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A Million Home Foreclosures: How Could it Happen?

Ask people to define the American Dream and you will hear phases such as "freedom, equal rights and equal opportunity," "a better life for my children," and "economic prosperity." When asked for an example of the dream, home ownership is often sighted. The Federal national Mortgage Corporation, Fannie Mae, the largest source of mortgage financing in the U.S. began its mission statement with: "At Fannie Mae, we're in the American Dream business. Our mission, our ultimate goal, is to help more families achieve home ownership."[1]

Why is homeownership so important? Historically, home ownership was tied to the right to vote. More recently, owning your home provides a broad array of financial and social benefits. The financial benefits stem from government policies that encourage homeownership. Property taxes and mortgage interest payments are deductable from personal income taxes providing a very tangible incentive to own rather than rent. Moreover, housing values appreciated steadily for more than two decades; you could "make money" while you slept. The equity that was built up in the value of a home could be tapped for cash to meet extraordinary expenses or temporary loss of income. Finally, the home was the retirement savings account for many Americans. When people retired, their house would be sold, they would receive another very generous tax avoidance, and they would live off the cash generated from the sale of the house.

Beyond these financial incentives, home owners also gained social benefits. Because your home is often one of your largest investments, there is a strong incentive to take responsibility for not only your own house but also for your neighborhood since locale is a primary determinant of housing value. The "involvement" behavior that results yields a range of positive social outcomes including impacts on children, health, and crime. With respect to children: "Research in this area has found large positive impacts of homeownership on educational outcomes, such as test scores and graduation rates, and social outcomes, such as teenage pregnancy."[2] Improved health outcomes are also correlated with homeownership. For example, home owners are more likely to remediate lead paint in the home than are renters. Even political participation is linked to home ownership. Substantially more homeowners vote than do renters. One study found that

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[1] www.fanniemae.com/aboutfm/understnading/mission. (visited 12/5/2006)
[2] The Social Consequence of Homeownership, Robert Dietz, June 18, 2003, p.4.

homeowners were 16% more likely to vote in local elections than renters.[3] Another reported that the homeowners voting rate was 69% compared to 44 for renters.[4]

The dream of homeownership became a reality for a growing portion of Americans over that past half century. From the turn of the century through the 1940s, approximately 45% of U.S. households were homeowners. The baby boom and post-war programs that increased credit availability helped boost homeownership to 63% by 1965. The ownership percentage remained in the 60-65% range for the next three decades. The ten year period from 1995 to 2005 saw another spurt in homeownership. By 2005, 69% of U.S. households owned their own homes.[5] (Exhibit 1) Minority homeownership rates accounted for a significant portion of the growth. For example, Hispanic ownership rates increased from 41% in 1994 to almost 50% in 2005.[6] Several factors explain the recent jump in home ownership. First, prices for homes were rising rapidly. Median home prices of new homes sold in the United States increased from $163,500 in January 2000 to $254,400 in 2007.[7] (Exhibit 2) The price increases put pressure on new home buyers to act now or be priced out of the market later. Second, interest rates for mortgages to finance the purchase of a home were at comparatively low levels. Exhibit 3 shows that mortgage interest rates were in the 5.5% to 6.5% range between 2003 and 2007 compared to 7% to 8.5% in the 1990s. This era of less expensive money and rising home prices encouraged new home buyers into the market and existing owners to upgrade to more expensive homes. A third explanation was the extension of mortgage credit to subprime borrowers, those individuals who do not have the income or assets to qualify for conventional mortgages.

Throughout the 20th Century vast majority of Americans financed their dream of home ownership with a loan collateralized by a mortgage on the home known as a conventional mortgage. The standard mortgage during the second half of the twentieth century was a 30 year fixed interest loan, averaging 6 percent for most of the period.[8] The amount of the mortgage was in the range of 80-90 percent of the value of the home. The mortgage process was essentially local: the home buyer went to a local bank for the loan; the bank used a local appraiser to verify the value of the home; the bank evaluated the repayment risk of the borrower and issued or rejected the application. Often the bank held the mortgage during its life. If a repayment problem arose, the borrower and bank could jointly work to resolve the issue. In order to increase the amount of funds available for mortgage loans, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), government sponsored agencies, purchased some of the loans from local banks. Taking these loans off the banks' books enabled the lending institutions to offer more mortgages. In turn Fannie Mae packaged the mortgages into securities and sold them to third party investors.

[3] Id. p.6.

[4] The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research, Rohe et al, Joint Center for Housing Studies of Harvard University, October 2001, p.18.

[5] Subprime Mortgages, Edward M. Gramlich, The Urban Institute Press, 2007, p.2.

[6] Homeownership: Patterns, Trends and Policies, John C. Weicher, Hudson Institute, May 18, 2006.

[7] U.S. Census Bureau, Median and Average Sales Process of
New Homes Sold in the United States.

[8] Edward M. Gramlich, Subprime Mortgages: America's Latest Boom and Bust 2 (2007).

At the dawn of the millennium, a new loan product was introduced for borrowers whose credit position would not qualify them for a conventional mortgage. These "less than prime" borrowers (or commonly referred to as subprime borrowers) were offered loans even with poor past credit, minimal income and limited assets. The rationale for the lender was that if the borrower defaulted the appreciation in home value would cover the costs of foreclosure on the property and it could be readily sold to another buyer. The subprime mortgages were primarily offered by mortgage bankers rather than traditional banks whose prudential regulations limited such loans.[9] With mortgage bankers and construction firms that sought buyers, there arose mortgage brokers, who contacted potential buyers and offered loans to finance purchase of homes. An additional mortgage bankers' enticement was "teaser" rate loans which offered very low interest payments and/or interest only repayment for a period of time. (Of course, the rates and payments ballooned after a few years.) For example, many adjustable rate mortgages offered fixed and low interest rates for the first 2 years of the loan replaced by higher and adjustable rates for the remaining loan period. Borrowers took the bait; subprime loans soared to more than $600 billion in 2005.[10] (Exhibit 4) The rapid growth of mortgage loans including to subprime borrowers was enabled by declining denial rates. (Exhibit 5) The potential for profits in this new model was evidenced by the number of independent mortgage brokers which grew from 7000 in 1987 to 53,000 in 2004.[11]

The assumption of ever increasing home prices which supported the subprime loans was erroneous. The escalation in home prices was a bubble and like all bubbles it burst. Over-building and speculation peaked and was replaced by a slowing of home sales and declining prices. In 2004 and 2005, 1.6 and 1.7 million new privately owned housing units were started. In 2007 the number fell to just over 1 million.[12] Existing home sales also slowed. Exhibit 6 shows that the inventory of existing homes increased steadily from 2005 to 2007. New home inventory also were at high levels. Weak demand rapidly translated into falling home prices. Median existing home prices in many cities across the U.S. fell more than 5-10% between 2006 and the end of 2007. In some locations the drop as even more precipitous. In Riverside California, for example, prices in 2008 were 25% lower than a year earlier.[13] The bottom line to the housing statistics was that once prices began to drop, a vicious cycle began: falling home prices, defaults, falling home prices, defaults.

The macroeconomic impacts of housing crash were quick to take hold. Overall economic growth as measured by GDP slowed from 2.8% to 3.6% in the period leading up to the bubble bursting in 2006 to an annualized 0.9% in the first quarter of 2008. The residential investment component for GDP declined more than 15% in 2007 alone. (Exhibit 7) Unemployment grew from 4.6% at the outset of 2007 to 5.7% at mid-year 2008.[14] In the

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[9] *Id.* at 7.
[10] Subprime Mortgages, Edward M. Gramlich, The Urban Institute Press, p.6.
[11] *Id.* at 19.
[12] U.S. Census Bureau, Quarterly Housing Starts, Table Q1.
[13] After the Clean Up, Lawrence Yun, National Association of Realtors May 29, 2008.
[14] Bureau of Labor Statistics, Current Population Survey. Accessed 8/12/2008.

construction industry unemployment exceeded 11% in April 2008.[15] More than ½ million construction jobs were lost since the building industry peak in September 2006.[16] Talk of recession increased with headlines such as "Credit Woes Hinting at Consumer Recession."[17] Fears of banks failing because of exposure to bad loans caused the first runs of banks in more than a decade. In February 2008, Federal Reserve Bank Chairman, Ben Bernanke, stated that "[t]here probably will be some bank failures."[18] Four months later his prediction proved all too accurate. IndyMac Bank which had $32 billion in assets became the second largest bank failure in the history of the country. The bailout of the bank's depositors by the Federal Deposit Insurance Corporation (FDIC) is expected to cost $4 to $8 billion.[19] The psychological impact of the failure was captured in the words of one depositor who "…leaned on the locked doors, pleading with an employee inside: 'Please, please, I want to take out a portion.' All she could do was read the two-page notice taped to the door."[20] The overall impact of the housing crisis (and soaring oil prices) led to the lowest level of consumer confidence in years. (Exhibit 8)

The "perfect storm" brewed in the subprime market. The loans which looked secure when housing princes were rising became problematic. A slowing economy meant that many mortgage holders, especially those who lost their jobs, found it harder to make their monthly payments. At the same time, the teaser rates, which enticed many to take loans they really could not afford beyond the low introductory rate period, were converting to the higher rates. The option of selling the home to pay off the loan was unrealistic in face of a slow real estate market with falling prices. Many subprime borrowers were not required to make a down payment on the home. Consequently in the first few years of homeownership they had not built any equity in the home. Others who had equity often took a second mortgage on the home to tap the cash value that had accrued. Borrowers increasing found it less expensive to simple turn over the keys to the loan holder and walk away from the house rather than try to meet the monthly mortgage payments.

For those that provided the loans, the "insurance" of foreclosing and selling the house to a new buyer became infeasible as prices fell, financing became tight and new, credit worthy buyer were had to find. Nevertheless, the number of foreclosed homes grew. Exhibit 9 shows that the foreclosure rate rose since 2005. The 2008 level was roughly two times the historic level.[21] In 2007, x households were forced to give up their homes because they were unwilling or unable to pay their mortgages. In June 2008 alone, x foreclosure procedures were initiated. The number of foreclosures in the remainder of 2008 and 2009 is expected to remain at unprecedented levels.

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[15] http://enr.ecnext.com/coms2/article_necoar080528b.

[16] Bureau of Labor Statistics, Employment Situation Summary, July 2008.

[17] Credit Woes Hinting as Consumer Recession, Luke Mullins, US News and World Report, November 10, 2007.

[18] Bernanke expects bank failures, The Washington Times, February 29, 2008.

[19] IndyMac bank seized by federal regulators, Kathy Kristof and Andrea Chang, Los Angels Times, July 12, 2008.

[20] Id.

[21] After the Clean Up, Lawrence Yun, National Association of Realtors
May 29, 2008.

The impact of subprime foreclosures was felt in urban and rural communities. In the Crown Heights and Bedford Stuyvesant neighbors of Brooklyn, New York, 25% of homes with subprime loans were in the foreclosure process at the beginning of 2008.[22] The subprime crisis hit the farm belt as well. The delinquency rate on subprime loans in Iowa in 200x was more than14% with more than 8% in foreclosure.[23] Foreclosure rates were almost double that rate for the subset of subprime loans that were adjustable rate mortgages.

The economic drain of foreclosures was significant for borrowers, lenders, neighborhoods, and municipalities. Estimates of the total costs per foreclosure were in the $80,000 range.[24] Borrowers loose any equity that they accumulated at foreclosure. Moreover they are faced with the costs of moving and finding new accommodations. Beyond the financial loss, the emotional costs can be large especially for families whose children must be uprooted. Put in human terms: "One child in every classroom in America is at risk of losing his/her home because their parents are unable to pay their mortgage."[25] The lenders face the direct cash costs of completing the foreclosure process and the loss in market value of the home at the time of resale. Given the weak housing market and the glut of homes for sale, foreclosures are bringing in only 50 cents on the dollar.[26] The lenders loss is even greater if an inflated appraisal of the house was used to justify the initial mortgage.

Beyond the direct participants in the subprime drama, "40.6 million neighboring homes will experience devaluation because of subprime foreclosures that take place nearby."[27] The Center for Responsible Lending estimated that each single family home foreclosed in a neighborhood reduced the value of the surrounding homes by 0.9% or on average $5,000. The loss is estimated to be 1.4% in lower-income areas.[28] Thus the total property value loss for the country totals $223 billion. The states with the largest devaluations are California ($60 billion), New York ($36 billion), Florida ($20 billion) and Illinois ($15 billion).[29] While almost all areas have been affected by the subprime problem there are some counties where the impact has been huge. The loss of housing value in Los Angles CA, Cook IL, Kings NY and Miami-Dade FL are estimated to be $27, $13, $12, and $10 billion respectively.

The lower property value had a cascading effect on municipalities whose budgets were funded through local property taxes which were reduced as home values dropped. At a time when local needs especially for housing assistance is growing cities and towns have less funds available for support. The local governments are also facing direct cash outlays associated with foreclosures. "The foreclosure of a single-family house, especially one that leaves the home vacant and unsecured, may, in some cases, cost cash-strapped

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[22] Report: Subprime Foreclosures Rampant in Brooklyn, www.borwnstone.com, January 2008.
[23] Subprime Foreclosures, Patrick Madigan, Assistant Attorney General, xxxx.
[24] Id.
[25] Foreclosure Statistics, NeighborWorks America, www.ForeclosureHelpand Hope.org.
[26] Id.
[27] Subprime Spillover, Center for Responsible Lending, CRL Issue Paper, January 18, 2008, p.1.
[28] Id.
[29] Id. p.2.

municipal governments in excess of $30,000 per property. Typical costs including loss of tax revenue, increasing policing, building inspections, legal expense, administrative costs to manage the foreclosure policy and more."[30]

1,000,000 foreclosures is so large a number it is hard to grasp its importance; yet, each 1 of the million has their own human story. A single mother of three lived in their South Chicago home. Health problems forced the mother onto long term disability. The insurance payments in conjunction with funds provided by her working children enabled the family to make ends meet. When the daughter lost her job, the family could not continue to meet their mortgage payments. A subprime lender offered to refinance her home with a fixed-rate mortgage. At the closing, however, the terms were not what she had been told: "They lied to me…its going to be a fixed rate for one year and then adjustable every six months."[31] She reluctantly signed. "You're at the closing, and you don't want to lose your home, and you don't have other options open…"[32] Her hopes that it would all turn out alright did not materialize. The need to replace her furnace, some pipes, and her washing machine put her finances into the red. Her failure to meet mortgage payments led the lender to begin actions to take her house. Her story actually has a happy ending. A community based non-profit helped her find a mortgage that she could afford and she was able to remain in her home. A million other homeowners have not been so lucky. Her case was not atypical. Research on the "tipping point" that results in homeowners defaulting shows that 32% experience a job loss and 25% have a health crisis.[33] The desperation associated with the possible loss of ones home is illustrated in a January 2008 story carried by CNNMoney. An Indiana homeowner "offered to pay a neighbor $5,000 to help her burn down her house and make it look like a botched rape attempt- all in order to claim $80,00 in insurance money…"[34] to solve her financial problems.

The subprime crisis continued to intensify during 2008. Senator Charles Schumer the chair of the Joint Economic Committee published a timeline of the subprime crisis in July 2008. The following entries[35] demonstrate the breath and depth of the crisis:

- January 15: Citigroup the largest bank in the U.S. announced that its mortgage portfolio dropped in value by $18.1 Billion.
- January 30: Standard and Poor's announced it would be cutting the credit ratings of $534 billion in subprime mortgage backed securities.
- February 29: A report from market analysts at UBS shows that losses within the financial sector from subprime mortgage back securities could reach $600 billion.
- March 16: Investment bank Bear Stearns announced that it will sell itself to JPMorgan Chase for $2 a share – a 93% discount on the current stock price.

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[30] Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom, National Multi Housing council, www.nmhc.org/content, visited 8/7/2008.
[31] The Tragedy of Foreclosure, Dona DeZube, Neighborhood Works Bright Ideas, Summer 2006, p.12.
[32] Id.
[33] Foreclosure Statistics, NeighborWorks America, www.ForeclosureHelpand Hope.org.
[34] Will foreclosures spark an arson boom?, Jon Birger, CNNMoney, January 10, 2008.
[35] Subprime Mortgage Market Crisis Timeline, The Joint Economic Committee, Senator Charles E. Schumer, July, 2008.

- April 29: First quarter data…revealed a 112% jump in foreclosure filings compared with the same period last year.
- May 21: …exactly five years after the peak in the housing boom, mortgage applications now stand at one-third of the volume of the high point in May 2003.
- June 5: For the first time in history, more than one million homes are now in foreclosure.

Whenever a bubble busts and many people are hurt, politicians, the media and everyday citizens ask the questions: How did this happen? Who is responsible? How should the problem be rectified? How should it be prevented in the future?

The "how" and "who" are clear with 20-20 hindsight. First, risky loans were not only offered but encouraged. Low introductory rate loans, known as "exploding ARMs" enticed borrowers into loans that could not be repaid in the long run. Second, there was weak underwriting. Those offering loans were at best lax and in some cases fraudulent in offering loans to borrowers who were highly unlikely to have sufficient funds to keep the mortgage current. Some of these loans were tied to costly fees if timely payments could not be made designed to strip the homeowners' equity first and then lead to foreclosure without the opportunity for refinancing.[36] Third, the loan originators lacked accountability of the loans. The vast majority of subprime loans were packaged and sold to investors in the secondary market. The originators held no residual responsibly for the repayment of the loan. Their incentive was to close loans and sell the mortgages as quickly as possible. Finally, there was minimal oversight of the process. The mortgage brokers who originated the loans were largely unregulated; they did not carry the prudential obligations of traditional banks. The backstop protectors, appraiser of the property and agencies that rated the packages of mortgages for secondary market investors, failed to provide realistic guidance.

One frustrating element of the current crisis is that the problems associated with subprime lending was not new news. Although the number of subprime loans was lower in the 1990s, there was ample evidence showing the issues with this form of lending. Between 1995 and 1999 in Boston the number of subprime foreclosures nearly tripled while foreclosures of conventionally financed homes were cut in half.[37] Mortgage delinquencies increased by almost 50% between 2000 and 2003.[38] (Exhibit 10) Nevertheless, lenders continued to offer subprime loans at an increasing rate. Why did lenders continue to make loans that they knew were problematic? According to an economist at the Mortgage Brokers Association: "Because investors continued to buy the loans."[39]

In the multi-billion dollar subprime debacle there is blame for all parties. Borrowers entered into loans that they should have realized were unsustainable. Lenders aggressive

[36] Losing Ground: Foreclosures in the Subprime Market and Their Costs to Homeowners, Ellen Schloemer et al, December 2006, Executive Summary p.3.

[37] Subprime Foreclosures: The Smoking Gun of Predatory Lending?, Bruce, Gruenstein et al, Housing Policy in the New Millennium, p. 265.

[38] Subprime Statistics, Time Dunne and Brent Meyer, Federal Reserve bank of Cleveland, 04.05.07

[39] Testimony of Julia Gordon, Center for Responsible Lending Before the U.S. House of Representatives Committee on Financial Services, July 25, 2008, p. 5.

marketed such loans in many cases knowing that the likelihood of repayment problems was high. They consummated the loans; however, because they assumed that rising housing prices would "make them whole" and in any case they would not be held to account for the bad loans. According to Federal Reserve Board Chairman Ben Bernanke many loans were "inappropriate or misled the borrowers."[40]

The appraisers were to provide critical insight into the value of homes to support mortgage loans. Accurate valuations are required to reduce the risks to those who hold the loans, or the loan backed securities. After all, it is the value of property that provides the collateral for the loan holder in the case of default. While appraisers "must perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interest. [,]"[41] there is ample evidence that they routinely provided valuations that were greater than the true value to the property in order to close loans. For example, New York Attorney General Andrew Cuomo filed suit on behalf of the people of New York against First American Corporation (and its eAppraiseIT unit) alleging that they "have abdicated their role in providing 'third-party, unbiased valuations'" by allowing eAppraiseIT's customer's "loan production staff to hand-pick appraisers who bring in appraisal values high enough to permit [customer] loans to close. . . . This wrongful conduct constitutes a deceptive, fraudulent, and illegal business practice. It violates New York law as well as federal law and regulations."[42]

A portion of the blame also falls at the feet of the investors. The subprime mortgages were sold to very sophisticated investors including banks such as CitiBank and Bank of America. Some of the largest investment banking firms, such as UBS and Merrill Lynch were also investors in subprime mortgages. These companies either failed to conduct appropriate due diligence or were convinced that the rising housing market and growing economy would secure their loans. In either case their subprime investments have led to multi-billion losses. In the case of Bear Stearns, over the second weekend in March 2008 a deal was made for J.P. Morgan Chase to buy the venerable investment firm for a mere for $2 per share. The Federal government provided $30 billion in guarantees to assure that the transactions would close.[43] Only a week earlier Bear Stearns stock traded at $50![44] In 2007, the company's stock stood at $170.[45] The collapse had a direct cause – excessive exposure to mortgage-backed securities associated with subprime loans.

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[40] Statement of Chairman Ben S. Bernanke, Federal Reserve Board, July 14, 2008.

[41] USPAP, *Ethics Rule,* http://commerce.appraisalfoundation.org/html/2006%20USPAP/ETHICS_RULE.htm (last visited May 21, 2008).

[42] *Id.* at 3.

[43] *With the Collapse of Bear Stearns and the Federal Reserve Heavily Involved in the Banking Business, the Question Many Traders Are Likely to Ask Is, 'Who's Next?,'* PR NEWSWIRE, Mar. 18, 2008, LEXIS, News Library, Curnws File.

[44] David Roeder, *Did Rumors Help Sink Bear Stearns?; Company, SEC Checking It Out; Some Big-Time Investors Got Caught Outside the Loop,* CHI. SUN-TIMES, Mar. 23, 2008, at 23, LEXIS, News Library, Curnws File.

[45] *With the Collapse of Bear Stearns and the Federal Reserve Heavily Involved in the Banking Business, the Question Many Traders Are Likely to Ask Is, 'Who's Next?,'* PR NEWSWIRE, Mar. 18, 2008, LEXIS, News Library, Curnws File.

The investors have explained their lack of homework on their reliance on credit rating agencies (CRAs). The CRAs evaluate the quality of debt and structured finance offerings for investors. Moody's Corporation, the first credit rating agency in the world, began rating bonds in the U.S. in 1909. Since that time Moody's and other CRAs have provided ratings on most government and private debt offerings and more recently on structured finance opportunities. The ratings are intended to provide potential investors with "forward-looking opinions that speak to the relative probability that principal and interest will be repaid in a timely manner."[46] Concerns about the reliability of ratings surfaced in the 1980s when the Washington Public Power Supply System could not repay more than $2 billion in debts. Those obligations were rated highly by the CRAs.[47] The questions intensified at the outset of the 21st century especially with the failure of Enron. The reliability and objectivity of CRAs ratings are once again being questioned in conjunction with the subprime. Chair of the Senate Committee on Banking, Senator Dodd, opened a September 2007 hearing on the role of the credit agencies in the subprime market stating: "Families all across this nation continue to struggle to hold on to their homes . . . because of abusive and predatory subprime lending. These loans were facilitated by Wall Street with the support of credit rating agencies."[48] A particular concern has been raised about the potential conflict of interest between the rating agencies and those "customers" who seek to sell the investments that the CRAs rate. While the industry has strenuously defended its ratings and protections against conflicts, an S&P's representative acknowledged that "we have learned hard lessons from the recent difficulties in the subprime mortgage area."[49]

One more actor in the subprime saga has accountability for the continuing crisis – the mortgage servicers. These companies provide the administrative services that link the borrower to the investor; they collect payments from the borrower and pay them to the investor. The servicer works for the investor. The agreement between these parties typically dictates how modifications to the loans can be structured. The terms often limited the opportunity to help find a solution for borrowers who were delinquent or in default. Even if a servicer wanted to renegotiate the terms of a loan, tax issues often limited flexibility. Finally, the financial incentives for servicers favor highly automated process not individual time consuming renegotiations.

The outlook for solving the subprime problem in the near term is bleak. The testimony of The Center for Responsible Lending's Julia Gordon before the U.S. House of Representatives Committee on Financial Services in July 2008 provides a compelling

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[46] MOODY'S INVESTORS SERVICE, CODE OF PROFESSIONAL CONDUCT 3 (2007), http://www.moodys.com/cust/content/Content.ashx?source=StaticContent/Free+Pages/Regulatory+Affairs/Documents/professional_conduct.pdf.

[47] *See* U.S. SEC. & EXCH. COMM'N, *supra* note 71, at 10 (noting that SEC and Congress "reviewed the regulatory treatment of credit rating agencies" at the time of the Washington Public Power Supply System's "large scale credit default").

[48] Press Release, Sen. Chris Dodd, Statement of Senator Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, on Hearing Entitled "The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets." (Sept. 26, 2007), http://banking.senate.gov/public/_files/dodd.pdf.

[49] *Id.* at 1.

case for concern: "Just one year ago, some in the mortgage industry claimed that the number of coming foreclosures would be too small to be significant…No one makes that claim today. Projections by Fitch Ratings indicate that 43 percent of recent subprime load will be lost to foreclosures, and at least two million American families are expected to lose their homes to foreclosures over the next two years. A study of the survival function of home mortgages in Cleveland illustrates the continuing vulnerability of subprime loans. As shown in Exhibit 11 only 60% of subprime mortgages to white homeowners are still current with no foreclosure actions taken. The number falls to 40% for black subprime mortgage holders.[50] What's more, industry projections forecast that by 2012 1 in 8 mortgages – that's all mortgages, not just subprime – will fail."[51]

The primary response of Congress, regulators and politicians to the crisis in the first half of 2008 was to encourage the servicers to reduce the number of foreclosures as the servicers were the only link between the borrowers and investors. As detailed above, this approach was hampered by the legal and business issues that make changing the terms of loans problematic. The rapid escalation in foreclosures was strong evidence that the voluntary program was not sufficient to solve the problem. As the second half of 2008 began there were calls for greater legislative and regulatory actions. A UBS analyst captured the rationale for intervention "when markets fail, lenders and borrowers need some sort of regulatory and legislative framework within which to manage problems, rather than be forced to act in the chaos of the moment."[52]

Legislative proposals to resolve the current crisis and prevent another in the future would require loan servicers to "engage in loss mitigation prior to foreclosure…"[53] and to assure that the new terms are affordable for the homeowner. Another proposal would require the servicers of ARM mortgages to notify borrowers of rate increases prior to the change. A House bill would delay foreclosures for up to nine months if the borrower continued to pay the minimum monthly obligation of the loan's teaser rate. There have even been calls to extend the power of bankruptcy courts to modify loans to include those of primary residences.

The discussions around remedying the subprime crisis have also called into question the financial/legal arrangement that enabled the packaging and re-selling of the mortgages to third party investors and created the separation between borrowers and lenders – securitization.

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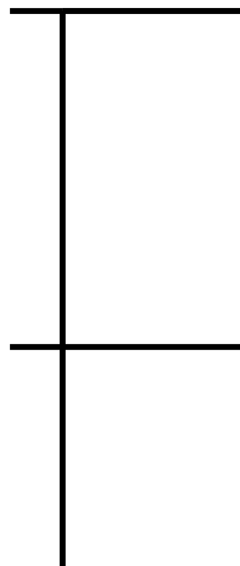
[50] Pathways To Foreclosure: A Longitudinal Study of Mortgage Loans, Cleveland and Cuyahoga County, 2005-2008, Coulton et al. June 2008, Center on Urban Poverty and Community Development, Case Western Reserve University, p. 10.

[51] Testimony of Julia Gordon, Center for Responsible Lending Before the U.S. House of Representatives Committee on Financial Services, July 25, 2008, p. 4.

[52] Id. p. 6.

[53] Id. p.10.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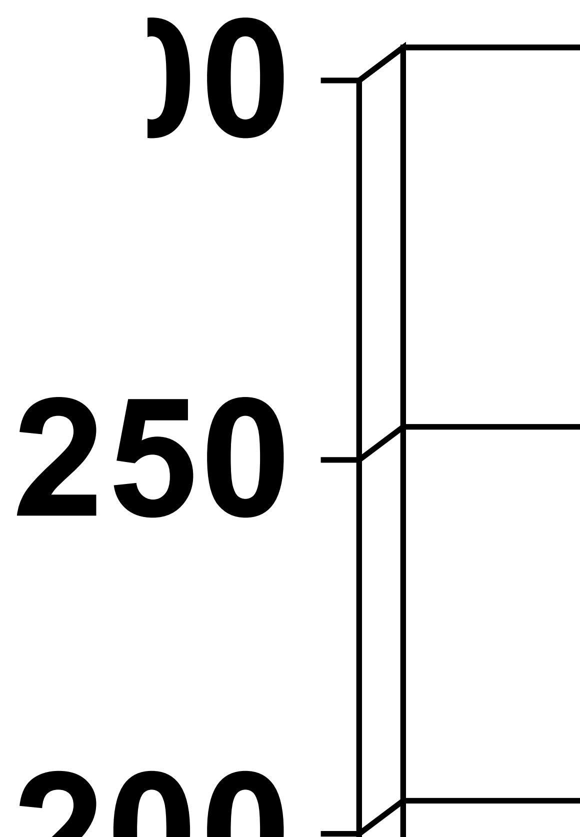
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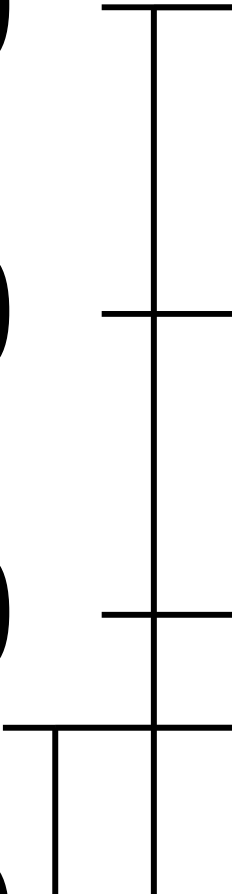
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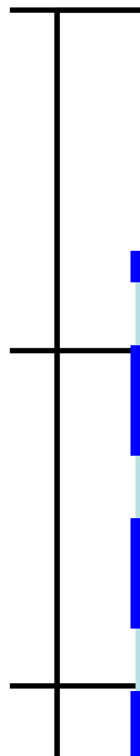
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Discussion Questions

Legal

- What are the legal restrictions on re-negotiating loans?
- Who does the servicer own an obligation to?

- Can the federal government require servicers to postpone foreclosures if the borrower remits minimal payments?

Business

- What are incentives of the loan originators, the servicers, and the investors?
- Why did sophisticated investors get caught with non-performing subprime loans?
- Is the subprime an example of market failure?
- How much reliance should an investor place on appraisals and ratings?
- Why did the subprime have such a large impact on the overall economy?
- Who is hurt by a liquidity crunch?

Public Policy

- Should subprime loans be banned?
- Should restrictions be placed on the use of "teaser" rate loans?
- What is the rationale for the federal government guaranteeing the sale of Bear Stearns?
- What are the social costs of the subprime crisis?
- What is the role of regulation in preventing another subprime disaster?