

The Current Subprime Mortgage Environment: Trends and Implications

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The recent decline in the subprime mortgage market undoubtedly will have ripple effects throughout the economy. As the market declined, the perception that subprime loans are akin to predatory loans has grown. While this perception is not necessarily accurate,² until recently there has been little comprehensive guidance or standards in the subprime lending market to ensure integrity in the origination process. This article will examine the decline of the subprime lending market and the resulting increased call for suitability standards in the subprime mortgage industry.

The Decline of the Subprime Market

Subprime lending came to life when investment bankers had the idea of purchasing mortgages from bank lenders, packaging them and issuing bonds to finance the purchases with the packaged mortgages as collateral. This practice of mortgage securitization has created enormous wealth for investors, but also has created an incentive structure that encourages originators to write riskier loans, collect fees and transfer the risk to investors.

The remarkable growth in the subprime market in the last 10 years is primarily the result of two distinct factors: investors' incessant search for higher yields, and ordinary Americans' pursuit of the American dream of homeownership – at whatever the cost or terms. Subprime loans grew rapidly in the late stages of the housing boom due to strong demand among households that were unable to acquire property in the housing market through traditional financing. Borrowers who cannot make the required downpayment, and who lack sufficient income to access traditional lenders, have flocked to subprime lenders.

Subprime loans are mortgages made to borrowers who generally have credit scores of 620 or below. Such scores often result from a record of paying debts late (or not at all) and other credit blemishes. Since these borrowers are viewed as high risk, their loans carry interest rates that are often at least 2 percent higher than those offered to traditional borrowers, and may contain risk compensating features, such as prepayment penalties. Examples of typical subprime mortgage products include:

- **Balloon Mortgages** – the borrower only pays interest for the first 10 or 15 years, after which a big lump-sum is due.
- **“No doc” or “Low Doc” Loans** – the lender accepts the borrower's stated income without any supporting documentation.

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² “[S]ubprime lending is not synonymous with predatory lending.” Statement on Subprime Mortgage Lending, www.federalreserve.gov/boarddocs/press/bcreg/2007/20070629/attachment.pdf.

- **Piggy-back Loans** – the combination of a first and second mortgages eliminates the need for the typical 20 percent downpayment.
- **Teaser Loans** – the borrower may qualify for an artificially low interest rate for an initial term of, for example, three years, and then the rate adjusts – requiring higher payments that are less affordable for the borrower.
- **Stretch Loans** – the monthly payments represent more than 50 percent of the borrower’s gross income.
- **2/28 Loan** – a type of teaser loan product that is nearly exclusive to the subprime market, 2/28 loans have an adjustable rate that is fixed for the first two years, and then adjusts to a rate index plus a margin.³

To properly understand today’s problem, one must consider the current subprime environment in view of a nearly 20-year economic cycle. Following the recession of the early 1990’s, the country entered one of the longest periods of economic growth in the past 60 years due in large part to the imposition of tight monetary controls by Federal Reserve Chairman Alan Greenspan and a government posture friendly to economic supply-siders ushered in by the 1994 election of a Republican majority in Congress. This environment allowed mortgage originations to hold steady at around \$1 trillion a year. Due to the stable environment, the Federal Reserve initiated interest rate reductions in 2001 that had an immediate impact on the mortgage market. As interest rates declined and home values increased, borrowers took advantage of the opportunity to refinance existing loans and cash-out equity. This also allowed increased opportunity for first-time home buyers. The result was a dramatic expansion in the mortgage market from 2001 to 2004, peaking in 2003 at just under \$4 trillion in new originations. When demand for new loans slowed in 2004, the market was left with overcapacity, prompting originators, urged by investors hungry for increased yields, to shift to more “innovative” products. Accompanying these innovative products were relaxed underwriting standards and temporary payment reductions, increasing risk for both borrowers and lenders.

For the past two years, subprime lending has constituted approximately 20 percent of the mortgage loan market share. As an example of the current trend in subprime loan performance, a recent nationwide survey conducted by the Mortgage Bankers Association showed that 14.44 percent of subprime borrowers with Adjustable Rate Mortgage (ARM) loans were at least 60 days delinquent in their payments in the fourth quarter of 2006. This was a 122 basis point increase over the same rate from the previous quarter. Foreclosure rates for subprime loans also increased 18 basis points during the fourth quarter of 2006.

Similar to the savings and loan crisis of the 1980’s, the decline in the subprime market has the potential to affect a variety of industries. For example, real estate (increased foreclosures may cause lower overall sale prices and an oversupply of housing inventories), retailers (retail sales may decline as customers’ discretionary spending contracts, especially retailers that draw price-sensitive consumers), and home improvement companies (for consumers facing foreclosure, home improvement may become a low priority). The ripple effect of the subprime mortgage market downturn will be felt immediately for the investors who sought the

³ Some of these issues have been discussed in the Interagency Statement on Subprime Mortgage Lending, discussed *infra*.

opportunities for high yields available in mortgage securitized assets. Unlike the savings and loan industry, however, where the losses were born by individual banks and their owners, due to securitization of mortgage-backed assets traded in the secondary market, the subprime loan losses will be diluted among investors worldwide rather than concentrated in the institutions that originated the loans.

Members of Congress have called for a temporary moratorium on subprime loan foreclosures and greater regulatory controls. During this session, Congress may seek to modernize the Federal Housing Administration to enable it to attract many consumers who would otherwise be drawn to subprime lenders. Additionally, this legislative season may draw amendments to the Home Ownership Equity Protection Act (HOEPA) to broaden the scope of loans covered under the Act's protections.

Consumer advocates also are calling for a federally mandated home loan suitability rule, similar to what is currently in place for investment securities. As discussed in detail below, those who support such a measure argue that a federal suitability standard, and the enforcement of such a standard, would deter predatory lending practices that may exist in the subprime market, while permitting appropriate innovation of new products. Opponents of a suitability standard argue that it is ill-placed in a home mortgage market where affordability is key, and where such standards might lead to frivolous lawsuits. There are also different public policy considerations underlying homeownership that are absent in securities investments.

On the regulatory side, several federal agencies may take action to address subprime lending. The Federal Reserve Board may issue new regulations in an attempt to set uniform federal guidelines to replace the hodgepodge of federal and state laws and regulations affecting the subprime loan market. In 2006, more than half of the subprime loans originated were done subject to exclusive state regulation. There is still some question regarding whether the Federal Reserve can do this under its existing rules, or whether additional legislation is required to authorize such rulemaking. The Federal Trade Commission (FTC) also may take a more aggressive enforcement posture, such as labeling some practices "unfair and deceptive." Unlike the Federal Reserve Board, the FTC may be able to take action more quickly, without a legislative fix, through a more aggressive reading of the Real Estate Settlement Procedures Act (RESPA), which governs disclosures to consumers about settlement costs and mortgage processes.

Suitability

There are many who have attacked the current laws and regulations governing the subprime lending industry as inadequate. Such critics argue that "contract law, disclosure, and consumer counseling fail because they place the onus on highly vulnerable victims to refrain from signing loans, rather than on the lenders and brokers who perpetrate these loans."⁴ These critics also suggest that fraud laws and antidiscrimination laws are too narrow in scope, and price

⁴ Katherine C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255, 1318 (May 2002).

regulation has extensive adverse effects. The answer, as such critics argue, is a suitability requirement imposed by law.

Origins of Suitability: The Securities Model

In the 1930's, the National Association of Securities Dealers (NASD) first adopted the concept of "suitability," proposing the notion that a salesperson "should recommend only securities that are suitable to the needs of the particular customer."⁵ The suitability doctrine has developed in the disciplinary rules of the securities industry self-regulatory organizations (SROs), and appear in the regulations and holdings of the Securities and Exchange Commission (SEC), as well as court decisions in private securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act)⁶ and Rule 10b-5.⁷

Rule 2310 of the NASD's Rules of Fair Practice provides:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.⁸

The rule also states that prior to executing a recommended transaction for a non-institutional customer, all NASD member broker-dealers must make "reasonable efforts to obtain information concerning": (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such broker-dealer in making recommendations to the consumer.⁹

In the regulatory adjudication arena, regulators have extended securities fraud beyond common-law fraud to include "acts that violate the obligation of fair dealing" by "professional broker-dealers and their salesmen."¹⁰ This principle has led to the position that recommending unsuitable securities to customers "violates the obligation of fair dealing."¹¹

Under the two major approaches to determining that an unsuitable investment constitutes fraud, the courts have held that a broker-dealer cannot "recommend a security unless there is an adequate and reasonable basis for such recommendation."¹² In order for this "reasonable basis" to exist, broker-dealers must do a reasonable investigation and base their recommendations on

⁵ Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 1010 (4th ed. 2001).

⁶ 15 U.S.C. § 78j(b).

⁷ 17 C.F.R. § 240.10b-5.

⁸ NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2310(a), IM 2310-2.

⁹ *Id.*

¹⁰ Manuel F. Cohen & Joel J. Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 *Law & Comtemp. Probs.* 691, 702 (1964).

¹¹ Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 *Duke L. J.* 445, 460-461.

¹² *Hanly v. SEC*, 415 F.2d 589, 597 (2nd Cir. 1969).

the results of the investigations.¹³ Such recommendations must also consider the risk thresholds of the customer.¹⁴ As suitability does not guarantee future performance, broker-dealers are not liable for securities that were suitable when purchased but that later suffered disappointing results for reasons beyond the salesperson's control.¹⁵

The suitability doctrine as developed by the SEC and the courts has rejected the notion that investor consent can cure otherwise unsuitable transactions. For example, in *Phillips & Co.*,¹⁶ the SEC held that a "broker is obligated to observe [the suitability requirement] regardless of a customer's wishes."¹⁷ In *Phillips*, the SEC affirmed a NASD finding that a broker violated the NASD's suitability rule by advising people of limited means to buy oil stock that he knew was too speculative for their financial circumstances, even though the customers voluntarily consented to the purchases.¹⁸ Later, the Commission suggested that even when customers are fully competent, disclosures might not be sufficient to cure suitability violations,¹⁹ thus apparently embracing a suitability requirement that cannot be waived by disclosures or customer consent.

Critics have also likened subprime lending to boiler-room practices. The SEC has applied the suitability doctrine to boiler-room sales of penny stocks when brokers recommend stocks without obtaining information on their customer's financial circumstances or risk preferences. Boiler-room operations refer to high-pressure sales of low-cost, speculative securities through cold calls over the telephone to unfamiliar and unsophisticated customers. For example, in *Mac Robbins & Co.*,²⁰ the SEC held that it is fraud for a broker-dealer "to induce a hasty decision by the customer" where "no effort [was] made by the salesman . . . to determine whether the security recommended [was] suitable for the customer."²¹

Suitability is Unsuitable for Mortgage Lending

Notwithstanding the appeal of having a well-developed body of precedent to serve as a model for applying a suitability standard to the subprime market, suitability is an inappropriate approach for the lending market.

Unlike the securities context, where a broker assumes the role of an agent and thus has a fiduciary duty to act in the client's best interest, lenders are not agents of the borrower, as they are the counterparty to the borrower, acting in their own best interests. Attempting to impose a suitability standard on lenders would alter the fundamental nature of the relationship. In addition

¹³ *Id.*

¹⁴ Mundheim, *supra* note 11, at 449.

¹⁵ See, e.g., Arnold S. Jacobs, 5C Litigation and Practice Under Rule 10b-5 211.01[b], at 9-63, 9-64 (1994).

¹⁶ 37 S.E.C. 66, 70 (1956).

¹⁷ *Id.*

¹⁸ *Id.* at 67-70; accord Stephen Thorlief Rangen, Exchange Release No. 38,486, 52 S.E.C. 1304, 1311 (Apr. 8, 1997) (upholding New York Stock Exchange's liability findings and sanctions for advising customers of limited means to invest in highly speculative margin purchases and excessively trading the accounts).

¹⁹ *Whitman & Stirling Co.* 43 S.E.C. 181, 182-183 (1966).

²⁰ *Mac Robbins & Co.*, Exchange Act Release No. 6846, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,853, at 81,174 (July 11, 1962).

²¹ Cohen & Rabin, *supra* note 8, at 1140.

to this basic difference in roles, the allocation of financial risk in the two types of transactions also illustrates the difference: in making an investment, it is the investor who is taking the market risk; in making a loan, it is the lender who takes the credit risk. Although arguably there are certain risks inherent in the mortgage lending environment, such as foreclosure, credit score/history, and bankruptcy, that militate in favor a suitability standard. Though these factors are influenced by the conduct of third parties, such as job loss, and the ability to pay one's debts as they become due, the borrower exercises far more control over these variables than the investor in the securities context. Even interest rate fluctuations, or initial teaser rates, are known to the borrower prior to the transaction, thus the borrower has the ability to avoid the pitfalls of these risks. Conversely, unlike securities investment, where the investor only stands to lose money, a borrower on a mortgage loan risks the loss of shelter, thus the public policy considerations may caution in favor of suitability notwithstanding the borrower's limited control over the risks.

The only workable solution to the ills of predatory lending is objective standards, coupled with targeted enforcement. Regulations that provide objective rules as to what constitutes a predatory loan, with several possible triggers to invoke predation status, appear to be the only workable solution. Such objective standards must be imposed at the national level, so as to avoid the hodgepodge of state regulations that will drive lending costs up, and create a patchwork of uncertainty for both borrowers and lenders.

Impact of Interagency Guidance

On June 29, 2007, the federal bank regulatory agencies – the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (FRS), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the “Agencies”) – issued final guidance on subprime mortgage lending (“Interagency Guidance”).²²

The Interagency Guidance provides direction for banks, savings associations, and credit unions, and their subsidiaries, holding companies, and nonbank subsidiaries of those holding companies, covering such areas as risk management practices, workout arrangements, consumer protection principles, control systems, and supervisory review. As with other interagency guidance, this document has caused those in the industry some concern that it will be used by plaintiff's lawyers to form the basis for a standard of care for alleging the unsuitability of loans. The Agencies have tried to dispel such notion that the Interagency Guidance establishes such a suitability requirement:

The Agencies disagree with the commenters who expressed concern that the proposed statement appears to establish a suitability standard under which lenders would be required to assist borrowers in choosing products that are appropriate to their needs and circumstances. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that

²² Statement on Subprime Mortgage Lending, www.federalreserve.gov/boarddocs/press/bcreg/2007/20070629/attachment.pdf.

this decision should be left to borrowers themselves. It is not the Agencies' intent to impose such a standard, nor is there any language in the Statement that does so.

Notwithstanding such a disclaimer, the Agencies have little control over the view that judges and juries take of such comprehensive best practices in the narrow field of subprime mortgage lending. For example, on June 6, 2007, a federal jury awarded \$220,000 to an 82-year-old borrower who sued a mortgage company for certain actions that the borrower claimed violated the New Jersey Consumer Fraud Act.²³ In this case, the plaintiff borrower alleged that the mortgage company, EquiHome, engaged in an unconscionable business practice in violation of the New Jersey Consumer Fraud Act by soliciting a mortgage that was not suitable for him. The plaintiff argued that EquiHome representatives convinced him to refinance his non-recourse reverse mortgage with no monthly payments, a credit line of \$76,000, and no risk of foreclosure, for a \$223,000, thirty-year conventional fixed rate mortgage with monthly payments of \$1,300 and a cash pay out of \$52,000. The plaintiff, whose primary income source was \$965 per month from Social Security, defaulted on the loan within one year of its closing. A jury found that EquiHome's conduct in soliciting the loan violated the New Jersey Consumer Fraud Act and entered a \$220,000 verdict in the plaintiff's favor. This verdict will now be trebled under the New Jersey Consumer Fraud Act and the plaintiff will be entitled to recover his attorney's fees and costs associated with bringing suit. Although no opinion was published discussing the application of a suitability standard, it is likely that future plaintiffs will attempt to argue that where mortgage lenders run afoul of the Interagency Guidance, such should render loans unsuitable and therefore actionable.

Conclusion

Subprime loans are not intrinsically evil – quite the contrary – they have served the purposes for which they were designed: generating high investment yield and creating opportunities for home ownership. At the end of the day, this subprime experience has shown policymakers the need for greater consumer disclosure. Even before legislative and regulatory intervention, consumers can avoid some of the pitfalls of subprime lending by being aware of:

- potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires
- the existence of any prepayment penalties, how such will be calculated and when penalties may be imposed
- the existence of any balloon payment
- whether there is a cost premium attached to a reduced documentation or stated income program
- the requirement to make payments for real estate taxes and insurance, if not escrowed, in addition to loan payments, and the fact that taxes and insurance costs can be substantial.

Whether the current debate over subprime lending will result in fundamental change, for better or worse, to this market for those with limited access to banking services remains to be

²³ *Leff v. EquiHome Mortgage Corp.*, Docket No. 05-CV-3648 (N.J. Super. Ct., Hunterdon County, June 6, 2007).

seen. It is certainly possible that this is merely a passing fad attributable to the agenda of a Democrat majority in Congress that has been stewing on the outside, anxiously awaiting the opportunity to correct what they perceive as a problem in the market. It is also possible that policymakers on both Pennsylvania Avenue and Wall Street will take a hard look at the practices of mortgage lenders, and the important role that they play, both on a micro and macro level, in the furtherance of the American dream. However long the debate lasts, what is likely to result is a correction on the part of legislators, regulators, the courts, and the marketplace to make the subprime mortgage lending environment more transparent and more informed.