

## The Virus that Engulfed Us All

All actors share the fault for the subprime lending crisis.

by Kathleen C. Engel, JD

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*This article is adapted for print from a talk Engel gave at AIER on June 21 as part of the Summer Fellowship Program. The presentation was moderated by Alan Chartock, president and CEO of WAMC Northeast Public Radio. It aired on the radio station, which broadcasts to seven states in the Northeast, at 90.3 FM and on the web at wamc.org.*

*A video of the entire presentation can be found at [www.aier.org](http://www.aier.org).*

The beginning for me was Cleveland, Ohio, where I lived until a few years ago. In the 1990s, Cleveland was having a renaissance after some tough decades. It was a very exciting time. There had been new developments downtown. The Cleveland Clinic, University Hospital at Case Western, and Cleveland State University were all growing. Life was looking up for Cleveland. Folk singers were no longer belting out songs about the river being on fire.

Then we started to see people driving around in cars with stickers that said, “Turn your house into a loan.” I began to wonder about these loans. Soon offers for loans blanketed the city.

I lived in a racially diverse neighborhood. It was half African-American and half white. We were targeted every day with flyers to refinance our home. We didn’t just get flyers; brokers would knock on our door and pester us on the phone. When my children heard a solicitor on the phone, they would say, “We know you’re a predatory lender.”

Brokers were skillful at finding people to target—especially those with homes that needed repairs. Many

communities around Cleveland had strong housing codes. Our homes were regularly inspected, and it seemed everyone was cited for something, from cracks in the driveway to an order to replace a roof or tear down a sagging garage.

As soon as people received housing code citations, the number of loan solicitations would multiply exponentially. This happened because the violations were open to the public at city halls. The mortgage brokers would go through the citations and contact the homeowners who needed major home repairs. At the time, people felt like the brokers were manna from heaven.

Brokers targeted neighborhoods based on their racial composition. They knew that there was pent-up demand for credit among African-Americans because banks had historically refused to make loans to them. They also knew that many African-Americans were mistrustful of banks because the banks had red-lined their neighborhoods. Instead of going to the local community banks that probably would have given them a decent deal, African-American homeowners too often signed on with the brokers who were working their communities. They were not alone. Borrowers of all races who did not have the experience to be wary of mortgage brokers were snookered as well.

To understand the tactics of mortgage brokers, I’ll tell you about a particular Cleveland-area broker, who was a young white man. When he was hired, his employer had the broker’s picture taken with a disabled child, another picture with an elderly woman, then a picture with a black woman and two biracial children, and finally a picture of him alone with two children.

His employer gave him a wallet-sized and an 8 x 10 print of each photo. Once the broker determined which persona would most likely appeal to the homeowner he was soliciting, he would show the appropriate picture. When the customers came into his office to sign the papers, he would have the matching 8 x 10 glossy on his desk.

The loans had very high interest rates and huge fees. People were paying interest rates of 18 percent when the market rate based on their credit risk would be about 7 or 8 percent. Fees could run in the tens of thousands of dollars. Many of the fees were for services borrowers did not even need. Predatory lending became the term used to describe these practices.

During this period, unlike later in the crisis, people tended to own their homes outright or close to it. They were taking out loans based on the equity in their houses, not on their incomes. A homeowner might take out a loan to buy a car, maybe to finance a child's education, or to pay for unexpected medical bills. Others used the equity in their homes to consolidate other debt such as credit card bills.

The borrowers often didn't have incomes to support the monthly loan payments. As soon as borrowers were about to default, their brokers would return and say, "I can take care of this for you. We'll just refinance." The broker would charge them as much as \$10,000 in fees, which would be tacked onto the principal of the loan, and the borrowers would have a larger and even less affordable loan.

Every time the brokers churned the loans, borrowers would lose more and more equity. Ultimately, the home would go into foreclosure. That's what we saw happening.

The research that ultimately resulted in my co-author and I writing *The Subprime Crisis*, which was published last year, began in the late 1990s. We sought to understand why lenders were making loans that borrowers couldn't afford to repay. To answer the question, we looked at the roles of brokers, appraisers, lenders, investment banks, credit rating agencies, and other entities. By examining the chain of actors who "touch" loans, we saw there were a multitude of problems. Fifteen years later, we are still researching and writing about these questions.

After a few years, predatory lending morphed into what became known as Alt-A lending. These loans had lower interest rates and fees, but were still much more expensive than prime-rate loans. Instead of lending based on the equity borrowers had in their homes, Alt-A loans were based on the flawed assumption that housing prices would rise indefinitely. Not infrequently, lenders made loans for 100 percent of the value of a home. If borrowers did not have the monthly income to afford a fixed rate loan, the lenders would put them in loans with teaser rates that would be affordable for a few years, but then would jump to very high rates the borrowers would not be able to afford. Then there were the infamous low-

doc and no-doc loans that were made without any solid evidence of income or assets.

Predatory lending and lax underwriting were coupled with a huge push toward homeownership that came from both the Clinton and Bush administrations. Homeownership is a good thing. For most people, it is the most important tool for accumulating wealth. The problem with the drive for homeownership was that policy makers were not scrutinizing the loan terms and lending practices that enabled people to buy homes. As a result, millions of people have lost their homes.

## Everybody Is to Blame

Mortgage lending has undergone a major transformation in the last few decades because of a process called securitization. Quite simply, securitization converts home loans into bonds.

To appreciate securitization, you have to consider how home loans were financed in the past. Banks used to make home mortgage loans and keep the loans on their books. They never had enough money to meet demand, and there was always a queue of qualified borrowers who wanted credit, but couldn't get it.

Securitization allows banks to sell their loans, most often to what used to be investment banks and now—since the financial crisis—are the investment arms of commercial banks. With securitization, lenders have a constant flow of money to lend to customers.

When loans are purchased to create bonds, we refer to the purchasing entity as the sponsor. The sponsors put all the loans into one pool. They then divide the pool into tranches, which is French for slices. The most senior tranche is high-grade bonds, and the most junior tranche is usually junk bonds. There are many intermediate grade bonds as well. The high-grade bonds are the most expensive and carry the lowest risk of default. The junk bonds are the inverse.

As borrowers make their monthly principle and interest payments, the owners of the highest rated bonds are paid first, and so it goes down the line until the holders of junk bonds are paid. If not all borrowers make their payments, the junk bonds suffer the first losses.

Financing of home loans through securitization has a major downside. No one minds the hen house.

Take mortgage brokers: They receive a commission when the loans they broker are consummated. Then they move on to the next loan. It is a similar scenario for lenders. Because they sell their loans, they have little

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incentive to make sure the loans are fair and affordable.

The sponsors make money on volume. They need to keep loans flowing through their securitization pipelines because they receive underwriting fees based on the dollar value of the loans they push through. They want large loans with interest rates that generate high yields, and they wanted a lot of them during the boom. The sponsors were constantly pressuring lenders to make more loans. Most investment banks bought subprime lenders to assure themselves a steady supply of loans.

The blame does not just rest with the financial services industry. While most borrowers were innocent, others knew what they were doing and were essentially placing bets that housing prices would continue to rise. The worst borrowers committed fraud by lying about their income and assets.

Investors were at fault, too. Instead of examining the quality of the assets backing the bonds they purchased, investors relied on the credit rating agencies who gave their Good Housekeeping Seal of Approval on the securities.

The credit rating agencies are also to blame. In the past, credit rating agencies rated securities and provided their ratings to those who paid to receive them. Decades ago, the rating agencies abandoned the user-pays model. Instead, they required that the sponsors pay the rating agencies to rate the quality of the bonds the sponsors were putting together.

In this “eat what you kill” environment, credit rating agencies needed to please their customers—the sponsors. The incentive was to give high ratings so the sponsors would seek their ratings in future deals. There are even examples of sponsors threatening to take their business elsewhere if they did not receive good ratings on their securities.

## The Failure of Government

The federal government knew about predatory lending from the outset, but did nothing. Sen. Phil Gramm of Texas, who was chairman of the Senate Banking Committee from 1995 to 2000, took the position that predatory lending shouldn't be regulated because it didn't have a definition. That message rang from the White House as well and, as a result, federal agencies failed to take steps to curtail mounting abuses and high-risk lending.

Bank regulators also played a role. When it became clear that there was no way that a federal anti-predatory law would get through the Senate because of Sen. Gramm, the states stepped into the void. North Carolina was at the vanguard when it passed a state anti-predatory lending law that restricted various predatory loan terms and lending practices. National bank regulators, who receive funding from the banks they regulate, took the position that no depository institution that had a national charter had to abide by state anti-predatory lending laws such as North Carolina's. The U.S. Supreme

Court upheld the regulators' rulings.

State banks did have to abide by the state anti-predatory lending laws while the mega-banks were excused by federal regulators. Although there were small banks that failed during the financial crisis, their failure was the result of the economic collapse, not because they were making bad subprime loans.

The Federal Reserve Board of Governors did have some power to regulate mortgage lending under the Homeownership Equity Protection Act (HOEPA). When HOEPA passed, Congress instructed the Fed to implement a provision of the new law prohibiting unfair or deceptive lending practices. Alan Greenspan, then the chairman of the Fed, refused to follow the Congressional mandate. So while the lending crisis was building, the Federal Reserve was passive.

The Federal Reserve was also the regulator of all bank holding companies. Any big bank is part of a bank holding company. As part of its authority, the Federal Reserve Board had the power to supervise and investigate subsidiaries of bank holding companies, which would include the subprime lenders that they owned.

Alan Greenspan refused to examine the bank subsidiaries. In fact, it was not until Ben Bernanke took over as the Fed chairman that the Fed began looking at the activities of subsidiaries. Even then, it was initially only a pilot program.

## Foreclosure Mills

When loans become part of securitization deals, an entity called a servicer collects borrowers' monthly loan payments, pays borrowers' real estate taxes and insurance, and passes funds along to be distributed to the investors who bought the bonds backed by the mortgage loans. The servicers also handle foreclosures.

Servicers subcontract out many aspects of foreclosures, including the legal work. The firms they engage are now infamously known as foreclosure mills. One role of such firms is to ensure that the foreclosure paperwork is in order and that the entity that owns the loan has the right to foreclose. Because foreclosing on a borrower's home has harsh consequences, the law has many formalities, including a requirement that the loan be in default. Similarly, to avoid the possibility that more than one entity could claim a right to foreclose on a piece of property, the law firms must verify that the proper party is foreclosing.

Many large foreclosure mills failed to comply with the legal requirements for foreclosure. They had employees signing thousands of affidavits falsely stating under the pain and penalty of perjury that they had reviewed the loan files and the borrowers were in default. In fact, the affiants had not reviewed the loan files at all. Similarly, the firms brought foreclosure actions without verifying who owned the notes and whether the alleged owners had the right to foreclose.

There are even cases where two different entities foreclosed twice on the same loan. Several of the big foreclosure mills have been shut down, and there are very serious criminal allegations against them.

## The Social Cost of Foreclosure

When you take out a mortgage on your house you do two things. You sign a note—which is just a contract to repay. And, through the mortgage you give the lender the right to take your property if you don't repay.

Traditionally, the note and the mortgage were both held at the lending bank. With securitization, loans were bought and sold to different entities. To transfer ownership of a note, the party to whom the note is payable must endorse the note just as you endorse a check. And, just as with a check, there can be multiple endorsements.

During the peak of securitization, the money was flowing at lightning speed, but the paperwork was not. The parties that put the deals together regularly failed to obtain the necessary endorsements and assignments. Not only that, they did not keep track of the original notes and mortgages, and often failed to record the mortgages at county land registries. Only when borrowers began defaulting did the flaws in the paperwork become apparent.

In Massachusetts, the Supreme Judicial Court has held that certain defects in the foreclosure proceedings make the foreclosures invalid. As a result, people who bought property at foreclosure sales don't always own the property they thought they purchased. If they borrowed money to buy the property, they still have to pay the loan, but the property is not theirs.

That is just the Massachusetts story. States take an array of approaches to foreclosure, and the validity of foreclosures varies based on each state's law as interpreted by the state courts.

More generally, what foreclosure has meant from a social perspective is that about 10 million homes will ultimately be lost to foreclosure. When people lose their homes, their children change schools. We know that the rate of teen pregnancy, high school dropout rates, and drug use are deeply influenced by changing schools.

Teachers in some of the hardest-hit areas have to design their curricula in week-long segments. No longer can they spend a month studying Egypt. This is because so many children are relocating and leaving or joining the classroom.

There is more pressure on homeless shelters, soup kitchens, and social service agencies. Communities are fractured. Neighborhoods have lost their communal spirit. Senior citizens have no neighbors to shovel

their walkways. Lost is the informal aid neighbors give one another when someone is sick or has had a loss. For people who are just getting by—because they have lost their jobs, because they are low-income, because they are sick—the collapse of social networks is even more devastating.

These are costs we are going to feel as a country for a very long time.

## A Plan to Clean Things Up

The housing market is critical to the wealth of the country. Our first priority should be stabilizing the housing market by reducing the principal borrowers owe on their loans—a practice known as cramming down. There are people who could afford their mortgages if they were crammed down. A cram down would enable them to stay in their homes, and their neighborhoods would be spared the blight of vacant homes.

There are also homeowners who cannot afford their homes even if they received a cram down. When their homes go into foreclosure and no one bids an acceptable price at the sale, the owner of the note purchases the property. Most often, the property remains vacant. At worst, it becomes invested with rodents or a haven for crime. In almost all cases, the home suffers from neglect and drives down the value of neighboring houses. This situation leads to my second priority: short sales.

With a short sale, homeowners seek to sell their homes to people who will pay a fair market price. The problem is that the fair market value is less than the amount due on the mortgage loan. For example, say somebody has a mortgage of \$100,000, and the fair market value of the home is \$80,000, the owner could say to the bank, "Look, if you'll take a \$20,000 hit, I can sell this house. At least you'll get \$80,000." Banks rarely say yes to proposals like this.

Short sales would also help borrowers who can afford their loans, but cannot afford to sell their homes, for example, if they are relocating because of work. They can't sell because their homes are underwater—they owe more than their homes are worth.

Banks should welcome short sales because the average return on a foreclosure is 50 percent of the loan amount. Short sales are a no-brainer.

I think all of us also need to recognize that if the housing market doesn't recover, the country is not going to recover. We all need to personally understand what is happening and to talk to politicians about our desire for them to lead with innovative policies. Politicians need to hear that the housing crisis affects not just people who are living on the financial edge, but all of us.

**Disclaimer:** *The views and opinions expressed in this article are those of the author's and do not necessarily reflect those of the American Institute for Economic Research.*