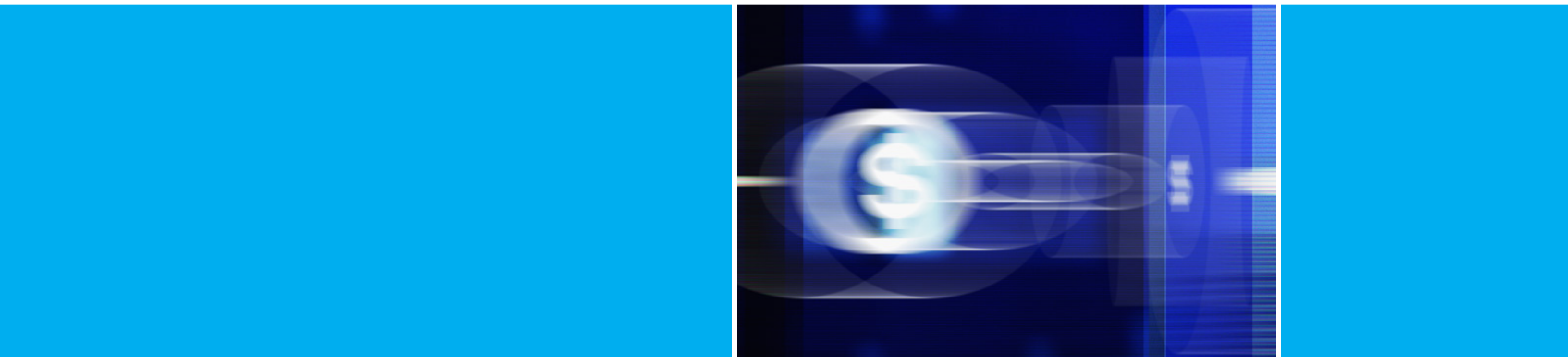

White Paper

What Should Government Do About the Subprime Mortgage Market?:

A Taxpayer's Guide

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July 2007

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Part I: The Current Situation and Its Roots

Introduction

In recent months, barely a day has passed without news or commentary on the high level of delinquencies and foreclosures in the market for subprime mortgages—that is, higher-interest loans to lower-income borrowers. Borrowers, brokers, lenders and investors involved in these mortgages have all been affected to some degree. Many observers have questioned whether the effects are limited to those who transacted most directly in this market. Will entire cities or whole neighborhoods be hurt by the foreclosures? Will the economy at large suffer from the bankruptcy of lenders or investors? Will things get worse before they get better?

Concerns about borrowers have elicited some of the strongest emotions. This is hardly surprising. Any issue that touches upon home ownership, and the fear of losing one's home, is bound to generate passionate discussion. Many voices within and outside of state and federal governments have called for action to help those currently facing or soon expected to face foreclosure. But what sort of action is appropriate? This paper will review the current situation and its origins, identify the different forms of government involvement that have been suggested, and apply economic principles to suggest a course of action for the future. I believe that the most effective approach will be one that carefully balances a government role for regulation with the need for borrowers, lenders and investors to bear responsibility for their own actions. Using government power to absolve borrowers or lenders of their responsibility, even without the direct use of taxpayer dollars, is likely to be costly to many, hurtful to the innocent, and helpful to those whose avarice and overreaching contributed so much to the creation of this situation.

The Subprime Market

Subprime mortgages are loans offered to lower-income borrowers, particularly those whose credit history, income level and net worth make them poor candidates for more traditional mortgages. Because these borrowers present a higher risk of default than those with higher incomes and better credit histories—by some estimates, perhaps six times greater[1]—banks and other lenders are rightfully concerned about their ability to pay back any money lent to them. Because of this concern, lenders will only work with these borrowers if they agree to pay more for their loans. This extra cost takes the form of higher interest rates, and higher points and fees.[2] Additionally, subprime borrowers often elect to accept extra risk in the form of variable interest rates as a component of their loan. For example, a widely used subprime mortgage product in recent years has been the "hybrid ARM," a type of 30-year adjustable rate mortgage (ARM) in which the borrower pays a low, fixed introductory (or "teaser") rate for the first two or three years, after which the loan's interest rate resets to a higher level, and adjusts periodically for the remainder of the loan's life. The borrower receives the "teaser" rate in exchange for accepting the risk of later interest rate increases. These loans are also known as "2/28s" or "3/27s," depending on the duration of the introductory rate.

Hybrid ARMs[3] are one of a number of loan structures sometimes called "alternative mortgage products" (or "AMPs"), a category that also includes extended maturity loans (e.g., 40-year fixed rate) and interest-only loans. Interest-only loans are structured so that during an introductory period, the borrower pays interest without paying down the principal balance, after which the monthly payment increases to allow the full amount of the principal to be amortized over the remaining term of the loan, at an adjustable rate. The initial payments on some AMPs are so low that they fail to even cover the interest that borrowers owe on the loan.

[1] Souphala Chomsisengphet and Anthony Pennington-Cross, "The Evolution of the Subprime Mortgage Market," Federal Reserve Bank of St. Louis *Review* (January/February 2006) 32.

[2] Interest on subprime loans tends to be about two percentage points higher than prime loans, with the "subprime premium" increasing when interest rates are higher, and decreasing when rates are lower. Id at 33–34.

[3] Hybrid ARMs that allow the borrower to choose from different levels of payment during the initial period are also referred to as "payment-option ARMs."

Thus, even though they are making monthly payments, these borrowers end up with a larger debt. These loans are known as "negative amortizing" loans. Generally, most AMPs allow the borrower to make smaller payments at the outset, followed by higher payments in later years.

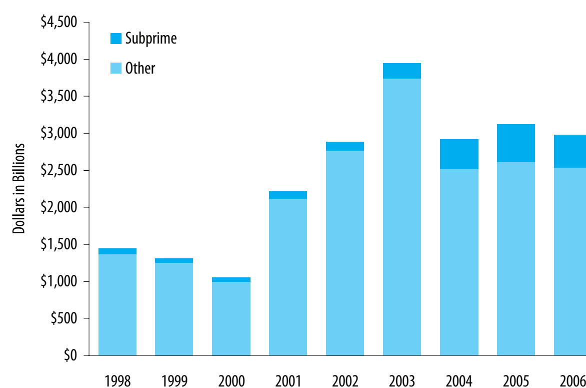
Originally, AMPs were developed to meet the needs of wealthier, more sophisticated borrowers who wanted lower initial payments so that they could invest their funds elsewhere during the introductory period. Later, lenders began marketing AMPs to lower income customers as "affordability products." The demand for AMPs in recent years, particularly the 2003–2005 period, was fueled by rising home prices in much of the country. Rising prices created challenges for first-time home buyers, for whom homes were growing less affordable, and opportunities for existing homeowners, who could take advantage of increased equity in their homes to refinance.

Many borrowers whose credit histories and incomes may have made traditional fixed- or adjustable-rate mortgages unobtainable were offered AMPs, either as purchase loans or refinancing loans ("refis"). One study estimates that over half of the subprime loans originating in the late 1990s and early 2000s were for cash-out refinancings, in which the new loan was larger than the old, with the borrower receiving the difference in cash.[4] Where the borrower was a first-time home buyer, as the Federal Deposit Insurance Corporation and Government Accountability Office (GAO) both noted, the low initial monthly payments of AMPs often allowed borrowers to purchase higher-priced homes than they could have qualified for using more conventional mortgages.[5]

Subprime mortgages grew in popularity in the early 2000s just as home values rose steeply in many parts of the country. Indeed, the two forces likely fed off each other: the availability of subprime credit helped to bid up home prices, which in turn increased the demand for loans targeted at lower-income borrowers. This is a textbook example of inflation: more money, made available through easier credit, chased a relatively constant number of homes in many metropolitan areas. Moreover, the housing boom and growing demand for subprime loans encouraged more lenders and mortgage brokers to enter the market and existing lenders to expand their subprime businesses, leading to more aggressive competition for subprime borrowers. Ultimately, home prices increased considerably faster than incomes.

From 1998 to 2003, subprime mortgages accounted for between 4% and 6% of all U.S. mortgage originations in dollar terms, as seen below in Figure 1. As the housing market grew rapidly in the years leading up to 2006—nationwide, home prices grew more than 8% per year in 2002 and 2003, and more than 10% per year in 2004 and 2005[6]—the mortgage market grew as well. While the total volume of single-family mortgage originations rarely exceeded $1 trillion per year before 1998, they were more than $2 trillion in most years thereafter, approaching or exceeding $3 trillion repeatedly. Subprime originations grew most significantly in the years 2004–2006, as seen in Figure 1:

Figure 1: Mortgage Origination



Source: Inside Mortgage Finance Publications, The 2007 Mortgage Market Statistical Annual, Vol. 1.[7]

4 Chomsisengphet and Pennington-Cross at 38.

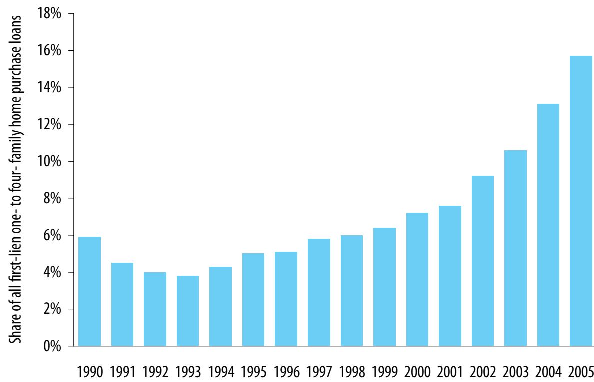
5 Sandra L. Thompson, Acting Director, Division of Supervision and Consumer Protection, Federal Deposit Insurance Corporation, Statement to Senate Committee on Banking, Housing and Urban Affairs, Subcommittees on Economic Policy and Housing and Transportation (September 20, 2006) 2; and Government Accountability Office, "Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved" (September 2006) 10–12.

6 Office of Federal Housing Enterprise Oversight (OFHEO), "Mortgage Markets and The Enterprises in 2006" (June 2007) ("OFHEO Report") 8.

7 Subprime mortgage volumes for years 2001–2006 are taken from the IMF table "Mortgage Originations by product," and those for earlier years are from the IMF table, "Mortgage Origination Indicators." The earlier subprime figures understate the total subprime market share as they include only those identified through mortgage-backed securities.

Not all of the growth in the demand for mortgages was driven by borrowers buying their primary residence. During the 1990s, some 6% to 7% of mortgage originations were for nonowner-occupied homes, but over the next six years the proportion of loans extended to investors and other nonowner-occupiers more than doubled, as seen in Figure 2:

Figure 2: Nonowner-occupied mortgage loans as percentage of all home purchase loans

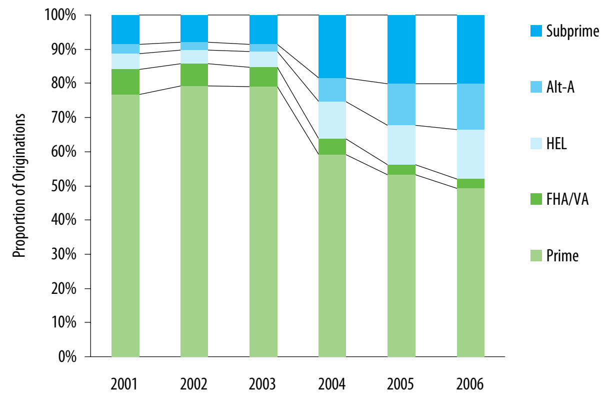


Source: Home Mortgage Disclosure Act data, cited in Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA Data" (2006) A135. Home purchase loans include all one- to four-family first-lien loans.

Within the subprime sector (in this case, defined as loans whose APR was at least 3% greater than the yield on a comparable-maturity Treasury security), 11% of loans originated in 2005 were for nonowner-occupied properties--that is, investment properties or second homes.[8]

In 2006, the housing market started to cool. New home sales fell more than 17% from the record highs of 2005.[9] Housing price appreciation dropped over the year as well, from double-digit rates in 2004 and 2005 to just 4.3%, the largest drop-off in 30 years.[10] As noted above, however, subprime originations were growing even as the market was cooling. Total subprime loans accounted for 20.1% of single-family mortgages originated in 2006, as seen below in Figure 3:

Figure 3: Composition of Loan Originations, 2001–2006



Source: Inside Mortgage Finance Publications, The 2007 Mortgage Market Statistical Annual, Vol. 1, Mortgage Originations by Product. Loans designated "prime" are conventional and conforming loans, and Jumbo loans. HEL designates home equity loans. FHA/VA designates loans originated or insured by the Federal Housing Administration or Veterans Administration.

As the housing market's rapid expansion came to an end, problems started emerging in the subprime sector. To understand why, let's take a moment to review the risks associated with subprime mortgages, and the causes and consequences of defaulting on mortgage loans.

Risk Factors Affecting Subprime Mortgages

Every loan carries the risk that the borrower will not be able to repay it, a risk called "default risk" when viewed from the borrower's perspective, or "credit risk" when viewed from the lender's perspective. In simple terms, the borrower's risk of default will increase when the amount to be repaid grows, or the borrower's ability to make payments declines.

In the case of subprime loans, the risk of default, and the consequences thereof, may be magnified by characteristics of the loans, the borrower, the lender, and the housing market itself.

- **Loan characteristics:** In a traditional mortgage, the principal amount declines every month from the inception of the loan. Many subprime loans, however, feature negative amortization: the initial monthly payment is less than the interest accruing on the loan, causing the principal amount of the loan to grow during the introductory period. In addition, the interest rate resets (typically

[8] Avery Brevoort and Canner (2006) at A132.

[9] OFHEO Report at 3.

[10] Id. at 6.

to a much higher rate) at the end of the introductory period. Together, these factors may contribute to an increase in monthly payment sometimes called "payment shock." Between one month and the next, subprime borrowers with this type of loan could see their monthly payment increase significantly. [11] On average, interest rates on 2/28 hybrid ARMs originating in 2004 increased by 2.5% upon interest rate reset in 2006, and would have increased by 5% in the absence of rate caps.[12] Thus, a mortgage with a 5% introductory rate would have reset to 7.5%, and the borrower's monthly payment would increase by up to 50%. In addition, some subprime loans impose prepayment penalties that increase default risk by limiting the borrower's flexibility (e.g., discouraging them from responding to a loss of income by taking a higher paying job in another location).

- **Borrower characteristics:** The limited financial resources of many subprime borrowers increases the danger that they will suddenly lose their ability to make payments (for example, when faced with a temporary loss of employment), or be unable to respond to payment shock. The borrower may also have taken out a larger loan, or borrowed a higher percentage of the home's purchase price, than was prudent, further increasing the risk of default, as well as the risk that his home's value will be less than the balance of the loan. The borrower's actions may have created more risk than the lender was aware of, if the borrower overstated his income on the loan application, failed to disclose that the down payment was borrowed, or if the borrower failed to notify the lender that after the interest rate reset, he was unlikely to be able to repay the loan. The borrower may also have been a speculator planning to purchase the home and resell or "flip" it at a significantly higher price, rather than live in it. Faced with falling rather than rising prices, a speculator could actually benefit from foreclosure, as the amount of money owed to the lender can easily exceed the value of the property forfeited in the process, and lenders rarely attempt to recover the shortfall from the borrower.

- **Lender characteristics:** The behavior of lenders may affect the risk levels of the loans they underwrite. Many, including government regulators, believe lenders should approve AMPs based on the buyer's ability to repay after rates reset (sometimes described as underwriting on a "fully indexed" basis).[13] If borrowers are approved based on their ability to make minimum payments during the introductory period, not the payments after rates are reset, they may borrow more money, and purchase more expensive homes, than they can truly afford, increasing credit risk.[14] Credit risk is also higher where the size of the loan leaves the borrower with little or no equity in the property. When a mortgage is "piggybacked" with a home equity loan, the borrower may be able to buy property with little or no money down (that is, with a combined loan-to-value ratio or "CLTV" of 100%—in some cases even higher), but the "cushion" that home equity can provide against adversity is eliminated.[15] Loans that require little or no documentation of the borrower's income make it incumbent on the lender to obtain other assurances of the borrower's ability to pay; failure to confirm the borrower's income adds to the loan's underlying credit risk. Many lenders depended on brokers to market their mortgage products and steer borrowers their way. If brokers failed to employ reasonable care when pre-qualifying borrowers, then the credit risk facing lenders would be larger than the lenders expected.[16] Collectively, these practices can exacerbate the existing

[11] One consumer who testified before the Senate Banking Committee saw her payments increase from $800 to $1,100; another, from $2,100 to over $2,300. Les Christie, "Subprime Lenders Push Back," CNNMoney.com (March 22, 2007).

[12] Fannie Mae, "Economic Commentary: What Were The Outcomes Of 2/28 Subprime Loans With 2006 Interest Rate Resets Now That All Of Their Locks Have Expired?" (June 18, 2007) 1.

[13] Department of the Treasury, Offices of the Comptroller of the Currency and Thrift Supervision, Federal Reserve System, Federal Deposit Insurance Corporation, and National Credit Union Administration, Statement on Subprime Mortgage Lending (June 29, 2007) 12 ("An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule").

[14] Thompson at 9–10.

[15] Thompson at 10–11.

[16] Because of the significant role played by brokers in recruiting borrowers and assessing their qualifications, lenders may seek to shift some portion of their foreclosure-related (or foreclosure-avoidance) costs to the brokers. Where this paper speaks of such lenders' costs, it should be understood to mean "lenders and brokers."

risks inherent in AMPs, a problem sometimes referred to as "risk layering."

- **Housing market characteristics:** Borrowers and lenders may have gambled on housing prices in certain regions continuing to climb indefinitely. The borrower whose home equity exceeds his loan balance may be able to sell his home at prevailing prices and pay off his debt, or borrow against the equity, but one with little or no equity—or, as may well be the case, negative equity—has no such choices. Negative amortization loans increase the risk that the borrower will have little or no equity to cushion the impact of payment shock in a falling housing market. Moreover, housing prices increases can often trigger property tax increases, aggravating the burden on homeowners.

Delinquency and Foreclosure

When a borrower misses a mortgage payment, the loan is said to be in default. Lenders typically will allow an account to remain delinquent (that is, in default due to non-payment or insufficient payment) for 90 days or more, to permit the borrower time to make additional payments, before exercising their right to take possession of the borrower's property—that is, to begin foreclosure.[17]

Once the borrower defaults on the loan, events may play out in a number of ways, with different implications for the costs imposed on the borrower and lender:

- The borrower may, of course, repay the loan, curing the default.
- The borrower may remain in the home without making payments (extending the delinquency period as long as possible), depriving the lender of the agreed-upon cash flow during this period.
- At some point, perhaps even before defaulting, the borrower may try to work with the lender to restructure the mortgage to bring his monthly obligations in line with his ability to pay. Whether the attempt is successful may depend on the borrower's equity in the home, whether the borrower's situation has changed, and how interest rates have changed since the loan originated. This may be the best possible outcome: by definition, it is acceptable to both parties, and the original lender recovers its loan principal.
- If the borrower neither makes payment nor renegotiates, he faces the choice of selling the home himself or letting the lender foreclose. If the home's market value is greater than the loan balance, the borrower is likely to sell it himself; this outcome does the least damage to his credit history, and will likely bring a higher price for the home than a foreclosure sale, potentially generating additional cash for the borrower. The lender receives the outstanding loan amount, although not the stream of payments he anticipated when the loan originated.
- If the loan balance is greater than the home's value, the borrower often does not elect to sell the home, leading the lender to pursue foreclosure. Foreclosure is a less-than-ideal outcome for buyer, lender, and others. From the lender's perspective, the eviction process is contentious, and foreclosure is costly: GMAC-Residential Funding Corp., a private issuer of mortgage-backed securities, estimates that it loses over $50,000 per foreclosed home.[18] The borrower must endure the emotional strain of eviction (unless he is a speculator who purchased a home with no intention of occupying it), and his credit rating will be badly harmed by the foreclosure, possibly preventing him from purchasing another home even if his financial circumstances improve.

Where We Are Today

Today, a significant number of homes purchased with subprime mortgages are in, or facing imminent, delinquency or foreclosure. In the first three months of 2007, some 44 million residential mortgages were being serviced in the US, of which just under 1% were 60 days delinquent, and under 2% were in the foreclosure process. But subprime mort-

[17] Anthony Pennington-Cross, Federal Reserve Bank of St. Louis Research Division, "The Duration of Foreclosures in the Subprime Mortgage Market: A Competing Risks Model with Mixing" (April 2006) 2.

[18] Cited in Desiree Hatcher, Federal Reserve Bank of Chicago, "Foreclosure Alternatives: A Case for Preserving Homeownership," Profitwise News and Views (Feb 2006) 1.

gages are performing much more poorly than mortgages as a whole. In the first three months of 2007, 3% of subprime mortgages were 60 days delinquent, and over 5% of them were in foreclosure; nearly half of those foreclosures started in the first quarter of 2007.[19]

Knowing the risk factors involved in subprime lending and the recent behavior of the housing market, we can now describe why so many loans are in delinquency or foreclosure:

- During the housing market boom, competition for both homes and loans increased the number of subprime loans offered, the size of the loans, and their exposure to payment shock and default risk if interest rates rose and home prices stagnated or fell;
- Brokers, who account for the majority of subprime loan originations, pursued subprime borrowers aggressively, sometimes recommending loans that were a poor match for the borrower's financial circumstances in their haste to close deals and earn their fees;[20]
- Similarly over-eager to attract borrowers and to close deals quickly, lenders engaged in poor underwriting practices, failing to obtain reasonable evidence of a borrower's ability to repay (a practice that gave stated-income loans the nickname "liar's loans"), offering no-money-down (high CLTV) arrangements, and approving borrowers based on "teaser" rates, not the loan's fully-indexed rate; [21]
- Seeking to qualify for the largest loans possible, and often assuming that home prices would continue upward, borrowers with little ability to manage payment shock or earnings fluctuation "maxed out" their loans, in some cases by materially inflating their earnings;[22]
- When housing prices leveled off, or actually declined in some regions, the house of cards collapsed: borrowers were frequently neither able to make their higher monthly payments when their interest rates reset, nor to tap into their home's equity to refinance or pay off the large principal amount outstanding.

The recent spate of subprime mortgage defaults has not only driven borrowers into delinquency and foreclosure, it has forced some lenders into bankruptcy and impacted many investors in mortgage-backed securities. It has also taken a toll on some communities. With so many stakeholders affected (and perhaps still more to be affected as more loans default), there has understandably been considerable attention focused on subprime lending in general, and the plight of the borrowers in particular. But do the problems actually require large-scale, government-sponsored solutions? That question will be answered in greater detail in Parts II and III of this paper, where specific types of government responses to the problem are described and analyzed.

Meanwhile, precedent would suggest not. Even though hybrid ARMs that originated in 2006 have not reached their reset dates (when it is reasonable to expect that payment shock will cause a sharp increase in defaults), current indications are that while these loans are performing worse than those of immediately preceding years, their observed delinquency rate is actually on par with subprime loans originating in 2000–2001. An analysis of subprime lending by Moody's Investors Service found that as of March 2007, approximately 7% of subprime loans originating in 2006 were facing delinquency, foreclosure, or being held for sale by the end of the year. While this is more than twice the delinquency and foreclosure rate of loans originating in 2003 or 2004, when likewise measured 12 months from the origination date, it is nearly identical to mortgages that originated and

[19] Mortgage Bankers Association, National Delinquency Survey, Seasonally Adjusted (2007).

[20] Ruth Simon and James R. Hagerty, "Mortgage Mess Shines Light on Brokers' Role," The Wall Street Journal Online (July 6, 2007) ("As business surged, some brokers put borrowers into loans they didn't understand, couldn't afford or were otherwise ill-suited for, one reason defaults have skyrocketed").

[21] Moody's Investors Service, Challenging Times for US Subprime Market (March 7, 2007) 3 ("As the lending market cools (e.g., when interest rates rise, home price increases abate, or the economy slows), competition among lenders for the reduced pool of borrowers heats up and lenders may lower credit standards (i.e., make riskier loans) in order to maintain origination volume. The riskier loans are more likely to become delinquent and default.")

[22] Mortgage Asset Research Institute, Inc., Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association (April 2006) 12 ("Stated income and reduced documentation loans speed up the approval process, but they are open invitations to fraudsters… Ninety percent of the stated incomes [in a sample of 100 reviewed loans] were exaggerated by 5% or more. More disturbingly, almost 60% of the stated amounts were exaggerated by more than 50%.")

were securitized in 2000–2001.[23] Today's subprime delinquency and foreclosure rates are consistent with a periodic downturn in the housing market, although the problem *appears* much more pronounced when compared only with loans that originated in the last three or four years.

Subprime mortgages are risky. Indeed, these products are defined by their risk. Lenders, brokers, borrowers, and investors alike should all expect significantly higher default rates than prime loans. The higher interest rates charged to borrowers reflect the higher risk of these loans. The "crisis" identified in the press, and cited as the motivation for various pieces of legislation, is business as usual in the subprime market. The only sure way to eliminate the high rate of foreclosures in the subprime market would be to eliminate the market entirely, punishing 95% of subprime borrowers for the misfortunes of the other 5%. Policies to address the "crisis" do not eliminate subprime lending, so they cannot hope to eliminate foreclosures. Some proposals effectively intend to keep the riskiest borrowers out of the market, by increasing regulatory oversight. This class of proposals could potentially improve the functioning of the market. A second class of proposals intends to shift the costs of foreclosure—in many cases, onto taxpayers. For reasons described below, these policies threaten to make home ownership even more costly for lower income borrowers.

[23] Moody's Investors Service, Challenging Times for US Subprime Market (March 7, 2007) 2.

Part II: The Major Proposals

While many agree that the current wave of delinquencies and foreclosures will strain households and communities, there is considerable disagreement as to whether government involvement is advisable, and if so, what shape it should take. Proposals for different forms of government intervention or assistance have been suggested by lawmakers, advocacy groups, and concerned citizens, among them:

- More complete, accurate and intelligible disclosures to borrowers
- Prohibition of unambiguously predatory conduct
- More stringent underwriting standards
- Assistance with renegotiating mutually acceptable refinancings to avoid foreclosure
- Consumer education
- Taxpayer-funded loans to borrowers experiencing or facing delinquency or foreclosure
- Restrictions on the rights of lenders to pursue foreclosure against borrowers now or soon to be in default

Each of these types of action creates a different kind of economic incentive for lenders, borrowers, investors and other stakeholders; each differs in the extent to which it interferes with a person's freedom to contract (and the corresponding duty to live with the consequences of one's choice); and each differs in the cost of execution, and who bears that cost: taxpayer and consumer bystanders, or those who accepted responsibility for subprime loans in the first place.

Helping the Borrowers of the Future

A number of proposals focus on forward-looking changes to the environment in which subprime loans would be offered and negotiated. They are targeted not at today's borrowers, but at those who may become subprime borrowers in the future. Broadly speaking, none of these provisions involve interference with existing contractual arrangements; rather, they seek to ensure that borrowers and lenders act truthfully and responsibly, and that their decisions are well-informed.

Many focus on the need for better disclosures to borrowers. To the extent that there has been a "failure" in the subprime market, it is largely a problem of "asymmetric information," a disparity between the knowledge possessed by lenders and brokers regarding their loan products, and the potentially poorer understanding of the borrowers who bought them. As the GAO observed, existing disclosure regulations were not designed to accommodate more complex loan products such as AMPs. "The information that borrowers receive about their loans through advertisements and disclosures may not fully or effectively inform them about the risk of AMPs. Federal and state banking regulatory officials expressed concern that advertising practices by some lenders and brokers emphasized the affordability of these products without adequately describing their risks."[24]

Where information is the problem, disclosure is the solution. In May 2007, Federal Reserve Chairman Bernanke characterized more effective disclosures as the "first line of defense against improper lending."[25] To that end, a group of federal regulatory agencies recently issued final guidance stating that "[c]ommunications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products... Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as necessary."[26] It is reasonable to require lenders to give borrowers complete, accurate and understandable information. Lenders, brokers and investors have no right to profit from ignorance, confusion or deception of their own making.

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[24] GAO Report, *supra* note 5.

[25] Remarks by Chairman Ben S. Bernanke, Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007), http://www.federalreserve.gov/Boarddocs/speeches/2007/20070517/default.htm ("Bernanke Remarks").

[26] Statement on Subprime Mortgage Lending, *supra* note 12 at 13ñ14.

Beyond disclosures, some (including Chairman Bernanke) have suggested that certain specific lending practices should be prohibited—but Bernanke would prohibit only those capable of "bright line" delineation, which are "never, or almost never, legitimate."[27] States already can and (to varying degrees) do regulate abusive practices that harm consumers. Federal regulation imposing greater uniformity in the definition and prosecution of abusive subprime lending may be preferable to a patchwork of potentially inconsistent state regulations, or more nebulous standards of behavior. Borrowers, moreover, are more likely to understand and exercise their rights if they are protected by uniform federal standards.

A third form of forward-looking governmental involvement is establishing and encouraging (and possibly enforcing) best practices by lenders and brokers, what Chairman Bernanke referred to as "principles-based guidance combined with supervisory oversight."[28] On June 29, 2007 federal regulators issued final guidance requiring, among other things: that lenders underwrite loans at the fully indexed rate, not merely the introductory rate; that lenders warn borrowers of an imminent rate reset, and allow them at least 60 days to refinance without penalty; and that lenders employing low-documentation applications obtain other evidence of the borrower's ability to repay (such as a tax return).[29] Senate Banking Committee Chairman Dodd observed that "[h]ad regulators enforced such a standard over the past several years, and had lenders abided by it, many of the problems that homeowners and the markets are experiencing today would have been avoided."[30]

Federal regulators have also recently encouraged lenders to "work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans," for example by converting ARMs to fixed-rate mortgages.[31] Thus, recent statements and guidance go directly to many of the root causes of the current situation, helping to prevent future harm by prohibiting some of the most unreasonable and risky lending practices and compelling a return to sound underwriting. The guidance and oversight process would thus seem to be a legitimate, desirable, and—based on recent developments—effective form of government involvement. Given the potential for market failure arising from incomplete information in this inherently risky market, government action in the form of regulation promises to improve the market's functioning in the long run.

Helping Today's Borrowers

A number of proposals at the state and federal level focus on assisting existing borrowers who may face delinquency or foreclosure today for loans taken out in the past. These proposals tend to contain one or more of the following elements:

- Financial assistance to the borrower, including offering to lend money to a borrower in order to repay a loan that is already delinquent or in foreclosure (often referred to as a "bailout");
- Prohibitions against foreclosure for some specified time period ("moratoria");
- Assistance and encouragement to borrowers and lenders willing to renegotiate the terms of their loans; or
- Community-based borrower education programs

At least four states—Massachusetts, New Jersey, Ohio and California—are currently considering some form of directly or indirectly taxpayer-funded bailout, and at least one—Massachusetts—is also pursuing a de-facto moratorium on foreclosures. Proposals intended to help existing borrowers raise questions that those targeted at future borrowers do not: do they interfere with existing contracts? If so, is there a compelling rationale for such interference? Is the proposal narrowly tailored to help only the most needy and most innocent borrower, or will it help those who share responsibility for their current situation? What sort of behaviors does it really reward, responsibility and self-sufficiency, or recklessness and dependency? Can it be administered in a way that

[27] Bernanke Remarks, *supra* note 25.

[28] Bernanke Remarks *supra* note 25.

[29] Statement on Subprime Mortgage Lending, *supra* note 12.

[30] Damian Paletta, "US Sens Dodd, Schumer Applaud Subprime Rules; Push for More," Dow Jones Newswire (June 29, 2007).

[31] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration, Statement on Working with Mortgage Borrowers (April 17, 2007).

truly meets the plan's objectives, or is it likely to invite abuse that undermines its goals?

The Massachusetts proposal provides a case study for these questions. A bill recently introduced in the state would create a $250 million fund for the restructuring of subprime loans facing foreclosure. Borrowers would repay their existing debt, and take on a new 30-year fixed-rate mortgage with interest of about 7.75%. Fannie Mae would contribute $190 million to the fund, with the remaining $60 million coming from the Massachusetts Housing Finance Agency (MassHousing). To qualify, borrowers would have to meet a household income cap of about $98,000 ($108,000 in the Boston area), and would have to be delinquent on their mortgages, but by no more than 60 days. The fund would aid approximately 1,000 borrowers statewide.

$250 million seems like a great deal of money to spend assisting 1,000 homeowners. Of course, if the new loans are repaid in full, the total cost of the program will be much lower. We must therefore ask, are the loans likely to be repaid? Is the program likely to be a viable long-term solution for borrowers and lenders? If reducing the foreclosure rate is a reasonable goal, is this really the way to do it?

The final section of this report will attempt to answer these questions.

Case study: Massachusetts refinancing fund

Program Highlights:

- Not approved by voter initiative or state legislature: enacted by a government agency of its own volition
- Fund size: $250 million
- Number of borrowers to benefit: 1,000
- Loan type: 30-year Fixed Rate Mortgage at 7.75%
- Lender must accept prepayment based on current market value of home

Borrower Eligibility:

- Must be < 60 days delinquent, not yet in foreclosure
- Income cap: 125% of state's median income (135% in Boston area)

Issues:

- Moral hazard: encourages borrowers to qualify by missing a payment.
- Adverse selection: lenders are more likely to participate when the state has overestimated current market value of the home, or when they have private information indicating a borrower is especially unlikely to repay the loan.
- Risk shifting: takes risk from borrowers and lenders, who agreed to accept it, and gives it to taxpayers, who did not. Taxpayers risk facing a bill totaling in the tens of millions.

Part III: Policy Assessment and Recommendations

Bailouts, Moratoria, and Other Contractual Interference

A mortgage, even a subprime mortgage, is in most cases a legally binding contract. Subprime mortgages are not inherently predatory or even inherently inadvisable. They open the housing market to those whose incomes and credit histories would otherwise preclude them from participating. The vast majority of subprime borrowers make timely payments and build equity in their homes. This access is not free to the borrower, nor is it free to the lender: subprime mortgages carry a higher risk of default and some person must accept the consequences of that risk. Economic theory suggests that borrowers and lenders who are not willing to accept the risk will not participate in the market.

Bailouts and moratoria threaten to alter the mutually agreed-upon arrangement of risk sharing between a borrower and a lender. Moratoria require lenders to accept more risk than they contracted for by extending the delinquency period and limiting the lender's ability to exercise its rights under the original loan agreement. In response, lenders will either decline to serve the subprime market, reducing the availability of financing for subprime borrowers, or they will demand additional payment (in the form of still higher interest rates or fees) from future borrowers, as compensation for the additional risk they bear. Bailouts similarly shift risk from borrowers and lenders to taxpayers or future borrowers.

The expectation that lawful contracts will be enforced as written is a cornerstone of our economy. (Unlawful contracts can, of course, be challenged in court.) It permits vast numbers of agreements of every imaginable kind to be entered into daily, with relatively modest transaction costs. The presumption of enforceability allows nearly all of those contractual arrangements to regulate themselves: parties honor their obligations because they assume that a court would compel them to do so if they did not. If this confidence is undermined, doing business becomes riskier and more costly. Some parties will consider (and ultimately engage in) breaches that they would not consider if they were assured of enforcement; in economic terms, this sort of behavioral response is called "moral hazard." Rational lenders will require compensation for the added risk associated with this moral hazard. Any "assistance" program based on interference with contractual relationships, no matter how well-intentioned, should therefore be met with healthy skepticism.

Proposals that call for taxpayer- or consumer-funded assistance to borrowers who would otherwise default on their loans and face foreclosure, and those that call for a moratorium on foreclosure, interfere with existing contracts. It is not only possible, but likely (some would say inevitable), that they simply will not work, for a number of reasons.

If defaulting borrowers were likely to repay loans at "bailout" rates, they would have found those terms in the marketplace.

Many proposals, including the Massachusetts plan, are based on the notion that a borrower who cannot pay enough to avoid foreclosure in the absence of governmental involvement, can repay a restructured (or "bailout") loan. But lenders are well aware of the high costs of foreclosure, and have strong incentives to avoid them. If the borrower were fundamentally willing and able to repay the original debt on a restructured basis, the lender would in many cases be far better off renegotiating with the borrower—"if" being the operative word here. The market's unwillingness to assist a buyer seeking a bailout loan should raise a red flag immediately: the bailout loan is not likely to be repaid. In the presence of a bailout plan, rational lenders will choose to keep the loans they expect to be profitable and shunt unprofitable loans off to the bailout plan, where taxpayers can bear the losses. In economic terms, this behavioral response is known as "adverse selection."

They won't impose a significant burden on the brokers and lenders whose practices contributed to the problem.

Publicly-funded bailouts don't necessarily impose costs on the brokers or lenders who played such a large role in the

problem. A high proportion of subprime loans were originated through brokers, who bore the initial responsibility for pre-qualifying borrowers and informing eligible borrowers of suitable loan products. But brokers faced incentives to close deals (and thus earn their fees) as quickly as possible, and may often have preferred certain products that were not in a customer's best interests over those that were more suitable, increasing the credit risk borne by lenders and investors. Lenders inflated the risk of their loans in various ways, as catalogued earlier, including lending at excessively high CLTV ratios, failing to confirm the borrower's ability to repay, encouraging buyers to overstate their incomes, qualifying the borrower based on teaser rates, providing inadequate disclosures of future rate increases, and so forth.

From the perspective of brokers and lenders, a high rate of delinquencies and foreclosures, with their accompanying losses, are the predictable and reasonable consequences of poor borrower prequalification and poor underwriting. Generally, bailout and moratoria proposals appear to place no burden on brokers at all. Some proposals purport to shift a portion of bailout costs to lenders by paying them less than the pre-default balance of the loan (Massachusetts), or by requiring them to waive some fees (California). Yet to the extent the lender is better off than in foreclosure—which will nearly always be the case—the lender is helped by the bailout. Lenders who would not expect to profit from government intervention will not seek it, or will not cooperate with government efforts to refinance the loan. No existing state proposal compels lenders to participate even when it would not be profitable for them to do so. In no meaningful sense is the lender bearing the cost of the bailout. In fact, the more a lender engaged in abusive or predatory practices, the greater the risk of loss it assumed, the higher the proportion of borrowers that will be entitled to assistance, and the more money the lender will then be paid as a result of the government bailing out the buyers. Indeed, the Massachusetts plan requires that the lender have engaged in "unfair or deceptive lending practices."[32] And to the extent the lender does bear some cost initially, that cost can and will be passed on to future borrowers. Innocent taxpayers and tomorrow's borrowers subsidize loans to predatory lenders, so that today's overreaching buyers can remain in homes they were never able to afford. Wealth is redistributed from the responsible, to the irresponsible, from the ethical to the unethical.

Bailouts and moratoria may encourage riskier behavior by lenders and borrowers alike.

A borrower who has no expectation that the government will rescue him from delinquency has stronger incentives to exercise personal responsibility in the management of his finances. If the borrower must bear the negative consequences of default himself, he is more likely to think twice before missing a mortgage payment to purchase a big-screen TV, or similarly non-essential item, or to increase his savings in preparation for a "rainy day." Bailouts could also increase the level of risk lenders generate through their own conduct. If the government promises to step in when a loan goes sour, why hesitate to make even the riskiest loans? Bailouts encourage moral hazard on the part of both lenders and borrowers. Moratoria encourage moral hazard on the part of borrowers.

Particular programs may be structured in ways that invite abuse—now and in the future.

Some bailout proposals aggravate the moral hazard by inviting abuse. The Massachusetts proposal, for instance, provides that to qualify for the bailout, a borrower cannot yet be in foreclosure, but rather must be 60 or fewer days delinquent. Thus, a borrower who would otherwise pay his mortgage, *can qualify for a bailout—and thus a potentially lower, fixed interest rate—by stopping his payments.* It would be irrational for a borrower to continue paying if the state were offering assistance conditioned on his being in default. The Massachusetts proposal also presents a perverse incentive to the lenders, whose recovery is capped by the propertyís current appraised value: lenders have the strongest incentive to participate when the property is overvalued, which defeats the purpose of the cap and invites an additional form of adverse selection. Any borrower assistance program that provides an incentive to *stop* paying, or an incentive to lenders to "game" the appraisal process will load still more costs onto taxpayers and future borrowers.

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[32] MassHousing, description of Foreclosure Prevention Loan program at www.masshousing.com (accessed July 25, 2007)

Implementing a bailout program today will, moreover, create problems for the future. The housing market is cyclical. Housing bubbles have burst before (and will burst again); increased pressure on low income borrowers has been felt before (and will be felt again). Intervention at this time will merely create an unhealthy precedent for the next time that markets do what they have always done—expand and contract, boom and bust. The expectation--or even the possibility-- that the government will step in and bail you out if you take on too much debt and gamble on rising home prices should not be part of the decision to buy a home.

They will help borrowers who should be bearing greater responsibility for their own role in the problem.

It may be true that many borrowers did not fully understand or appreciate the terms of their loans. This explains, but does not excuse, some portion of the problem. It certainly does not justify creating a new class of borrower who is effectively relieved of the duty to read and understand the documents he is signing. Where a borrower's understanding was distorted by a lender's lies, misrepresentations, or material omissions, the borrower should have redress through the courts. And mandatory disclosures can certainly be improved to reduce the level of buyer misunderstanding in the future. But where the lender's conduct was lawful, the loan should be enforced as written. The purchase of a home is such a significant financial transaction that the borrower should expect to do his homework and get whatever help he needs to understand the commitment he is entering into, just as he is expected to do when taking out an auto loan, student loan, or other major obligation.

Some borrowers essentially gambled with the loan proceeds and lost--as gamblers usually do. A small but significant portion of recent subprime originations was used to purchase investment properties and second homes.[33] In many cases, these borrowers were counting on home prices to continue rising at least long enough for them to spruce up the property and "flip" it at a significant profit. This is an inherently risky strategy, and those who pursued it should bear the consequences of the risk they assumed--just as they would surely get to retain the fruits of their strategy had it succeeded. No assistance plan should help speculators who attempted to profit from the housing bubble, or the lenders who enabled this behavior.

In some instances, borrowers were more than unsophisticated or unlucky: they were irresponsible or unscrupulous. Many borrowers exploited low documentation or underwriting standards to qualify for larger loans and buy better or larger homes than they could truly afford. Some, perhaps most, misrepresented their ability to pay, possibly with broker or lender encouragement.[34] Others bought homes with little or no money down, counting on home prices to continue rising—in essence, gambling with their family's most valuable asset. Using someone else's money to remove these accepted risks from borrowers' shoulders will only encourage more borrowers to accept even greater risks, and potentially act even more dishonestly.

It may well be that brokers or lenders aggressively encouraged borrowers to exploit low documentation requirements, or the availability of high LTV loans. Ultimately, no matter how strongly the broker or lender encouraged a particular size or structure of loan, the buyer should know his own ability to pay, now and in the future.

These programs treat borrowers who took on too much debt better than those who managed their finances responsibly.

Not every subprime borrower is facing delinquency or foreclosure. The vast majority, in fact, are keeping up with their payments, however difficult it may be for them. But a similarly situated borrower, potentially one with an identical loan and identical income, whose only real difference is that he has not managed his personal finances wisely, may qualify for assistance that dramatically lowers his monthly payment. Or, the borrower being assisted may only have *claimed* to have income sufficient to support the original loan; his actual income may be lower. Yet he receives financial assistance at another's expense, so that he can remain in a larger home than he could reasonably afford, while his more responsible neighbor makes sacrifices to meet his

[33] In addition to the HMDA data cited earlier, a recent survey found that 8% of the subprime loans that originated in Q4 2006 were for nonowner-occupied properties. Mortgage Bankers Association, Year-End 2006 Subprime Mortgage Originations Survey.

[34] MARI Report, *supra* note 22.

monthly obligations. Bailout and moratorium programs are inherently unfair.

Ultimately, we have to confront the fact that not every person who wants to own a home has the financial wherewithal to be a homeowner. Some borrowers face foreclosure today because they were *never* suitable candidates for a home loan, or at least never candidates for loans as large as those they originally accepted. Borrowers with highly volatile earnings may be better off renting their housing, if only because a rented home is less costly to vacate should economic necessity require it. Others may be better off owning smaller or otherwise less expensive homes. Forcing delinquent or over-stretched borrowers to make new housing arrangements consistent with the reality of their earnings is not necessarily an unfair or inappropriate outcome.

At the end of the day, taxpayers and consumers at large will pick up the bill for costly contractual interference.

As explained above, if today's borrowers were able to repay their existing loan amounts—either under the terms of their original loans or pursuant to refinancing—the high cost of foreclosure would drive lenders to renegotiate voluntarily. The borrowers who cannot refinance today are those who are not expected to repay their debts even if their payments were lowered. If a bailout program is adopted, and if borrowers cannot or will not repay their debts, who will really bear the costs? The answer depends on the particulars of the program, but in general, taxpayers and/or future borrowers will foot the bill. The Massachusetts proposal, for instance, would use a funds from federal and state taxpayer-supported entities (Fannie Mae and MassHousing) to finance the prepayment of existing loans. The California proposal calls for "donations from public or private sources."

A moratorium program creates the same problems. A short-term moratorium on foreclosure is not likely to be effective (a borrower's circumstances are less likely to improve in a shorter period of time), yet the more time a borrower has to "rebound," the more costly the program becomes. Lenders will essentially finance the borrower's property during the moratorium period, and will end up either passing the costs along to new borrowers or withdrawing from the subprime market entirely. In either case, consumers suffer.

Whatever the nature of the interference, if lenders conclude that any loan they offer today faces a serious risk of governmental interference and alteration in the future, they will build legislative risk into the price of all loans. In the end, whether they pay through taxes or the cost of borrowing, the many must pay to benefit the few.

Where Should We Go From Here?

The plight of existing borrowers should not be ignored. While heavy-handed intervention is to be avoided for many reasons, less intrusive forms of assistance are entirely legitimate, and many have proven themselves successful. Additional funding to expand the scope of proven programs may indeed be money well spent.

Many of the most promising forms of borrower assistance involve community-based consumer education and foreclosure-avoidance activities, such as those supported by NeighborhoodWorks America (NWA). In a September 2005 report focused on the costs and impact of foreclosure ("NWA Report"), NWA highlighted a few of the many community-based development organizations that have dramatically reduced foreclosure rates not by costly, sweeping assumptions of borrower obligations, but through borrower education (in some cases, spanning the entire home ownership lifecycle), debt management, assistance with loss mitigation, and very limited, short-term financial assistance involving relatively small sums loaned to borrowers who meet stringent eligibility criteria.[35] The NWA Report serves as a reminder that there are a multitude of ways to help borrowers avoid foreclosure, short of taxpayers taking over their mortgages.

Consumer education is a theme running through every successful program. One program serving the city of Cleveland offers free counseling sessions on managing finances, making payments on time, homeowner insurance, preventative maintenance and foreclosure prevention.[36] One study of foreclosure-prevention programs cited by NWA found that

[35] NWA Report, *supra* note 19.

[36] NWA Report at 16.

"good budget counseling alone in many cases can help borrowers recover from delinquency."[37]

Many programs involve helping borrowers and lenders renegotiate voluntarily. Borrowers often do not realize that loan restructuring is an option, and may not know how to present their "best case" to the lender. Lenders, for their part, may not always appreciate the range of alternatives to foreclosure, or the merits of pursuing a particular alternative with a particular borrower. Indeed, some community programs include lender education components, just as they include borrower education.[38] A program that helps to determine the borrower's reasons for going into default, assess the borrower's true ability to pay (perhaps combined with debt management counseling), brings the parties together, and presents the alternatives accurately, can often avoid foreclosure in a way that meets both borrower and lender needs.

NWA identifies five "loss mitigation" techniques, each of which provides an alternative to foreclosure: loan modification, special forbearance (that is, an extended repayment plan), home sale by the borrower pursuant to a "preforeclosure" agreement (which may include some cost sharing between borrower and lender), deed-in-lieu of foreclosure (assignment of the property to the lender, potentially coupled with a cash payment to the borrower), and an FHA-specific alternative called "partial claim."[39] Not all of these approaches allow the borrower to remain in the home, which is as it should be: many borrowers face foreclosure today because they bought homes they cannot afford under any reasonable loan structure. But all of these approaches have the potential to leave both borrower and lender in a better position than under foreclosure. Borrowers and lenders alike may well need assistance understanding, choosing and pursuing these alternatives; programs to provide that assistance may be worth funding.

Direct financial assistance to the borrower is a feature of some community-based programs, but unlike the massive, six-figure loans contemplated by the Massachusetts plan, loans to qualified homeowners are often $5,000 or less. They are typically offered only to borrowers who can demonstrate that they are financially responsible, and face only a temporary setback in their ability to pay their mortgage. For example, a small but successful program in Boise, Idaho offers loans from $1,500 to $5,000 to borrowers who are delinquent for reasons outside their control (such as job loss or medical emergency), but who are now employed and have never had a bankruptcy at the time of application. The administrative cost of the program is an average of $906 per loan.[40] By contrast, the Massachusetts plan would award an average of $250,000 apiece to borrowers.

[37] Christi Baker, Essential Components of Post-Purchase Program Models. Chrysalis Consulting, based on the work of Lucy S. Gorham, Roberto G. Quercia, and William M. Rohe for the Center for Urban and Regional Studies at the University of North Carolina at Chapel Hill (2004), cited in NWA Report at 24.

[38] One program in Indianapolis "provides training programs to reach both consumers and real estate professionals who may have contact with borrowers who are at risk of defaulting on their mortgages. Many real estate professionals have not received in-depth training in loss-mitigation practices, such as restructuring the mortgage after payments have become delinquent." NWA Report at 20.

[39] NWA Report at 5.

[40] NWA report at 15.

Conclusion

The current subprime mortgage situation reflects the predictable result of simple economic forces: greater access to credit meant more home buyers bidding up home prices, increasing the demand for mortgage products with "affordability" features, attracting more brokers and lenders to the market, who competed for more borrowers, who bid on more homes, causing prices to rise…a self-reinforcing cycle, but not one that could last forever. When the boom turned to bust, as it has before, lenders and borrowers alike were left to face the consequences of their choices.

We can learn from the current problems, and take reasonable steps to help lenders and borrowers make well informed decisions in the future. Government cannot stop the housing market from expanding and contracting, but it can make future contractions less painful:

- It can require that borrowers receive complete, accurate and intelligible information about mortgage products.
- It can hold lenders and brokers to higher, more uniform standards during loan origination, increasing the likelihood that borrowers will be able to repay their debts.
- It can support community-based groups that provide counseling to homeowners, helping them understand how to live within a budget, how to manage debt, how to deal with unanticipated financial setbacks, and how to negotiate with lenders.

Mortgage risks created by ignorance or avarice can and should be reduced. But risk cannot be eliminated from the process; it is an inherent part of the mortgage market. Bailouts and moratoria alter the mutually agreed-upon risk sharing between lender and borrower, undermine the expectation that contracts will be enforced as written, and alter borrower and lender behavior in ways that make those measures unlikely to achieve their intended goals, while their costs are borne primarily by taxpayers and consumers who played no role in creating the problem. They are not the solution.