Book Review: The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps

David J Reiss, Brooklyn Law School

Available at: https://works.bepress.com/david_reiss/43/
Book Review

by David Reiss
Brooklyn Law School

THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011)
By Kathleen Engel & Patricia McCoy

John Godfrey Saxe’s 19th century poem, “The Blind Men and the Elephant,” opens with six learned men

Who went to see the Elephant
(Though all of them were blind),
That each by observation
Might satisfy his mind.

The financial crisis is the Elephant of our time. Over the last couple of years, more than six wise men and women have written books purporting to explain the financial crisis and many more such books are surely in the works. Most of these wise ones suffer from the same limitations as the poem’s learned men. As each reaches out, he or she can only make out one small part of Our Elephant – maybe the rampant fraud at mortgage origination or the distortions of short term profit-seeking or the complexity of the CDO² – but go on to confidently opine on the essential nature of this beast. The SUBPRIME VIRUS is a cut above the books that have come before it because of its authors’ breadth of knowledge of financial institutions and consumer protection.

Engel and McCoy come to this project after many years of writing rigorous, data-driven scholarly articles on banking and consumer law topics. Indeed, their 2002 TEXAS LAW REVIEW article is widely considered to be the seminal article on the law and economics of predatory lending and the two of them have been mentors to many who came later to this field (including me). The book moves away from their scholarship a bit by revealing some of the frustrations
that they have suffered over the years as their scholarly work on the subprime sector was
dismissed by lending industry executives and government regulators who should have known
better. So in 2011 they are entitled, like Cassandra, to demand, “Hear me! Understand!” THE
SUBPRIME VIRUS is thus written as something of an indictment of many of the players who are
responsible for various aspects of the crisis. That being said, the authors remain committed, as
with their scholarly work, to a careful analysis of the facts before them.

The book is divided into four parts. The first part, “The Subprime Market Takes Off,”
provides an excellent, albeit brief introduction to the modern residential mortgage market as it
develops from the 1970s onward (see DAN IMMERGLUCK, FORECLOSED (2009) for a more
detailed and longer-term perspective). It traces the changes in the regulatory structure as well as
changes in the business of originating and servicing mortgages. It focuses on the growth of
predatory lending as well as just plain abusive practices that became rampant in the subprime
sector of the market.

At first blush, the second part, “Contagion,” provides a blow by blow of the crisis from late
2006 through late 2009 – a second draft of history. But this section is no mere rehash of the
headlines from THE NEW YORK TIMES and THE WALL STREET JOURNAL. While the authors do
recount the failures of Lehman Brothers and Bear Stearns and the extraordinary bailouts of AIG,
Fannie Mae and Freddie Mac and the banking system, they do so in a way that contextualizes the
extraordinarily difficult decisions that Presidents Bush and Obama, Federal Reserve Board Chair
Bernanke and Congressional leaders had to make as crisis piled on top of crisis. This part ably
documents how the serious problems in the subprime mortgage market were able to infect the
rest of the financial sector.
“Regulatory Failure,” the third part, builds on this history to provide an explanation of how the subprime boom (and inevitable bust) came about. The authors focus on the regulatory environment and lay blame for much of the crisis at the feet of George W. Bush-era financial institution regulators. They convincingly portray these regulators as ideologically pro-lender, captured and sometimes venal. They also convincingly portray Wall Street firms as highly adept at fighting off regulations that would interfere with their ability to profit and expand the size of their markets.

The last part, “Solutions,” contains a thorough review of the reforms implemented in the Dodd-Frank Act that deal with consumer protection on the one hand and systemic risk on the other. These authors are part of a small group of academics who take seriously the notion that those two issues are deeply related to each other, a view that I agree with. What is most striking to me about this part is that the authors were able to synthesize so many aspects of Dodd-Frank only a few months after that monstrously complex law was enacted. Like Dodd-Frank itself, the authors focus on the causes of the last crisis. I worry, however, that they, and Dodd-Frank for that matter, do not fully address what may cause the inevitable, next bubble. And I worry that some of the authors’ proposed solutions – such as better regulation – may ring a bit hollow when they have spent so much time discussing the systemic failures of banking regulators.

The book does have certain limitations. To start with, the book takes more of an advocacy position than many of the authors’ scholarly articles. Their frustrations and reform agenda are front and center -- but the authors’ sympathies are clearly set forth and they do not resort to caricature and simplification as do many who have written about this debacle. Unsurprisingly, McCoy has recently taken a high level position with the Consumer Financial
Protection Bureau, clearly hoping to implement many of the reforms discussed in The Subprime Virus.

As a result of this advocacy, the book suffers a bit from taking some shortcuts in a way that can undercut the reader’s trust. For instance, they write in amazement that “Eighty percent of securities backed by subprime mortgages were rated AAA, and 95 percent were rated A, AA or AAA.” (50) While this sounds like clear evidence of making a silk purse out of a sow’s ear, the authors do not contextualize this statement in a way that makes sense of how securities could be structured through overcollateralization and insurance to achieve such investment-grade ratings. While rating agencies did screw up royally, they had developed protocols that, if properly followed, could have legitimately led to such stellar ratings. Such passages make certain parts of the book more polemical than the vast majority of it.

Finally, the book does not engage much with alternative theories that have been proposed to explain the subprime crisis. Adam Levitin and Susan Wachter’s forthcoming article in the GEORGETOWN LAW REVIEW, Explaining the Housing Bubble (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401), is perhaps a better resource for understanding the range of explanations that have been set forth.

Saxe’s poem ends with a moral that applies with equal force to many of the pundits that have weighed in so confidently on the causes of our ongoing crisis:

The disputants, I ween,
Rail on in utter ignorance
Of what each other mean,
And prate about an Elephant
Not one of them has seen!

THE SUBPRIME VIRUS does not fall into this trap. It is an excellent book that begins to fill the gap between the scholarly literature about the subprime crisis and serious financial journalism. I
would say that the greatest value of the book is in how it links the local and global aspects of this crisis. I intend to rely on this book for my course on the mortgage markets. The book also lends itself to courses on financial regulation, consumer protection and real estate finance. It offers both a great overview and relevant detail that is exactly right in a classroom context. It also provides a coherent and reliable narrative for those of us who have followed the crisis closely – it helps to bring the forest into focus separate from the trees amongst which we toil.