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## Private risk, public risk: Public policy, market development, and the mortgage crisis

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## PRIVATE RISK, PUBLIC RISK: PUBLIC POLICY, MARKET DEVELOPMENT, AND THE MORTGAGE CRISIS

Daniel Immergluck\*

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# PRIVATE RISK, PUBLIC RISK: PUBLIC POLICY, MARKET DEVELOPMENT, AND THE MORTGAGE CRISIS

Daniel Immergluck

## **Abstract**

This article describes the development of mortgage markets in the United States in the twentieth century, with an emphasis on the growth of high-risk market segments beginning in the 1990s. It focuses on the federal role in the development of stable, risk-limiting products and markets. The author then examines the growth of securitization, including structured finance and its impact on mortgage markets. Finally, the article discusses the policy debates and developments surrounding subprime and other high-risk mortgage lending from the 1990s through the 2007-2008 mortgage crisis. The author concludes that knowledge of the problems and costs of high-risk lending had a minimal impact on policy making and that mortgage markets are not well served by a deregulationist paradigm.

# PRIVATE RISK, PUBLIC RISK: PUBLIC POLICY, MARKET DEVELOPMENT, AND THE MORTGAGE CRISIS

*Daniel Immergluck\**

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## INTRODUCTION

Following the boom in subprime and high-risk lending from 2002 to 2006—after an earlier escalation in the late 1990s—loan defaults and foreclosures surged in many parts of the country in 2006 and 2007.<sup>1</sup> As the subprime debacle evolved into a broader mortgage crisis, which later catalyzed national and global economic decline, the costs of failing to regulate a new, high-risk mortgage market—revolutionized by private-label securitization—became painfully obvious. By early 2008, the mortgage crisis had led to direct losses to investors in mortgage-backed securities in the \$350 to \$420 billion range, but because these losses occurred at leveraged financial institutions, their full impact was estimated to be \$2 trillion or more.<sup>2</sup> By August of 2008, write-downs and losses of mortgage-backed securities by commercial and investment banks had climbed to over \$500 billion, and were projected to end up at somewhere on the order of \$1 trillion or more, even before accounting for leveraged impacts, and some were predicting that total write-downs and losses would reach well beyond these levels.<sup>3</sup> The impacts on financial institutions were further magnified by the use of credit default swaps and other derivative instruments.

By the fall of 2008, the problems of credit and financial markets had grown so large that they had brought down a number of major financial firms, including Lehman Brothers, Washington Mutual, and AIG, and compelled the government takeover of the government sponsored enterprises, Fannie Mae and Freddie Mac. Even more broadly, the financial crisis had spread to commercial paper markets and inter-bank lending, slowing credit flows in these markets and affecting a much broader segment of the real economy. These developments led the Treasury Department, together with the Federal Reserve Board, to push for a major federal program to purchase distressed mortgage-backed and related securities from financial institutions.<sup>4</sup> After some substantial fits and starts, the Emergency

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1. Based on Mortgage Bankers Association data, the number of loans entering foreclosure in the fourth quarter of 2007 topped 400,000, up from under 200,000 per quarter as recently as 2005 and under 100,000 as recently as 1999. See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., STATE OF THE NATION'S HOUSING, EXECUTIVE SUMMARY 4 (2008), available at [http://www.jchs.harvard.edu/publications/markets/son2008/son2008\\_executive\\_summary.pdf](http://www.jchs.harvard.edu/publications/markets/son2008/son2008_executive_summary.pdf).

2. See ADRIAN BLUNDELL-WIGNALL, THE SUBPRIME CRISIS: SIZE, DELEVERAGING AND SOME POLICY OPTIONS 10 (2008), available at <http://www.oecd.org/dataoecd/36/27/40451721.pdf>.

3. See Yalman Onaran, *Banks Subprime Losses Top \$500 Billion on Writedowns*, BLOOMBERG, Aug. 12, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY&refer=home>.

4. See Joe Nocera, *36 Hours of Alarm and Action as Crisis Spiraled*, N.Y. TIMES, Oct. 2, 2008, at A1, available at <http://www.nytimes.com/2008/10/02/business/02crisis.html>.

Economic Stabilization Act was passed which provided for a \$700 billion Troubled Assets Relief Program (“TARP”), which provided the ability to buy mortgage-backed securities and to invest in equity shares of financial institutions.<sup>5</sup>

As the country’s attention moved from a severe, but narrower, subprime mortgage crisis to a much broader national and global economic crisis, less notice was given to the costs of the heavy and concentrated foreclosures caused by subprime lending. Borrowers lost their homes and saw their credit records decimated. Many renters—who clearly had no role in the mortgage process—found themselves with little notice to vacate their homes. Neighborhoods around the country were littered with vacant and abandoned properties, which can depress the values of nearby homes and create havens for blight and crime.<sup>6</sup> The problems were not just confined to the inner-city. In some places, entire suburban or exurban subdivisions that had been planned or started at the peak of the high-risk lending boom in the mid-2000s were left half-empty or worse. Cities and suburbs were forced to become custodians of abandoned properties in order to slow the contagion effects of derelict properties.<sup>7</sup>

This Article describes the development of mortgage markets in the United States during the twentieth century, with particular emphasis on the growth of high-risk market segments beginning in the 1990s. Part I provides a brief look at the history of institutional mortgage markets in the United States, with particular focus on the federal role in the development of stable, risk-limiting products and markets. Part II turns to the growth of securitization. It then discusses structured finance and its impacts on mortgage markets, again with specific attention to the role of federal policy in nurturing these systems. Finally, Part III discusses the policy debates and developments surrounding subprime and other high-risk mortgage lending from the 1990s through the 2007–2008 mortgage crisis.

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5. See Press Release, U.S. Dep’t of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), available at <http://www.treas.gov/press/releases/hp1207.htm>.

6. See DANIEL IMMERGLUCK, FORECLOSED: HIGH-RISK LENDING, DEREGULATION, AND THE UNDERMINING OF AMERICA’S MORTGAGE MARKET 149-53 (2009) [hereinafter IMMERGLUCK, FORECLOSED].

7. See Daniel Immergluck, *Community Response to the Foreclosure Crisis: Thoughts on Local Interventions* 11-17 (Fed. Reserve Bank of Atlanta, Discussion Paper No. 01-08, 2008), available at [http://www.frbatlanta.org/filelegacydocs/dp\\_0108.pdf](http://www.frbatlanta.org/filelegacydocs/dp_0108.pdf).

## I. THE DEVELOPMENT OF RISK-LIMITING MORTGAGE MARKETS IN THE UNITED STATES

The structure of homeownership finance played a key role in the relatively limited extent of homeownership in the United States through the early decades of the twentieth century. Prior to the late nineteenth century, institutional lending for homeownership was relatively rare, although early forms generally date back to the first terminating building society in 1831.<sup>8</sup> For the nonaffluent, owner occupancy was usually achieved during this pre-institutional period through some combination of doing one's own construction, extensive household savings, borrowing from individuals, and land contract financing.<sup>9</sup>

It is no coincidence that institutional lending in the United States and in England grew substantially with the Second Industrial Revolution and large scale urbanization in the late nineteenth century and early twentieth century. Rural homesteaders faced fewer obstacles to homebuilding and ownership than urban households. Land was relatively inexpensive and materials could generally be harvested off the land. As cities grew and land values rose, however, working class and modest-income families could rarely afford to buy land and build a house without some sort of financing over time.<sup>10</sup>

The rise of stable, risk-limiting mortgage finance markets in the broad middle part of the twentieth century—epitomized by the long-term dominance of the plain-vanilla thirty-year fixed-rate mortgage—was dependent on a persistent and substantive role for the federal government. The timeline of U.S. mortgage market development and change is not one of bright lines and clear boundaries, although there were certainly periods during which change occurred quite rapidly. Rather, different outside forces—including those based in technology, policy, and demography—interacted with each other to produce new financial products and practices, changes in the structure of the financial services industry, and various opportunities and vulnerabilities among homeowners and would-be homeowners in different parts of the country.

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8. See DAVID MASON, FROM BUILDINGS AND LOANS TO BAIL-OUTS: A HISTORY OF THE AMERICAN SAVINGS AND LOAN INDUSTRY, 1831–1995, at 17-18 (2004).

9. Land contract financing involves a “buyer” agreeing to make monthly payments (on top of what is usually a substantial up front deposit) over a fixed period for occupancy with some notion that, possibly after repeated contract renewals, the buyer will assume ownership. They resemble rent-to-own arrangements. See Marc A. Weiss, *Marketing and Financing Home Ownership: Mortgage Lending and Public Policy in the United States, 1918-1989*, 18 BUS. & ECON. HIST. 110 (1989).

10. *Id.* at 110-11.

### A. The Local Building and Loan

From the early decades of the twentieth century through at least the 1970s, it is arguable that no single type of lender was more important to the development of government-supervised, risk-limiting mortgage markets than the building and loan (“B&L”), later called the savings and loan (“S&L”). The B&L became a major provider of mortgage credit, and because of its direct and indirect impacts on the structure of home finance and the mortgage market itself. Traditional, permanent B&Ls developed into a significant industry in the later decades of the nineteenth century.<sup>11</sup> Early B&Ls were primarily local institutions, with many members knowing each other or having some common association. Social and geographic cohesiveness gave them an informational advantage that kept underwriting costs and defaults low. B&L members/borrowers depended on the solvency and profitability of the B&L, and the fate of the B&L rested closely with the success of borrowers.<sup>12</sup>

Besides B&Ls, life insurance and mortgage companies were important providers of mortgages in the late nineteenth century and early twentieth centuries.<sup>13</sup> Mortgage companies made loans and then sold either individual loans (what would now be called “whole loan” sales) or bonds backed by the loans to investors. The bonds sold by mortgage companies, however, were not like the mortgage-backed securities that became so common in the late twentieth century. These bonds more closely resembled corporate bonds because they remained general obligations of the originating mortgage company, and the underlying mortgages remained on the books of the mortgage company.<sup>14</sup>

Local B&Ls grew significantly in the early twentieth century—supported to some degree by state-level regulation that had begun in the late nineteenth century—and maintained their emphasis on homeownership

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11. The early B&Ls, which date to well before the Civil War, were actually local “terminating building societies.” Those joining a terminating B&L would make regular payments on shares they purchased in the B&L as a form of savings. Once enough capital was accumulated in the B&L to build or purchase a house, the capital was auctioned off to the member willing to pay the highest interest. Once everyone had paid for their loans in full, the organization closed its doors. See MASON, *supra* note 8, at 18.

12. Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL’Y DEBATE 147, 154-55 (1996), available at [http://www.mi.vt.edu/data/files/hpd%207\(1\)/hpd%207\(1\)%20lea.pdf](http://www.mi.vt.edu/data/files/hpd%207(1)/hpd%207(1)%20lea.pdf).

13. *Id.* at 156-59.

14. See D. M. Fredericksen, *Mortgage Banking in America*, 2 J. POL. ECON. 203, 210-15 (1984); see also KENNETH A. SNOWDEN, MORTGAGE COMPANIES AND MORTGAGE SECURITYIZATION IN THE LATE NINETEENTH CENTURY 11-12 (2008), available at [http://www.uncg.edu/bae/people/snowden/Wat\\_jmcb\\_aug07.pdf](http://www.uncg.edu/bae/people/snowden/Wat_jmcb_aug07.pdf).



finance.<sup>15</sup> After the Panic of 1907 and through the boom period of the early 1920s, the number of local B&Ls grew, buttressed by the social and cultural mores that favored homeownership and by the general growth in real estate and the economy.<sup>16</sup> With the real estate collapse of the late 1920s and the onset of the Great Depression, the number of B&Ls declined, but at the beginning of the Great Depression, B&Ls made about one-fifth of home mortgages in the United States.<sup>17</sup> Moreover, commercial banks tended to fare even worse than B&Ls in the early 1930s, in part because bank depositors could withdraw their funds more quickly than those who held B&L shares, which exacerbated bank runs and failures.

There were significant differences in the structure and nature of credit provided by various types of lenders. B&Ls provided longer-term loans with higher loan-to-value ratios (but still rarely ever exceeding 80%) than banks or insurance companies.<sup>18</sup> In the 1920s, the average term of mortgages was eleven years for those written by B&Ls, versus six to eight for those from insurance companies and two to three for those from commercial banks.<sup>19</sup> Average loan-to-value ratios were 60% for B&Ls and 50% for those from other lenders.<sup>20</sup> The shorter term, interest-only loans with relatively low loan-to-value ratios made by banks and insurance companies were known as “straight” mortgages. Homeowners with these loans had to take out new loans much more frequently, and so would incur the up-front costs associated with more frequent borrowing. The limited loan-to-value ratios of these loans typically required the involvement of a substantial second mortgage which came with very high fees and interest rates. They

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15. See MASON, *supra* note 8, at 28-29, 37-39.

16. *Id.* at 53-54, 59-60.

17. *Id.* at 60.

18. Loan-to-value ratios are important in underwriting loans for lenders and borrowers for several reasons. From the lender's perspective, a lower loan-to-appraised value means that, in case of foreclosure, the lender is more likely to recover the full value of the principal lent, especially in the event of falling property values. A lower loan-to-value also tends to be associated with a larger down-payment, which means that the borrower has put more of his or her own money into the property. From the borrower's perspective, lower loan-to-value ratios can protect them in the case of falling property values by allowing them to refinance or sell the home without an out-of-pocket loss. Lower loan-to-values may, however, also make it more difficult for the borrower to afford the down-payment on a home. One alternative is to secure a second, subordinate loan to supplement the primary, first mortgage. Private mortgage insurance was developed to allow lenders to provide higher loan-to-value ratios (larger first loans) to reduce down payment requirements.

19. See Lea, *supra* note 12, at 162.

20. See *id.*

were typically offered by marginal participants in the financial industry and were often unregulated and operated in violation of state usury laws.<sup>21</sup>

### B. The 1930s: Federal Leadership in Home Finance

By the early 1920s, the federal government had become a supporting—and sometimes catalyzing or initiating—actor in the promotion of homeownership in the United States.<sup>22</sup> It was not until the 1930s, however, that Congress and the executive branch became key participants in the development, expansion, and direction of homeownership and mortgage finance. Before the 1930s, many Americans, even many with decent incomes, found it very hard to borrow sufficient funds to purchase a home. The homeownership rate at the turn of the century was just above 46% and, despite the very large economic expansion of the 1920s, it had climbed to only just under 48% by 1930.<sup>23</sup> Up until 1940, the U.S. homeownership rate remained relatively low compared to post-World War II levels.

Initial federal involvement in the mortgage market is often attributed to President Roosevelt's New Deal. To be sure, the 1934 National Housing Act,<sup>24</sup> which created the Federal Housing Administration ("FHA"), was one of the most important pieces of housing legislation in the twentieth century. It followed the Federal Home Loan Bank Act of 1932, however, which President Hoover proposed and signed.<sup>25</sup> This bill created the Home Loan Bank system to provide liquidity to savings and loans to increase

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21. HOME FINANCE AND TAXATION: LOANS, ASSESSMENTS, AND TAXES ON RESIDENTIAL PROPERTY 28 (John M. Gries & James Ford eds., 1932).

22. See Lawrence J. Vale, *The Ideological Origins of Affordable Homeownership Efforts*, in CHASING THE AMERICAN DREAM: NEW PERSPECTIVES ON AFFORDABLE HOMEOWNERSHIP 19-24 (W. Rohe & H. Watson eds., 2007).

23. When compared to some other countries, the U.S. rate was not particularly low, but this was partly attributable to the relatively rural nature of the U.S. at the time and to the desire of recent immigrants to own their own home. See Richard Harris & Chris Hamnett, *The Myth of the Promised Land: The Social Diffusion of Home Ownership in Britain and North America*, 77 ANNALS ASS'N AM. GEOGRAPHERS 173-90 (1987). Reliable data on homeownership rates between decennial censuses at the national level are not available for the 1920s. The real estate sector had slowed down in the late 1920s prior to the stock market crash of late 1929. See Ernest Fisher, *Changing Institutional Patterns of Mortgage Lending*, 5 J. FIN. 307-10 (1950). Therefore, it is very likely that the homeownership rate in the 1920s peaked before 1930. It is unlikely, however, that it hit rates substantially above 50% given the substantial barriers to ownership.

24. National Housing Act of 1934, ch. 847, 48 Stat. 1246 (codified as amended at 12 U.S.C. §§ 1701-1749 (2006)).

25. Federal Home Loan Bank Act of 1932, ch. 522, 47 Stat. 725 (codified as amended at 12 U.S.C. §§ 1421-1449 (2006)); see also SUSAN HOFFMAN, POLITICS AND BANKING: IDEAS, PUBLIC POLICY, AND THE CREATION OF FINANCIAL INSTITUTIONS 160-61 (2001).

their role in the mortgage market.<sup>26</sup> Hoover and others saw the longer-term, higher loan-to-value amortizing mortgage provided by savings and loans as a key tool in promoting homeownership and stimulating the housing market.<sup>27</sup> The law gave the federal government a significant role in promoting and standardizing the mortgage market. Government not only authorized, but also invested in, the creation of the new secondary market institutions by initially capitalizing the Home Loan Banks. Member institutions were required to purchase small amounts of stock to become the owners of the Banks over time.

The Home Loan Bank system fostered a new standardization and federal endorsement of the B&L-type loan. It was also the first direct government vehicle for dealing with the long-term/short-term liquidity mismatch that faced B&Ls with short-term deposits. By allowing banks to “rediscount” their mortgage assets, the government was creating liquidity, thereby stimulating the mortgage and housing market. B&Ls were generally local institutions, so imbalances could arise in terms of supply and demand for credit in different parts of the country. The Home Loan Bank system also provided for geographic redistribution of lending capital. Some older, developed areas had a surplus supply of lending capital, while other growing areas had surplus demand for mortgages. The Home Loan Bank system provided a system of “banks for banks,” in which thrifts could lend and borrow through the regional Home Loan Bank, which in turn could exchange funds throughout the system. This redistributed funds throughout the nation in a more efficient manner.

Like most government policy regarding financial markets, the Home Loan Bank Act was contested. Insurance companies and mortgage companies who viewed B&Ls as competition and did not provide the B&L form of loan argued against the bill at that time. They claimed that the Home Loan Banks were unnecessary and encouraged unsound lending with overly long maturities and excessive loan-to-value ratios. They argued that the non-amortizing straight mortgage—essentially a short-term (three to seven years), interest-only loan—was proper finance. By encouraging longer-term mortgages, opponents argued, the Home Loan Banks would encourage precisely the sort of overbuilding that helped cause the Depression in the first place.<sup>28</sup>

Roosevelt pushed for more aggressive interventions in the housing market. The Home Loan Banks did little in the near term for homeowners who

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26. See HOFFMAN, *supra* note 25.

27. *Id.* at 160.

28. *See id.* at 167.

were losing their homes through foreclosures. Moreover, because they were wholesale institutions, the Banks were perceived as benefiting only lenders and not borrowers.<sup>29</sup> In fact, they were vulnerable to this charge in part because, although the Home Loan Bank Act did call for direct lending, the Banks did not have any such capacity.

Instead of merely reorganizing the Home Loan Banking System to suit the demands for more direct assistance to homeowners, Roosevelt and Congress passed the Home Owners Loan Act (“HOLA”) of 1933.<sup>30</sup> HOLA created the Home Owners Loan Corporation (“HOLC”), which purchased mortgages in default from lenders using funds raised in the bond market.<sup>31</sup> HOLC also made refinance loans directly to homeowners with the intent of providing a more manageable loan.<sup>32</sup> It was capitalized and owned by the federal government and governed by the Federal Home Loan Bank Board. To enable homeowners to remain in their homes, HOLC used long-term federal bonds to buy the loans, extend the term of loans, and lower monthly payments.<sup>33</sup> Up to 80% of the loans were fully amortizing over fifteen years.<sup>34</sup>

HOLC has generally been perceived as successful. It made loans from 1933 to 1936 and did not incur substantial losses over the long term. The HOLC received 1.9 million loan applications, accounting for approximately 40% of homes with residential mortgages during this period. The HOLC funded approximately one million loans for a total of \$3.1 billion.<sup>35</sup> HOLC served approximately 20% of homeowners with existing mortgages, a remarkable number.<sup>36</sup> The HOLC has been accused of institutionalizing redlining practices through the use of its risk rating maps.<sup>37</sup> While the

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29. A “wholesale institution” is one that does not lend directly to homeowners or homebuyers, but rather to lenders themselves. Institutions lending directly to homeowners or homebuyers are considered “retail” institutions. For more information on wholesale lenders, see Jack Guttentag, *Mortgage Lenders, Mortgage Brokers & Loan Officers*, (Dec. 22, 2000), [http://www.mtgprofessor.com/A%20-%20Type%20of%20Loan%20Provider/lenders\\_brokers\\_and\\_loan\\_officers](http://www.mtgprofessor.com/A%20-%20Type%20of%20Loan%20Provider/lenders_brokers_and_loan_officers).

30. Home Owners Loan Act of 1933, ch. 64, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-1468c (2006)).

31. See C. LOWELL HARRISS, *HISTORY AND POLICIES OF THE HOME OWNERS’ LOAN CORPORATION* 7-13 (1951)

32. See Kristen B. Crossney & David W. Bartelt, *The Legacy of the Home Owners’ Loan Corporation*, 16 *HOUSING POL’Y DEBATE* 547, 551 (2005).

33. See HOFFMAN, *supra* note 25, at 169-70.

34. *Id.* at 170.

35. See HARRISS, *supra* note 31, at 1-2.

36. *Id.*

37. See Crossney & Bartelt, *supra* note 32, at 571.

agency's maps may have furthered or reinforced redlining practices, it actually made many loans in areas that it rated as high-risk.

The next major development in federal mortgage policy was the National Housing Act of 1934, which created the Federal Housing Administration ("FHA").<sup>38</sup> The FHA was created in large part to stimulate job creation, but was responsible for introducing a key credit enhancement that had a strong direct effect on credit availability and served as a model for modern private mortgage insurance, which became a critical tool in assisting homebuyers with less than 20% equity to purchase a house.

In addition to offering mortgage insurance, the FHA established the twenty-year and later, thirty-year, fully amortizing, fixed-rate mortgage with an 80% loan-to-value ratio as the dominant, standardized mortgage format for the remainder of the twentieth century.<sup>39</sup> FHA loans also increased the standardization of mortgages generally, setting the stage for the eventual expansion of secondary market activity and securitization that dominated the last quarter of the twentieth century.<sup>40</sup> The FHA was a major force in the standardization and commoditization of mortgage credit.<sup>41</sup>

The FHA increased the supply of mortgage credit and allowed for predictable, low-risk, long-term financing, making the true effective costs of financing lower and reducing the risks to borrowers due to uncertainties regarding the availability and pricing of credit in the future. From the 1930s to the 1940s, the average term for mortgages made by S&Ls increased from eleven years to fifteen years.<sup>42</sup> For insurance companies, who were larger FHA users, the average term increased from between six to eight years to twenty years.<sup>43</sup> Overall, the average loan-to-value for mortgages increased from less than 60% to 75%, and the bulk of loans became fully amortizing, helping homeowners to build equity over time.<sup>44</sup>

The FHA had a large impact on the overall housing market. From 1935 to 1939, FHA insured loans accounted for 23% of single-family lending.<sup>45</sup>

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38. National Housing Act of 1934, ch. 847, 48 Stat. 1246, 1246 (codified as amended at 12 U.S.C. §§ 1701-1749 (2006)), available at [http://fraser.stlouisfed.org/docs/historical/martin/54\\_01\\_19340627.pdf](http://fraser.stlouisfed.org/docs/historical/martin/54_01_19340627.pdf).

39. Lea, *supra* note 12, at 161.

40. *Id.*

41. *Id.* at 161-63.

42. *Id.* at 162.

43. *Id.*

44. *Id.*

45. Kerry D. Vandell, *FHA Restructuring Proposals: Alternatives and Implications*, 6 HOUSING POL'Y DEBATE 308 (1995).

This share grew to 45% during the years 1940 to 1944, while accounting for 22% of outstanding residential mortgage debt by 1945.<sup>46</sup>

The end of World War II saw the advent of the Veterans Administration (“VA”) program. Within one year after the war, VA-guaranteed mortgages had increased from just 1% of outstanding residential mortgage debt to 9% of such debt.<sup>47</sup> From 1945 to 1956, during the peak of the postwar suburbanization boom, VA loans accounted for 35% of net new mortgage flows, with the FHA accounting for another 14%.<sup>48</sup> The FHA program gradually declined in significance, until the late 1960s when Congress authorized a substantial expansion of FHA activity, including a major subsidized loan component.<sup>49</sup> By 1970, FHA loans still accounted for almost 30% of single-family loans.<sup>50</sup>

The roles of the FHA and the VA in the mortgage market were also associated with a shift—at least for a while—away from the conventional S&L delivery of mortgage finance and toward FHA/VA mortgages, for which insurance companies and commercial banks were major lenders (S&Ls were relatively smaller players in the FHA and VA loan market). Insurance companies, who in the past had purchased individual loans or invested in mortgage company debentures, now began to develop correspondent relationships with mortgage companies, in which they would agree to purchase pools of loans from the mortgage companies. These were not mortgage-backed securities, which came later, but literally bulk purchases of loans that the insurance company agreed to purchase once they were made by the mortgage company.<sup>51</sup>

After introducing FHA insurance and before creating the VA loan, the federal government created the Federal National Mortgage Association (now known as Fannie Mae) in 1938 to create a secondary market in FHA-insured loans. Fannie Mae allowed a new form of intermediation between non-depository mortgage originators such as mortgage companies and investment capital from other sources. This meant that a new source of capital became available for the mortgage market. In 1968, Fannie Mae became a “government-sponsored enterprise” (“GSE”), a for-profit, privately owned corporation that is subject to some—albeit limited—federal over-

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46. *See id.*; *see also* SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 33 (1961), available at <http://www.nber.org/books/klam61-1>.

47. *See* KLAMAN, *supra* note 46.

48. *Id.*

49. *Id.*

50. *See* Vandell, *supra* note 45, at 309.

51. *See* KLAMAN, *supra* note 46, at 245-48.

sight.<sup>52</sup> Its mission had also changed to focus on providing liquidity to the non-GSE, or conventional, mortgage market.<sup>53</sup>

Thus, the two major “circuits” for U.S. housing finance both relied heavily on federal intervention and support over the course of their development.<sup>54</sup> The S&L circuit was supported by deposit insurance and the Home Loan Banks provided a critical source of liquidity, while also drawing some support from FHA and VA programs. In the meantime, mortgage companies, commercial banks, and insurance companies made loans supported by FHA and VA programs, and later by Fannie Mae and Freddie Mac. Prior to the 1960s, the FHA/VA circuit was particularly important. Beginning in the late 1960s, as VA and FHA programs declined in their overall share of mortgages, the S&L circuit grew more dominant. This generally persisted until the 1980s and the explosion of the GSE secondary markets and securitization, which essentially superseded the old FHA/VA circuit and once again favored nonlocal lenders such as mortgage companies.<sup>55</sup> In both circuits, the public sector seeded, nurtured, and was largely responsible for the size and functioning of mortgage markets, and especially the dominance of the long-term fixed rate mortgage.<sup>56</sup>

These markets were not without serious and pervasive problems, including discrimination and redlining.<sup>57</sup> Their basic structure, however, constituted a sound base upon which to build a fairer system, and in the late 1960s and into the 1970s, a number of federal statutes—the Fair Housing Act, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, and the Community Reinvestment Act—were adopted toward this end. While implementation and enforcement of these laws were frequently lackluster, there were occasional periods of significant progress towards fair, affordable, and sustainable home finance.<sup>58</sup>

### C. The Growth of Unstructured, Plain-Vanilla Securitization

Put most simply and broadly, mortgage securitization is a process in which the funding of—or investments in—mortgage loans is separated

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52. *See* Lea, *supra* note 12, at 164.

53. *Id.*

54. *See id.* at 152-53.

55. *Id.*

56. *Id.*

57. “Redlining” refers to the practice of not offering or extending credit to certain neighborhoods or submarkets due, in part, to the economic or racial composition of the residents of the area. *See* DANIEL IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 236-45 (M.E. Sharpe ed., 2004) [hereinafter IMMERGLUCK, CREDIT].

58. *Id.*

from the origination (and originator) of the loans. The loans stand, together in pools with many other loans, “on their own” and are no longer tied to the fate of the originating lender.<sup>59</sup> A key objective of securitization is to isolate the loans that eventually provide cashflow to the investors from the originating lender. In general, the alternative is either for the loans to be sold as individual “whole loans” to buyers who assume these loans as individual loans that they (or their agent) then service, or for the loan to remain on the balance sheet of the lender. Debenture sales, like those used by the early mortgage companies, are also an alternative, but have not been widely used in the United States.

Securitization led directly to the widespread “vertical disintegration” of the lending process. It enabled the origination process to be separated from the process of the funding and servicing of the loan. This process has also been called the unbundling of the mortgage process, although the term unbundling is less precise and can refer to several different mortgage market processes. Vertical disintegration meant that more contractual relationships were now required among originators, issuers of the securities, investors that purchased the securities, credit rating agencies, servicers, and other mortgage market participants.<sup>60</sup> In the dominant S&L circuit, these functions were generally integrated within the local S&L that originated, funded, and serviced the loan.

Mortgage securitization has often been portrayed as a private-sector financial innovation. Yet, in its early, less structured and complex forms, it was the Government National Mortgage Association (Ginnie Mae), the federal agency that facilitates the purchase of FHA loans, that issued the first residential mortgage-backed securities (“RMBSs”) in 1970, guaranteeing interest and principal payments on pools of FHA- and VA-insured mortgages.<sup>61</sup> In the mid-1970s, Ginnie Mae also spurred the use of RMBSs by directly subsidizing below-market-rate RMBSs so that investors would get market-rate returns.<sup>62</sup> RMBSs further increased the number and types of investors in the mortgage market, as well as the number of new lenders in the market.<sup>63</sup> Also in 1970, the Emergency Home Finance Act created

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59. For a more extensive discussion of securitization in mortgage markets see ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 318, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT (2008), available at [http://www.newyorkfed.org/research/staff\\_reports/sr318.pdf](http://www.newyorkfed.org/research/staff_reports/sr318.pdf).

60. See Michael G. Jacobides, *Industry Change Through Vertical Disintegration: How and Why Markets Emerged in Mortgage Banking*, 48 ACAD. MGMT. J. 465 (2005).

61. See CHARLES R. GEISST, VISIONARY CAPITALISM: FINANCIAL MARKETS AND THE AMERICAN DREAM IN THE TWENTIETH CENTURY 91-93 (1990).

62. *Id.* at 92-93.

63. *Id.* at 93.



the Federal Home Loan Mortgage Corporation, now Freddie Mac, to provide secondary market capacity for the Home Loan Bank system members and allowed Fannie Mae and Freddie Mac to perform secondary market operations for conventional mortgages.

The first generation of the RMBS was the “pass-through” certificate. Prior to the development of the pass-through RMBS, lenders frequently sought to convert loans into cash to replenish their cash available for lending and to reduce a variety of risks that can come from holding a large amount of long-term mortgages on their balance sheets.

Ginnie Mae, and later Fannie Mae and Freddie Mac, reduced the transaction costs of converting loans into cash. They purchased the loans and assembled them into pools of similar types of loans. These pools also enabled the diversification of risk by including loans from many lenders and different regions. They then issued “certificates,” in which the cash flow generated by the loans in the pool was passed through to the investors in a pro-rata fashion. This was a fairly straightforward and transparent process. Again, in addition to the diversification of loans across lenders and regions, a major apparent advantage for investors of these new securities compared to the old-fashioned debenture issued by mortgage companies prior to the Great Depression was the fact that these bonds were not as exposed to the risk of the originating lender going bankrupt.

There are variations on the pass-through structure, including one in which the GSE or Ginnie Mae does not actually purchase the loans, but guarantees the loan pool that is assembled by another issuing firm. Regardless of the details, this sort of pass-through security does not involve any complex hierarchical structuring into different layers of risk. Therefore, such “single-class” pass-throughs are typically not classified as part of what are known as “structured finance” vehicles.

Fannie Mae and Freddie Mac served as buyer-holders of loans in their portfolios, as well as conduits of mortgage capital from investors to lenders. Securitization via the GSEs offered several advantages to lenders. It provided greater diversification in risks in the value of the lender’s assets, yielded more liquidity to lenders because these diversified assets are more marketable than whole loans, and redistributed credit supply across regions, so that regions with few local sources of credit suffered from fewer constraints on credit flows.

One consequence of the growth of securitization and the GSEs, however, was that S&Ls lost market share to mortgage companies that had gained access to inexpensive funds and were able to offer long-term, fixed rate mortgages at competitive interest rates. The national scope of mortgage companies and their lack of branches allowed them to benefit from econo-

mies of scale and specialization. S&Ls were still both savings and lending institutions that had relied upon their local knowledge for competitive advantage. In the age of securitization, such advantages were made much less relevant by the commoditization and pooling of residential credit.

In its early forms at least, securitization promoted the standardization of mortgage terms and underwriting requirements.<sup>64</sup> This standardization was accompanied by an increased supply of computer-processed and national-scale credit information systems, reducing the benefit of local information. Additionally, the scale and inherent subsidies of the secondary markets meant that they offered lenders lower cost capital for making mortgages. Loans became more standardized and “one-size-fits-all.” Mortgages increasingly resembled commodities rather than individualized products. These changes also resulted in growing economies of scale for most of the stages of the lending process, including funding and servicing. At the same time, these large new national lenders—mostly mortgage companies or bank-owned mortgage companies—developed more “wholesale” lending channels, in which they originated loans through large numbers of sometimes quite small scale and often localized mortgage brokers.

#### D. The Rise of Structured, Risk-Inducing Securitization

Pass-through RMBSs, though assisting in geographically diversifying the underlying default risk that investors would face, did little to deal with another sort of risk facing investors: prepayment timing risk. When interest rates decline, borrowers prepay their loan by refinancing. This can hurt pass-through RMBS investors who had hoped for an ongoing, predictable income stream from the RMBSs. At this point, however, it becomes difficult for these investors to find an investment opportunity that will generate the same sort of return at similar levels of overall risk as the original investment in the security.

At least partly in order to deal with this problem, Freddie Mac issued the first collateralized mortgage obligation (“CMO”) in 1983.<sup>65</sup> A CMO is a more complicated form of RMBS than a pass-through because it allocates prepayment risk across different investors—some of whom are more willing to accept such risks than others—by structuring the security into different segments that pay back over varying schedules. Also, CMOs offer the ability to create a vertical hierarchy of default risk by allowing some bond-

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64. See Lea, *supra* note 12, at 166-68.

65. See Frank Nothaft, Chief Economist, Freddie Mac, Celebrating the Anniversary of Revolutionary Concepts (May 12, 2003), [http://www.freddiemac.com/news/finance/commentary/051203\\_concepts.htm](http://www.freddiemac.com/news/finance/commentary/051203_concepts.htm).

holders to receive their principal back before others and some more risk-tolerant bondholders to bear losses associated with defaults of the underlying loans before the holders of less risky senior bonds. These different segments of risk are called “tranches” (French for “slices”) and are generally classified according to the rating they receive from the credit rating agencies, such as AAA, AA, A, BBB, BB, B, etc.

CMOs and similar structured finance vehicles had an important impact on mortgage markets because they essentially peeled apart various types and degrees of risk and allocated these to different classes of investors depending on their appetite and tolerance for different sorts of risk. In this way, investors who would not invest in a pass-through security backed by loans exhibiting anything but the lowest default risks or were likely to prepay could invest in a bond that was designed to be highly secure. These AAA senior tranche bonds would provide relatively modest interest rates to investors, with lower-rated and riskier tranches earning higher interest rates. CMOs also served investors with different preferences for when they would receive their principal back and how much prepayment risk they would likely bear.<sup>66</sup> In these ways, CMOs appealed to a broader segment of potential investors and drew in more capital into mortgage markets. They also enabled the capital markets to provide credit to a wider spectrum of credit risk at the borrower end.

Thus, securitization encouraged risk-based pricing (although how accurately the pricing matched the risk is subject to debate) rather than the traditional system of credit rationing, where essentially no institutional lender would lend to borrowers below certain, more conservative risk thresholds. In the brave new world of securitization, the more innovation employed, and the more the mortgage cash flows were repackaged, the more risk could be tolerated in the home financing transaction. As the risk at the origination level increases, defaults and foreclosures increase, which produce substantial negative spillovers on communities and longer-term impacts on borrowers.

The issuance of mortgage-backed securities in the subprime market increased from \$87 billion in 2001 to almost \$450 billion by 2006.<sup>67</sup> In the “Alt-A” market, issuance of RMBSs increased from approximately \$11 billion in 2001 to more than \$365 billion by 2006.<sup>68</sup> The combination of this

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66. *Id.*

67. See ASHCRAFT & SCHUERMANN, *supra* note 59, at 2.

68. Alt-A loans are mortgages that are generally made to borrowers with fairly strong credit scores but that exhibit riskier features than prime loans due to the nature of the loan or property. They are often made with little or no documentation of income or assets, for example. *Id.*

explosive growth of securitization since 2001, as well as the decline of GSE issuance from 2003 to 2006, meant that the securitization of subprime and Alt-A loans together almost equaled total GSE issuance by 2006 (\$814 billion versus \$905 billion). Adding in the non-agency securitization of jumbo mortgages meant that non-agency securitization exceeded GSE securitization (\$1.033 trillion to \$905 billion) in 2006.<sup>69</sup>

The simple growth of non-agency CMO-type RMBS was not the entire story of why so much capital flowed into high-risk mortgage markets starting in 2002 and 2003. There were fundamental shifts in the financial engineering of mortgage securities, including most notably the vertical layering of securities, which would themselves be comprised not just of underlying mortgages, but also of RMBSs themselves—in other words, the creation of securities that were themselves generated by cash flows from other securities. Thus, the borrowers were now even further removed from the eventual funders of their loans. In the first wave of nonagency securitization, pension funds and other institutional investors would invest in RMBS which were comprised of thousands of individual mortgages. They may be very senior investors or higher-risk AA or BBB investors, and they relied on the credit rating agencies to correctly evaluate the risks of the underlying loans and the tranches (based on available enhancements and the level of subordination beneath their particular tranche).

A new form of highly complex security was used heavily for the subprime and Alt A mortgage markets—the collateralized debt obligation (“CDO”). The CDO involved the additional layering between the institutional investor and the borrowers. In CDOs, RMBS bonds—particularly those with less than AAA ratings—are themselves pooled with RMBS bonds derived from other loan pools, which may be of varying quality or ratings. The cash flows from these bonds are then pooled in the new CDO special purpose vehicle and a new set of CDO bonds are produced, with senior and subordinate tranches. By this tranching of the cash flow coming from a pool of RMBS (and potentially other CDO bonds), the “sow’s ear” of lower grade bonds produced what were thought to be “silk purses,” in the form of higher rated CDO bonds. The CDO is generated from a spectrum of RMBS and sometimes other kinds of bonds, some of which may be other CDO bonds. Of course this all presumes a great deal of knowledge of the risk of the underlying mortgages or other assets, because now investors are essentially betting that the arrangement of cash flows from a large number of lower or mixed grade investments will yield some amount of higher grade investments.

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69. *See id.*

The CDO increased the value of higher-risk, lower-rated CMO bonds, thus increasing the markets' overall appetite for higher risk lending. In order to provide credit enhancement to the higher rated, senior tranches of CMOs, originators were often required to purchase the lowest-rated, highest risk "residual" tranches from the CMOs derived from their loans. Beyond reducing risk to higher-tranche investors, the assumption of the residual should theoretically encourage the lender to be more risk-averse in its lending because it will absorb the first losses emanating from the loan pool. The CDO market, however, enabled some lenders to sell off their residual interests to CDO arrangers, thereby reducing its "skin in the game" or exposure to losses from its own lending practices.<sup>70</sup>

Another innovation employed in the second high-risk lending boom was the structured investment vehicle ("SIV"). An SIV was a specialized investment company set up solely to purchase long-term, fixed income investment assets, such as mortgage-backed securities by using less expensive, shorter-term commercial paper.<sup>71</sup> SIVs required the ability to borrow frequently and inexpensively, both to remain liquid and to earn a profit. Commercial and investment banks set up SIVs as off-balance sheet investments, to reduce their risk. Many banks, however, essentially guaranteed the liquidity of SIVs, ensuring that they would refinance the commercial paper debt if needed. Thus, when the credit crisis hit in 2007, many banks were forced to essentially bail out the SIVs that they had set up and managed, sometimes actually acquiring their assets and putting them on the banks' balance sheet.<sup>72</sup>

What came to be known as "structured finance," the engineering of CMOs, CDOs, SIVs, and other complex mortgage-related investment vehicles, turned out to suffer from a broad array of perverse incentives and transactional failures.<sup>73</sup> Without sufficient regulatory oversight or interventions, these vehicles helped produce large amounts of default risk in the origination of home loans.

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70. See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2040, 2066-68 (2007).

71. Standard & Poor's, *Structured Investment Vehicle Criteria*, [http://www2.standardandpoors.com/portal/site/sp/en/us/page.article\\_print/2,1,1,0,1031342466642.html](http://www2.standardandpoors.com/portal/site/sp/en/us/page.article_print/2,1,1,0,1031342466642.html) (last visited Mar. 30, 2009).

72. See Shannon Harrington & Elizabeth Hester, *Citigroup to Consolidate Seven SIVs on Balance Sheet*, BLOOMBERG, Dec. 13, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=amwIRXuKwRR8&refer=home>.

73. See ASHCRAFT & SCHUERMAN, *supra* note 59; see also IMMERGLUCK, *FORECLOSED*, *supra* note 6, at 100-11.

## II. FEDERAL POLICY IN THE LATE TWENTIETH CENTURY: NURTURING SECURITIZATION, THE DECLINE OF ORIGINATE-TO-HOLD LENDING, AND BACK-DOOR DEREGULATION

Although Fannie Mae was created in 1938 and Ginnie Mae and Freddie Mac introduced RMBSs in 1970 and 1971, the eventual dominance of securitization in mortgage markets by the late twentieth century is perhaps best attributed to federal financial deregulation of the early 1980s followed by some specific industry-supported legislation later in that decade. By explicitly favoring the securitization circuit over the traditionally dominant S&L circuit, federal policy-makers provided critical help in shifting the structure of the mortgage industry in at least three ways: 1) from a predominantly local to a predominantly national system; 2) from an originate-to-hold model to an originate-to-distribute model; and 3) from one in which most loans were made by relatively more regulated lenders (S&Ls) to one in which predominantly unregulated mortgage companies and a growing set of essentially unregulated mortgage brokers dominated.<sup>74</sup> Combined with the failure of policy-makers and regulatory agencies to increase regulatory supervision of these emerging lenders and the federal preemption of state regulations, these moves meant that the path toward greater overall deregulation of the mortgage marketplace was well paved by the middle to late 1980s. Moreover, legislators and regulators constructed policy that allowed for regulated depository institutions, especially commercial banks, to acquire or affiliate with these less regulated entities so that the new financial conglomerates could conduct most of their mortgage lending through less regulated and supervised mortgage company subsidiaries and affiliates, thereby minimizing regulatory oversight.

A critical ingredient to the growth of securitization was the Depository Institutions Deregulation and Monetary Control Act of 1980<sup>75</sup> (“DIDMCA”), which phased in the general abolition of state usury limits on first mortgages by 1986.<sup>76</sup> DIDMCA also extended the ability of na-

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74. “Originate-to-hold” lending, or sometimes called “portfolio lending,” is a process in which a lender makes a loan and does not sell or securitize it afterwards. The lender holds the loan “in portfolio,” until it is paid off or defaults. “Originate-to-distribute” lending is the alternative, and can take several forms. The lender originates the loan but then relatively quickly sells it to another party or bundles it with other loans either for a bulk sale or securitizes it directly. See Amiyatosh K. Purnanandam, *Originate-to-Distribute Model and the Sub-Prime Mortgage Crisis* (Mar. 13, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1167786>.

75. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.).

76. See PATRICIA A. MCCOY & ELIZABETH RENUART, JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE LEGAL INFRASTRUCTURE OF SUBPRIME AND NONTRADITIONAL HOME*

tional banks (those regulated by the OCC) to be governed only by the usury limits of their home state to most other types of depository institutions.<sup>77</sup> This ability, labeled “interest rate exportation,” allowed depositories to generally override state usury limits. The ability to export rates from low regulation states, which was given to national banks in a 1978 Supreme Court decision, made it harder to regulate from the state level and allowed large national lenders increased advantages in the marketplace, again increasing returns to scale in the industry.<sup>78</sup>

With the adoption of the Alternative Mortgage Transaction Parity Act<sup>79</sup> (“AMTPA”) in 1982, federal policy-makers continued moving to override state consumer credit protections and make it easier to commoditize credit at a national scale, thus fueling large scale delocalized lending sources.<sup>80</sup> AMTPA overrode state laws that regulated various terms of “alternative” loans, including those with features such as adjustable interest rates and balloon payments.<sup>81</sup> The law also allowed mortgage companies, which are primarily state-regulated, to opt for federal regulations issued by the federal S&L regulator (now the Office of Thrift Supervision) rather than comply with the lending regulations of the state in which they were operating. Thus, AMTPA provided significant federal preemption to non-depository lenders, similar to the expanded federal preemption that DIDMCA had provided to depository institutions. And these non-depositories were precisely the sort who relied especially on securitization as a means of funding their loans. Ironically, DIDMCA and AMTPA were partly designed to help S&Ls recover from their struggles in the financial marketplace. In the long run at least, they most likely did the opposite.

The RMBS market grew during the decade, with issuance by Fannie Mae and Freddie Mac increasing from \$14 billion in 1982 to \$160 billion in 1986.<sup>82</sup> In addition to the policy changes, the development of the CMO was a parallel factor in RMBS growth, but it is unlikely that this level of growth would have occurred without the deregulatory actions in DIDMCA and AMTPA.

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MORTGAGES 5-6 (2008), available at [http://www.jchs.harvard.edu/publications/finance/understanding\\_consumer\\_credit/papers/ucc08-5\\_mccoy\\_renuart.pdf](http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-5_mccoy_renuart.pdf).

77. *Id.* at 6.

78. *Id.* at 5, 16-17.

79. Alternative Mortgage Transaction Parity Act of 1982, Pub. L. No. 97-320, 96 Stat. 1545 (codified in scattered sections of 12 U.S.C.).

80. *Id.* at 6-7.

81. *Id.* at 6, 17.

82. See Peter Chinloy, *Public and Conventional Mortgages and Mortgage-Backed Securities*, 6 J. HOUSING RES. 173, 186 (1995).

The early 1980s were also important for laying the groundwork for later policy changes that directly supported mortgage securitization. In 1981, President Reagan created the President's Commission on Housing in part to look at housing finance problems, including unstable interest rates and the problems they caused for the mortgage market. In 1982, the Commission found that:

a broader-based and more resilient system will be needed to supply the funds a strengthened housing finance system will require. . . . [T]he nation can no longer rely so completely on a system of highly regulated and specialized mortgage investors and a single type of mortgage instrument if the strong underlying demand for housing credit is to be met.<sup>83</sup>

As the director of the Commission later recalled, the Commission argued that all sorts of lenders and borrowers should have “unrestricted access” to the money and capital markets. Moreover, the Commission advocated that mortgage-market participants—and by this it appears they were thinking more of investors and originators than of borrowers—should have “reliable ways of managing interest-rate risk.”<sup>84</sup> The Commission went on to recommend a variety of specific policy proposals to more closely and easily link broader capital markets to the “underlying demand” for housing credit. These included exempting RMBS from taxation at the issuing level, having the Securities and Exchange Commission promulgate regulations for streamlined self-registration of issuing RMBS, and other regulatory changes.

At least two statutes followed directly from the recommendations of the President's Commission. First, the 1984 Secondary Mortgage Market Enhancement Act<sup>85</sup> (“SMMEA”) facilitated non-GSE or “private-label” securitization in various ways, including exempting RMBSs from state-level registration and expanding the ability of banks and thrifts to hold RMBSs as assets on their balance sheets.<sup>86</sup> The CMO was also directly supported by a piece of the 1986 Tax Reform Act,<sup>87</sup> which created the Real Estate Mortgage Investment Conduit (“REMIC”), a legal structure for trusts that are used in structured RMBS, especially CMOs. REMICs eliminated any

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83. Kent W. Colton, *The Report of the President's Commission on Housing: The Nation's System of Housing Finance*, 11 REAL EST. ECON. 133 (1983).

84. See Kent W. Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System* 11 (Joint Ctr. for Hous. Studies, Harvard Univ., Working Paper W02-5, 2002).

85. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (codified as amended at 15 U.S.C. § 77r-1 (2006)).

86. See MCCOY & RENUART, *supra* note 76, at 8 & n.40.

87. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified in scattered sections of 26 U.S.C.).



problems with potential “double” taxation of cash flows as they flow through the CMO.<sup>88</sup>

By furthering securitization and enabling lenders utilizing the secondary markets to provide loans at lower cost, at greater scale, and across a larger geographic scope, DIDMCA and the pro-securitization policies put pressure on traditional, localized S&Ls. They had difficulty competing on price or terms. Larger, national scale mortgage companies could provide loans at lower cost, in part because Fannie Mae and Freddie Mac passed on some of their explicit and implicit federal subsidies in the form of lower-cost capital.

The Garn-St. Germain Act<sup>89</sup> also allowed depositories to cross state lines to acquire failing institutions, providing the first major move toward interstate banking.<sup>90</sup> At the same time, depositories capitalized on the increasing failures of thrifts and banks to argue for eliminating limitations on intrastate bank branching. Then, in the late 1980s, more changes in bank and thrift regulation supported the growth of securitization even more. The 1989 Financial Institutions Reform Recovery and Enforcement Act<sup>91</sup> (“FIRREA”)—the S&L “bailout” bill—required thrifts to rid themselves of loans to improve their liquidity and lower their risks. This was followed shortly by similar rules for banks via the Federal Deposit Insurance Corporation Improvement Act (“FDICIA”) of 1991.<sup>92</sup> Mortgages in portfolio received a 50% reserve requirement rating while RMBSs received only 20%.<sup>93</sup> This effectively increased the cost to depositories of holding loans in portfolios.

By the 1990s, Fannie Mae and Freddie Mac’s loan purchases accounted for more than one half of new mortgage originations. The preemption of state consumer protections increased the market for RMBSs by increasing the returns to investors (by increasing fees and rates paid by borrowers). By stoking the creation and growth of a new set of lenders, by removing

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88. *Id.*

89. Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.).

90. See DAVID R. ALLARDICE ET AL., THE GARN-ST. GERMAIN DEPOSITORY INSTITUTIONS ACT OF 1982: THE IMPACT ON BANK HOLDING COMPANIES 19 (1983), available at [http://www.chicagofed.org/publications/economicperspectives/1983/ep\\_mar\\_apr1983\\_part1\\_garcia.pdf](http://www.chicagofed.org/publications/economicperspectives/1983/ep_mar_apr1983_part1_garcia.pdf).

91. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C.).

92. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.).

93. FED. RESERVE BD., DIFFERENCES IN CAPITAL AND ACCOUNTING STANDARDS AMONG THE FEDERAL BANKING AND THRIFT AGENCIES (1999), <http://www.federalreserve.gov/boarddocs/rptcongress/differences/default.htm>.

deposit rate regulations favoring S&Ls, and by fostering the development of the mortgage brokerage industry, federal policy essentially constituted the death-knell for S&Ls and installed a regime of both government-sponsored and private-label securitization as the dominant sources of mortgage capital.

The decline of the S&L circuit (thrifts) began in the mid-1970s as RMBS issuance began. When S&L market share began dropping in the 1980s it was essentially absorbed by GSE RMBSs. Private label RMBSs began slowly in the mid-1980s but began to grow at a faster pace in the early 1990s, as the early subprime mortgage market developed. By 1995, the GSEs and GSE mortgage RMBSs accounted for 51% of outstanding mortgage credit.<sup>94</sup> Banks had reached a share of 19%, with thrifts down to 14%.<sup>95</sup> Thrifts were down from a high of 58% in 1973 and 26% in 1989, the year of the FIRREA savings and loan crisis bill.<sup>96</sup> Private-label RMBSs were just beginning to get started, rising from 2% of outstanding mortgages in 1990 to 6% in 1995.<sup>97</sup>

### III. POLICY DEBATES OVER REGULATING HIGH-RISK MORTGAGE LENDING, 1995–2008

Much of the media coverage of the 2007–2008 mortgage crisis gave the impression that the problems of high-risk lending had come as a total surprise to policy-makers. There was often little mention of well documented problems in the high-risk mortgage market dating back to the middle-to-late 1990s and the decade-long policy battle over regulating subprime loans. Federal regulators were said to be “asleep at the wheel” and somehow missed this major development in credit markets.<sup>98</sup>

The increase in high-risk mortgages from 2002–2007 followed a major, albeit smaller, boom in subprime lending in the late 1990s. Some minor changes in federal regulation of subprime refinance lending occurred in 2001 through changes to regulations implementing the Home Ownership and Equity Protection Act<sup>99</sup> (“HOEPA”) in response to problems during the first subprime boom. The financial services industry, however, successfully fought off most calls for increased regulation.<sup>100</sup>

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94. See IMMERGLUCK, FORECLOSED, *supra* note 6, at 45.

95. *Id.*

96. *Id.*

97. *Id.*

98. See Arthur Levitt, Jr., *Regulatory Underkill*, WALL ST. J., Mar. 21, 2008, at A13.

99. Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2190.

100. See IMMERGLUCK, CREDIT, *supra* note 57, at 211-35.

As problems of predatory lending and higher foreclosure rates among subprime loans came to light in the late 1990s, consumer and community groups around the country became increasingly focused on the issue. There were concerns and policy debates over predatory and high-cost lending before the late 1990s. In the late 1980s and early 1990s, Washington-D.C. based consumer advocates such as the National Consumer Law Center and others worked to get HOEPA passed in 1994.<sup>101</sup> HOEPA was focused on increasing regulation of very high-cost home equity and refinancing loans. It established a threshold of loan pricing and loans priced over this threshold became subject to special disclosures and a few prohibitions of certain loan practices and terms. Consumer advocates argued for stronger restrictions on high-cost loans, but were only successful at obtaining regulations that relied primarily on increasing disclosures to borrowers.

While HOEPA may have had some restraining effect on small, “hard-money” lenders that charged interest rates in the high teens and low twenties, it did not restrain subprime lending in any meaningful way and may have, in fact, provided the regulatory context for the growth of the market. Besides relying mostly on additional disclosures as the fundamental way to protect borrowers, HOEPA employed pricing thresholds or “triggers” over which proscriptive regulations would kick in. These thresholds, however, were generally much too high to address the vast majority of subprime loans and could be easily avoided by pricing just under the threshold or by shifting pricing from interest rates to up-front fees or contingent fees that were not included in the pricing calculations.<sup>102</sup> The subprime market actually grew faster after 1995, especially for refinance lending, the primary target of HOEPA. With the explosion of the subprime market came the growth of predatory lending and, soon, an increase in defaults and foreclosures as well.

In 1997, the Federal Reserve Board, which is responsible for adopting regulations under the HOEPA, examined early implementation of the law. The following year, the Board, together with the Department of Housing and Urban Development, issued a joint report to Congress that addressed issues such as loan-flipping, credit insurance, and related issues of abusive

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101. See NEIGHBORHOOD FUNDERS GROUP, DEFENDING THE DREAM: HOW FUNDERS CAN CURTAIL PREDATORY LENDING TO HELP INDIVIDUALS AND COMMUNITIES 25 (D. Visser ed., 2006), available at [http://www.nfg.org/publications/Defending\\_the\\_Dream\\_2006.pdf](http://www.nfg.org/publications/Defending_the_Dream_2006.pdf).

102. See NAT'L CONSUMER LAW CTR. ET AL., COMMENTS TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM REGARDING PROPOSED REGULATIONS RELATING TO UNFAIR TRADE PRACTICES IN CONNECTION WITH MORTGAGE LENDING 5-6 (2007), available at <http://www.consumersunion.org/pdf/HOEPA-comm08.pdf>.

and predatory lending.<sup>103</sup> Few of the recommendations, however, were ever implemented.

Some states moved to increase regulation of subprime lending in the middle-to-late 1990s.<sup>104</sup> Some restricted the use of prepayment penalties or balloon payments in mortgages. Other states tightened mortgage broker and banker licensing and regulation. These laws, however, were generally not very comprehensive and attacked only small pieces of the abusive and predatory lending problem.

As subprime lending reached a critical mass in the late 1990s, the disproportionate concentration of high-risk loans in urban neighborhoods began to be felt more acutely, especially in the form of foreclosures and abandoned housing. Moreover, subprime and predatory lending became not just a consumer issue but also posed problems for community development. Concentrated foreclosures hurt neighborhoods and cities, adding to the unfairness of the loss of homes to individual families.

#### **A. North Carolina Makes the First Big Move Toward More Comprehensive Regulation of Subprime Loans**

Advocates for stronger mortgage regulation found some initial success at the state and local levels. In North Carolina, a state with a long history of community reinvestment activism, a number of organizations became involved in the issue. These included the country's largest community development credit union, the Center for Self-Help, as well as the Community Reinvestment Association of North Carolina and the North Carolina Fair Housing Center. This group formed the hub of the Coalition for Responsible Lending, which was able to gain the support of a major statewide elected official, the attorney general, who played a significant role in the legislative campaign. The legislature's black caucus was also supportive.<sup>105</sup>

Advocates for increased regulation of subprime home loans in North Carolina developed a bill that would go far beyond HOEPA in limiting the practices that could be used in making high-cost loans. In the summer of 1999, the North Carolina legislature passed the first comprehensive anti-predatory lending legislation in the country. The bill followed the thresh-

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103. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & THE DEP'T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT (1998), available at <http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf>.

104. See Raphael W. Bostic et al., *State and Local Antipredatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47, 49 (2008).

105. See IMMERGLUCK, CREDIT, *supra* note 57, at 212-13.

old approach of HOEPA, but set the triggers significantly lower so that the law would capture a substantial segment of subprime loans while avoiding prime loans. It then prohibited certain lending features that, in the case of high-cost lending, were often viewed as predatory. The bill was supported by both the Mortgage Bankers Association of North Carolina and the North Carolina Association of Mortgage Brokers.

Following the North Carolina law, two states, New York and Massachusetts, issued regulations aimed at the predatory lending problem, although these measures were substantially weaker than the North Carolina legislation. Other states began debating similar measures. On the local level, the City of Chicago and Cook County, Illinois, each proposed local ordinances aimed at the problem in early 2000.<sup>106</sup> Unlike the North Carolina legislation, the Chicago and Cook County ordinances did not call for regulating lenders. Rather, the proposals relied on a significant history of local laws aimed at encouraging banks to be socially responsible by linking government financial business to responsible banking. Chicago, for example, had an ordinance dating back to 1974 that required banks accepting municipal deposits to disclose data on their lending in the city.

The Chicago ordinance and others like it in Oakland, Atlanta, Dayton, Cleveland, and Detroit sought to withdraw municipal business from firms engaged in predatory lending. These laws followed earlier municipal deposit ordinances aimed at encouraging banks to reinvest in urban neighborhoods. They also bore close resemblance to anti-Apartheid ordinances that many cities passed in the 1980s, in which cities refused to do business with firms that invested in South Africa. The industry responded quickly by appealing to state legislatures, where they had more lobbying experience and relationships, to override the local ordinances. Some of the local predatory lending ordinances—including those in Detroit, Dayton, and Cleveland—were soon overridden by state legislation or by state courts. By preempting these incentive ordinances, state legislatures or courts told local governments that they did not have a right to choose the financial institutions with which they did business.

### **B. Lenders, the GSEs, and the Credit Rating Agencies Fight Attempts to Regulate High-Risk Mortgage Lending at the State Level**

Following the initial actions of a few early states, other states continued to consider more comprehensive antipredatory lending regulations. By

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106. See Malcom Bush & Daniel Immergluck, *Research, Advocacy and Community Reinvestment*, in ORGANIZING ACCESS TO CAPITAL: ADVOCACY AND THE DEMOCRATIZATION OF FINANCIAL INSTITUTIONS 162-64 (Gregory D. Squires ed., 2003).

2007, all but seven states had some manner of “mini-HOEPA” statutes or sets of laws restricting prepayment penalties, balloon payments, or predatory practices or terms.<sup>107</sup> There was great variation, however, in both what sorts of loans these statutes covered and the extent to which the laws proscribed various practices or products.<sup>108</sup> Many state statutes were not very comprehensive or very strong. Some essentially just recreated the federal HOEPA protections in state law. Many so-called “anti-predatory lending” laws at the state level had been heavily influenced by state banking lobbyists. The result was that the pricing thresholds over which the regulations would kick in were often the same as the very high federal HOEPA thresholds and the restrictions themselves were often very minimal.

When consumer advocates and community organizations made efforts to strengthen lending regulations, they were often thwarted by industry advocates and lobbyists. Banking and financial services lobby groups have traditionally had a great deal of influence over state legislatures in the mortgage regulation arena. Moreover, federal banking laws put pressure on state legislatures to accommodate banking interests. Because banks are allowed to export interest rate and fee regulations from their home state, they often aggressively lobby state legislatures for favorable regulations that they can then use to override regulations in other states.

Economic development has frequently been used as a major argument in such lobbying. Lenders sometimes agree to maintain facilities—or simply the “main office” location—in the home state in exchange for favorable regulations. Some states have gone so far as passing laws aimed at encouraging bank locations and facilities by reducing regulations in exchange for economic development commitments by the institutions. Delaware, for example, passed a law in 1981 that eliminated fee and rate restrictions on consumer loans and reduced income taxes in exchange for employing at least 100 people in the state.<sup>109</sup> Other banks have worked to win regulatory concessions on mortgage regulations, which they can then export around the country. A very large bank lobbied the Illinois legislature unsuccessfully in 2000 and 2001 to gain exemption from essentially any regulations on fees for second mortgages, a freedom which it would then be able to export to other states. The bank holding company argued that economic development would occur as a result of the policy and threatened to locate its

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107. See Bostic et al., *supra* note 104, at 50-52.

108. *Id.*

109. See IMMERGLUCK, CREDIT, *supra* note 57, at 212.

new main charter in Ohio or another state if the deregulatory bill did not pass.<sup>110</sup>

Key actors in state-level policy debates were the GSEs Fannie Mae and Freddie Mac and the three primary credit rating agencies, Standard & Poor's, Moody's, and Fitch. These firms had significant leverage over state policy-makers. The GSEs could refuse to purchase certain types of loans in a state. The rating agencies could refuse to rate mortgage-backed securities containing loans covered by certain state laws, severely limiting regular liquidity and marketability of such loans, at least in the near term.

Beginning in Georgia in early 2003, the GSEs and the credit rating agencies became actively involved in influencing state legislation by proclaiming that it would not rate securities containing any loans covered by the state's new antipredatory lending law.

In 2001, on the heels of the hearings held around the country on predatory lending by federal agencies, Senator Vincent Fort introduced an anti-predatory lending bill in the Georgia state legislature.<sup>111</sup> In the next session in 2002, Governor Roy Barnes, an ally of Fort's on the predatory lending issue, introduced what was to become the Georgia Fair Lending Act ("GFLA"). After undergoing a number of changes, the bill was passed and went into effect in late 2002. The law was immediately considered one of the strongest state anti-predatory lending laws in the country. Built off of North Carolina's statute, the Georgia law was stronger, especially because it held purchasers of loans accountable for violations of the law, in what is known as assignee liability, something the North Carolina law lacked. Assignee liability was a key issue, because it meant that a regulatory violation followed the loan through the securitization process and affected subsequent parties in the chain of capital. This essentially overrode the problem created by the holder-in-due-course doctrine, which enabled funders of loans to shield themselves from liabilities created by predatory and abusive practices by brokers and others in the origination process.

Immediately after the law went into effect, the lending and mortgage brokerage industry began a concerted campaign to overturn it, especially after Governor Barnes lost his reelection bid in late 2002.<sup>112</sup> They gained their most important ally in early 2003, when Standard & Poor's issued a

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110. See Greg Hinz, *Lobbying Bid Falls Short for Bank One; Dimon's Bill All But Dead for Veto Session*, CRAIN'S CHI. BUS., Nov. 19, 2001, at 4.

111. Letter from Vincent D. Fort, Georgia State Senator, Dist. 39, to Leo C. O'Neill, President, Standard & Poor's (Jan. 28, 2003), available at [http://www.federalreserve.gov/secrs/2006/august/20060808/op-1253/op-1253\\_5\\_1.pdf](http://www.federalreserve.gov/secrs/2006/august/20060808/op-1253/op-1253_5_1.pdf).

112. See Jack Milligan, *Learning THE Hard Way*, 64 MORTGAGE BANKING 26, 30 (2004).

press release saying that it would not rate securities backed by Georgia mortgages for fear that some of the underlying loans might violate GFLA. The press release stated:

Loans governed by the GFLA are categorized as “Home Loans”, “Covered Home Loans”, or “High Cost Home Loans”, with each category having its own requirements and, in the case of Covered Home Loans and High Cost Home Loans, fees, points, and annual percentage rate tests. According to Standard & Poor’s, violations of the statute will subject non-complying parties to potentially severe liability. Most importantly, however, the GFLA subjects assignees of Home Loans that violate the Act to potential liability. Thus, transaction parties in securitizations, including depositors, issuers and servicers, might all be subject to penalties for violations under the GFLA.<sup>113</sup>

This press release, which was later followed by similar actions by Moody’s and Fitch, was the critical factor in enabling opponents of GFLA to severely weaken the law by essentially removing the assignee liability provision. In a letter to Standard & Poor’s CEO, Senator Fort pointed out that Standard & Poor’s misconstrued the original GFLA assignee liability provision, which actually only applied to high-cost loans.<sup>114</sup> The letter also asked Standard & Poor’s to identify and explain the firm’s financial relationships with lenders, issuers, and brokers, suggesting that the firm may have been suffering from conflicts of interest and benefiting from continued securitization of high-risk products.<sup>115</sup> It was not long before lending industry advocates had managed to have GFLA replaced by a much weaker law, in which the assignee liability provisions were effectively gutted.

Contrary to some of the media discussion that followed the Georgia debate, rating agencies could rate securities with assignee liability provisions, as long as the potential damages from the provisions could be quantified.<sup>116</sup> Nonetheless, efforts to create assignee liability provisions in state or federal regulations, even when damages were made quantifiable, were a key flash-point for industry advocates in mobilizing against regulation.

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113. See Press Release, Mortgage Banker’s Ass’n of Am., Standard & Poor’s to Disallow Georgia Fair Lending Act Loans (Oct. 12, 2005, <http://www.mortgagebanker.org/NewsandMedia/PressCenter/32153.htm>).

114. See Letter from Vincent D. Fort to Leo C. O’Neill, *supra* note 111.

115. *Id.*

116. Engel & McCoy, *supra* note 70, at 2094.



### C. Federal Agencies Study Abusive Lending and Regulators Warn of Subprime Risks to Banks

In 1999 and 2000, a variety of developments were putting pressure on federal regulators to act on the predatory lending problem. In 1998, lower mortgage rates and higher prepayment rates lowered subprime lender profitability. Moreover, many subprime lenders experienced higher default rates than they had anticipated.<sup>117</sup> On top of this the Asian and Russian financial crises of 1997 and 1998 made raising capital much more difficult. The result was the failure of a significant number of subprime lenders.

On the policy front, states were looking closely at the North Carolina law and a variety of localities were considering local ordinances aimed at slowing abusive lending. In 1999, the U.S. Department of Housing and Urban Development (“HUD”) and the U.S. Treasury Department created a Task Force to develop federal policy recommendations to address predatory lending.<sup>118</sup> The HUD-Treasury Task Force held hearings in five large cities in the spring of 2000 and issued a report in June containing a number of federal policy recommendations, including calling on the Federal Reserve Board to use more of its authority under HOEPA to outlaw predatory practices.

In Congress, separate and opposing bills were introduced in Congress backed by consumer and industry interest groups. In May 2000, the House Banking Committee held a hearing on predatory lending in which the Federal Reserve Board was chastised by Chairman Jim Leach (R-IA) for not using its authority to act on the issue. The Federal Reserve had not acted on the recommendations made in the 1998 joint Federal Reserve-HUD HOEPA report. Chairman Leach asked, “if there is a problem out there, if Congress has given very strong authority to regulators and the Federal Reserve, our regulators, is the Federal Reserve AWOL? That is a question that I think demands a response.”<sup>119</sup>

Even before the surge of federal policy activity in 1999 and 2000, federal bank regulators had recognized the growth of subprime lending and at

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117. Letter from Emory Rushton, Senior Deputy Comptroller for Bank Supervision Policy, U.S. Office of the Comptroller of the Currency, to Chief Executive Officers of All Nat'l Banks, Dep't & Div. Heads & All Examining Personnel (Mar. 3, 1999), available at [http://www.ffiec.gov/ffiecinfobase/resources/retail/occ-bl-99-10\\_interag\\_guid\\_subprime\\_lending.pdf](http://www.ffiec.gov/ffiecinfobase/resources/retail/occ-bl-99-10_interag_guid_subprime_lending.pdf).

118. See U.S. DEP'T OF TREASURY & U.S. DEP'T OF HOUS. & URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING (2000).

119. See *Predatory Lending Practices: Hearing Before H. Comm. on Banking and Financial Servs.*, 106th Cong. 54-55 (2000) (statement of James Leach, Chairman, Comm. on Banking and Financial Services), available at [http://commdocs.house.gov/committees/bank/hba64810.000/hba64810\\_0.htm](http://commdocs.house.gov/committees/bank/hba64810.000/hba64810_0.htm).

least its risks to lenders. In March 1999, the four bank and thrift regulators issued an "Interagency Guidance on Subprime Lending."<sup>120</sup> This guidance, however, was clearly focused on the need for depository institutions to minimize any institutional risk that they may have had in holding high-risk subprime loans on their balance sheets. The eight page guidance devoted less than half of a page to concerns over consumer protection, and much of this was concerned with how well banks "identify, monitor and control the consumer protection hazards associated with subprime lending."<sup>121</sup> The guidance did address some of the risks that originators faced in making and securitizing subprime loans, but did not address the risks that banks and thrifts took on in purchasing subprime mortgage-backed securities to hold on their balance sheets.

State and local policy developments, the HUD-Treasury report, and public and congressional concern led the Federal Reserve Board to hold public hearings in four large cities in the summer and fall of 2000 on potential revisions to HOEPA regulations. At the end of 2000, the Board proposed some significant, albeit modest, changes to the HOEPA rules. The largest changes in the rules involved classifying single-premium credit insurance ("SPCI") within the definition of fees under HOEPA and lowering the interest rate threshold at which a loan would be classified as "high-cost." The former meant that almost any loan with single premium credit insurance would be classified as a high-cost loan under HOEPA (since SPCI typically exceeds the 8% point fee trigger in the law), thereby increasing the disclosures and protections associated with the loan. The latter meant that more high-rate loans would be covered by HOEPA. The Board, however, failed to use its broader powers under the Act to more substantially expand the coverage or impact of the law.

The most successful effort by consumer and community advocates was the push to effectively ban SPCI. Considered by many to be an egregious predatory practice, SPCI involved selling people insurance that covers loan payments should some calamity (for example, death or disability) occur. SPCI was relatively unique among insurance products, however, in that it was financed completely up-front into the loan. With SPCI, rather than pay the premiums monthly or some other periodic way, the borrower paid the entire five to ten years of insurance up-front via the premium being added onto the mortgage amount. The lump-sum premiums for such policies could amount to 15% of the principal amount of the loan. This increased the loan amount and reduced borrower equity. Moreover, unlike in the

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120. See Letter from Emery Rushton to Chief Executive Officers of All Nat'l Banks, *supra* note 117.

121. *Id.*

case of insurance that is paid monthly, if the borrower got into trouble, she could not stop paying the insurance portion of her monthly payment without defaulting on the mortgage.

Consumer and community groups began focusing on problems with the product as a key focus of their anti-predatory lending campaigns. By the summer of 2000, consumer activism on SPCI and the inherent problems with the product compelled Fannie Mae and Freddie Mac to pledge not to purchase loans containing the product. Following this, the product was condemned in the HUD/Treasury Report, and later in 2000, the Federal Reserve recommended including SPCI in the HOEPA definition of points and fees. Then, by the summer of 2001, three large sellers of SPCI voluntarily announced that they would no longer offer it. By the end of 2001, the Federal Reserve finalized its proposal to include SPCI in the definition of points and fees, which essentially made any loan with SPCI a high-cost loan under HOEPA and therefore subject to heightened regulation.<sup>122</sup>

1. *The OTS and OCC Act to Preempt State Regulation of High-Risk Lending*

As more states began to adopt predatory lending regulations in 2001 and 2002, lenders began to turn to Washington to push for lender-friendly federal policies that would override state laws. Lenders argued that state laws would create a “patchwork” of regulation across the country that would reduce the efficiency of the banking system by making it difficult for lenders and secondary market firms to operate national lending operations. Advocates of state laws, including governors, attorneys general, and legislators, countered that states have a right to protect their citizens, especially when it came to something as important as protection of homeowners and borrowers. Moreover, much of real estate law—including foreclosure law—already varied across states, and mortgage markets had accommodated such differences without causing significant harm to credit access. In fact, by the early 2000s, vendors had begun marketing software that enabled lenders to monitor compliance with various state predatory lending laws. One firm, for example, marketed a product called the “Predatory Lending Monitor,” which interfaced with major loan origination systems. From September 2002 to March 2003, the company had completed nineteen installations of the product.<sup>123</sup>

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122. See IMMERGLUCK, CREDIT, *supra* note 57, at 215-16.

123. Press Release, ExperITy Releases Version 2.0 of Its Predatory Lending Monitor (Mar. 8, 2003), [www.experity.com/press\\_releases/PR\\_3\\_18\\_2003.html](http://www.experity.com/press_releases/PR_3_18_2003.html).

To block state predatory lending laws in the early 2000s, the lending industry pursued a mixed strategy of seeking a federal statute aimed at preempting state laws and, at the same time, trying to get federal bank regulators to preempt state laws. The first approach would remain difficult as long as Democrats held significant power in the Senate and, perhaps more importantly, as long as Senator Paul Sarbanes, a supporter of increased mortgage regulation retained the ranking Democratic seat on the Senate Banking committee. Therefore, lenders—particularly banks, thrifts and bank-owned mortgage-companies—also adopted the second strategy. Both thrifts and national banks appealed to their federal regulators (the OTS and the OCC, respectively) to preempt state predatory lending regulations. The OTS regulates federal savings banks and the OCC national banks. Federal law gave both regulators significant ability to preempt state consumer protection regulations. In the late 1990s and early 2000s, they wielded such power aggressively, rebuffing states' attempts to adapt consumer protection laws to a changing financial marketplace, something Congress and federal regulators were not doing.

Unfortunately for those who favor state authority in this arena, some federal regulators have a vested interest in preempting state consumer protection laws. The ability to preempt state law is perhaps the greatest source of value in the federal thrift and national bank charters. Regulators can gain political power based on the number and size of the banks that fall under their regulatory supervision. In some cases, a regulator's operations are funded by levying fees on the institutions they regulate. This can encourage an agency to pursue policies that are friendly to banks—especially larger ones. If a regulator does not use its ability to allow banks under its supervision to preempt state consumer protection regulations, the bank may change its charter so that it is regulated by a more lender-friendly agency. The impacts of charter changes can be significant. Even one very large bank shifting its charter to another regulator can significantly affect an agency's revenues. When Chase Manhattan Bank (now J.P. Morgan Chase) merged with Chemical Bank in 1995 and changed from a national to a state charter, it was estimated that the OCC lost 2% of its budget in fees.<sup>124</sup> Even if an agency's funding is not directly tied to the banking assets under its supervision, if fewer and fewer institutions fall under its supervisory umbrella, its power and relevance will be called into question. In the long run, this could jeopardize the agency's very existence.

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124. Richard J. Rosen, Senior Economist, Fed. Reserve Bank of Chi., Presentation, 2002 Federal Reserve Bank of Chicago Bank Structure Conference: Is Three a Crowd? Competition Among Regulators in Banking (May 8, 2002).

The more power that a regulator has to effectively override state regulations—and the more it exercises such power—the more likely it is that institutions will want to be chartered under that regulator’s authority. In the past, competition between regulators was mostly restricted between the national bank (OCC) charter and the state charter (FDIC, Federal Reserve, and state regulators). As thrifts were allowed to behave more like commercial banks, however, and banks became more involved in mortgage markets, the thrift-bank distinction became less meaningful, increasing the competition among regulators.

There have been repeated concerns that banks “forum shop” to find the most comfortable regulator.<sup>125</sup> Since at least the late 1990s, this “race for the bottom” includes regulators vying to offer banks as much preemption power as they can. Demonstrating the importance of preemption to the value of a charter type, a banking attorney was quoted in the *American Banker* regarding the OCC’s preemption actions as asking, “Why would you want a national charter but for the preemption authority?”<sup>126</sup>

The OTS moved first to override state mortgage regulations by preempting key provisions of Georgia’s predatory lending law in January of 2003, so that federal thrifts were exempted from the law. A week later, it preempted New York’s state predatory lending law. State regulators immediately objected to the OTS moves. Community groups saw the OTS’ action—under Bush appointee James Gilleran—as particularly antagonistic, given that the preceding director of the OTS, Clinton appointee Ellen Seidman, had voiced some of the strongest concerns over predatory lending among federal regulators.<sup>127</sup>

The OCC was not about to let the thrift charter gain a clear regulatory advantage over the national bank charter. It had issued a letter to national banks in November 2002 asserting its jurisdiction over all state regulators and asked banks to inform it if a state regulator may have asserted its authority over a national bank. In comments to the press after the OTS decision, the OCC pointed out that it needed a request from a bank before it could follow the OTS’ preemption move.<sup>128</sup>

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125. See Ann B. Matasar & Deborah D. Pavelka, *Federal Banking Regulators’ Competition in Laxity: Evidence from CRA Audits*, 4 INT’L ADVANCES IN ECON. RES. 56, 56-57 (1998).

126. Todd Davenport, *Why OCC May Tread Lightly on Georgia Law*, AM. BANKER, Apr. 9, 2003, at 1.

127. Rob Blackwell, *Second OTS Preemption: Predator Law in N.Y.*, AM. BANKER, Jan. 31, 2003, at 1.

128. *Id.*

It was not long before a national bank, National City Bank of Cleveland, requested that the OCC preempt the Georgia law. Community groups, governors, attorneys general, and state legislatures argued that the OCC should not move to preempt state consumer protection laws. In the summer of 2003, the OCC did preempt the Georgia antipredatory lending law, even after industry interests had succeeded in weakening the law at the state level.<sup>129</sup> The agency went on to suggest that it would preempt all similar state laws, and issued proposed regulations to do so. The OCC's move in some ways was a more assertive move in defense of banks to ignore state laws, because its authority under banking statutes to preempt state consumer protection laws was less well established.

Federal regulators went even further and argued that even mortgage lenders that were subsidiaries of national banks or federal thrifts would benefit from federal preemption. The federal courts upheld this position when challenged by state regulators. The financial services regulator for the state of Michigan challenged the ability of a mortgage company subsidiary of a national bank to escape state regulation.<sup>130</sup> The state regulator argued that because the mortgage company, Wachovia Mortgage, was not itself a national bank but only the subsidiary of a national bank, Michigan's laws should not be preempted. In 2007, the U.S. Supreme Court found in favor of the bank, stating that the preemption powers given by the National Banking Act covered subsidiaries of national banks as well as the banks themselves.<sup>131</sup>

The policy debate between state and federal regulators over preemption became quite heated, with some advocates for state regulation being particularly outspoken. Foremost among these was Elliott Spitzer, Attorney General for New York State. In 2003, Spitzer threatened to sue the OCC over its preemption activities.<sup>132</sup> After Spitzer initiated an investigation into racially discriminatory behavior by national banks in New York State, however, the OCC joined an industry trade group in suing him and effectively prevented the investigation.<sup>133</sup> Spitzer had perhaps a higher profile than other advocates for the rights of states to regulate lending, but he was

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129. U.S. Office of the Comptroller of the Currency, Preemption Determination and Order Concerning the Georgia Fair Lending Act, <http://www.occ.treas.gov/gflaqas.pdf> (last visited Feb. 15, 2009).

130. See *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1, 2 (2007).

131. See generally *id.*

132. Editorial, *Spitzer Threatens to Sue U.S. Regulator Over Loan Exemption*, N.Y. TIMES, Dec. 11, 2003, at C1, available at <http://query.nytimes.com/gst/fullpage.html?res=9404EFDD173CF932A25751C1A9659C8B63>.

133. *Court Blocks Spitzer Inquiry into Loan Data*, N.Y. TIMES, Oct. 13, 2005, at C3, available at <http://www.nytimes.com/2005/10/13/business/13lend.html>.

not alone. Many other state regulators and attorneys general also argued against the federal agency's aggressive preemption practices as well.

During the second high risk boom in the mid-2000s, exotic mortgage products became more widespread in both the prime and subprime markets. As banks and thrifts became increasingly drawn into higher-risk markets, and as the performance of such products began to show some weaknesses, banking regulators issued some warnings about their use. In 2003, the OCC issued another warning about the risks posed by subprime loans to the banks it regulated. The agency was particularly concerned that national banks might suffer "legal, reputation and other risks" in acquiring loans through mortgage brokers or by purchasing loans from originators.<sup>134</sup>

Despite their issuing warnings about the risk to lenders involved in subprime lending, except for the modest changes to HOEPA in 2001, federal policy-makers made essentially no substantive changes in regulations aimed at curbing lending abuses and the growth of excessively risky lending practices in the subprime market. In fact, federal regulators facilitated the expansion of high-risk lending and paved the way for the second high-risk boom by actively preempting states' attempts to increase lending regulations when federal policy makers would not.

In the second high risk boom, there was an increase in the use of "alternative" or exotic loan structures, including interest-only, negative amortization and payment-option loans. These structures were applied to both the subprime and prime markets. Subprime loans were increasingly structured as hybrid adjustable rate loans in which the interest rate would be fixed for two or three years and then allowed to adjust. Many prime loans were also structured with adjustable rates. As different exotic features were layered on top of each other, many observers became increasingly worried about the underlying risk in the mortgage marketplace.

In the early to mid-2000s, consumer advocates and the U.S. General Accounting Office called on federal regulators to do more to regulate the affiliates and subsidiaries of banks that were increasingly dominating the subprime and high-risk loan markets. In general, the supervision of these lenders was left to state financial service regulators and to the Federal Trade Commission, both of which lacked the level of supervisory resources as the federal banking regulators. In early 2004, the General Accounting Office issued a report calling for stronger regulatory supervision in the subprime market and specifically called for giving the Federal Reserve

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134. See Advisory Letter 2003-3 from U.S. Office of the Comptroller of the Currency, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans, to Chief Executive Officers of All Nat'l Banks & Nat'l Bank Subsidiaries (Feb. 21, 2003), available at <http://www.occ.treas.gov/ftp/advisory/2003-3.pdf>.

more explicit power to conduct regular examinations of lenders affiliated with banks through bank holding company structures.<sup>135</sup> Earlier in 2000, Edward Gramlich, a Federal Reserve Board Governor, had urged Alan Greenspan, Chairman of the Board, to direct examiners to examine the lending of bank-affiliated mortgage companies on a pilot basis.<sup>136</sup> The suggestion was rebuffed by Chairman Greenspan.<sup>137</sup>

More generally, even though federal regulators had issued caution to banks holding subprime loans directly on their balance sheets, they generally supported the growth of the subprime mortgage market. The most important support came in the form of the preemption of state consumer protection laws, but key federal regulators also issued statements and studies that argued that subprime lending was providing increased homeownership among minority and lower-income groups, which in turn gave support to similar arguments made by industry lobbyists working against efforts in Congress to increase regulation. The evidence presented for these claims, however, was quite limited, and there was little analysis of the benefits and costs associated with subprime lending or even whether subprime-financed homeownership was economically beneficial to borrowers.

In July of 2003, the OCC released a controversial working paper entitled, "Economic Issues in Predatory Lending," during the agency's decision-making process over its first preemptions of state consumer protection laws.<sup>138</sup> The OCC study argued that state anti-predatory lending laws reduced levels of subprime lending and suggested that this was a negative outcome because it reduced "credit availability." It now looks quite likely that subprime markets were, in fact, providing socially inefficient amounts and types of credit. The OCC report relied primarily on a study by the industry-funded Credit Research Center at Georgetown University, which found that the number of subprime originations in North Carolina had declined by approximately 14% as a result of the state passing the first anti-predatory lending law. The OCC paper suggested that this was an undesirable effect of the law. Many would now likely question, however, whether a decline in subprime lending of 14% was an undesirable result. By re-

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135. See U.S. GEN. ACCOUNTING OFFICE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 9-10 (2004), available at <http://www.gao.gov/new.items/d04280.pdf>.

136. See Edward L. Andrews, *Fed and Regulators Shrugged as the Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, at A1, available at <http://www.nytimes.com/2007/12/18/business/18subprime.html>.

137. *Id.*

138. U.S. OFFICE OF THE COMPTROLLER OF THE CURRENCY, ECONOMIC ISSUES IN PREDATORY LENDING (2003).



stricting abusive practices and reducing the number of loans with excessive upfront fees, such laws are likely to discourage the riskiest loans.

The OCC was not alone in its support for the booming subprime industry. Federal Reserve Governor Gramlich gave a speech in 2004 that, while acknowledging the problems of higher foreclosure rates in the subprime market, clearly viewed higher levels of subprime lending as a positive trend: “Despite the caveats, the net social evaluation of these trends is probably a strong positive.”<sup>139</sup> Only three years later, Gramlich seemed much less certain on this count.<sup>140</sup> Gramlich had also argued in 2004 that “subprime lending represents a natural evolution of credit markets.”<sup>141</sup> Gramlich was clearly not alone in this opinion, especially among economists at the federal regulatory agencies. Subprime lending was often viewed as generally an organic, natural outgrowth of technological and financial innovation that was somehow purely the product of unfettered free markets. Yet the history of deregulation and supportive policies supporting structured mortgage finance suggests otherwise. Housing finance markets are politically and socially constructed. They are the products of decades of lobbying and policy debates at the state and federal levels.

In late 2005, as the market for exotic loans boomed and increasingly involved both prime and subprime loans, the four banking regulators issued proposed guidance on “nontraditional” mortgage products—what many called exotic loans—and issued final guidance in October of 2006.<sup>142</sup> Responding to the late 2005 proposal, consumer groups warned that regulators were not going nearly far enough. In particular, they argued that regulators should direct lenders to underwrite adjustable rate loans using the maximum interest rate to which a loan might adjust. In fact, many subprime and other adjustable rate loans were approved based on initial, low fixed introductory or “teaser” interest rates that later could adjust upwards a great deal. Advocates also generally called for the essential prohibition of no-documentation or stated-income loans, while regulators merely discouraged the use of such products. Of course, the guidance was inherently limited in

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139. Edward M. Gramlich, Member, Fed. Reserve Bd. of Governors, *Subprime Mortgage Lending: Benefits, Costs, and Challenges*, Speech before the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004) [hereinafter Gramlich, *Subprime*], available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm>.

140. Edward M. Gramlich, Senior Fellow, Urban Inst., *Booms and Busts: The Case of Subprime Mortgages*, Address in Jackson Hole, Wyoming (Aug. 31, 2007), available at [http://www.urban.org/UploadedPDF/411542\\_Gramlich\\_final.pdf](http://www.urban.org/UploadedPDF/411542_Gramlich_final.pdf).

141. See Gramlich, *Subprime*, *supra* note 139.

142. U.S. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., *INTERAGENCY GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS* (2006), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20060929a1.pdf>.

its impact on the mortgage market, because it applied only to depository institutions directly regulated by the four regulators and not to the many affiliate and independent mortgage companies that were, on average, more active in the subprime and high-risk markets.

In 2006 and early 2007, as problems in subprime and higher risk market segments became much clearer and caused significant disruptions to broader financial markets, regulators responded with additional proposals and hearings. The Federal Reserve Board held hearings related to subprime and predatory lending in both 2006 and 2007 and, in early 2007, issued a draft proposal for increased regulation of the subprime market. After the 2007 hearings, the Board issued a more complete set of regulatory proposals with particular attention to using HOEPA to regulate a substantially broader segment of the subprime market, rather than just the very high-cost segment that HOEPA had been used to address previously.

After the fall 2006 election, when Democrats gained control of the House of Representatives and Barney Frank (D-MA) took over as chair of the House Financial Services Committee, there was also some movement in the legislative arena. Frank sponsored a bill that contained many substantive regulations that consumer advocates had been proposing for over a decade. The bill that eventually passed the House in 2007, however, also contained some key language that would preempt some state efforts to impose assignee liability in a stronger way than the federal law would. Despite the fact that the 2007–2008 subprime crisis had been caused in large part by breakdowns in the mortgage supply chain—which is precisely what assignee liability is designed to guard against—industry lobbyists had once again successfully weakened the law in this regard.

Of course, by late 2007, a good deal of the damage done by high-risk lending had already been put in motion and the subprime market had been substantially shut down. Therefore, proposals to increase regulation would be relevant in the longer term to prevent a repeat of mortgage market excesses and abuses. Many of the proposals both in the Frank bill and in the proposed HOEPA regulations would constitute significant regulatory improvements and help set the stage for sounder lending markets going forward.

#### CONCLUSION

The risks and costs of poorly regulated, high-risk lending markets had become clear during an earlier, but somewhat smaller, boom in high-risk lending in the middle to late 1990s. For a variety of reasons, some of which are beyond the scope of this Article, the knowledge of the problems and costs of high-risk lending had minimal impact on policy making.

While regulators and legislators in office during the more recent 2002–2007 high-risk lending boom could have done much more to reduce the eventual fallout, the seeds of the fundamentally flawed market structures and regulatory systems that allowed the crisis to develop had been sowed much earlier.

Since the early 1980s, there has been a deliberate movement, aggressively promoted by the financial services sector, by some in Congress, federal regulatory agencies, to reduce the public sector oversight of the financial services sector. The proponents of deregulation—and of adapting regulations or supervision to emerging market segments—have argued that reducing the regulatory restrictions on the financial system unleashes free market efficiencies. In their perspective, less government involvement is almost always seen as a superior model for any form of exchange of goods or services.

In the arena of financial services regulation, the shift over the last thirty years toward increasingly deregulationist policies has been at least as political as any other phase in U.S. history. Some argue that the successes of deregulationist advocates have been related, both as a cause and a result, to the increasing concentration of wealth in the United States. In a vicious cycle, financial services providers are served well by deregulation and are then able to push for even more deregulation.

Lobbying by the financial industry, however, has not been the only factor supporting deregulation. Public policies are shaped by more than a simple competition of special interests; they are shaped by the competition of ideas.<sup>143</sup> Clearly, both interests and ideology have been important in shaping policy in this arena. Campaign finance and the dominance of corporate lobbyists have clearly been important in continuing movement toward the deregulation of mortgage and consumer finance. Deregulationist, free-market ideology has been accepted, however, even by many who do not have clear financial interests in an unregulated financial system. By the late twentieth century, many policy-makers had developed priorities that include strong anti-regulatory postures. Regulation often became viewed as inherently ineffective or counterproductive.

One effect of the recent devotion to free markets, however, has been to conceal the highly political nature of banking and credit markets. It has served to mask the extent to which market developments in mortgage finance were derived from a long history of government action and involvement. To hear some analysts describe financial developments, one might

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143. For more discussion of ideology and housing policy, see R.A. HAYS, *THE FEDERAL GOVERNMENT AND URBAN HOUSING: IDEOLOGY AND CHANGE IN PUBLIC POLICY* (2d ed. 1995).

gather that private entrepreneurs and lenders developed most of the successful innovations and developments in consumer finance and mortgage markets, while public sector involvement had only been counterproductive. In fact, government actors created, subsidized, and institutionalized many of the most successful, sustainable, and risk-limiting mortgage products and practices since the early part of the twentieth century. This includes the long-term fully amortizing mortgage, private mortgage insurance (especially in its recent forms), and all sorts of standardization and discipline that enhanced the stability of the financial services industry and served to limit foreclosure risk in mortgage markets. Meanwhile, many private sector innovations, such as highly structured and multiple-order securitizations, stated-income and piggy-back loans, and others, have proven to be abject failures.

Of course, public policy has aided and abetted some harmful developments as well as positive ones and, specifically, had a significant role in paving the way for a fundamentally flawed system of structured mortgage finance that was the principal driver of the 2007–2008 crisis. But the principal policy approach that encouraged and enabled the boom-bust problems of recent decades was comprised largely of deregulation and the preemption of states' efforts to regulate when they felt federal regulation lacking.

It has become painfully obvious that mortgage markets are not well served by a deregulationist paradigm. Periods of stability and incremental progress towards access to affordable and sound credit and capital have involved a strong, proactive role for the public sector, both in terms of providing and standardizing risk-limiting mortgage products and in terms of providing a regulatory infrastructure that constrains market booms and busts.

The flood of high-risk credit after 2002 was fundamentally enabled by a strong, deregulationist push on the part of the financial services industry, as well as many federal policy-makers, to avoid or eviscerate state and federal regulation and constraints that had resulted in a robust, but risk-limiting, mortgage finance system. Especially since the 1980s, deregulationist forces typically dominated the development of consumer and mortgage finance policy. These policies paved the way for the connection of unrestrained global capital markets to create investment structures designed primarily to speed the flow of high-cost and high-risk credit to local communities, and especially to communities most vulnerable to such costs and risks.

The market structures that developed under a very weak regime of government oversight and regulation—although sometimes with specific tax and legal advantages—ignored the very powerful negative spillovers of ex-

cessively risky and irresponsible lending. The result was that mortgage lending was not treated much differently than markets for most mass-marketed consumer products. There was little thought given to the fundamentally distinct nature of real estate and housing, or to the impacts of foreclosure on households' long-term economic prospects and on neighborhoods and cities.