institutions, and restraining the ability of local bankers to serve their customers on an individualized basis. Banks can easily meet the federal capital requirements, and (perhaps somewhat less easily) any new licensing requirements, and (subject to the new lending restrictions) can still originate prime mortgage loans for sale in the secondary market. But, as with state agencies, a bank administering federal loan underwriting criteria is not the same as a bank exercising independent judgment with regard to credit eligibility. This will undermine the traditional role of community banks, likely leading to further consolidation in the industry and reduced local discretion as to the availability and allocation of credit.

VII. Conclusion

So, here are the ingredients for a perfect credit storm: Too much state and

34. *See supra* this text at notes 20-22.

35. *See, e.g.*, Derrick M. Land, *Residential Mortgage Securitization and Consumer Welfare*, 61 Consumer Fin. L.Q. Rep. 208 (2007).

36. *See supra* this text at notes 20-22.

37. *See supra* note 32.

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,[38] and increased public subsidies may be demanded as a substitute for private funding.[39]

Having impaired 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.

38. Predictions of the future are obviously difficult, but this one seems safe. Of course, many of us who witnessed the decline of the thrift industry in the 1980s were inclined to predict that it meant the onset of a massive credit crunch in housing, and perhaps even a crippling blow to private mortgage finance. And it did, at least for awhile, until the early to mid-1990s when the securitization industry (and some tax reform) stepped in to give us a 15 year reprieve. Now it seems to be happening again, but this time state common law may not be there to provide an alternative solution.

39. *See, e.g.*, James R. Hagerty, *Mortgage Crisis Extends Its Reach*, Wall Str. J., Nov. 13, 2007, at A1 (noting the increased importance of federally-related housing lenders as private markets retrench). *But see* Grant, *supra* note 25 (noting that federally-supported lenders are not immune to private credit risks).

ASF Streamlined Foreclosure...

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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 chosen by the servicer should maximize the net present value of the recoveries to the securitization 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. Tax 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 a servicer generally could modify a loan if it is reasonably foreseeable that a non-delinquent 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) had not previously provided any guidance as to what the term "reasonably foreseeable" meant, 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 860A through 860G 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[15] 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 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. A "significant modification" is usually characterized as one in which the modification changes the yield by more than the *(Continued in next column)* *(Continued from previous column)* greater of 25 basis points or 5% of annual yield, or extends the maturity by the lesser of five years or 50% of the original term of the instrument.