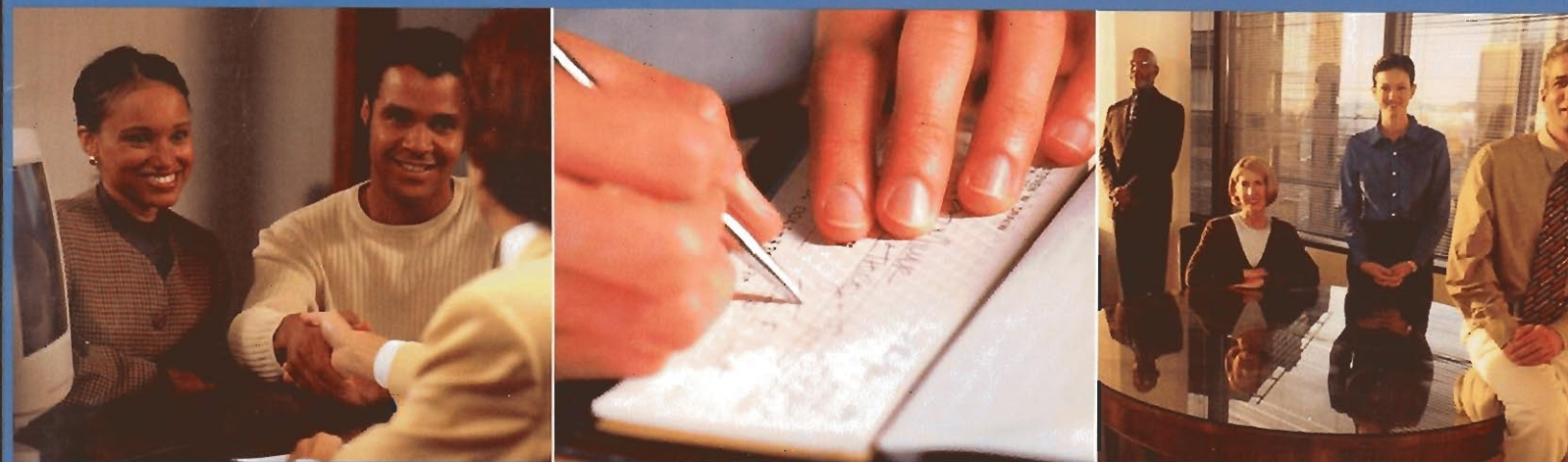


# Mortgage Developments 2007

Answers to Your Top Questions



**Sheshunoff**<sup>TM</sup>

# MORTGAGE DEVELOPMENTS 2007

## ANSWERS TO YOUR TOP QUESTIONS

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# 11 Legal and Ethical Issues in Mortgage Banking: The Subprime Mortgage Meltdown

**Gil Sandler**

*In this article, the author discusses ethics and legality in the mortgage banking industry. He also provides a detailed description of the rapid growth of new mortgage products, the effects of increased globalization and securitization of mortgage-based financial products on this sector, and the abuses brought upon the system by the players working in the industry. According to the author, these trends, culminating in the recent subprime mortgage market collapse, have reached levels of moral and ethical abuse that require more stringent regulatory oversight.*

There is often a fine line between business ethics and legality. In the 21st Century, technology and globalization have so radically altered the economy that law and regulation lag behind new business methods. The result is that commercial conduct that at first seems acceptable is practiced to excess, then slowly begins to appear unethical, then becomes outrageous to the point of requiring legal prohibition.

This progression was witnessed in the past decade as economic journals trumpeted accounting and corporate fraud, and law enforcement pursued previously revered corporate pirates. The markets moved from accounting fraud to widely

practiced abuses, such as “market-timing” in mutual funds (permitting big investors to buy at old prices after new net asset values were set) and back-dating stock options to historically lower exercise prices. Eventually, these practices were exposed and then, suddenly, made illegal. The Sarbanes Oxley Act of 2002, for example, was enacted to make individuals in public companies personally responsible for accurate financial reporting, the cost of which discouraged companies from going public. A similar progression occurred with insider trading, which remains acceptable, however unethical, in European and Asian securities markets, but became so abused

that the Securities and Exchange Commission (SEC) began to enforce its prohibition in the 1980s.

## Ethics and Legality

Ethics may be broadly defined as “a set of moral principles or values.” In the *Merriam-Webster Collegiate Dictionary* ethics is defined as, “the principles of conduct governing an individual or a group professional ethics.” Each discipline, including the learned professions and business segments, has its own distinct set of moral principles that defines ethical behavior. Over time, business practices become established based on ethical standards and unacceptable deviations give rise to legal prohibitions and limitations.

Typically, a practice must become publicly reviled before lawmakers and regulators are sufficiently motivated to abandon their lobbyists to investigate, hold hearings, and promulgate safeguards. By then, public investors and consumers may have lost billions as a direct result of immoral and fraudulent business conduct, and the worst offenders keep their fortunes after token penance or sentences in low-security hotels. Cases in point abound. A few of the Enron Gang got hit pretty hard — Skilling, Lay (deceased), Causey, Fastow, etc. — while some energy traders and many others moved on with personal fortunes, while joking about having cornered the California power market and turned out its lights. CEOs Dennis Kozlowski (Tyco), Richard Scrushy (Healthsouth), and Richard Grasso (NYSE) were exposed for having out-pirated such legendary corporate knaves as Robert Vesco (Investors Overseas Services) in moving corporate treasuries into personal treasure troves. New

York’s former Attorney General, Elliot Spitzer (now Governor), compiled an impressive list of prosecutions and fines for widely practiced unethical business practices, including: “market-timing;” backdating stock options to dates of lower market prices to guarantee profits; and using post-loss insurance products to enable public companies to manage earnings.

The mortgage banking industry has had its share of abusive anti-consumer practices. Fannie Mae and Freddie Mac suffered stock price declines but retained their AAA ratings, in spite of successive restatements of managed earnings. Disguised and confusing summaries of mortgage closing costs led to uniform RESPA settlement statements (equally inscrutable) and improved disclosure of adjustable rate resets. Predatory lending practices also received periodic regulatory enforcement. These abuses will seem mild compared to the imminent market implosion caused by the collapse of the subprime mortgage market.

The rapid growth of new mortgage products, fed by easy money and increased globalization and securitization of mortgage-based financial products, has reached a level of moral and ethical abuse that may rival the Enron debacle. These abuses have given rise to new laws and regulations governing mortgage banking.

## Flashback to 2000

The economy is reeling from the burst of the technology bubble. Retirement and consumer investments are bludgeoned by market declines. After downsizing, forced consolidation, layoffs, and buyouts force millions into premature re-

tirement, new jobs are scarce due to global outsourcing and the unavailability of new capital for technology. The Federal Reserve Board (the Fed) decides it must encourage capital and consumer spending by precipitously dropping short-term borrowing rates through its Treasury repurchase activity. This should also reduce longer term interest rates across the board. Significantly, it will directly reduce banks' prime lending rates for home equity and other consumer loans, rushing new money into the consumer economy. While the Fed clearly intends to encourage home ownership by making mortgages more affordable, little visible concern is expressed for the possible over-expansion of the housing industry due to the availability of easy money. Nor is there any acknowledgement of the possible adverse impact on borrowers of new, highly leveraged mortgage products made available to under-qualified borrowers.

### The Federal Reserve Takes Action

Mixing ancient spirits with often-obtuse rhetoric, Chairman Alan Greenspan pulls the "easy money" trick out of his steaming caldron to heat up a recessionary economy. By dropping the Federal funds rate to one percent in 2001 and 2002, the Fed encourages homeowners to tap their primary source of net worth and savings — their homes. Four years later, consumers have withdrawn — and spent — trillions in mortgage refinancing proceeds and home equity loans. Unfortunately, however, these low rates combined with loose underwriting standards to fuel rampant and dangerous speculative fever.

### The Low-Rate Real Estate Boom — 2001–2004

The economy is roaring and at its hub is the burgeoning housing industry. Accounting for 15-30 percent of job creation and GDP, public owned home builders open new developments for first and second home buyers in areas where they were able to stockpile or option land for little cash. Florida, Arizona and Nevada experience binge growth in construction permits, but the infection spreads throughout both coasts to accommodate the much anticipated arrival of baby boomer retirees. Cheap mortgage money is all that is needed to fill the prescription and the sputtering economy is pulled out of the rubble by housing.

The math is fairly simple. At ever lower mortgage rates, home buyers can qualify for greater mortgage proceeds — assuming they are required to qualify at all. The old 80 percent loan-to-value (LTV) lending standard is replaced by myriad mortgage choices, marketed aggressively by a new army of hungry mortgage brokers. Option adjustable rate mortgages (ARMs), in which the borrower picks his initial pay rate and the difference is added to his balance, are presumed to be easily repaid by a virtually guaranteed increase in his home's value upon refinancing or sale. Interest-only jumbo mortgages at low rates are mixed at closing with home equity loans up to the full amount of inflated appraisals. Instead of being required to qualify for higher reset rates, ARM borrowers are underwritten at initial rates, while many "no-doc" loans are written without regard to income qualification.

In this process, legal standards are nearly invisible and enforcement is limited. Lenders are untroubled. They believe, much like bond and stock traders, that “the trend is your friend,” so housing prices will continue to appreciate indefinitely — until they do not. As in other areas of the economy, brokers will sell anything to anyone, but take no responsibility. Why should the mortgage broker be any different, especially since individual agents are not required to be educated or trained in anything beyond collecting commissions and fees? With “no-doc” loans and Option ARMs eligible for securitization and easy funding, even borrowers who could not get a credit card or used car loan suddenly qualify for jumbo mortgages. Brokers did not verify information within or outside the virtually blank mortgage application. Part-time students, fast-food clerks, and car salesmen morph into mortgage brokers and roam the plains in search of new borrowers.

Freshly painted storefronts and highway signs announce the opening of new mortgage brokerage offices. Local production offices staff up at job fairs, assigning each new agent a laptop and phone. They provide a few hours of telephone sales training, but little or no education in mortgage products or their suitability. The branch manager dreams of production, never pondering the ethics of rushing new applications from under-qualified borrowers into the pipeline. Nor do ethical issues trouble the broker-agent or mortgage executives, whose increasing volume provides cash bonuses, award trips, and stock options. Wall Street bankers and their well-paid attorneys have no complaints, either. As long as the applications and Wall Street securitization

money keep flowing, no one worries about the day when the music will stop.

Appraisers are equally co-opted by greed. Expecting property values to keep increasing, they have no desire to cut off their pipeline from their referring brokers by being conservative. As long as all parties involved in the mortgage origination and closing process are motivated by the promise of more commissions and fees, ethical standards will continue to be ignored. Until recently, however, legal requirements were largely limited to fine print disclosures of rate reset rules and privacy notifications.

Builders and real estate brokers find easy marks in consumers who can suddenly afford whatever they sell. As can be seen in any car showroom, the amount the customer can afford mysteriously increases the price he is enticed into paying. With little regard for cost, which can be attributed to unrealized appreciation in land value, home builders price each phase of new development at 10-20 percent more than the last, simply because they can. Their well-oiled marketing machine can sell each unit before construction commences as waiting lists are filled by early buyers who become “referral agents.” This process creates instant appreciation in the theoretical, though fictitious, value of each unit in the last phase, which in turn, facilitates their marketing effort. Sound familiar?

It may take headlines to remind us of the rules of musical chairs, but fast money games follow the same pattern. While the music keeps playing, everyone stays on the dance floor and no one thinks about chairs. After reading hundreds of unsolicited invitations claiming to have ap-

proved shaky credit for low rate, no down-payment mortgage loans, a second home begins to sound like a good investment to the consumer. The unsophisticated borrower never thinks that the home value could decline or the mortgage rate could rise to double his monthly payment and believes, almost religiously, that infinitely appreciating property values will support a higher loan balance. Then, too, no one recognized the similarities between this seemingly legitimate real estate investment and a pyramid marketing scheme. Unfortunately, there is no investment adviser or registered securities broker to stand behind our new real estate investor/mortgage borrower to determine the suitability of the investment or the mortgage product. Ironically, one of the biggest subprime lenders, New Century Financial, which recently announced a discounted sale of \$4 billion in subprime loans (*The New York Times*, March 22, 2007, P. C10 (Reuters)), had a public policy of approving loan applications evidencing “the borrower’s ability to repay,” and that it considered “whether loan terms were in the borrower’s best interests.” (G. Ip and D. Paletta, “Regulators Scrutinized in Mortgage Meltdown,” *The Wall Street Journal*, March 22, 2007, P. A1, 14).

At the core of every pyramid structure is the basic premise that the pyramid will continue to grow, even though there is no detectable basis for any participant making enough profit to justify the risk. From 2001-2004, reduced Federal funds rates and lax lending policies created a new version of this same game. The perception of riskless profits enhanced by the excitement of early buyers profiting from price increases infected such unlikely real estate investors as mid-

dle-income civil servants, fixed income retirees and even students with little or no credit, doubling or tripling the realistic demand for new condominiums and subdivisions. The game may have begun as an entirely laudable and ethical attempt to stimulate a dormant economy and make home ownership more affordable, but it has degenerated into an unethical, if not illegal, game for profit-hungry entrepreneurs. Less publicized than the Wall Street bankers, energy traders, and the Internet millionaires, public home builders, mortgage lenders and their colleagues, the mortgage brokers and appraisers, often became instant stock option millionaires.

## 2005–2007: The End of the Game

A game is fine — even ethical — if everyone wins, or has an equal chance to win under clearly defined rules. But if the rules are not understood, or if the results are managed by professionals able to exploit information or circumstances within their exclusive knowledge or control, the game becomes unethical before it will ever be considered illegal.

The professionals in the housing market generated huge commissions and fees during the heavy volume of new and refinanced mortgages by selling cheap stock acquired in their publicly traded companies, or by rushing new mortgage applications into processing without regard to qualification or suitability of the product to the borrower. Seeing their volume decline during the Fed’s 18 inflation-fighting rate increases from 2004 to June 2006, they began to plan for a tighter money policy. Home builders cancelled projects, returned optioned land, and laid off construction workers. They reduced invento-

ries with promotional programs, while fighting cancellations and aggressively enforcing previously ignored anti-flip clauses against previous purchasers. While succeeding layers of investors got stuck with new units, stock option grantees in publicly traded home builders and mortgage lenders exercised options and cashed out.

Investigations into market-leading insider stock sales and managed earnings reports at New Century and other subprime lenders are just beginning. For example, the SEC has begun to look into a variety of abuses in the subprime market and potentially “front-running” sales of stock by mortgage insiders — such as Countrywide Financial’s CEO Mozillo’s sale of \$140 million worth of stock — may arouse inquiry. Separately, New Century Financial announced a federal criminal inquiry into accounting fraud and stock sales. (S. Hughes, “SEC Says It’s ‘Looking at Subprime,’” *The Wall Street Journal*, March 20, 2007; P. C7.) The subprime loan market to less creditworthy borrowers with little or no verified income has grown from 5 percent of the market in 2003 to over 20 percent of loans made in 2006. Yield-hungry investors, including foreign investors and hedge funds, flooded the market for billions of BBB and BBB-rated baskets of subprime loans at yields 300 basis points (bps) and higher above conventional mortgage backed securities (MBS). Since the slow response of federal banking agencies to tighten lending standards began in late 2006, conventional bank lenders have been forced to review income documentation. At the same time, higher rates and swollen housing inventories — also caused by Federal rate increases and credit-tightening — have produced resale price drops of 5-20 per-

cent in most markets, most notably in the areas of aggressive new projects. With falling prices, suddenly conservative lenders have now become more selective in approving mortgage broker applications and they now encourage appraisers to find lower valuations. The result is that many low-equity borrowers are unable to refinance.

By March 2007, the high-volume subprime lenders have been left gasping for breath. Most have folded or left the market. New Century Financial, NovaStar Financial, Accredited Home Lenders, Fremont Investment & Loan, Ownit Financial, ResMae Mortgage Corp, Mortgage Lenders Network have all stopped making new loans and will enter or approach bankruptcy, though some will be kept alive by Wall Street so vultures can pick over their remaining assets. These lenders all relied on Wall Street credit lines to fund loans and did not reserve capital to cover their obligations to repurchase delinquent loans, which have mushroomed to more than 13 percent of total loans. By contrast, other large multi-loan financial institutions like HSBC Bank, Countrywide, H&R Block, and GMAC all expect to absorb losses in the subprime sector with minor effects on earnings, but will be forced to inject capital into subsidiaries and reserve for losses.

The domino effect of this shake-out — evidenced by home builder stock declines of 25–50 percent and broad market drops of 5–10 percent from late 2006 highs — is predicted to hit all sectors of the housing market. The infection could easily spread from the subprime mortgage market to “Alt.-A” mortgages and to ARM borrowers facing lower appraised values upon refinancing. (Alt.-A loans are those made to borrowers with

moderate credit, but minimal equity or little income and/or limited income documentation. Most high LTV and Option ARMs fall into the Alt.-A category.)

Subprime defaults are likely to send housing prices lower as foreclosures and “short sales” flood the market. (“Short sales” are sales of property at or below the outstanding mortgage balance. It relieves the borrower of deficiency liability and avoids costly foreclosures. See J. Lahart, “Housing Sector May be Knocked By Mortgages,” *The Wall Street Journal*, February 27, 2007, P. C1.). Even borrowers with good credit will have trouble making their payments if their jumbo interest-only ARMs or Option ARM accretion loans balloon to grab 50 percent or more of their income. If so, it could become the surprise trigger that finally frustrates the Fed’s proudly-acclaimed “soft landing” and propels the economy over the edge into a real slowdown, or even a recession. If this doomsday forecast comes true, it will be because the Fed has overshot its inflation fighting goal, and probably overdid its easy money booster.

Responsible easing of credit through rate reductions is an important tool to promote consumer spending and economic growth. The Fed could have found other ways of stimulating or slowing the economy without blowing up and bursting the housing balloon through interest rate movements. However, by encouraging speculation through low rates and loose underwriting practices, the stage was set for capitalistic mortgage lenders to make millions of unsuitable loans to under-qualified borrowers without regard for future rate or payment resets or market value declines.

## The Ethics of the Mortgage Market

What we are seeing is the end result of depersonalization of the mortgage lending business. (See Ip and Paletta, *supra*, at A14). In Jimmy Stewart’s days as President of the Savings & Loan in “It’s a Wonderful Life,” he knew every depositor and every borrower. A few short years ago, a branch banker knew quite a bit about each mortgage applicant and could make an individualized credit recommendation, aided, of course, by FICO scores and the appraisal. By moving the funding source to Wall Street, which sells MBS and collateralized debt obligation (CDO) bonds to foreign investors, pension fund managers, and hedge funds, several discrete layers are interposed between the money and the borrower. With the mortgage broker, mortgage banker, and Wall Street all motivated by commissions, and the remote investor looking only to yield and ratings, legal and ethical responsibilities are abandoned in favor of volume and efficiency. Thus far, these ethics seem to have been consistent with minimal legal standards and limited regulatory oversight.

## Everybody Wins (for a While) in an Up-Market

The key players in this drama all face ethical issues, but choose not to recognize them. Wall Street generates millions in underwriting fees by continuing to fund any financial package that can be rated. Rating agencies generate rating fees by helping bankers and lawyers with rosy analyses of the performance of subprime loan

pools — much more optimistic than the early commercial loan pool securitizations. Non-bank lenders easily raise the minimal capital necessary to fund and sell loans to Wall Street without being required to fund proper reserves for defaulted loans. In order to reduce their overhead, these lenders generate volume through independent mortgage brokers operating out of cars and apartments, whose sole responsibility is to submit an application from anyone with a Social Security number or taxpayer ID. These applications are often blank or completed by the broker, since they are “no-doc” loans — in many cases to first-time or poor credit borrowers whose ability to make any monthly payment depends on excess amounts funded through a mortgage based on inflated appraisals. In a rising market — which continued through 2005 — no one suffered because non-performing loans could be repaid from sales at a higher price or refinanced with greater proceeds. Even high-yield BBB rated subprime mortgage pools had relatively low default rates.

## Somebody Really Loses in a Down-Market

That scenario changed in the fourth quarter of 2006, as Fed rate hikes and tighter lending standards reduced the number of qualified buyers, dropping property values by 15 percent or more in many markets. Speculators were driven into cancellations, “short sales” at the mortgage amount or foreclosures. The prospect of future loss led many low or no-equity borrowers to fail on even the first few payments, triggering buy-back clauses in securitization sales. Low-rated

subprime pools saw delinquency rates rise from 4.5 to 13.3 percent, with the likely prospect of even higher default rates after foreclosures. (M.Whitehouse and S. Lueck, “Subprime Fears Spread,” *The Wall Street Journal*, March 14, 2007, P. A1).

This reversal of the five-year upward trend caught the market by surprise. Within a very short time, losses were spreading from home building company investors to mortgage lenders. New Century Financial, NovaStar, and Accredited Home Lenders filed or approached bankruptcy, while their Wall Street backers cut credit lines and reserved for losses. Diversified financial institutions like HSBC Bank, GMAC, and H&R Block increased reserves. Wall Street firms with mortgage lending operations (Lehman, Goldman, Morgan Stanley, Bear Stearns, etc.) appear able to weather the storm due to hedging, credit default insurance, and huge trading and investment banking profits.

The real loser is likely to be the innocent borrower who cannot refinance at higher rates, stuck with an unaffordable mortgage, tighter credit criteria and lower valuations. Millions of these mortgage borrowers without “chairs” will lose their equity and be shut out of the economy. At the same time, the sheer volume of foreclosure and “short sales” could swell already high inventories and push down values for several more years. The indirect effect of declining property values is reduced home equity loans to support consumer spending and further job losses in construction and real estate related fields.

## The Need for Mortgage Reform

### Revision of Lending Standards

Ironically, the very inflation which the Fed is now fighting with 350 bps via 18 rate increases since 2004, would not have been as serious a concern without the housing bubble resulting from speculation due to lax lending standards. Most of the losses — past and future — being forecast as a result of the subprime market shakeout and its aftershocks could have been prevented by prudent regulatory oversight and lending criteria during the era of cheap money. A simple requirement of real equity would have limited speculation in new development. Requiring more equity for non-owner occupied units, or requiring investment borrowers to meet project income tests from commercial cash-flow models could also have limited speculation and frothy double digit appreciation. Thus, revised lending oversight and underwriting criteria are at the heart of mortgage reforms. Similarly, “no-doc” mortgages may be fine for self-employed borrowers who invest more equity and option ARMs can be underwritten at realistic reset rates. Policy exceptions can always be made for affordable or senior housing or by careful use of tax credit programs, but easy money without lending standards was not the best or only way to stimulate a dormant economy.

Banks and other regulated lenders have already begun tightening underwriting and disclosure requirements. (See Hughes, *supra*, at P. C7.) This will make it more difficult for many borrowers in the subprime and Alt.-A categories to refinance their existing mortgages and obtain new loans

on previously committed purchases. Unfortunately, this is too little too late for borrowers and small speculators who leveraged their slim resources to make their fortunes in real estate.

### Regulation of Mortgage Professionals

Borrowers are often first solicited by independent brokers whose emails, telemarketing calls and snail mails promise approved credit, cash out, investment gains, and other enticing rewards just by making a simple phone call. These brokers seize the chance at easy money by hustling around taking mortgage applications without a thought for suitability or ability to repay. Is this entrepreneurial sales activity illegal or even unethical? Surely not, but what if the broker solicits a low-income jumbo applicant for a subprime mortgage whose accreted value after a low payment option period is likely to exceed the value of the property? What if the broker encourages the appraiser to inflate its value because, after all, the lender wants volume and expects housing values to continue rising?

### Mortgage Brokers

The first point of contact for non-bank loans is the mortgage broker. These persons need to be better-trained, individually licensed, and properly supervised to comply with clearly framed suitability standards similar to those imposed on securities brokers. Requirements of licensing, testing, continuing education, and supervision would eliminate many of the less diligent and ethically challenged brokers seeking a quick payday.

The need for registration of securities brokers for the protection of investors or licensing of insurance brokers is analogous to the need for regulation and training of mortgage brokers selling complex mortgage products. After all, for many consumers, their home will be their single biggest investment and, in that sense, their mortgage is a critical investment product. Some states regulate mortgage sales agents and brokers, as well as mortgage banking firms, but licensing, testing and oversight at the agent level are minimal.

The original exemption of mortgages from securities regulation by definitional exclusion under the Securities Act of 1933 (as amended), and the Securities Exchange Act of 1934 (as amended), at the behest of the banking lobby, was based upon the assumption that mortgage loans were extended by heavily regulated and well-capitalized banks and savings institutions. Back then, no one envisioned billions of dollars flooding the markets through entrepreneurial mortgage brokers obtaining fast funding from Wall Street and yield-hungry hedge funds. Insurance products were exempted from the definitions of “securities” for similar reasons. Perhaps this exemption should be revisited, or replaced by another set of regulations that require mortgage brokers to act responsibly in recommending suitable mortgages and to “know their customers.”

In addition, state banking, licensing and consumer protection agencies will need greater authority — unopposed by federal regulators — to require proper disclosures, cooling or rescission periods and enforcement capacity. Despite scant federal enforcement action, federal banking regulators are believed to have preempted local

enforcement efforts in New York and Georgia, among other states. (See Ip and Patella, *supra*, at P. A14).

## Appraisers

The appraiser’s situation is different because he or she is already licensed, but not really supervised, and has limited accountability. The appraiser knows little about the suitability of complex mortgage products, but can easily manipulate “comparable” property resale values to require more or less equity to meet underwriting standards, and is often pressured by the mortgage broker or real estate broker at the risk of losing referrals. Again, in a rising market, no one worries about errors or liability, and who could really prove one comparable was better than another. Valuation is merely an opinion, and absent provable fraud or collusion, the risk to his license is less of a concern than lost business referrals from dissatisfied mortgage brokers. Additional regulation should include continuing education, periodic re-testing and record review, and, possibly, a requirement of more detail in appraisals. Contingent compensation — direct or indirect — should be prohibited, as should referral fees.

## Mortgage Lenders

The next layer of reform should reach to the lender level. Removed from real contact with the borrower and having little or no financial information, the lender relies solely on the broker and the all-important appraisal. If lending standards are clearly stated, a mortgage underwriter can make fair decisions, and help the banker and broker match the mortgage product

to the borrower. Maybe a middle-income buyer should find a less expensive home in an older neighborhood and work his way up the ladder, instead of being hooked on a low teaser-rate Option ARM, which resets to grab 50 percent of his monthly income. Everyone gets paid a bit less — the real estate and mortgage broker, the lender, etc. — but the loan will stick and the borrower will not be dislocated by a foreclosure.

Another potential solution to the rapid demise of high-rolling mortgage bankers would be a minimum capitalization and reserve requirement. Non-bank lenders are still acting as banks and should have the ability to repurchase and structure workouts of delinquent loans without dumping them into foreclosure pools. If mortgage bankers have to use their own capital to retain portions of loans and reserve for defaults, and their earnings will be hit by losses, they may be a bit more careful in originating abusive loans.

Certain types of mortgage loans, e.g., “no-doc” or “low-doc” — less than 15 percent equity, non-primary residences — should be retained by the original lender for a minimum period of time. This would shift many of those loans to banks and other better capitalized financial institutions that have the capability to properly underwrite and service the loans, and that should be in a better position to know their customers. It would also remove incentives for abusive loans.

## Mortgage Funding Sources

At the core of the problem is the fact that home mortgages are now funded through a highly regulated industry — securitization through regis-

tered broker-dealers. The many different means of participation by major securities firms present numerous ethical and legal conflicts. Wall Street underwrites pools of mortgage-backed securities and has incentive to maximize the volume and yield of pools. This leads bankers to seek out high-yield subprime loans from originators who may be notoriously lax in underwriting and verifying information. Even though bankers require repurchases of defaulted loans, they often buy loans from undercapitalized lenders who are ready to file for bankruptcy as soon as their credit lines are cut. Perhaps Wall Street should have some responsibility for mortgage lender-originators, similar to its responsibility when performing clearing operations for other smaller firms that leave investors with losses.

Wall Street also earns underwriting fees for selling equity in public mortgage lenders and through the extension of warehouse credit lines for mortgages originated until they can be packaged and sold. What if those mortgages are poorly underwritten or extended to “straw” or fictitious borrowers in sales at manipulated prices — all of which have occurred in recent months? Would the bankers’ due diligence procedures detect this fraud? If so, would the investment bank risk loss on its credit line by refusing to underwrite the pool?

These conflicts are not materially different than those faced by investment banks that underwrite equity and debt for companies in which the firm has an LBO or seed capital position. Disclosure tends to be an acceptable solution and meets regulatory requirements. The mortgage securitization market deals almost exclusively with sophisticated investors who can assess and afford

the risk of default. So long as the pools contain full disclosure and ratings reflect careful analyses of pool performance in varying markets and rate conditions, investors can choose their yield and make informed decisions.

Congress is set to make serious inquiries into abusive and predatory lending practices and to extend their scope of inquiry to subprime loans made to unqualified borrowers. Senator Chris Dodd is proposing consideration of federal relief for defaulting mortgagors, while housing advocacy groups are calling for an unlikely legal moratorium on foreclosures. (V. Bajaj, “For Some Subprime Borrowers, Few Good Choices,” *The New York Times*, March 22, 2007, Pp. A1, C10.).

Congressman Barney Frank of the House Financial Services Committee is proposing to send liability for abusive mortgages all the way up the mortgage funding chain, but this policy will need teeth to provide the funding mechanism to forestall defaults and avoid foreclosure. This notion of sending liability for abusive mortgages up the chain was part of a 2002 Georgia statute that was modified to avoid an industry withdrawal from lending in that state. (See Ip and Patella, *supra*, at P. A14.). Some form of reserve or insurance to cover payment shortfalls could be funded by Wall Street and the mortgage industry, as well as by fines. (Hitt, Lueck & Hagerty, “Congress Primed to Act on Risky Home Loans,” *The Wall Street Journal*, March 15, 2007; P. A6.).

Wall Street’s big buyers — hedge funds, pension funds and foreign investors who bought into MBS and CDO bond pools — stand to lose the

most in quantitative terms when poorly underwritten or fraudulent mortgages default. Investors in public mortgage lenders will also suffer as their companies file for bankruptcy. However, the primary focus should be on the real victims — the unsophisticated mortgage borrower. The only effective solution, which will be vigorously opposed by mortgage bankers, is to make certain unsuitable mortgages subject to equitable reformation by requiring lenders to refinance them at lower rates, extend low-rate periods, and, if the borrowers cannot meet those terms, to arrange “short sales” on reasonable notice.

Wall Street firms, which securitize billions in mortgages and buy mortgages from irresponsible firms known to be aggressive purveyors of high-risk mortgages and do not require proper documentation, should also be required to buy back defaulted loans and pools. In combination with reserve fund and insurance programs, this type of regulation could at least avoid premature foreclosures and the resulting impact on property values.

Finally, regulators should address the continuing need for affordable housing. Recent Congressional hearings have exposed the paucity of federal enforcement and investigatory proceedings during the past five years of tripling volume in subprime lending. Many subprime and Alt.-A loans were clearly unsuitable for buyers with inflated housing prices who could not qualify for conventional loans or carry those mortgages after an initial teaser period. Nor should amateur speculators with limited credit capacity have been allowed to borrow with no or little equity on to-be-built units, on the assumption that they would be bailed out by continuing price

inflation. The solution to the housing bubble should not have been to hope for a soft landing by raising interest rates 18 times in one-and-a-half years, but to control it through prudent lending and underwriting standards.

Instead of unqualified borrowers being lured by profit-oriented mortgage brokers into unaffordable homes and mortgages, borrowers need to have better access to and understanding of subsidized mortgage programs that enable them to build equity and remain in their homes at reasonable reset rates. Refinancings of subprime loans in the new tight-money environment have led to public calls for reactivation of the FHA program, under which borrowers with as little as 3 percent equity would pay 2 percent mortgage insurance for federal loan guarantees. (K.J. Dunham, "Mortgage Woes May Help Revive FHA," *The Wall Street Journal*, March 16, 2007, P. A4.).

## Conclusion

Depersonalization in mortgage lending is the heavy price paid for the funding efficiencies of Wall Street securitization. The widely accepted ethical indifference towards subprime borrowers in the lowest quartile of credit standards has finally crossed over into a need for new legal standards. The reforms suggested here are too much to hope for, and probably more than is needed. Regardless of merit, most will be quashed by the mortgage banking industry before reaching any legislative committee, and others will fail along the way. The mortgage banking industry, for example, successfully pressed Georgia to modify its 2002 anti-predatory lending law. (See Ip and Paletta, *supra*, at P. A14.).

Similar ethical lapses in business sectors, such as securities, banking and insurance, have led to industry self-regulation with varying degrees of governmental oversight. Either or both would be welcome additions to the multi-trillion dollar mortgage market.