

# LexisNexis Expert Commentaries

Robert M. Jaworski on Subprime Mortgage Lending

## **The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis**

In meteorological terms, a “perfect storm” is a storm whose intensity is magnified by the convergence of several distinct weather events. A “perfect storm” is not necessarily confined to the weather, however, as current events in the subprime mortgage loan business demonstrate. This commentary will outline some of the apparent causes for the perfect storm that has hit the subprime mortgage industry and some of its immediate effects, and then focus on the legal issues likely to emerge in its aftermath.

Like other perfect storms, the subprime mortgage lending crisis had not just one cause, but many. And the causes were a long time in the works.

### **THE CAUSES**

**Loan originations declined as interest rates rose.** The origins of this storm can be traced back to the long refinance boom which ended only a few years ago when mortgage interest rates began their steady climb from record low levels. During the boom, industry players (investment banks, lenders and brokers alike) profited handsomely from unprecedented origination activity, and, no doubt, expected those levels of profitability to continue. As interest rates inched higher, however, originations (and profits) declined.

**Marketing of exotic loan products.** To reverse this decline, keep up the flow of originations to the secondary market, and—it should not be forgotten—allow more people to achieve the American dream of home ownership, lenders and brokers began to aggressively market more exotic loan products. These included:

- interest-only and payment-option adjustable rate mortgages (“ARMs”), originally intended for use by sophisticated real estate investors and professionals (“Nontraditional mortgage loans” or “NTMs”);
- reduced documentation loans, originally intended for use by self-employed borrowers and other borrowers who possessed the necessary income and/or assets to qualify but, for one reason or another, had difficulty being able to document that ability consistent with Fannie/Freddie underwriting standards (“stated income” loans);
- “2/28” or “3/27” ARM loans, ARM loans with an initial 2- or 3-year period during which the interest rate would remain fixed; and
- so-called “80-20 piggyback” loans, 80% loan-to-value (“LTV”) first-lien loans combined with 20% LTV second-lien loans, designed to eliminate the need for expensive private mortgage insurance.

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**Making the loan “work.”** Marketing efforts concerning these more exotic loan products were often directed to borrowers for whom these loans may not have been a good fit and were boosted by the use of below-market “teaser” rates that would be in effect, typically, for only a short initial period. Moreover, the features of these various types of loans were often combined to make the loan “work,” *i.e.*, so that the loan could close. The result was as desired—more originations. But this increase in originations also sowed the seeds for the current crisis.

**Speculation and fraud** also played a part in this perfect storm. Real estate speculators used these exotic products to purchase properties without having to put up a lot of their own money or prove income and assets. Borrowers (and/or loan officers in some cases) exaggerated income on stated income loans (dubbed by some, for this reason, as “Liar’s loans”) in order to obtain loans for which they would not otherwise have qualified. And criminals found that many of the features of these loans made it easier to perpetrate property-flipping and other illegal schemes.

**Expectation that interest rates would remain stable and home values appreciate.** Generally, however, the perception of all involved at the time was that these were “good loans.” Lenders, secondary market purchasers of these loans, and borrowers (at least those who understood their loans) felt confident that interest rates would remain stable and perhaps even decrease, and that home values would continue to appreciate, thereby enabling the borrowers to refinance before their loans reset. Borrowers were also optimistic—as they almost always are—that their financial situations would improve. (Unfortunately as well, many borrowers may not have fully appreciated when their loans closed how drastically their payments could change under certain situations.)

Regrettably for all concerned, interest rates did not remain stable, but rose; borrower’s financial situations on the whole did not improve; and, most importantly, home values did not continue to appreciate, and in some areas of the country, actually fell. The perfect storm was upon us.

#### IMMEDIATE EFFECTS

**Preventive action in 2006—too late.** Realizing that some of these more exotic loans carried significant repayment risk, having been underwritten for the most part at the loan’s initial interest rate rather than the fully-indexed rate, the federal bank regulators took preventive action late in 2006, too late however to ward off the storm. They issued formal Interagency Guidance on Nontraditional Mortgage Product Risks (“Guidance”) to the banking industry which requires banks (and other lenders, following the decisions of many state mortgage regulators to adopt the CSBS/AARMR version of the Guidance<sup>1</sup>) to employ more vigorous underwriting standards in connection with these loans and to do a better job of alerting consumers to their potential pitfalls (which, coincidentally, may make it more difficult for banks to refinance these borrowers into new loans when their existing loans reset) [[71 Fed. Reg. 58609 \(October 4, 2006\)](#)].

<sup>1</sup> CSBS is the Conference of State Bank Supervisors, a trade association whose members are state bank regulators. AARMR is the American Association of Residential Mortgage Regulators, a trade association whose members are residential mortgage regulators. Previous to issuance of their version of the Guidance, these two organizations had combined to work on the design for a multi-state licensing system for non-bank mortgage lenders and brokers.

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**Decrease in loan purchases—increase in enforcement—subprime lenders going out of business.** Seeing all of this, secondary market purchasers of subprime loans, already nervous about the quality of their loans and perhaps also the financial stability of their loan sellers, cut back on their purchases of new subprime loans and, at the same time, demanded that sellers buy back some of these loans. At this time also, state regulators began to ramp up enforcement efforts against subprime lenders. The result was that upwards of 20 subprime lenders, including some of the nation's largest (e.g., New Century Financial Corp. ["New Century"], Mortgage Lenders Network, USA, Inc., and Ownit Mortgage Solutions), were forced to go out of business, and others were forced to sell loan pools on the "scratch and dent" market at substantial discounts, seek out emergency sources of liquidity to enable them to carry on their businesses and/or search for buyers.

**Goals.** Against this backdrop, state and federal legislators, and regulators, began to search for solutions, both to deal with the potential for a substantial increase in foreclosures when these loans reset and to prevent a recurrence of this perfect storm.

#### RESPONSES

**New ideas; new impetus for old ideas.** Actions aimed at dealing with the ramifications of the perfect storm and to prevent a recurrence are being taken, and will likely continue to be taken, simultaneously, in both the legislative and regulatory arenas, as well as in the courts.

**Legislative responses.** Congress is considering numerous federal legislative initiatives to deal in one way or another with the subprime crisis. These include various bills, and bill proposals, to beef up protections against predatory lending, to regulate mortgage lenders and brokers on the federal level, to make it tougher for mortgage holders to foreclose, to expand the FHA's authority to allow it to refinance more subprime loans, and to make money available to prevent foreclosures. Which of these bills, if any, will be enacted and what form they will take is unknown, but it appears from the tenor of the debates so far that providing federal dollars to stem the anticipated tide of foreclosures (branded by some members of Congress as a "bailout") has the least chance of success, whereas expansion of the FHA's authority is viewed as a fairly likely outcome. In addition, some form of federal anti-predatory legislation or regulation seems likely to become a reality, with Congress seeming to want the Federal Reserve Board ("FRB") to use its regulatory authority to deal with this issue rather than to have to deal with it itself.

Two other proposals are likely at least to be debated:

1. a proposal to limit or eliminate holder-in-due course protection for loan purchasers, which would in effect enlist the help of secondary market participants to police lenders and brokers; and
2. a proposal to impose a suitability standard on mortgage lenders and/or a fiduciary duty upon mortgage brokers.

More about these proposals later.

**State legislatures** have also been busy attempting to deal with the subprime situation, and their responses have been even more varied than those being floated in Congress. They include efforts such as the following:

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- To enact, or strengthen existing, comprehensive anti-predatory legislation;
- To place a fiduciary responsibility or a standard of “good faith and fair dealing” upon mortgage brokers in their dealings with borrowers;
- To require individual loan originators to be licensed and to meet prescribed educational and/or testing requirements;
- To restrict the advertising and marketing practices of lenders and brokers, particularly with respect to ARM loans;
- To impose upon lenders a requirement that they verify the borrower’s income and/or determine that the borrower has the “ability to repay” the loan and/or be able to demonstrate that a refinance loan will provide the borrower with a “tangible net benefit”;
- To criminalize mortgage fraud;
- To increase resources devoted to enforcement efforts connected to mortgage lending; and
- Generally, to raise standards for mortgage lenders and mortgage brokers.

As one would expect, the foreclosure process has also received much attention by state legislators. Proposals in this area include:

- Foreclosure moratoriums, voluntary or otherwise;
- The insertion into the foreclosure process of additional consumer protections;
- Government “requests” for lender forbearance; and
- Establishment of rescue funds to prevent foreclosures.

**Regulatory responses.** The big question in terms of administrative agency responses to the subprime crisis is what will the FRB do now that it has had its June 14, 2007 hearing on Subprime Lending. The FRB is authorized by the Home Ownership and Equity Protection Act (“HOEPA”),<sup>2</sup> to prohibit, by regulation or order, acts or practices in connection with

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<sup>2</sup> Chastising the FRB for its failure to act in accordance with this provision, Senator Dodd pointed out, in remarks made during a Senate hearing on subprime lending, that this provision in fact obligates, rather than merely authorizes, the FRB to take action.

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(A) mortgage loans that [it] finds to be unfair, deceptive, or designed to evade the provisions of this section; and  
(B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower. [[15 U.S.C. § 1639](#) (l), (2).]

However, the FRB has indicated that it will proceed cautiously in this regard.

Other federal agencies may also play a role. The General Counsel of the Federal Deposit Insurance Corporation (“FDIC”) has recently raised the possibility that federally insured depositories might have to hold capital against some securitized mortgage loans, to protect against the risk of buyback demands. In addition, representatives John Dingell (D-Mich.) and Barney Frank (D-Mass.) have urged the Federal Trade Commission and the FDIC to do more to safeguard consumers in light of the U.S. Supreme Court’s decision in *Watters v. Wachovia Mortgage* (which held that the states were preempted from enforcing their laws against operating subsidiaries of national banks) [[127 S. Ct. 1559 \(April 17, 2007\)](#)].

Recently, the federal bank regulators released their final Statement on Subprime Mortgage Lending (“Subprime Guidance”) [[72 Fed. Reg. 37569](#) (July 10, 2007)]. The Subprime Guidance requires banks to analyze a borrower’s capacity to repay the loan according to its terms, and to take into account both principal and interest obligations at the fully indexed rate with a fully amortizing repayment schedule, plus a reasonable estimate for real estate taxes and insurance, whether or not escrowed. Consistent with this requirement, the Subprime Guidance encourages banks to use debt-to-income ratios, including, specifically, “front-end” ratios (the percentage of monthly gross income necessary to meet the borrower’s monthly housing expense, including principal, interest, real estate taxes and insurance) to quantify a borrower’s repayment ability, *particularly* if the bank is going to rely upon reduced documentation, “piggyback” second mortgages, or other (“risk layering”) features that significantly increase the risk to both the bank and the borrower. With respect to stated-income loans, the Subprime Guidance allows banks to make such loans only in exceptional circumstances, *i.e.*, where verified and documented mitigating factors exist that will clearly minimize the need for direct verification of the borrower’s income.

Finally, by focusing greater scrutiny on consumers’ understanding (or lack of understanding) concerning these more exotic mortgage products, the subprime crisis may also provide a boost to HUD’s efforts to adopt rules designed to achieve comprehensive RESPA reform, which, of late, have focused on improving and enhancing the good faith estimate of closing costs to make it something upon which consumers can place greater reliance.

State mortgage and securities regulators have also been busy. Reportedly, the U.S. Securities and Exchange Commission (“SEC”) is looking into New Century’s restatement of financial results announced this past February, and the U.S. Attorney’s Office for the Central District of California is conducting a criminal inquiry into trading in New Century’s stock and accounting errors.

In addition, State mortgage regulators in a number of states have issued cease and desist orders against New Century and other subprime lenders for failing to fund loans that have been closed and for other violations. Many states also adopted the Subprime Guidance issued by the federal bank regulators

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almost immediately after it came out, and more are expected to do so. And some have developed or are considering developing “Best Practices” guidelines for mortgage bankers and bankers to follow.

**Litigation responses.** Litigation responses to the subprime crisis have only just begun. Securities class actions have been started against several subprime lenders that are public corporations. Secondary market purchasers of subprime loans have sued lenders for failing to honor buy back demands and/or to account for missing escrow payments. While borrowers have been attempting for some time now to defend against foreclosures by alleging improprieties in the origination of their loans, such tactics will no doubt become more prevalent as the publicity attached to the subprime crisis accelerates and more and more of the blame for the crisis is placed—rightly or wrongly—on lenders and brokers. Employees of the now-defunct subprime lenders will likely sue for unpaid compensation. And plaintiffs’ class action attorneys will be searching for opportunities to sue subprime lenders. (Of particular interest to them in this regard may be a settlement of a class action recently entered into by Wells Fargo Bank in which it was claimed, among other things, that Wells Fargo failed to give subprime borrowers accurate information about their loans.)

Even investment banks will not be immune from legal actions as a result of this crisis. Bondholders have already filed suit against one investment bank for failure to disclose risks involved with the purchase of bonds backed by subprime loans. And the Ohio Attorney General has indicated that he intends to sue not only lenders, but also investment banks, on behalf of borrowers and the Ohio Public Employees Retirement System (which invested in bonds backed by subprime mortgages).

Finally, an interesting class action lawsuit has been filed in New York Supreme Court which threatens to alter the relationship in that state between lenders and the mortgage brokers who place loans with them. The complaint contends that mortgage brokers act as *agents* of their lenders, thereby making the lenders liable for any misdeeds committed by the broker during the origination process. Using this theory, plaintiffs hope to have the lender held liable, specifically, for the mortgage broker’s alleged falsification of loan documents that enabled the borrowers to obtain loans in amounts far beyond their ability to repay.

#### LEGAL AND POLICY ISSUES

**Numerous and complex legal and policy issues** are raised by the responses to the subprime crisis highlighted above, including:

- Should comprehensive federal anti-predatory legislation, if enacted, preempt similar state and local laws?
- Should stated income loans be regulated?
- Would more disclosure concerning the risks involved with NTMs, stated income loans, 2/28 and 3/27 ARM loans, and 80-20 piggyback loans, significantly increase consumers’ understanding of these products and, in so doing, significantly reduce their risk?

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- Should prepayment fees be eliminated?
- Should non-bank mortgage lenders and brokers be licensed at the federal level, and if so, what should be the proper role of the states?
- Should mortgage brokers be impressed with a fiduciary obligation or a duty of “good faith and fair dealing” with respect to their customers, or should their relationship by determined by contract?
- Should mortgage lenders be obligated to make sure that the loans they make to borrowers are “suitable” for them, provide them with “tangible benefits” and/or are “affordable” to them?
- Would a foreclosure moratorium cause more harm than good?
- Should holder-in-due course protections for assignees of residential mortgage loans be eliminated?

A brief discussion of some of the more significant of these issues is set forth below.

**Federal preemption of state and local anti-predatory lending laws.** This is an issue that is sure to be hotly contested. Should Congress seek to enact comprehensive federal anti-predatory lending legislation, the mortgage industry will no doubt insist upon inclusion of a provision that will preempt any similar state laws and regulations. The industry’s fear is that once national standards have been established, presumably following careful consideration by the Congress and with input from all concerned, individual state and/or local government authorities may determine that those standards are too lax or do not go far enough in one regard or another and need to be strengthened; in other words, that recent history—specifically, the enactment in numerous state and local jurisdictions of anti-predatory lending laws and regulations modeled after but that go beyond HOEPA—will repeat itself.

Consumer groups, on the other hand, will likely fight just as hard to keep a preemption provision out of the bill. They will argue essentially that a uniform national standard is simply not flexible enough to meet the needs of borrowers in every locality, *i.e.*, that, because mortgage loan borrowers in one community may face problems different from those faced by borrowers elsewhere or because the communities themselves may be impacted differently as a result of those problems, state and local governments need to have the ability to legislate solutions to these problems at the local level.

Closely associated with this preemption issue is whether such state anti-predatory lending laws, as well as other state consumer protection laws, should apply to federally-chartered banking institutions as well as non-bank lenders and brokers. Based on the *Watters* decision and other judicial precedent, it appears from a legal perspective that the answer is no. However, depending upon how the debate proceeds concerning the establishment of comprehensive federal anti-predatory lending standards, the states may well seize the opportunity to attempt to raise this issue before Congress.

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**Federal licensing.** Also sure to be debated is the issue as to whether or not non-bank mortgage bankers and/or mortgage brokers should be licensed and/or supervised at the federal level. In an effort intended in part to head off such a possibility, state mortgage regulators through AARMR and with the help of CSBS, have been hard at work developing a multi-state licensing system, which is scheduled for implementation beginning in 2008. Despite these efforts, however, the possibility exists that Congress will see a need for more control at the federal level and decide that national licensing is a better alternative. Another possibility is that Congress will allow the states to retain their current licensing authority over non-bank lenders and brokers, but create a separate federal license. Holders of this federal license, the qualifications for which would presumably be more demanding than existing state law qualifications, would be authorized to do business in every state without having to obtain state licenses.

If a national licensing system were to be put in place, alongside or in lieu of the existing state licensing system, two issues that would have to be dealt with are what law would apply in connection with loans originated in a particular state, and who would enforce that law. States can be expected to lobby hard to preserve their authority in this area.

**“Suitability.”** This is yet another touchy subject. Consumer groups have been pushing to force mortgage lenders (and brokers) to make a determination, before closing a loan to a borrower, that the loan is “suitable” for that borrower. They point to a similar standard currently in place with respect to the sale of securities by stockbrokers on behalf of their clients, which they say has worked well.

Mortgage industry backers have argued, however, that the role of a stockbroker is materially different than that of a mortgage lender. The stockbroker, for example, takes the clients’ money and invests it, whereas the lender obtains money for the borrower. Also, clients ordinarily look to their stockbrokers for advice as to which stock to buy or sell and when, whereas borrowers historically deal at “arms length” with lenders, considering them in the same way as a purchaser of a product does the seller. Industry proponents further maintain that a suitability standard should be rejected because it is unworkable, would create enormous potential liability for lenders, and would cut off credit to deserving borrowers.

**Holder-in-due-course protection.** Finally, there is the question whether or not assignees of residential mortgage loans should continue to possess holder-in-due-course (“HDC”) protection with regard to the loans they purchase. HDC protection insulates the holder of a mortgage note from most claims and defenses that the borrower may have against the original creditor (or any assignees prior in the chain of title).

Eliminating HDC protection for assignees would mean that, when an assignee purchases a loan, it would also assume legal responsibility for any misdeeds on the part of the originating lender. To protect its investment in the loan as much as possible, and limit its risk, an assignee would then be forced to undertake substantial due diligence concerning both the lender and the loan origination process, in effect, requiring the assignee to supervise its lenders.

Critics of the HDC doctrine maintain that this would be a good thing, since secondary market purchasers of loans are in a better position than borrowers to oversee lenders. However, there are real concerns that elimination of HDC protection for assignees could dry up funds for housing and/or substantially increase the cost of such funds, resulting in significantly higher interest rates for borrowers.

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#### CONCLUSION

**Change is certain, but the details are not.** As indicated, the impact of the perfect storm in the subprime lending industry has been severe, and is or will be felt by industry members, employees, investors and consumers alike. Moreover, the debate as to what to do about it will likely be vigorous and public. This virtually ensures that something will be done. The only questions are what will be done, and when.

The most likely outcome is usually the one that offers the least resistance. On the federal level, that would translate to Congress pressuring mortgage holders to practice forbearance (in lieu of foreclosure) when these problem loans reset, but leaving it up to the FRB to adopt rules to deal with the most egregious lending practices that contributed to the subprime crisis. To the extent that such action might then be considered by state and local authorities to be inadequate, these authorities would likely step in to try and come up with additional and discrete remedies.

Nevertheless, the only certainty at this point is uncertainty. No one knows what will happen. Continued vigilance and participation by all concerned in the process will hopefully ensure that the solutions arrived at to deal with the aftermath of this perfect storm will prove to be helpful, or at least not more harmful than the storm itself.

**About the Author.** Robert M. Jaworski is a partner in the Financial Services Regulatory Group of Reed Smith, LLP in Princeton, New Jersey and a former Deputy Commissioner of the New Jersey Department of Banking. He is also Co-Chair of the RESPA and Housing Finance Subcommittee of the American Bar Association's Consumer Financial Services Committee; the former Editor of Pratt's Mortgage Compliance letter, a national publication on mortgage compliance issues; and the Secretary of the Board of Directors of the New Jersey Bar Association's Banking Law Section. Mr. Jaworski provides federal and state compliance and regulatory advice to banks, mortgage lenders and other consumer financial services providers, and regularly assists Reed Smith litigators in defending financial institutions in individual and class actions. He has written on real estate topics for several LexisNexis publications, including [Real Estate Financing](#) (LexisNexis Matthew Bender), which features his Special Alert on *State Governmental Responses to Problems in the Subprime Mortgage Loan Origination Business*.

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