

# THE SUBPRIME MELTDOWN: HOW WE GOT HERE AND WHERE WE ARE TODAY

*By Jennifer L. Dickenson, Esq.*

*Jennifer Dickenson would like to acknowledge and thank her colleagues Deborah S. Bailey, Esq. and Christopher R. Lane, Esq. for their contributions to this paper.*

## How We Got Here

In 1927 the English writer Aldous Huxley observed “facts do not cease to exist because they are ignored.”<sup>1</sup> In the future when historians dissect the anatomy of the “Subprime Meltdown” they will most likely agree that this shock to our financial market is one of the most severe credit illiquidity crises of our time. By simply ignoring the facts, all of the market participants helped to cause the present crisis. From Wall Street, to Lenders and loan officers, to Main Street, the Federal Reserve, the Media, Rating Agencies, the Credit industry and the individual borrowers themselves, there is more than enough blame to go around for this financial crisis. Ultimately, it is likely historians will say that the problems we now have are an aggregate of fundamental miscalculations of risk akin to other debt crises such as the Latin American Debt Crisis of the 1980’s that seriously disrupted credit and capital flow.

A subprime loan includes both loans to borrowers of questionable creditworthiness and very large loans to otherwise creditworthy borrowers.<sup>2</sup> It is a relatively new segment of the mortgage market. Prior to 1995, the subprime segment of the mortgage market was largely ignored because it was mostly comprised of homeowners who were deemed too high risk and for a variety of reasons were denied credit in the prime market. In the mid to late 90’s as a result of a variety of pressures such as the need to increase the pool of homeowners and the need for mortgage lenders to grow their revenue streams, the pool of credit to borrowers grew via subprime lending and financial engineering. As the financial markets “engineered” different types of loan products and securities, they successfully and dramatically expanded the lending market well beyond its former framework.

With the advent of mortgage-backed securities, defined by the Securities and Exchange Commission as “debt obligations which represent claims to cash flows from pools of mortgage loans and most commonly on residential property”<sup>3</sup>, Wall

Street found a big partner in big business. The Wall Street Investment Bankers created a new security which used the mortgages as collateral. The Collateral Debt Obligations (CDO’s) were broken down into pieces (or “tranches”) which included loan types from “A” paper to subprime. Bond insurance was purchased for the “A” and similar paper loans and AAA ratings to BBB ratings were given to these tranches. The subprime pieces were not rated.

The CDO’s were a mixed bag of good loans, not-so-bad loans and bad loans. The rating agencies reasoned that the payment performance for the underlying loans in the good paper



Jennifer Dickenson is a founding partner of metro-Atlanta based Dickenson Gilroy LLC.

tranches would more than compensate for the expected risk of default on subprime loans. The rating agencies therefore provided their ratings based on the value of the good loans and not-so-bad loans only. Investors pursuing these investments of course had no knowledge of these tortured assessments and were under the improper impression that they could rely upon the strong AAA rating of the mortgage-backed securities they had received.<sup>4</sup>

For at least a decade, it did look like a good scenario all around. Property values had been increasing, interest rates were low, real estate and mortgages seemed like a good investment.<sup>5</sup> Because it was such a good investment, Wall Street Investment Bankers developed an appetite for these financial products because they knew they

could sell more. Pressure for more product grew, and money started getting pumped into the financial sector which meant Lenders could supply more loans which would in turn be batched into mortgage-backed securities, which would then be sold, and so on. There was enormous pressure on the Lenders to create more mortgages. In order to do so, the Lenders needed Borrowers and in order to widen the pool of Borrowers who could qualify for their loans, lenders began loosening their underwriting standards and increasingly created more “exotic” loan products.

By 2002 there was a full blown mortgage and housing boom which attracted a plethora of new players into the world of lending with varying levels of knowledge and professionalism. Two things happened as a result: 1) More competition, and 2) loosening of lending practices. In an effort not to be priced out of the market place, many traditionally conservative lenders disregarded their risk models and ignored risk factors that would have traditionally prevented them from making the same loans less than a decade ago. The rate of subprime lending had grown so much that the 1995 securitization rate<sup>6</sup> of subprime securities which was 28.4% had increased to 58.7% by 2003.<sup>7</sup>

The subprime crisis began to gain momentum in 2006 when home prices unexpectedly began to fall and adjustable-rate mortgage (ARM) interest rates started refixing at now higher rates causing borrowers to default on their mortgages at a pace much higher than anticipated. This reality was exaggerated in the subprime market and led to an immediate and severe problem with collections on those mortgages. By the time the investors’ losses were in the billions, they had understandably lost confidence in the entire credit market. Almost immediately, the demand for mortgage-backed securities began to dry up leaving substantially less money in the financial markets to make new loans. Since these securities had been sold all over the world, the problems created by the unanticipated default rates were widespread from Main Street USA to the furthest corner of the globe.

It would be improper to ignore the dramatic impact the media has had upon the crisis at hand. Although real estate is generally considered

a local matter, within a 24 hour news cycle, the various media as a whole began to report the story of falling home values as a national, even international, phenomenon. Even in markets where there were no significant issues with home prices declining, prices began to decline once the media started their broad brushstroke reporting on the matter. The problem which began in the subprime markets began to expand into the prime markets and the media continued to report on the bad news with full force. As a result of the non-stop coverage, consumer confidence weakened and became widespread. Consumers stopped buying houses because of what they saw and read in the media. This cessation of buying activity created an oversupply of real estate inventory. Supply began to outstrip demand and prices began falling further.

The Federal Reserve and its former Chairman Alan Greenspan has been another target of late. After September 11, 2001, Greenspan initiated a period of aggressive rate reduction from 2000 to 2004 in order to sure up an economy that was weakened by the effects of September 11. Housing was already doing well and the reduction of interest rates allowed people to pay more for their homes.<sup>8</sup> A loosening of underwriting guidelines meant homebuyers were now able to put less down-payment on the real estate they were purchasing. All of these factors added more fuel to what was already a powerful housing boom. It was the continued reduction of interest rates in the face of this already positive news (regarding the housing markets) that have left some to question the wisdom of Greenspan's decisions to continue reducing rates as he did. Greenspan himself has since said that he was surprised how the markets were responding and that this was not his intention.<sup>9</sup>

Of course it would be a significant oversight to ignore the complicit nature of borrowers too willing to believe in propositions which appeared to be too good to be true.<sup>10</sup> Borrowers miscalculated the risk of home values and valuation as well as their ability to refinance their ARM loans believing erroneously that home prices will always increase. First time homebuyers were getting 100% financing with interest only loans with no realistic plan to pay down the principal balances on those loans. With the real property having decreased in value, Borrowers with no equity in their homes to begin with, were resigned to making mortgage payments escalating beyond what the borrower had anticipated or could afford. With an asset the borrower can not sell or pay for, the problem becomes one of the consummate "catch 22". There are legitimate cases where Borrowers did not know what they were signing and had no knowledge of the loan terms. The large majority of people who received the subprime or exotic loans did, however, understand the terms but simply miscalculated the risk of the loan products and their reliance upon certain home valuations. In most cases, they were given loans

that should never have been made. However, it can be argued that the willingness of so many borrowers to take the risks involved was not rational either.

## Where We Are Today

The climate today in the halls of Congress and behind the closed doors of many government agencies is one of certain activity driven by brute political force. One gets the sense that the economics of a financial crisis which just so happened to spill over into a crisis affecting American homeowners during an election year is simply too tempting and politically advantageous to pass up. The politicians have a considerable stake in being part of a solution, perceived or real, to this very complex problem.

At a recent conference in Washington, D.C., a Department of Housing and Urban Development ("HUD") official made the statement that Real Estate Settlement Procedures Act ("RESPA") reform "number one needs to get passed and number two we need to get it right". This statement nicely sums up the climate today.

As a result of this frenzy to do something, there has been a considerable amount of activity on the federal and local level to take curative measures to assuage the problems at hand. A few of the main actions will be discussed here.

### RESPA Reform

HUD has wanted to reform RESPA for quite sometime with the last real press for change in 2004. That proposal ultimately lost it's momentum in the face of severe industry opposition. However, before laying down the 2004 proposal, HUD vowed to address RESPA reform again which they have now done.

HUD published it's Proposed RESPA Rule on March 14, 2008.<sup>11</sup> The proposal is presently in a 60 day comment period expiring May 13, 2008. The proposed rule and the Economic Analysis that accompanies it are hundreds of pages long. Industry professionals have repeatedly requested an extension to the comment period because the breadth of the proposal is far reaching and there are concerns that the present 60 day period is insufficient to understand potential unintended consequences. HUD has refused to extend the comment period.

#### The main elements of the 2008 RESPA Proposal are discussed below:

##### A. New Good Faith Application and Mortgage Application

A Borrower will now make application (which can be oral) by providing sufficient information for the lender to arrive at a preliminary credit decision. Within 3 days of the application, the lender shall be obligated to supply a Good Faith Estimate (GFE) (presumably so that the consumer will be able to comparison shop). If the lender is chosen by the consumer, the lender will then have the Borrower complete a mortgage application. The lender will not be able to reject the

Borrower unless the mortgage application is sufficiently different than the GFE application.

The Good Faith Estimate is now a four page document designed by HUD to improve the transparency to the borrower of the costs of obtaining a loan and the key loan terms all in one, easy to understand document.

##### B. Tolerances

HUD has effectively established three different types or classes of fees reflected on the GFE. Fees such as the lender or broker's own service charge (e.g. underwriting fee) will be subject to a zero tolerance in that the fee charged at closing must match the GFE exactly or be less than what was quoted on the GFE. There is a ten percent tolerance for the aggregate of additional settlement charges such as lender-required settlement services where the lender selects the third party provider (i.e. tax search fees), lender-required settlement services where the borrower selects a third party provider recommended by the lender (i.e. the closing services, title insurance) and optional owner's title insurance when the borrower uses a provider identified by the lender.

Charges not subject to any tolerance would include escrow reserves, homeowner's insurance and lender-required services where the borrower independently selects his own third party provider (i.e. closing services, title insurance). However, the rule does establish an exception for "unforeseeable circumstances" which are defined in the proposed rule, in part, as "(1) acts of God, war, disaster, or other type of emergency that makes it impossible or impracticable for the originator to perform, or (2) circumstances that could not be reasonably foreseen at the time of the GFE application, that are particular to the transaction and that result in increased costs...that were not described to the loan originator in the GFE application..." In the case of an unforeseeable circumstance the tolerance limitations will not apply.

##### C. Disclosure of Yield Spread Premiums

The proposal would require lenders and mortgage brokers to disclose a yield spread premium, if any, on the GFE as a credit to the borrower's total origination cost.

##### D. HUD-1 Closing Script

The closing attorney or escrow officer will be obligated to read this new addendum to the HUD-1 out loud at closing to the Borrower. The script will include a recital of the key loan terms, differences between the GFE and the final HUD-1, and will serve as a notification to the consumer in the event tolerances have been exceeded.

##### E. Average Cost Pricing

The rule would allow mortgage lenders and brokers to use average cost pricing for their settlement services so long as the method approved by HUD is used. Only loan originators are included under this rule.

## **F. Required Use**

Under RESPA, affiliated companies are prohibited from requiring the buyer to use their affiliated company; a consumer must always be given a choice. Under the new rule, required use will be redefined and expanded to include economic incentives and disincentives which are based upon the borrower's use or failure to use a particular provider of settlement services. Offering a package of settlement services for less than the cost of purchasing those services separately will not constitute a "required use" however.

## **The Economic Stimulus Act of 2008, H.R. 5140**

The Economic Stimulus Act was signed by President Bush on February 13, 2008. The terms of the law will expire upon the one year anniversary of its enactment. It is being touted as a "Bipartisan Growth Package" which will help protect the economic health of the nation.<sup>12</sup>

Generally, the goal of the Economic Stimulus package is to put money into the hands of consumers so that they, in turn, will be stimulated to spend more money which will in turn help fuel the economy. Individuals and couples filing jointly, assuming they meet the adjusted gross income of less than \$75,000 and \$150,000, respectively, will be given a minimum of \$300 per person and \$600 per couple. Eligible tax payers will also receive an additional \$300 per child. These amounts are expected to be mailed out some time in May 2008.

The Act also provides for investment incentives for business owners by temporarily amending the tax code. This provision provides that American businesses which buy new equipment this year shall be permitted to deduct an additional 50% of the cost of their investment in 2008. The idea is that businesses will be more likely to expand and create new jobs because buying equipment, software and tangible property will actually lower businesses' taxes.

## **HOPE NOW**

This cooperative effort among mortgage counselors, servicers, investors and lenders is geared towards reaching out to homeowners who are in default. The organization attempts to help the debtor homeowner refinance into a new mortgage or receive a modification.

## **Project Lifeline Initiative**

This initiative of the Bush administration provides HOPE NOW servicers additional means to access those homeowners who are severely delinquent with their mortgage payments. Project Lifeline has the ability to provide, in some cases, a temporary 30 day pause to the foreclosure process in an effort to work out a long term solution to the delinquency.

## **FHA Secure**

In August 2007, the Bush Administration launched FHA Secure at the Federal Housing Administration (FHA). This initiative sets out to expand the pool of consumers that FHA can work with in offering refinancing opportunities. These borrowers, with otherwise good credit histories, would be considered ineligible for FHA loans due to their present state of mortgage delinquency.

## **Mortgage Forgiveness Debt Relief Act of 2007**

In December 2007, the President signed this act which was created to help homeowners avoid foreclosure by removing the specter of additional taxes when they refinance their home mortgages. Under this Act, homeowners have a 3 year window in which to refinance their mortgage and pay no federal taxes on any debt forgiveness they may receive.

## **Higher Mortgage Limits for Both FHA and FNMA/FHLMC**

Under the Economic Stimulus Act, there has been a temporary increase in the loan limits for Government Sponsored Enterprises (GSEs) with the hope that it will bring stability and liquidity and affordability to the housing finance system. These adjustments will mostly affect housing markets in high-cost areas such as California.

This legislation increases the loan limitations as "the maximum original principal obligation of a mortgage that may be purchased... shall be the higher of a) the limitation for 2008 (i.e. \$417,000); or b) 125% of the area median price for a residence of the applicable size but in no case to exceed 175% of the limit for 2008."

Fannie Mae and Freddie Mac cannot therefore purchase any loan for which the original principal balance exceeds \$729,750.00 or 175% of the 2008 limitation. In most parts of the country median prices are below \$250,000.00 so the limit will remain at \$417,000.00.

## **National Registry for Loan Officers and Independent Appraisals**

There has been considerable discussion on the national and state level about having a National Registry for Loan Officers which seems to be finding considerable support. In Georgia, SB 375<sup>13</sup> has been offered during the 2008 Georgia General Assembly legislative session in support of such a national registry and it appears likely that it will pass. Another initiative which has found significant support on both the national and local level is the idea of segregating appraisers from the lenders that request their services by law. Some lenders are already utilizing the services of these independent agencies in an effort to curb appraisal and mortgage fraud.

In March of this year an Agreement was struck by the Office of Federal Housing Enterprise Oversight (OFHEO), the Attorney General of New York, Fannie Mae and Freddie Mac which is geared towards combating fraudulent appraisals used in the mortgage process. With an eye towards guaranteeing accurate and independent appraisals, the agreement eliminates broker-ordered appraisals, prohibits appraiser coercion, and reduces the use of appraisals prepared in house through captive appraisal management companies in underwriting mortgages. This agreement also establishes a complaint hotline and a Home Valuation Code of Conduct. The Agreement will apply to lenders selling mortgages to Fannie Mae or Freddie Mac and will be effective January 2009.

## **Fannie Mae Changes Underwriting Guidelines**

Issued on December 5, 2007, Announcement 07-23, Fannie Mae amended their requirements for purchase money transactions. Included in this announcement is a clarification of the difference between "financing concessions" and "sales concessions." A financing concession is defined as a financial contribution from an interested party which provides a benefit to the borrowers in the financing transaction (i.e. closing cost credits). Financing concessions are subject to Fannie Mae's Interested Party Contribution (IPC) limits but are allowed. Financing Concessions which exceed the stated limits are considered Sales Concessions.

Sales Concessions are described as concessions which also include contributions provided by an interested party that benefit the borrower but are not integral to the financing transaction (i.e. a carpet allowance of \$3,000). Other examples of Sales Concessions are non-realty items such as cash, furniture, decorator allowances, moving costs or other "giveaways." These sales concessions will now be deducted from the sales price when calculating loan-to-value and combined loan to value ratios for underwriting and eligibility purposes.

These adjustments reflect an acknowledgement and an attempt to cure some of the looser guidelines the lending industry has permitted in recent years. The hope is that by revamping some of these guidelines, more protections will be in place to ensure that quality loans are originated.

There are many different approaches to curing the credit crunch, the illiquidity crisis or whatever the nom de jour may be for the economic crisis we are all collectively experiencing. From the practitioner's perspective, it will be interesting to see the long term effects of the proposals and laws being passed regarding this complicated and multi-layered situation. ■

1. Aldous Huxley, Proper Studies, 1927.

2. Megan Dorsey and David Rockwell, Financing: Residential Real Estate 60 (8th ed. 1990)

3. www.sec.gov/answers/mortgage securities.htm

4. Steven L. Schwarcz, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown,

Duke Law School Legal Studies Research Paper Series, Research Paper No. 175, November 2007.

5. Jack Guttentag, Shortsighted About the Subprime Disaster, Washington Post, May 26, 2007 @ F02.

6. The securitization rate is equal to securities issued divided by origination in dollars.

7. Federal Reserve Bank of St. Louis Review, January/February 2006, 88 (1), pp.34-35

8. How Credit Got So Easy and Why It's Tightening, The Wall Street Journal, August 2007.

9. Dr. Mark Skousen, Alan Greenspan and The Housing Market...Is The Former Fed To Blame For the Real Estate Meltdown, Advisory Panelist, Investment U.

10. www.financeproject.org/publications/FESfinancial literacy.pdf

11. RESPA Proposed Rule and Economic Analysis. Available at www.hud.gov/offices/ogc/resp.cfm

12. www.whitehouse.gov/news/releases/2008

13. SB 375 available at www.legis.ga.gov/legis/2007\_08/search/sb375.htm