Subprime Mortgage Market Developments

Ekaterina V. Gill
Slaten & O'Connor, PC
kgill@slatenlaw.com

The subprime sector of the mortgage lending industry has recently been going through turbulent times, which have led to the ongoing crisis affecting not only this industry, but also the housing market, other related industries and global financial markets.

The subprime mortgage meltdown began in 2006 with a steady increase in foreclosures, a decrease in home prices and sales, rising interest rates and subsequent bankruptcies or closedowns of subprime lenders. This meltdown reached its peak in the summer of 2007 when some subprime lenders had a sharp decrease in liquidity which threatened their ability to meet loan origination obligations, and when prices of securities backed by subprime mortgages dropped drastically.

On August 17, 2007, the Federal Reserve opened the discount window to allow subprime lenders to borrow money at the discount rate to meet the temporary shortages of liquidity. This action was followed by a half point cut of the interest rate by the Federal Reserve and other measures designed to inject liquidity into the banking system. The discount window and the interest rate cuts are only short-term solutions to the problem and will not solve all of the problems plaguing the subprime mortgage lending market.

President Bush attempted to address some long-term solutions to the problems associated with the subprime market in his speech of August 31, 2007. He encouraged lenders to work with borrowers to adjust their mortgages when needed and promised to provide government intervention aimed at assisting subprime borrowers to avoid defaults on their mortgages. This government initiative would: 1) allow certain borrowers to participate in Federal Housing Administration programs; 2) launch a foreclosure avoidance initiative; 3) increase financial literacy of the subprime borrowers; 4) provide tax relief to certain borrowers; and 5) require lenders and brokers to provide improved and clearer disclosures to borrowers.

Whether long or short-term, substantive corrections to the current situation in the subprime mortgage lending market are necessary. In order to find the right solutions to the problems troubling the industry, it is important to look to the core of the crisis, which relates back to the original subprime borrowers and defaults on their mortgages.

Background

Generally, subprime borrowers are borrowers that display some credit risk characteristics, which typically include weakened credit history or low repayment capacity. Subprime loans have a higher risk of default and potentially higher gains than loans to prime borrowers.[1]

To meet the credit needs of subprime borrowers, lenders have developed various innovative products. Some of these products have low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable rate plus a margin for the remaining term of the loan (Adjustable-Rate Mortgages, or ARMs). Some ARMs often include prepayment penalties, no or very high payment caps or periodic interest rate caps, "balloon" payments, loan features that result in frequent refinancing, or require borrowers to pay insurance and taxes separately from their mortgage payments. These products could potentially result in "payment shock" to the borrower, and consequently cause the borrower to default on the loan.

Subprime lending should not be confused with predatory lending.[2] Subprime lending is not predatory per se. In fact, when a subprime loan is appropriately underwritten, priced and administered, it provides a great vehicle for subprime borrowers to obtain credit. However, there are forms of subprime lending that can be considered predatory and abusive.

<u>Problem Areas</u>

The main problem areas in the subprime mortgage lending market are associated with the sharply increasing number of defaults (loans that are 90 days or more past due) and foreclosures. Defaults and foreclosures are caused by a variety of factors or any combination thereof.[3] In addition to risky underwriting standards, predatory lending practices, or payment shock features described above, defaults may be caused by the financial inability of a subprime borrower to make mortgage payments, which is frequently caused by job loss, significant medical expenses, divorce or other financial challenges.

<u>Proposed Solutions</u>

Although borrowers, lenders, investors and regulators seem to clearly recognize the primary problem areas in the subprime mortgage lending industry, there appears to be no consensus in finding a corrective solution to these problems.

The solution involves several possible approaches which are being discussed by various groups. Some propose that federal legislation prohibiting certain practices can be enacted, while others suggest that regulatory agencies' or states' guidelines or regulations would

---

[1] The terms "subprime," "subprime loans," and "subprime borrowers" are defined in the *Expanded Guidance for Subprime Lending Programs*, issued on January 31, 2001.

[2] Predatory lending practices are more specifically discussed in the *Expanded Guidance for Subprime Lending Programs*, issued on January 31, 2001.

[3] Various factors causing foreclosures, with an emphasis on the role of predatory lending practices in foreclosures of subprime mortgages, are explored in detail in the Office of the Comptroller of the Currency's Economics Working Paper: 2006-1, *Foreclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices*, August 2006, which can be found at http://www.occ.treas.gov/ftp/workpaper/wp2006-1.pdf

be more beneficial, as they would give more flexibility and discretion to lenders. Questions also arise as to whether these new laws or regulations should aim either at improving financial literacy of borrowers or at limiting certain lending practices, requiring additional disclosures and tightening underwriting standards, or both. There is a wide variety of opinions as to whether lenders should underwrite "low-documentation" or "stated income loans," and whether lenders should have the burden of determining a borrower's ability to repay, thus placing more liability on lenders rather than on borrowers.

The subprime mortgage lending market is already subject to a number of federal and state laws, including the Real Estate Settlement Procedures Act,[4] Truth in Lending Act,[5] and Home Ownership and Equity Protection Act,[6] that provide consumer protection to borrowers. However, some concerns about consumer protection still remain unresolved. A number of states have either enacted or proposed legislation that focuses on subprime lending issues or predatory lending practices. Unfortunately, there is no uniformity among the states, which creates a great deal of compliance problems for national lenders. There is a slew of bills proposed on the federal level as well.[7] It remains unclear, however, whether the proposed federal legislation will ultimately help the borrower or whether it will restrict the availability of credit in the subprime market. Obviously, enactment of any new federal laws would also create concerns of federal preemption of conflicting state legislation.

The abundance of state and federal enforcement actions, as well as plaintiffs' cases, against lenders will provide additional corrections to subprime mortgage lending practices.

On the regulatory level, federal financial regulators[8] have issued several statements regarding nontraditional mortgage products,[9] stratagies for working with borrowers,[10] and

[4] 12 U.S.C. §1261 et seq.
[5] 15 U.S.C. §1601 et seq.
[6] 15 U.S.C. §1639.
[7] Some pertinent bills are: Obama, *S. 1222* (April 25, 2007) (To stop mortgage transactions which operate to promote fraud, risk, abuse, and under-development, and for other purposes). Schumer, *S. 1299* (May 3, 2007) (To establish on behalf of consumers a fiduciary duty and other standards of care for mortgage brokers and originators, and to establish standards to assess a consumer's ability to repay, and for other purposes). Bachus, *H.R. 3012, Fair Mortgage Practices Act of 2007* (July 12, 2007) (To amend the Truth in Lending Act to provide for the establishment of fair mortgage practices, generally, and for subprime mortgages in particular, to provide for a national system for licensing or registering residential mortgage loan originators, and for other purposes). Ellison, *H.R. 3081, Fairness for Homeowners Act of 2007* (July 18, 2007) (To amend the Truth in Lending Act to protect consumers from certain practices in connection with the origination of consumer credit transactions secured by the consumer's principal dwelling, and for other purposes). Miller, *H.R.3915, The Mortgage Reform and Anti-Predatory Lending Act of 2007* (October 22, 2007) (To amend the Truth in Lending Act to reform consumer mortgage practices and provide accountability for such practices, to establish licensing and registration requirements for residential mortgage originators, to provide certain minimum standards for consumer mortgage loans, and for other purposes).
[8] Federal financial regulators consist of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.
[9] *Nontraditional Mortgage Product Guidance*, 71 FR 58609 (October 4, 2006).

subprime mortgage lending. The Statement on Subprime Mortgage Lending[11] concentrates on underwriting, risk management, internal controls and consumer protection regarding hybrid ARMs, no or low-documentation and other subprime mortgage products. The Statement on Subprime Mortgage Lending is supervisory in nature and, although it applies only to federally regulated institutions, including banks, thrifts and credit unions, it impacts other lenders as well.

To address similar issues related to securitized subprime mortgages, federal financial regulators and CSBS issued a Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages.[12] This Statement encourages federally regulated financial institutions and state-supervised entities that service securitized mortgages to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve home ownership, if authorized by pooling and servicing agreements.

Conclusion

The heightened default and foreclosure rates will most likely continue for some time. However, the demand for subprime mortgage products is not expected to decrease. Certainly, the market will correct itself over a period of time. In the interim, we will likely see the emergence of a great deal of legislation, regulations or guidance addressing subprime mortgage lending issues in the near future, which will, hopefully, help to stabilize the present crisis in the subprime mortgage lending market.

---

[10] *Statement on Working with Mortgage Borrowers*, issued on April 17, 2007, which can be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070417a1.pdf

[11] *Statement on Subprime Mortgage Lending,* 72 FR 37569 (July 10, 2007). Following the issuance of the Statement, the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators and the National Association of Consumer Credit Administrators adopted a similar document, *Statement on Subprime Mortgage Lending*, for state banking regulators to issue to their licensed mortgage providers. http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final_CSBS-AARMR-NACCA_StatementonSubprimeLending.pdf

[12] *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*, issued on September 4, 2007, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070904a1.pdf