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The Legal Infrastructure of Subprime and Nontraditional Home Mortgages

Patricia A. McCoy and Elizabeth Renuart

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Introduction

We are at a crossroads. The regulatory landscape of mortgages, through decades of deregulation, crass competition for charters, and aggressive concentration of federal power at the expense of state laws protecting local citizens, has failed to curb abuses in the mortgage market in any meaningful way. The subprime crisis was the direct result of not policing the market, resulting in to skyrocketing foreclosures, falling homeownership rates, lost municipal tax revenues, vacant buildings, and distress to the economy as a whole. The persistent nature of these problems strongly suggests that proper re-regulation of mortgage loans, with a strong federal floor plus state regulation, is necessary to stabilize the economy and make homeownership sustainable.

In this chapter, we provide a critical analysis of the legal landscape of residential mortgage lending and explain how federal law abdicated regulation of the subprime market.[1] In the loan origination market, federal deregulation and preemption of state law combined to produce a system of dual regulation of home mortgages which precipitated a race to the bottom in mortgage lending standards. In the process, numerous aggrieved borrowers were left with little or no recourse for abusive lending practices. Even borrowers who *do* have valid claims and defenses against their originators find their legal safety net similarly frayed. That is because in cases where their loans were securitized – as were the vast majority of loans – the antiquated legal doctrines surrounding securitization strip those borrowers of most claims and defenses in foreclosure actions brought by securitized trusts. This laissez-faire state of residential mortgage

[1] We use the term "subprime" to refer to home mortgage loans carrying higher interest rates or higher points and fees when compared to loans to the best-qualified borrowers (also known as "prime" borrowers). Although the subprime market was designed for borrowers with impaired credit, lenders frequently also made subprime loans to unsuspecting borrowers who could have qualified for the best-rate prime mortgages. See, e.g., Brooks & Simon (2007). Accordingly, our definition of subprime loans turns on the high-cost nature of those loans, not on the borrowers' credit profiles.

law, combined with the absence of elementary legal protections for the nation's most vulnerable borrowers, have coalesced to produce the worst foreclosure crisis in the United States since the Great Depression.

The Evolving Legal Architecture of the Residential Mortgage Origination Market

Today, federal disclosure law forms the main regulatory paradigm for the oversight of residential mortgage credit. That was not always the case, however. Until 1980, state and federal laws regulated the substantive terms of mortgage loans. This regulation included maximum caps on interest rates, otherwise known as usury laws, and restrictions on other loan terms and practices. In this section, we chronicle how federal disclosure laws came to displace the extensive former regime of state regulation.

Legal Developments Preceding the Emergence of the Subprime Market

Modern consumer credit transactions in the United States are regulated (or not) by an overlapping set of state and federal laws, which are riddled with exceptions and undermined by federal banking agency preemption. These complexities and loopholes did not always exist. Indeed, across-the-board usury caps reigned in state law until the 20th century.[2] Due to an upsurge in high cost "salary" lending[3] and loan sharking in the early 1900s, states began to pass "specialty" usury laws, each of which addressed a specific loan product, *e.g.*, a small loan, a retail installment sales finance contract, or revolving credit.[4] These laws were exceptions to the states' general usury caps, permitted lending at higher rates and fees, and regulated some non-interest aspects of the transactions.[5]

[2] Peterson (2003, pp. 862-863). The state usury caps were modeled upon the Statute of Anne, passed in England in 1713, which set a maximum interest rate of five percent per annum. *Id.* at 843-844; Renuart & Keest (2005, p. 14).

[3] Salary lending was the precursor to the payday lending of today.

[4] Drysdale & Keest (2000, pp. 618-621).

[5] Throughout the 20th century, states used a variety of techniques to regulate consumer credit generally for the protection of borrowers. These included limitations on attorneys' fees, credit insurance premiums, ''service charges," appraisal fees, commitment fees and other charges for services that a creditor may impose. Moreover, many of these laws were (and are) unrelated to direct limitations on the interest rate or other charges which a creditor may assess. For example, state credit statutes frequently render unenforceable some particularly one-sided contract clauses such as waivers of a borrower's legal rights, confessions of judgment, or wage assignments. Other restrictions make the consumer debt more easily repayable. For example, a special usury law might grant the lender the right to collect a higher interest rate than the general usury law but might require that the rate be fixed and the loan repayable in equal monthly installment over a minimum period of time. Renuart & Keest (2005) § 1.3; Saunders & Cohen (2004, p. 4) (noting that "[w]hile one could describe this scheme as "piecemeal," it led to relatively comprehensive protection for consumers").

Mortgage lending, for the most part, remained under the auspices of state general usury laws until 1933.[6] Only national banks had the option of selecting the higher of a federal rate or the maximum allowed under state law, giving them "most favored lender" status.[7] However, credit tightening exacerbated by events leading up to and following the 1929 stock market collapse created a national housing crisis and the need for a national solution.[8]

Presidents Hoover and Roosevelt faced high foreclosure rates, a housing industry "still flat on its face,…two million men unemployed in the construction industry, and properties falling apart for lack of money to pay for repairs."[9] As a result, Congress passed the Home Owners' Loan Act in 1933 to help distressed homeowners by refinancing their short-term, renewal mortgages with new 15-year amortizing loans that carried annual interest rates of no more than 6 percent.[10] Federally-chartered "savings and loan" associations, the vehicles for making these loans, were born.[11]

One year later, Congress, at the behest of President Roosevelt, his Cabinet, and others, quickly adopted the National Housing Act.[12] Among other things, this law created the Federal Housing Administration and the FHA-insured mortgage loan program. For the first time, a federal law created usury and credit regulation that applied to participating lenders, regardless of how and where they were chartered. The program limited the interest rates to 5% and gave the administrator discretion to raise the cap to 6%. It imposed maximum loan amounts. Moreover, the FHA required appraisals, imposed loan-to-value ratios and underwriting criteria based on the borrower's ability to repay, and specified that the mortgage lien be in first position.[13]

[6] Peterson (2003, pp. 862-863). The state usury caps were modeled upon the Statute of Anne, passed in England in 1713, which set a maximum interest rate of five percent per annum. *Id.* at 843-844; Renuart & Keest (2005, p. 14).

[7] 12 U.S.C. § 85. The federal rate is 1% above the discount rate on 90-day commercial paper in effect at the federal reserve bank in the district where the institution is located; for example, the discount rate on September 7, 2007 on 90-day "AA" financial paper was 5.48%; adding 1% equaled a rate of 6.48%. Federal Reserve Release (2007a). Because state laws routinely contained strict usury caps until 1980, national banks operated under a solid usury regime in contrast to today.

[8] Federal Housing Administration (1959, p. 2).

[9] *Id.* By 1933, non-farm foreclosures had reached 252,400 and housing starts had plummeted to less than a tenth of the 1925 record of 937,000.

[10] Pub. L. No. 73-43, 48 Stat. 128; Mansfield (2000, pp. 479-480). A significant portion of the mortgage loans outstanding during the period from 1925-1929 were non-amortizing or partially amortizing loans. Willen (2007, p. 5).

[11] Federal credit unions came into existence in 1934 when Congress created the National Credit Union Administration. Congress deemed it critical to create a deposit insurance fund in 1933 and passed the Federal Deposit Insurance Act.

[12] June 27, 1934, ch. 847, 48 Stat. 1246, *codified at* 12 U.S.C. § 1701 *et seq.* The bill was introduced on May 14, 1934 and subsequently was passed and signed by the President on June 27, 1934.

[13] Federal Housing Administration (1959, pp. 5, 10). In 1935 alone, the FHA insured 23,400 mortgages totaling $94 million. *Id.* at 12.

Toward the end of World War II, the Servicemen's Readjustment Act of 1944 gave the Veterans' Administration (VA) authority to begin a mortgage insurance program similar to that of the FHA.[14] The VA could guarantee $2,000 of home mortgage debt owed by an individual who had served in the armed forces at an interest rate of 4%. Later, these agencies were allowed to set the maximum interest rates on insured mortgage loans until 1983 for FHA loans and until 1992 for VA loans.[15] After those dates, Congress repealed this authority and effectively eliminated rate caps.[16]

In the 1960s, Congress concerned itself with two serious problems faced by consumers when shopping for credit: the non-standardized methods of computing interest that resulted in apples-to-oranges comparisons of rates and the fact that rates alone, in any event, did not reflect the full cost of credit, given the additional fees charged in connection with credit.[17] After several years of hearings, Congress passed the Truth In Lending Act (TILA) in 1968 to "assure a meaningful disclosure of credit terms" so that consumers could comparison shop and avoid expensive and abusive credit.[18] TILA did not regulate or restrict the terms of credit. Rather, Congress created a disclosure regime to complement the existing substantive credit regulation embodied in state law.[19] Congress explicitly deferred to and expected the states to substantively regulate consumer credit.[20]

The late 1970s and early 1980s were watershed years for usury law. Efforts were underway in the states to pass uniform consumer credit codes that would consolidate all or parts of their diverse usury laws and make credit regulation more uniform from state to state.[21]

[14] Pub. L. No. 78-346, §§ 500, 501, 58 Stat. 284, 291-92.

[15] Mansfield (2000, pp. 483-484). "In addition to being controlled by agency-dictated rate ceilings, FHA and VA loans were also subject to state interest rate caps between 1958 and 1979, unless a state's usury provision specifically exempted such mortgages from the state's usury laws. Thus, from the inception of these two loan programs until 1979, the interest rate that lenders could charge for FHA and VA loans was effectively capped at whichever was the lowest rate, the VA/FHA rate or the state usury rate." *Id.* at 484.

[16] 12 U.S.C. § 1709(b)(5) (FHA); 38 U.S.C. § 3745, 38 C.F.R. § 36.4311 (VA).

[17] Keest (1995, pp. 360-361).

[18] 15 U.S.C. § 1601(a).

[19] When TILA was enacted, it was adopted against a background of widespread state credit regulation. Most states still had usury limitations. House Hearing (1967, p. 139) (testimony of James L. Robertson). TILA's drafters never thought that its disclosure rules would be sufficient to fix all the problems with consumer credit. House Hearings (1967 p. 133) (testimony of James L. Robertson) ("I do not think this bill is going to cover all of the abuses in the credit field. . . . It is merely a start in the right direction.").

[20] S. Rep. No. 90-392 (1967, p. 8) (the Senate Banking Committee sought to "encourage as much State legislation in this area as is possible so that the Federal law will no longer be necessary.").

[21] Renuart & Keest (2005, pp. 30-31). The Uniform Consumer Credit Code (UCCC) was meant to consolidate the various specialty usury laws into one set of comprehensive provisions covering consumer credit. Versions of the

However, in 1978, the Supreme Court decided the case of *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*[22] In *Marquette*, the Court gave national banks the right to take their most favored lender status across state lines and preempt the usury law of the borrower's home state. As a result, national banks could establish their headquarters in states with high usury limits -- or none at all – and charge the high interest rates permitted by the bank's home state to borrowers located in any other state. The holding came to be known as the "exportation doctrine" and subsequently transformed the credit marketplace.[23]

Emboldened in part by this decision, South Dakota and Delaware decided to attract the lending industry as part of their economic development strategy and repealed their usury caps. They wanted to "provide [their] citizens with the jobs and benefits a large national credit card operation [could] provide (attracted by the ability to export limitless credit card rates to other states)."[24] It worked. South Dakota's tax revenues from banks went from $3.2 million in 1980 to almost $27.2 million in 1987, with the comparable figures for Delaware rising from $2.4 million to almost $40 million.[25] This strategy had the effect of weakening the resolve of states that wished to retain consumer credit protections, as their local banks argued that having to comply with such laws put them at a competitive disadvantage with out-of-state banks.

Simultaneously, conventional mortgage interest rates began to rise dramatically, from 7.38% a year in 1972 to 9.63% in 1978 (the year of the *Marquette* ruling) to 13.77% in 1980.[26] These rates exceeded many state usury ceilings, severely restricting mortgage lending in some states. In response to this crisis, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980.[27] This law affected state usury caps in two significant ways. First, it abolished all interest ceilings for first-lien mortgages on residences and

1968 and 1974 editions were adopted in about eleven states. This effort at uniformity failed, in part, due to federal preemption.

[22] 439 U.S. 299 (1978).

[23] Though the case involved credit card lending, the core of the holding was not limited to any credit product type.

[24] Independent Community Bankers' Ass'n of South Dakota v. Board of Governors, Federal Reserve Sys., 838 F.2d 969, 975 (8th Cir. 1988) (noting also that South Dakota repealed its usury cap and holding that South Dakota cannot protect its state banks against out-of-state holding companies that purchase in-state banks by restricting their location to one office).

[25] The Economist (July 2, 1988, p. 26).

[26] Federal Reserve Board, H.15 Selected Interest Rates, Historical Data, Conventional Mortgages, Annual Rates, http://www.federalreserve.gov/releases/h15/data.htm (accessed Sept. 13, 2007). These rates reached their peak in 1981 with an annual average rate of 16.63%. *Id.*

[27] Pub. L. No. 96-221, tit. v, 95 Stat. 164. Prior to 1980, Congress addressed the rising interest environment in more limited ways by preempting state usury caps for FHA and VA loans. Mansfield (2000, pp. 484-492).

mobile homes.[28] The law defined "interest" restrictions to include both periodic rate caps and the costs included in the TILA annual percentage rate, thus broadening the scope of the preemption.[29] Second, it extended the national bank "most favored lender" status to the other types of depository institutions.[30] This expansion meant that most depository institutions could select which of the two available rates, the one based on the federal discount rate or the applicable state rate, they wished to use in any given transaction of any type.[31] Just as important, these institutions could take advantage of the *Marquette* decision and export their home state's rates to sister states.[32]

Another Congressional override of state consumer credit laws occurred in 1982 with the enactment of the Alternative Mortgage Transactions Parity Act (AMTPA).[33] This Act addressed the structure of mortgage loans by trumping state laws that restricted variable rate terms, balloon payments, and negative amortization. Its preemptive effects are available to virtually all types of residential lenders.[34] The law covers all "alternative" loans, both first and subordinate lien loans, but not fully amortizing fixed-rate loans.[35]

[28] 12 U.S.C. § 1735f-7a. Congress allowed the states to opt out of this provision of DIDMCA by April 1, 1983. About fourteen states opted out, although not all chose to maintain their usury caps. Renuart & Keest (2003, pp. 105-108).

[29] S. Rep. No. 96-368 at 19, *reprinted in* 1980 U.S.C.C.A.N. 236. According to the Truth In Lending Act, the annual percentage rate is defined to include both the interest that will be earned over the loan term and certain costs associated with the loan, *e.g.*, origination and broker fees, points, and other closing costs. 15 U.S.C. § 1605.

[30] 12 U.S.C. § 1463(g) (federal savings and loan associations); § 1785(g) (federal credit unions); § 1831d(a) (state-chartered banks and savings banks). Under federal law, states still have the ability to opt out of the most favored lender preemption.

[31] However, as states relaxed or removed their usury caps, as discussed later, these depositories could make loans with liberal or no rate restrictions.

[32] In the early 1980s many states also enacted "parity" or "wild card" laws, the purpose of which was to put state banks on equal footing with their federal bank counterparts. Renuart & Keest (2005, pp. 120-21). Presently, nearly every state has enacted some form of parity provision. Shroeder (2003, p. 202).

[33] 12 U.S.C. § 3801 *et seq.*

[34] A handful of states, however, timely opted out of federal preemption under AMTPA. Renuart & Keest (2005, §§ 3.10.1, 3.10.2 at n. 679).

[35] "Alternative" mortgage loans include: loans in which the finance charge or interest rate may be adjusted or renegotiated; loans with fixed rates but which implicitly permit rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule (balloon loans); loans involving any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions. 12 U.S.C. § 3802. The Office of Thrift Supervision, the agency with the authority to enact AMTPA regulations governing non-depository lenders, repealed the preemption as it related to prepayment penalties and late fees in 2003. 12 C.F.R. § 560.210, *amended by* 67 Fed. Reg. 60,542 (Sept. 26, 2002). In support of its decision, the agency stated: "OTS believes that laws on prepayment penalties and late charges are a key component in states' regulation of predatory lending. Because these laws reflect each state legislature's judgment, after due consideration, about appropriate consumer protections applicable to state chartered lenders, OTS will not construe its authority under AMTPA to frustrate these state efforts where another less intrusive construction of AMTPA is permissible." Id. at 60,548.

Congress' immediate motivation for enacting DIDMCA and AMTPA was to revive thrift lenders and the mortgage market, which had both plunged into crisis with the rampant inflation of the late 1970s. Ultimately, however, both statutes had other far-reaching structural effects. By liberalizing the permissible features of loan products and facilitating differential pricing according to risk, the DIDMCA and AMTPA set the legal stage for the emergence of the subprime mortgage market a decade later.

The Rise of the Subprime Market and Re-Regulation

The home mortgage market of today bears little resemblance to its predecessor of past years. Before the advent of securitization, lenders underwrote their loan applications by hand and held most of their home mortgages in portfolio. Given the risks of holding such long-term assets, lenders rationed credit and only extended loans to borrowers with perfect or nearly perfect credit, the so-called "prime" customers.[36] Customers with weaker credit – including numerous minorities – were shut out of the home mortgage market altogether.

This state of affairs changed due to four developments that laid the groundwork for the emergence of the subprime market. Deregulation, as just discussed, was the first of these developments. Federal deregulation permitted lenders to charge a risk premium to less creditworthy borrowers in the form of higher interest rates and fees. Equally importantly, deregulation allowed lenders to market new and more complex types of mortgage products, including adjustable-rate mortgages and loans with balloon payments and negative amortization, which expanded the pool of eligible borrowers and helped lenders control for interest-rate risk.[37]

While deregulation dismantled legal obstacles to the subprime market, other innovations, mainly technological in nature, helped to bring the subprime market to life. Previously, the mortgage market had labored under a number of challenges that made lenders wary of making loans to consumers with blemished credit. Lenders lacked sophisticated and reliable models for evaluating default risk. In addition, lenders raised capital for mortgages regionally, not nationally or internationally, which led to regional imbalances and credit crunches. Finally, the mortgage market lacked a well-established mechanism for diversifying the heightened risks of

[36] Engel & McCoy (2002a, pp. 1271-1273); Munnell et al. (1996, pp. 25-53); Stiglitz & Weiss (1981, pp. 394-397).
[37] See also Engel & McCoy (2002a, p. 1275).

subprime loans through the capital markets. In a few short years, however, a series of innovations solved these problems and paved the way for the subprime market.

Transformation of the Residential Mortgage Market

In the 1970s and 1980s, technological advances revolutionized residential mortgage lending. One such advance was *statistical credit scoring models and automated underwriting*, which made it possible to price disparate credit risks, opening up credit to people who had previously been deemed unqualified for loans. Before the advent of these technologies, underwriters analyzed residential loan applications manually, drawing on personal experience, intuition, and strict underwriting standards. With the introduction of statistical modeling and automated underwriting, analysts concluded that traditional underwriting requirements such as a 20 percent down payment, two to three months of expenses in savings, continuous employment for one to two years, stellar credit records, low debt ratios, and full documentation could be relaxed without significantly boosting default rates. Eventually, the automated technologies caught on and gave lenders confidence to offer home loans with reduced down payments or piggyback loans, reduced savings requirements, higher debt-to-income ratios, stated income underwriting, and liberal employment standards.[38]

The second innovation was *securitization*, which made capital markets financing available to originators to lend while allowing them to spread the risk of long-term mortgages among secondary market investors. Securitization consists of bundling loans, selling them to a trust, and carving the cash flows from the mortgages into bonds sold to investors that are backed by the collateral underlying the mortgages.[39] This new technology, which was the brainchild of Lewis Ranieri, became commonplace in the prime market in the 1980s once Freddie Mac and Fannie Mae embraced it. The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) made it easier for private entities to issue private mortgage-backed securities and for banks and thrifts to buy these securities.[40] Subsequently, once statistical modeling and

[38] Fannie Mae, Freddie Mac, and private lenders all adopted the flexible lending standards afforded by automated underwriting. Belsky & Calder (2005 p. 8); Belsky & Retsinas (2005); Gates et al., (2002); U.S. Departments of Commerce and Housing and Urban Development (2002).

[39] For more detailed description of the process of securitization, see Engel & McCoy (2007b, pp. 2045-2063).

[40] Codified in scattered sections of the United States Code at 12 U.S.C. §§ 24, 105, 1464(c)(R), 1757(15); 15 U.S.C. §§ 77r-1(a), (c), 78c(a)(41), 78g(g), 78h(a), 78k(d)(1). Among other things, SMMEA exempted "mortgage related securities" from registration under state blue sky laws (subject to state opt-out), authorized shelf registration for these securities, amended the margin requirements to permit bona fide delayed delivery of mortgage related

automated underwriting gave mortgage professionals the confidence to price subprime loans, securitization expanded to the subprime market in the early 1990s.[41]

Securitization paved the way for the emergence of subprime lending in several critical respects. First, it solved the term mismatch problem of lenders, who previously had been forced to hold most mortgages in portfolio and thus borrow short and lend long. With securitization, lenders could sell their mortgages to investors in return for cash and get them off their books. At the same time, securitization sliced and diced the added risk of subprime mortgages into ever finer strips and spread it among millions of investors, who were arguably better able to diversify that risk than lenders. Securitization also relieved lenders of any need to maintain deep capital reserves. Instead, in a continual cycle, lenders could make a batch of loans, collect up-front fees from the borrowers, securitize the loans, and then plow the cash proceeds into a new set of loans, which in turn would be securitized. Finally, securitization injected huge sums of capital into lenders from investors who were hungry for higher returns. This capital markets finance opened the door for a new breed of nonbank subprime lender, who was thinly capitalized, free from federal banking regulation, and indifferent to the reputational concerns of banks and thrifts.[42]

New government incentives to lend to low- and moderate-income borrowers comprised the last development leading to the rise of the subprime market. Federal legislation establishing affordable housing goals for Fannie Mae and Freddie Mac, consisting of quotas for loan purchases from low- and moderate-income households and high-minority or low-income census tracts, pushed both government-sponsored entities (GSEs) into wholesale purchases of subprime mortgage-backed securities.[43] Similarly, the Community Reinvestment Act rewarded federally insured banks and thrifts for originating or buying mortgages to minority and lower-income

securities, preempted state investment laws that would otherwise block state-chartered financial institutions, pension funds, and insurance companies from investing in these securities (also subject to state opt out), and expanded the powers of federal chartered banks, credit unions, and thrift institutions to hold mortgage-backed securities as assets. Id.; Gambro & Leichtner (1997, pp. 140-141, 153-154, 167-168); Pittman (1989); Shenker & Colletta (1991, pp. 1386-1388).

[41] Engel & McCoy (2002a, pp. 1273-1274); Engel & McCoy (2007b, pp. 2045-2048); Ranieri (1996).

[42] Engel & McCoy (2002a, p. 1274); Engel & McCoy (2007b, pp. 2045, 2056-2057).

[43] In recent years, Fannie Mae and Freddie Mac helped meet their affordable housing goals by purchasing AAA rated subprime mortgage bonds. See, e.g., Fannie Mae (2007, p. 8) ("approximately 2% of [Fannie Mae's] single-family mortgage credit book of business as of both March 31, 2007 and December 31, 2006 consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans"). According to the Office of Federal Housing Enterprise Oversight (OFHEO), as of September 2007, the investment portfolios of the two GSEs together contained $170 billion in private-label subprime mortgage-backed securities. Office of Federal Housing Enterprise Oversight (2007).

borrowers.[44] Meanwhile, President George W. Bush promoted expanded home ownership for working whites and minorities through his Ownership Society initiative,[45] aided by the American Dream Downpayment Act of 2003,[46] which authorized subsidies to 40,000 low-income households per year to cover down payments and closing costs. The legacy of historical discrimination against blacks and Hispanics guaranteed pent-up demand for these new loans.[47]

With the convergence of these developments, subprime mortgages experienced meteoric growth from 1994 through 2006. In 1994, subprime mortgage originations were only a drop in the bucket, totaling $35 billion and accounting for only five percent of total new mortgages that year. By 2005, subprime originations had soared to $625 million and comprised fully one-fifth of total mortgage originations.[48]

Predatory Lending Concerns and Partial Reregulation

Early in the emergence of the subprime mortgage market, concerns surfaced about lending abuses, concerns that spurred Congress into action. The result was the Home Ownership and Equity Protection Act of 1994 (HOEPA), which prohibits certain predatory lending practices in the costliest subprime loans. HOEPA only applies to "high-cost" refinance loans, which the statute defines as refinance mortgages exceeding either of the following two thresholds:

- where the annual percentage rate (APR) at closing exceeds the yield on the comparable Treasury security plus eight (ten) percent for first-lien (junior-lien) loans; or
- where total points and fees exceed the greater of eight percent of the total loan amount or $400 (indexed annually).[49]

For non-purchase loans that qualify as "high-cost loans," HOEPA regulates their terms and practices. Among other things, HOEPA and its implementing regulations restrict or ban balloon clauses, loans without regard to the borrower's ability to pay, negative amortization, increased interest rates after default, prepayment penalties, due-on-demand clauses, payments to home

[44] Engel & McCoy (2002a, pp. 1276-1277); Engel & McCoy (2002b); Federal Financial Institutions Examination Council (2001) (explaining the conditions under which mortgage-backed securities receive Community Reinvestment Act credit).

[45] See, e.g., "Increasing Homeownership," http://www.whitehouse.gov/infocus/homeownership/.

[46] 42 U.S.C. § 12821.

[47] Engel & McCoy (2007a, pp. 6-10).

[48] Gramlich (2007, p. 6).

[49] 15 U.S.C. § 1602(aa)(1)–(4); 12 C.F.R. § 226.32(a)(1), (b)(1). In 2007, the dollar trigger equaled $547. 71 Fed. Reg. 46388 (Aug. 14, 2006).

improvement contractors, and early refinancings. In addition, lenders who make HOEPA loans must provide special Truth in Lending disclosures to loan applicants in advance of closing. Lenders who violate HOEPA and their assignees are liable to borrowers for violations of the Act.[50]

HOEPA has a serious Achilles heel, which consists of its narrow coverage. Lenders discovered that they could evade HOEPA's triggers by switching to adjustable-rate mortgages featuring teaser rates with low initial APRs. As a result, even though the Federal Reserve Board lowered HOEPA's triggers effective in 2002, HOEPA still only applied to one percent of all subprime home loans.[51]

In the years following HOEPA's passage in 1994, allegations of predatory lending continued to mount[52] and the majority of states stepped into the breach, enacting anti-predatory lending statutes of their own. Most of these state statutes were patterned after HOEPA and had lower triggers and/or more stringent loan restrictions. By the beginning of 2007, twenty-nine states and the District of Columbia had mini-HOEPA laws. Some of these states plus other states also had older provisions on their books restricting prepayment penalties and sometimes balloon terms. In addition, other states that eschewed mini-HOEPA laws implemented alternative approaches to predatory lending, such as broker certification or licensing statutes, disclosure laws or state banking regulations. State anti-predatory lending laws of one type or another became so widespread that by the start of 2007, only six states -- Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota – did not regulate any of the subprime loan terms raising the greatest concern, namely prepayment penalties, balloon clauses, or mandatory arbitration clauses.[53]

Backlash: Preemption Rulings by Federal Banking Regulators

The states that enacted anti-predatory lending laws did not legislate in a vacuum. Instead, they instituted their laws against a background of federal preemption that suspended the effect of those state laws for certain loan products and certain lenders. As we noted earlier, DIDMCA nullified interest caps by states on first-lien mortgages on residential structures and mobile

[50] 15 U.S.C. § 1640(a); 12 C.F.R. §§ 226.32, 226.34. HOEPA's assignee liability provisions are very broad and holders of HOEPA loans are "subject to all claims and defenses . . . that could be raised against the original lender." 15 U.S.C. § 1641(d)(1).

[51] Gramlich (2007, p. 28).

[52] For a partial list of adjudications, settlements, and consent orders in cases alleging predatory subprime mortgages, see Engel & McCoy (2007b, pp. 2063-2065 n. 121).

[53] Bostic et al. (2007, pp. 49, 55-58).

homes and clothed state banks, thrifts, and credit unions with most favored lender status, thereby allowing them to export their home state usury laws to other states for junior-lien loans and for other types of loans. AMTPA overturned state restrictions on adjustable rate, balloon term, and negative amortization loans. In addition to these two congressional statutes, the U.S. Office of Thrift Supervision (OTS) had issued scores of opinion letters and several sets of regulations since the mid-1990s asserting federal preemption of state laws restricting residential mortgages for federal savings associations. OTS preemption solidified in 1996 when the OTS enacted a sweeping preemption regulation.[54]

The OTS regulations predated the modern state anti-predatory lending laws. Starting in 1999, as more and more states adopted those laws, national banks and their mortgage lending subsidiaries lobbied their federal regulator, the Office of the Comptroller of the Currency (the OCC), to afford them the same relief as federal thrifts. Eager to accommodate its regulated entities and to attract state banks to convert their charters to federal charters, the OCC issued its now famous 2004 regulation that was virtually identical to the preemption regulation adopted by the OTS.[55] In retrospect, it is apparent that both agencies conferred broad federal preemption on the institutions that they regulate in order to win more charters to their supervisory fold.[56]

Collectively, these pronouncements permit national banks and federal saving associations to ignore a whole host of state credit protection laws.[57] Certain types of state laws are not preempted but only if they incidentally affect the exercise of the institutions' powers.[58] In addition, state agencies have no right to enforce even applicable state laws, such as state lending

[54] 12 C.F.R. § 560.2.

[55] 12 C.F.R. §§ 34.3 (mortgage lending), 7.4008 (general lending).

[56] Wilmarth (2004b, p. 37). In contrast, neither state-chartered banks, credit unions, nor independent non-depository lenders have the same support in the law to claim broad preemption of state law. Renuart & Keest (2003, pp. 85-91).

[57]For example, these institutions may make mortgage loans without regard to state laws relating to: licensing, registration, or reporting by creditors; the ability of a creditor to require or obtain insurance for collateral or other credit enhancement or risk mitigant; loan-to-value ratios; the terms of credit, including the schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, term to maturity of the loan, or the ability to call the loan due and payable upon the passage of time or a specified event external to the loan; escrow or similar accounts; security property; access to and use of credit reports; disclosure and advertising requirements in credit application forms, credit solicitations, billing statement, credit contracts, or other related documents; disbursements and repayments; rates of interest; the aggregate amount of funds that can be loaned upon the security of real estate; processing, origination, servicing, sale, or purchase of, investment in, or participation in mortgages; due on sale clauses, with some exceptions; and covenants and restrictions that must be contained in a lease to make it qualify as acceptable security for a real estate loan. *See also* Wilmarth (2004a, pp. 233-236); Renuart & Keest (2005, pp. 68-76); Peterson (2007, pp. 70-72) (discussing these rules and their consequences).

[58] These areas of state law include contract, tort, criminal, homestead, rights to collect debts, property, taxation, and zoning laws. However, the agencies retain the "right" to decide, on a selective and *ad hoc* basis, that these and any other state laws are preempted.

discrimination laws, against these institutions.[59] Such visitorial powers arguably vest solely in the OTS and the OCC.[60] Furthermore, neither of these federal agencies replaced the preempted state laws with comparable, binding consumer protection regulations of their own, thus creating a consumer protection vacuum for federally chartered banks and thrifts.[61] In their most controversial move, recently upheld by the Supreme Court,[62] the agencies extended bank preemption privileges to the operating subsidiaries of these depositories.[63]

The cloak of federal preemption helped boost the attractiveness of being owned by (or merging with) a parent depository institution, in comparison with remaining an independent nonbank lender.[64] Moreover, the justification for limiting the benefits of federal preemption to depository institutions and their operating subsidiaries proved to be elastic and easily manipulated. Recently, both agencies opined that mere agents or independent contractors of these depositories, in certain circumstances, are entitled to preempt state registration and licensing laws.[65] Consequently, the paramount question of what law, if any, applies to the four corners of any given consumer credit contract is difficult to discern.

Taken together, these federal preemption statutes and rules create major loopholes in the applicability and enforcement of state anti-predatory laws and credit regulation. The most important loophole exempts federally chartered thrifts and banks from state provisions and supervision. Specifically, federal savings associations, national banks, and their nonbank lending subsidiaries are free from state anti-predatory lending laws under federal banking regulators' interpretations of the Home Owners' Loan Act and the National Bank Act, respectively.[66] In

[59] 12 U.S.C. § 484, 12 C.F.R. § 7.4000 (OCC visitorial powers); Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982) (OTS regulations cover saving associations from cradle to grave).

[60] However, the courts retain power to enforce applicable law when cases are filed by private litigants.

[61] Wilmarth (2004, pp. 306-311, 353-356). Frank Alexander correctly forecast this development more than a decade before the OCC preemption rule. Cf. Alexander (1993).

[62] Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559, 1564 (2007).

[63] 12 C.F.R. § 559.3(h) (OTS); 12 C.F.R. § 12 C.F.R. § 7.4006 (OCC).

[64] The increased attractiveness of the federal depository charter may explain the fact that from 2004 – when the OCC unveiled its preemption rule – to 2006, the total market share of higher-priced residential mortgages made by independent mortgage companies shrank from 50.6% to 45.7%. Over the same time period, the total market share of higher-priced residential mortgages originated by depository institutions and their subsidiaries and affiliates grew from 49.4% in 2004 to 54.3% in 2006. Avery et al. (2007, pp. A88-A89); see also Wilmarth (2004, pp. 358-59). In a similar vein, from 2004 to 2007, the percentage of total U.S. commercial banking assets held by national banks (including their shares in mortgage lending subsidiaries) grew nineteen percent, from 57% to 68%. OCC (2004, p. 7); OCC (2007, p. 9).

[65] OTS Letter P-2004-7 (Oct. 25, 2004); 66 Fed. Reg. 28,593 (May 23, 2001) (OCC).

[66] See, e.g., 68 Fed. Reg. 46,264 (Aug. 4, 2003) (OCC preemption of Georgia law); OTS Letter (2003) (OTS preemption of New Mexico law).

addition, some states, such as Georgia, have parity or "wild card" laws that exempt state-chartered banks and thrifts and their subsidiaries from state anti-predatory lending laws to the same extent as national banks and federal thrifts.[67] In those states, state anti-predatory lending laws only apply to independent non-depository mortgage lenders. These independent lenders originated less than half -- 45.7 percent -- of higher-cost mortgages made in 2006.[68] Even in regulated states, the degree of regulation applying to independent non-depository mortgage lenders depends on the strength and coverage of a particular state's law. Finally, AMTPA relieves even independent lenders from state restrictions on usury and adjustable rate, negative amortization, and balloon clauses except in plain vanilla fixed-rate, fully amortizing mortgages.

Dual Regulation of the Home Mortgage Market

As our discussion of federal preemption suggests, the mortgage lending industry operates under a dual regulatory structure which varies according to the entity. Depository institutions are regulated under federal banking laws and a subset of those institutions – namely, federally chartered depositories and their subsidiaries – claim they are exempt from state anti-predatory lending and credit laws by virtue of federal regulation. In contrast, independent non-depository mortgage lenders escape federal banking regulation but have to comply with state laws, except for state provisions preempted by DIDMCA and AMTPA. Only state-chartered banks and thrifts in some states (a dwindling group) are subject to both sets of laws.

Under the dual system of regulation, depository institutions are subject to a variety of federal examinations, including fair lending, Community Reinvestment Act, and safety and soundness examinations that independent lenders are not. Similarly, banks and thrifts must comply with other provisions of the Community Reinvestment Act, including reporting requirements and merger review. Federally insured depository institutions must also meet minimum risk-based capital requirements and reserve requirements, unlike their independent non-depository counterparts.

The parallel regulatory universe that consists of federally chartered banks and thrifts and their mortgage lending subsidiaries has serious implications for consumer protections for loans made by those lenders. Due to federal preemption, the only anti-predatory lending provisions

[67] See, *e.g.*, Ga. Code Ann. §7-6A-12; Johnson (1995).
[68] Avery et al. (2007, pp. A88-A89).

that national banks and federally chartered thrifts must obey are HOEPA and agency guidances on subprime and nontraditional mortgage lending.[69] Of these, HOEPA has extremely narrow scope.[70] Meanwhile, the guidances lack the binding effect of rules and their substantive content is not as strict as the stronger state laws. In the main, the guidances are enforced through federal bank examinations, backed by the possibility of agency enforcement. However, federal examinations are sparse to non-existent for mortgage lending affiliates of banks and thrifts.[71] This creates a significant loophole, because these lightly regulated lending subsidiaries accounted for one-quarter of all subprime originations in 2006.[72] The OCC has also been demonstrably lax with respect to enforcement actions against national banks. The public record reveals only a handful of OCC actions against national banks – mostly small institutions -- for violations of consumer protection laws. Left untouched were some of the largest national bank franchises – including Citibank and Fleet Bank-- that were the subject of enforcement action by other state or federal agencies for alleged predatory lending violations.[73] The OCC's inaction, coupled with ineffectual examinations and guidances, epitomized the breakdown in federal regulation that fueled the subprime crisis.

All this would be of less concern if borrowers could pursue federally chartered depository institutions and their mortgage lending subsidiaries privately. But the guidances provide no private relief to borrowers who lack HOEPA loans, either in the form of private rights of action or defenses to collection or foreclosure. Instead, injured borrowers with home mortgages from national banks, federal thrifts, or their subsidiaries can only turn to federal call centers for help, which have a policy of not intervening on behalf of consumers. Instead, these poorly staffed call centers stop with lamely advising consumers that "[i]f your case involves [a factual or

[69] Board of Governors of the Federal Reserve System et al. (1999); Federal Deposit Insurance Corporation et al. (2007b); Office of the Comptroller of the Currency et al. (2001); Office of the Comptroller of the Currency et al. (2006); Office of the Comptroller of the Currency et al. (2007). Of course, these lenders, like all lenders, are subject to prosecution in cases of fraud. Lenders are also subject to the Federal Trade Commission Act, which prohibits unfair and deceptive acts and practices (UDAPs). However, with the exception of the U.S. Office of Thrift Supervision, federal banking regulators have been slow to propose rules define and punish UDAP violations by banking companies in the mortgage lending area.

[70] For example, covered lenders reported only making 15,172 HOEPA loans nationwide, which accounted for less than 0.1 percent of all originations of mortgage refinancings and home improvements loans nationwide reported under the Home Mortgage Disclosure Act for 2006. Avery et al. (2007, p. 22 & tbl. 4).

[71] The late Federal Reserve governor Ned Gramlich stressed in his book on subprime lending that the Federal Reserve almost never examined mortgage lending affiliates of banks. Gramlich (2007b, pp. 8-9).

[72] Avery et al. (2007, tbl. 9).

[73] Engel & McCoy (2007b, pp. 2063-2065 n. 121); Wilmarth (2004, pp. 353-357); Wilmarth (2007, pp. 14-16).

contractual dispute between the bank and the customer], we will suggest that you consult an attorney for assistance."[74]

This unlevel playing field leaves lenders and borrowers alike dissatisfied. Although national banks, federal savings associations, and their lending subsidiaries enjoy federal preemption, they nevertheless complain that independent lenders are free from federal examinations and the strictures of the Community Reinvestment Act. In response, independent lenders protest that they are handicapped vis-à-vis lenders who have federal preemption because they have to comply with a patchwork of different and sometimes demanding state laws. Meanwhile, borrowers with loans from federally chartered depository institutions or from lenders in lightly regulated or un-regulated states lack protection against predatory lending practices and foreclosures. In late 2007, matters came to a head after mounting subprime foreclosures threw the capital markets into a tailspin. Late that fall, the House of Representatives passed a federal anti-predatory lending bill and Senator Dodd, chairman of the Senate Committee on Banking, Housing, and Urban Affairs, introduced an even stronger bill.[75]

Consequences of Deregulation and Preemption

The past quarter century has revealed the effects of federal deregulation on the mortgage market and homeowners. First, mortgage lenders however configured (whether as banking institutions or finance companies) could charge any interest rate and certain fees in unlimited amounts when originating mortgage loans, opening the floodgates to predatory lenders who imposed high rates and fees.[76] Second, home equity debt grew significantly after 1983 because, in part, it was marketed to pay off other debts, thus shifting both non-mortgage secured and unsecured debt into home-secured debt.[77] Third, the DIDMCA created an economic incentive for lenders to engage in loan flipping injuring borrowers who sought to tap their home equity. Under that statute, lenders can avoid state usury laws governing second-lien home equity loans and lines of credit by refinancing the original mortgage and taking first-lien position, thereby qualifying for DIDMCA's interest preemption and earning higher fees on the larger loan

[74] U.S. Government Accountability Office (2006, pp. 8-9, 23-25); Wilmarth (2007, pp. 17-19).

[75] H.R. 3915; S. 2452.

[76] Mansfield (2000, pp. 539-551).

[77] The proportion of families borrowing through mortgage loans grew between 1989 and 1995 and the median amount of mortgage debt outstanding rose almost 30%. Kennickell, Starr-McCluer & Suden (1997, p. 16). The share of households using non-mortgage installment borrowing declined in the same period, suggesting a substitution of borrowing via mortgage loans, among others. Id. at 17. See also Mansfield (2000, pp. 522-526).

principal in the process.[78] Fourth, while banks and savings and loan associations dominated the mortgage origination market in 1982 as compared to non-depository finance companies, by 1996 these roles had reversed.[79] This change is significant because finance companies (whether stand-alone companies or affiliates of banks) are credited with the majority of predatory lending.

Explosive Growth of Adjustable-Rate Mortgages

The growth of adjustable rate mortgage (ARM) products can be tied directly to the passage of AMTPA because it paved the way for lenders to make these loans without regard to consumer protections under state law. Just since 2001, the dollar volume of ARMs grew from $355 billion to $1.3 trillion in 2006.[80] The percentage of ARM loans (not including interest-only ARMs) originated from 1998 to 2004 increased from 32% to almost 55%.[81] In recent years, lenders sold nontraditional ARMs in increasing numbers.[82] These products include: 2/28 or 3/27 ARMs (many with below-market teaser rates for two or three years and then conversion to the fully-indexed rate);[83] interest-only ARMS (permitting interest-only payments for a set period of time during which the rate may fluctuate, resulting in negative amortization and rising principal); option payment ARMs (offering up to four payment options, including minimum and interest-only payments, which, if chosen, result in negative amortization and rising principal); and 40-year ARMs (in which payments are calculated based on a 40-year payment term but the loan terminates in 30 years, resulting in a final large balloon payment).

These nontraditional ARMs are so complex that even savvy borrowers have difficulty understanding the risks that they present. Worse yet, subprime lenders peddled many of these loans to borrowers who not only did not understand them but had little change of avoiding default. These nontraditional mortgages were offered "by more lenders to a wider spectrum of borrowers who [might] not otherwise qualify for more traditional mortgage loans and [might] not fully understand the associated risks."[84] Many of these products were underwritten with less

[78] Mansfield (2000, pp. 548-551). Flipping is the practice whereby lenders refinance homeowners from one loan to another without providing any real net benefit to the borrower. Rather, the refinance increases revenues to brokers and lenders and strips equity from the home. 67 Fed. Reg. 60,542, 60,548 n. 35 (Sept. 26, 2002).

[79] 67 Fed. Reg. 60542, 60545 n. 14 (Sept. 26, 2002); Kennickell, Starr-McCluer & Suden (1997, p. 20).

[80] Mortgage Market Statistical Annual (2007, Vol. I, p. 4).

[81] Schloemer, Li, Ernst & Keest (2006, p. 46).

[82] Duncan (2006, p. 18); see also Avery et al. (2007, pp. 8-9).

[83] Cagan (2006, pp. 24-27); see also FitchRatings (2006, pp. 2-3).

[84] Interagency Guidance (2006, p. 17).

stringent income and asset verification requirements ("reduced documentation") and often were combined with simultaneous second-lien loans, leaving borrowers with little or no equity. Indeed, federal banking agencies were sufficiently alarmed over the increased risk to financial institutions posed by these products that they issued guidelines in 2006 addressing risk management and safety and soundness concerns.[85] As well they should have, since these controversial "exotic" ARMS[86] exploded in the last three years, with dollar volume rising from $205 billion in 2004 to $775 billion in 2006.[87]

The risks associated with these loans are evident from the increased foreclosure rates (and loss of homes to homeowners). Between 1998 and 2003, the foreclosure risk of these ARMs was 62% to 123% higher than that of fixed-rate mortgages.[88] Balloon loans posed a foreclosure risk ranging between 14.1% to 85.9% higher than loans without this feature.

By late 2006, the first wave of the risky ARMs made in 2004 through 2006 came due to reset and the house of cards collapsed. Housing prices declined on a national basis for the first time since the Great Depression, sharply in some markets, and distressed borrowers discovered that they had limited options. Rising interest rates, stricter underwriting, and harsh prepayment penalties made it difficult to refinance, while falling real estate values made it hard for delinquent borrowers to sell their homes. Defaults soared and so did foreclosures. By August 2007, foreclosures nationwide had more than doubled from August 2006 and the Mortgage Bankers Association predicted that foreclosures would continue to rise. The following month, Secretary of Housing and Urban Development Alphonso Jackson told the House Financial Services Committee that HUD expected one-quarter of the ARMs due to reset by the end of 2008 to be sold in foreclosure.[89] Later that fall, the U.S. Congress Joint Economic Committee predicted that subprime foreclosures would directly destroy $71 billion in housing wealth and another $32 billion in housing wealth due to the spillover effect of those foreclosures on surrounding properties. The Joint Committee further forecast that states and cities would lose more than $917 million in property tax revenues brought on by subprime foreclosures.[90]

State Responses to Federal Preemption

[85] *Id.*
[86] Fishbein & Woodall (2006, pp. 19-21) (raising the question of whether these loans are "toxic" and describing the payment shock that can await consumers who hold these loans).
[87] Mortgage Market Statistical Annual (2007, Vol. I, p. 6).
[88] Schloemer, Li, Ernst & Keest (2006, p. 21).
[89] Jackson (2007).
[90] United States Congress Joint Economic Committee (2007).

Another result of federal preemption has been the process engaged in by state legislatures to reconsider what role, if any, usury statutes should play in a modern economy. Many states picked one of two paths. They repealed their general usury ceilings completely (or for particular types of credit) or they modified their interest ceilings to permit them to fluctuate with some published market rate. A smaller group of states retained their usury ceilings embodied in lending laws, criminal codes, or state constitutions.

Many states in both groups replaced or augmented their traditional usury laws with newer types of credit regulation in the form of state mini-HOEPA laws. For both groups of states, however, the legal landscape now prevents them from enforcing these laws against national banks, federal savings associations, and their mortgage lending subsidiaries.

These developments heralded the rise of the philosophy that disclosure is a "market-perfecting" mechanism and preferable to a competitive market than any regulation of credit. TILA, as the primary federal disclosure law, now shoulders most of the consumer protection load.[91] This means that the consumer credit marketplace is governed almost exclusively by disclosure rules.[92] Unfortunately, though not surprisingly, the provision of information regarding proposed credit terms has not operated to control unscrupulous or greedy market forces. Not only are the mandated disclosures woefully inadequate but consumers operate on an unequal playing field in relation to mortgage brokers and lenders. Contracts are not negotiated (consumers must take it or leave it), information asymmetries benefit industry players, and fraudulent marketing techniques lure potential borrowers into the trap.[93] Subprime mortgage lending did not exist before 1980. Its gestation and birth occurred in the current deregulated environment.[94]

Business Models in the Current Environment

The vast majority of consumer credit lenders are either depository or non-depository institutions. Depository lenders are those that accept deposits from their customers and lend money to the general public or, in the case of credit unions, to their members. Depository lenders include banks, savings associations, credit unions, and industrial loan banks.[95] Federal

[91] Gov't Accountability Office, GAO-06-929 (2006 p. 6).
[92] Edwards (2005, p. 204); Peterson (2003, p. 881).
[93] Engel & McCoy (2002, pp. 1280-1283).
[94] Id. at 1272-1273, 1299.
[95] Industrial loan companies or industrial banks are state-chartered and state-regulated financial institutions. ILCs have active charters in seven states—California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah. Federal

law primarily controls the creation and operation of national banks, federal savings associations, and federal credit unions. Their chartering laws are, respectively, the National Bank Act, the Home Owners' Loan Act, and the Federal Credit Union Act. State law primarily governs the creation and some operations of state chartered banks, credit unions, and industrial loan companies. Every state has a state banking law. However, extensive federal safety and soundness regulation applies to most state-chartered depositories because almost all of them subscribe to federal deposit insurance, either from the Federal Deposit Insurance Corporation or the National Credit Union Administration.

Non-depository lenders include mortgage finance companies, retailers, convenience lenders, payday and auto title lenders, and pawnbrokers. These businesses are primarily regulated under state law, apart from businesses that are subsidiaries of banks or thrifts. The chart below lists who supervises whom in the consumer credit market.

law treats an industrial loan company as any other state-chartered bank, with one important exception—an industrial bank may be owned by a commercial enterprise that does not thereby become a bank holding company. Since ILCs are creatures of state law, state law generally applies to most of their activities. In addition, the state in which they are chartered will determine whether or not ILCs are different from a bank in any functional manner. For most purposes, ILCs can function as banks. Like other state chartered banks, ILCs may be eligible for FDIC insurance (although the FDIC placed a moratorium on ILC deposit insurance applications by holding companies that are engaged in commerce through January 2008 (Federal Deposit Insurance Corporation (2007a)). This insurance is useful: an insured state bank, including an ILC, is entitled to interest rate exportation and the "most favored lender" status, to the same extent as a national bank. Renuart & Keest (2003, pp. 38-39 2007 Supp.).

Figure 1: Who is in Charge

Type of Lender	**Primary Supervisor(s)** [96]
National bank (and its nonbank operating subsidiaries)	Office of the Comptroller of the Currency (OCC)
Federal savings association, federal savings bank (and their nonbank operating subsidiaries)	Office of Thrift Supervision (OTS)
Federal credit union	National Credit Union Administration (NCUA)
State bank, state savings bank, or industrial loan bank	State Banking Commissioner, Federal Reserve Board (if a member of the Federal Reserve System) or Federal Deposit Insurance Corporation (FDIC) (if not a member of the Federal Reserve System)
State savings association	State S&L Commissioner and the OTS
State credit union	State credit union administrator and National Credit Union Share Insurance Fund, if insured
Finance companies, other lenders	State financial institution agencies

Given the legal environment we described earlier in this chapter, lenders consider several factors when deciding upon a structural business model. The initial factors include: whether to incorporate as a depository or non-depository.[97] If the choice is to become a depository, then the issue becomes: which type of charter---federal or state---and which banking supervisor are preferable and where should the institution locate its headquarters? If the choice is to become a

[96] The Federal Reserve Board also supervises bank holding companies and the nonbank sister affiliates of banks. Following the passage in 1994 of the Interstate Banking and Branching Efficiency Act, the FDIC, the Federal Reserve Board, and state banking supervisors entered into cooperative agreements that address examinations of state-chartered banks with out-of-state branches. Accordingly, state banking supervisors may examine state chartered banks in their states, sometimes including branches located in other states. However, the state bank's primary federal supervisor, either the FDIC or the Federal Reserve Board, can and does conduct its own examinations, generally in alternate years.

[97] There is a "franchise" value to a bank charter. For example: 1) the bank chartering process erects high barriers to new entrants and dampens competition by making expansion by banks and thrifts subject to government approval; 2) the charter provides access to federal deposit insurance which confers a unique competitive advantage in attracting customers; 3) federal deposit insurance allows banks and thrifts to acquire deposits inexpensively because insured depositors do not receive high interest payments for the use of their money; 4) possession of a charter gives banks access to the Federal Reserve's payment system, critical to the quick and efficient movement of money; 5) insured depository institutions can access the discount window of the Federal Reserve for short-term liquidity short-falls; and 6) a bank charter is critical for United States banks to obtain banking privileges in many foreign countries. McCoy (2000, § 3.02[2]).

non-depository, the next question becomes in which state or states should the lender incorporate and do business?

The banking system consists of two parallel tracks for banks and thrifts---those that operate under federal charters and those that operate under state charters. Depository institutions can choose to be chartered primarily by a federal or a state agency. However, entry controls exist that are designed to keep out risky enterprises and manage competition for existing banks. The type of bank powers, the extent of preemption rights available to a depository institution, and the legal infrastructure under which it will operate flow from this choice.[98]

When deciding upon a depository versus a non-depository charter, one considers several factors. Banks must abide by risk-based capital and reserve requirements that are much more stringent than asset rules or bonding requirements under state lender licensing laws.[99] Fees for licensing and examination are invariably lower for non-depositories. Any examinations are generally more lenient and less frequent for non-depositories.[100] Through the use of bank holding companies and operating subsidiaries, depository institutions can expand into products that are off-limits to banks and thrifts themselves, diversify risk and level revenue through multiple lines of business, isolate activities presenting increased risk to reputation and fisc in nonbank subsidiaries, and utilize certain tax advantages.[101] Finally, banks and thrifts can convert their charters without permission or conditions from their current regulator, as long as they receive permission from the new chartering agency. This permits depositories to escape from an inhospitable regulator. However, the ease of conversion is tempered by high transaction costs.

There are several relevant questions to be answered when choosing a particular bank supervisor.[102] Which supervisory agency offers ease and predictability of success in obtaining a charter? Which agency charges more for the chartering process, annual assessments, and

[98] McCoy (2000, Ch. 3) (discussing the history of the dual banking system and the choices among charters).

[99] All banks, thrifts, and credit unions must hold approximately 10% of their transaction accounts in reserve with a federal reserve bank or similar institution. *Id.* at § 11.05. All insured depository institutions are further subject to minimum risk-based capital requirements. *Id.* § 6.03.

[100] The federal banking agencies must conduct a "full-scope," on-site examination of each insured depository institution every 12 or 18 months. 12 U.S.C. § 1820(d)(1). The Federal Deposit Insurance Act makes no mention of examinations of operating subsidiaries. While OCC regulations do call for examinations of operating subsidiaries, they do not specify their frequency or scope. 12 C.F.R. § 5.34(e)(3). The Federal Reserve rarely, if ever, examines nonbank sister affiliate mortgage lenders of banks. Gramlich (2007b, pp. 8-9).

[101] McCoy (2000, § 4.01).

[102] *Id.* at § 3.02[3](b) (discussing these factors).

examination costs?[103] Who is toughest in the examination process?[104] Which legal regime promises the broadest bank powers and ability to preempt state law?[105] Finally, which charter provides the fewest restrictions to interstate branching? In the realm of mortgage banking, of all of these factors, the most significant incentive to select a federal charter and be supervised by either the OCC or the OTS is federal preemption.[106]

Implications for Consumers and the Rule of Law

As we have shown, consumers take the biggest hit when well-established credit protections are repealed. Deregulation and preemption allow businesses to select not only the most favorable regulator but also which set of laws apply to them, an unprecedented shift in the consumer credit market. In addition, constitutional questions about our republican form of government and the sovereign role of the state in matters historically within their control arise. The implications of what these changes have wrought are profound and merit the most careful attention by federal and state elected officials. We address these issues below.

Banks and thrifts want to operate using a national business and legal platform

A fair generalization at this point in time: depositories and their related companies are either very large or very small. Only a small percentage of all banks are not part of a bank holding company.[107] Large banks and their holding companies want to operate at a national level and do not want to deal with the differences among fifty sets of state law. They want preemption or federal deregulation, whichever helps them to achieve this goal.[108] The management of banks who are queasy about the trends we describe may feel that they have no choice but to ride along with the rest.

[103] The OCC is generally the most expensive, which helps explain its incentives to offset its cost structure by offering institutions broad federal preemption.

[104] The OCC has a reputation for tough examinations of national banks, but not of their operating subsidiaries.

[105] In our view, the OTS holds the lead in the preemption race though the OCC is a close second. The national bank charter, however, offers broader powers than the charter for federal savings associations.

[106] Wilmarth (2004b, p. 37).

[107] Total U.S. commercial bank assets in 2005 exceeded $8.9 trillion. Independent banks that are not part of a bank holding company accounted for only about $212 billion of this total or roughly 2%. Report on the Condition of the U.S. Banking Industry (June 2007, p. B12).

[108] 69 Fed. Reg. 1904, 1908 (Jan. 13, 2004) (observing that "[f]or national banks…the ability to operate under uniform standards of operation and supervision is fundamental to the character of their national charter); Peterson (2005, p. 8) (arguing that "current efforts to preempt state law have little or nothing to do with federalism in general or in uniformity in particular, but are, in fact, simply efforts to deregulate.").

Federal banking regulators are engaged in a race for charters

As discussed earlier, the OCC and the OTS have jockeyed over the last eleven years to make the charter and legal regimes for their institutions more desirable than each other's. The FDIC has been under pressure to enter this race to keep state chartered banks competitive.[109] Both the OCC and the OTS pay for their operations from the chartering, annual, and examination fees they receive from their constituents, the federally chartered banks and thrifts. More and bigger is better. One way each positions itself to be more attractive is to expand activity powers and the preemption of state laws, which translates to deregulation. The bottom line: charter competition is the name of the game until and unless Congress creates a unitary chartering and supervisory system or puts curbs on unilateral agency preemption orders.

Independent finance companies are likely to migrate into operating subsidiaries

State licensed finance companies and lenders (other than lending subsidiaries of national banks and federal thrifts) are subject to the full panoply of state and federal law that applies to their business. These companies experience a cost disadvantage vis-à-vis banks because they must comply with state consumer protection laws. Moreover, if they engage in business in other states, they likely need to be licensed in each state. Their compliance costs rise when entering business in each state, particularly when expanding into many or all states. The likely result over time is that these companies will sell themselves to bank holding companies which will align them as operating subsidiaries of national banks. Indeed, this reaction to the banking preemption regulations is well underway.[110] Consequently, the recent state efforts to regulate

[109] 70 Fed. Reg. 60, 019 (Oct. 14, 2005) (noting that the Financial Services Roundtable, a trade association for financial services companies, petitioned the FDIC to issue rules expanding the preemption powers of state-chartered banks so as to reach parity with national banks).

[110] In 2004 and 2005 alone, JP Morgan Chase, HSBC and Bank of Montreal (Harris Trust) switched from state to national bank charters. Wilmarth (2007, pp. 11-12). In 2007, another seven state banks made the same switch. Hopkins (2008b). See also Finance Commission of Texas and Credit Union Commission of Texas (2006, p. 26) (reporting that between January 16, 2003 and December 14, 2005, the Texas Consumer Credit Commissioner received cancellation notices for 47 licenses from companies specifically claiming federal preemption as operating subsidiaries of national banks). At least three large banks and their operating subsidiaries relinquished their licenses and sued their former state regulators when the regulators balked: National City Bank of Indiana, Wachovia Bank, and Wells Fargo Bank. Nat'l City Bank of Indiana v. Turnbaugh, 463 F.3d 325 (4th Cir. 2006); Wachovia Bank, N.A. v. Burke, 414 F.3d 305 (2d Cir. 2005); Wachovia Bank, N.A. v. Watters, 431 F.3d 556 (6th Cir. 2005), aff'd, 127 S. Ct. 1559 (2007); Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005). See also H&R Block, Inc. (2007, p.3) (reporting that the OTS approved the charter of the H&R Block Bank in March 2006, and that "we will realign certain segments of our business to reflect a new management reporting structure.").

predatory lending practices out of the market, described elsewhere in this chapter, will fall in the face of federal preemption.

Operating subsidiaries and affiliates may be loose cannons

In general, operating subsidiaries and affiliates of banks are rarely examined, in contrast with banks themselves, for safety and soundness.[111] Among other things, Congress tied the hands of the Federal Reserve System in examining sister mortgage lending affiliates of banks in the Gramm-Leach-Bliley Act of 1999. The Federal Reserve must limit the focus and scope of those examinations to lenders that could have a materially adverse effect on the safety and soundness of any bank or thrift affiliate due to its size, condition or activities or the nature or size of its transactions with that institution.[112] Instead, to the fullest extent possible, the Federal Reserve is supposed to make use of bank and thrift examination reports by other state and federal banking regulators.[113] In addition, banks and thrifts need not include their mortgage lending subsidiaries in their Community Reinvestment Act examinations.

Regulators likely prefer that the subprime activities of a bank be pushed into a subsidiary due to concerns about the bank’s reputational risk. Nonbank subsidiaries are less sensitive to reputation than are the parent banks. Although examiners may be worried about safety and soundness, the failure of the subsidiary is not nearly as momentous as the failure of the parent bank. Regulators cite “safety and soundness” as support for higher profit and fee-generating activities by subsidiaries and their parents on grounds that this contributes to the continued solvency of these institutions.

The federal banking agencies are not consumer protection agencies

Bank safety and soundness, not consumer protection, is the primary concern of the OCC, the OTS, the Federal Reserve Board, and the FDIC. The laws that create and authorize these agencies say nothing about consumer protection. However, there are federal unfair and deceptive acts and practices (UDAP) standards embodied in the Federal Trade Commission Act

[111] Gramlich (2007b, pp. 8-9).

[112] Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, ' 111 (codified at 12 U.S.C. ' 1844(c)(2)(C)).

[113] *Id.* (codified at 12 U.S.C. ' 1844(c)(2)(D)).

that apply to federal depository institutions.[114] Nevertheless, the consumer has no legal right to enforce those provisions. Similarly, other consumer protection rules or guidances that the OCC and the OTS may issue are unenforceable by consumers.[115] As for the enforcement record of the OCC, in particular, it has been "undistinguished."[116]

In 1994, Congress required the Federal Reserve Board to prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair or deceptive.[117] Congress specifically flagged mortgage refinancings associated with abusive lending practices or that are not in the interest of the borrower as areas of concern.[118] In 2001, the Board used this authority to prohibit a narrow set of early refinancings of HOEPA loan and to forbid structuring a loan as open-end in order to evade HOEPA.[119] Only after subprime abuses triggered a full-blown economic crisis, however, did the Board propose amending its rules to prohibit unfair or deceptive practices in other parts of the mortgage market.[120]

Preemption of state consumer credit and protection laws by depository institutions can result in the "wild west"

Where state law is displaced, a vacuum arises unless there is federal law on point to replace that loss. In the area of consumer credit, there is little federal consumer credit regulation beyond the disclosure rules. In these circumstances, the contract alone controls the lender-consumer relationship. Consequently, the "law" becomes the terms listed in the contract. The lenders write the contracts. They are contracts of adhesion, meaning the consumer cannot

[114] The Federal Trade Commission Act requires the Federal Reserve Board (for "banks"), the OTS (for saving associations.), and the NCUA (for federal credit unions) to prescribe regulations defining with specificity unfair or deceptive acts or practices. 15 U.S.C. § 57a(f). These same agencies must also adopt regulations for these institutions "substantially similar" to regulations prohibiting acts or practices issued by the FTC within 60 days after the FTC rules take effect. The FTC has issued several regulations addressing particular unfair or deceptive practices. The Federal Reserve Board and the OTS applied some of the FTC rules related to lending activities to banks and savings associations. 12 C.F.R. part 227 (FRB); 12 C.F.R. part 535 (OTS). The OCC recognizes that it has no authority to define unfair or deceptive practices. 69 Fed. Reg. 1904, 1911 n. 55 (Jan. 13, 2004).

[115] The OCC included a single anti-predatory lending provision in its broad preemption regulations of 2004. 12 C.F.R. §§ 7.4008(b), 34.3(b). The rule prohibits national banks from making a loan based predominantly on the value of any collateral without regard to the borrower's ability to repay. The OTS recently published a request for public input on how it could use its authority to address unfair or deceptive practices of federal savings associations. 72 Fed. Reg. 43570 (Aug. 6, 2007).

[116] Wilmarth (2007, p. 14-15).

[117] 15 U.S.C. § 1639(l)(2).

[118] Id.

[119] 66 Fed. Reg. 65604, 65612-14 (Dec. 21, 2001).

[120] 73 Fed. Reg. 1,672 (Jan. 9, 2008).

negotiate the printed terms. If we return primarily to the law of the contract, we return to the notion of "caveat emptor"---consumer beware -- because no one is protecting the consumer.

State attorneys general and law enforcement can observe only on the sidelines.

Finally, given the visitorial powers of the OCC and the OTS, state law enforcement over federally chartered depository institutions and their mortgage lending subsidiaries has dried up. With respect to those institutions, state attorneys general and state banking commissioners are impotent.

In conclusion, the recent history of subprime and nontraditional mortgage loans is a story of failure and rank indifference by the federal government. The seeds of this crisis were planted in the late 1970s and early 1980s, when Congress and the Supreme Court deregulated state usury caps on residential mortgages and thereby removed legal obstacles to the rise of the subprime market. A quarter century later, once the subprime market had matured, rampant abuses in that market compelled a majority of the states to enact mini-HOEPA laws regulating the terms of high-cost mortgages, not their price. Instead of welcoming supervision by the states, however, federal banking regulators greeted the state laws with hostility. In a series of federal preemption rulings, the Office of the Comptroller of the Currency and the Office of Thrift Supervision excused national banks and federal thrifts and their nonbank mortgage lending subsidiaries from complying with the state laws. As a result, as long as lenders who enjoyed preemption complied with arcane federal disclosure laws, they could lend with impunity and pass off recklessly underwritten loans to unsuspecting investors through securitization. It only took three short years after the OCC's preemption rule triggered a race to the bottom for recklessly underwritten subprime and nontraditional loans to plunge the U.S. economy into crisis.

Regulation of Capital Markets Financing of Residential Mortgages

So far we have seen that on the origination side, deregulation and federal preemption significantly weakened the legal safety net for subprime and nontraditional mortgages. Borrowers from federally chartered banks and thrifts and their mortgage lending subsidiaries were stripped of recourse against their originators for abusive loans. In unregulated and lightly regulated states, borrowers with loans from other types of lenders found themselves in the same boat.

The plight of distressed borrowers did not stop there, however. Starting in the early 1990s, capital markets investment financed the rapid expansion of the subprime and nontraditional loan markets. That investment, which generally took the form of securitization, had its own separate legal infrastructure which altered the rights and bargaining power of borrowers, often radically. Borrowers have no control over whether their loans are securitized and sold to investors. Nevertheless, when home mortgages are securitized, aggrieved borrowers in many states lose claims and defenses they could have raised against their lenders in foreclosure or collection proceedings when brought by the assignees on their loans. Similarly, the layer of complexity added by injecting a whole new edifice of parties, including investors, securitized trusts, trustees, rating agencies, bond insurers, and servicers, and the legal safeguards accorded to them make it much more difficult for distressed borrowers to negotiate workouts of delinquent loans. In the remainder of this chapter, we describe securitization in greater detail and chronicle how securitization eroded the legal safety net of borrowers even further.

The Process of Securitization

We begin with a thumbnail sketch of securitization. In securitization, a lender bundles its loans and sells them to a separately incorporated affiliate or an investment bank. The buyer sells the bundle in turn to a second legally separate entity, which is known as a "special purpose vehicle" or "SPV" and is generally a trust. This series of transfers to a legally distinct SPV accomplishes two objectives. First, it shields the loans from seizure under U.S. bankruptcy laws in case the lender goes bankrupt. Second, this bankruptcy remoteness helps the loan pool, standing alone, qualify for a higher credit rating from the rating agencies than the lender who originated them.[121]

Once the loan pool is ensconced in the trust, an investment bank repackages the monthly principal and interest payments from the loans into bonds, parcels out the bonds to an array of tranches with different credit risks, and sells the bonds to investors.[122] These bonds are referred to as "mortgage-backed securities" (MBS) or "asset-backed securities" (ABS) because they are backed by collateral in the form of the mortgages on the borrowers' homes. These security

[121] McCall & Blum (1996, pp. 137, 140); Schwarcz (1994, p. 142); Schwarcz (2004, pp. 1552-1553).

[122] Issuers also securitize prepayment penalties as Net Interest Margin Securities or "NIMS." For a description of tranching and different ways of slicing and dicing the cash flows from loan pools, see Engel & McCoy (2007b, pp. 2046-2047, 2054, 2078).

interests are governed by Article 9 of the Uniform Commercial Code plus state collection and foreclosure laws. Once ready for marketing, the bond offerings are sold to investors either as private placements or public offerings under the antifraud provisions and other safeguards of the Securities Act of 1933 and the Securities Exchange Act of 1934.[123]

A passive trust is the preferred choice for SPVs housing securitized loan pools because the trust form confers two important protections on investors. First, under state trust law, a trustee must be appointed to administer the trust. The trustee is generally a reputable bank and owes a strict fiduciary duty by law to administer the trust for the best interests of the investors. Second, the trusts, when properly structured as Real Estate Mortgage Investment Conduits (REMICs) or Financial Asset Securitization Investment Trusts (FASITs), garner significant tax advantages in the form of flow-through tax treatment, thereby avoiding corporate level taxation.[124]

Private Law Aspects: Rating Agencies, Bond Insurers, and Servicing Contracts

In addition to the myriad sources of law just described, securitized trusts are also subject to private ordering from multiple sources. Rating agencies, which are needed to rate the bonds, impose restrictions on the contents of the loan pool and the latitude for loan modifications and workouts. Bond insurers place restrictions of their own on servicing and loan workouts as a condition to providing insurance for securitized tranches. In addition, securitized trusts delegate the responsibility for administering the loan payments and collection efforts to servicing companies under contracts known as pooling and servicing agreements. Pooling and servicing agreements also contain provisions governing the vote needed to sell the loan pool outright.

From a practical standpoint in recent years, it was impossible to market mortgage-backed securities, whether prime or subprime, without securing credit ratings from one or more of the top rating agencies. For one thing, in order to qualify for the protections of SMMEA, the offering must be rated in one of the two highest rating categories by one of the nationally recognized rating agencies.[125] More importantly, investors insisted on credit ratings because they feared – correctly, as the events of 2007 proved – that lenders might pass off bad loans to the secondary market. Rating agencies sought to defuse this concern by evaluating credit risk for

[123] Securities Act of 1933, 15 U.S.C. §§ 77a et seq.; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq.

[124] Pollock & Shaff (1999, pp. 156-157). For a general description of FASIT and REMIC tax treatment, see Gambro & Leichtner (1997, pp. 156-158).

[125] Gambro & Leichtner (1997, pp. 140-141).

each tranche in a bond issue and assigning it a credit rating. These credit ratings ranged from the top-rated AAA down to single B or their equivalents.[126]

The rating agencies treated three types of subprime loans as unratable: HOEPA loans, specific high-cost loans originated in Indiana, Massachusetts, Maine, and New Jersey, and loans that violate state or federal consumer protection laws.[127] In order to obtain ratings, issuers had to provide representations and warranties that these loans were excluded from the loan pools.[128] In addition, as will be discussed, rating agencies imposed restrictions on loan workouts, loan modifications, and waivers of prepayment penalties as a condition of ratings.

For the senior tranche to qualify for a top rating, the issuer usually had to add credit enhancements to provide an added cushion against losses. Issuers generally added internal credit enhancements of their own. In addition, for the stronger originators and servicers, monoline bond insurers frequently furnished external credit enhancements in the form of financial guaranties to investors to pay timely interest and ultimate principal if the issuer could not meet its payment obligations.[129] To guard against claims, bond insurers held (and continue to hold) sellers and servicers to minimum standards for operating histories and financial strength and require the removal of any servicers who fall below certain triggers. These bond insurers are rated by the rating agencies and strive to maintain top AAA ratings.[130]

Finally, trusts enter into servicing contracts with major servicing companies to process monthly loan payments, distribute the proceeds due to the trusts, and collect on any loans that become delinquent or go into default. These servicing contracts, called “pooling and servicing agreements” or PSAs, often place restrictions on a servicer’s ability to negotiate forbearance or

[126] For a description of the ratings process, see Engel & McCoy (2007b, pp. 2046-2047, 2050-2051, 2054-2057). In 2007, the rating agencies came under harsh criticism for “generally benign” credit risk assessments of subprime MBS. See, e.g., Lucchetti & Ng (2007).

Although in theory the rating agencies can face suit by disappointed investors or issuers for reckless or negligent ratings, in reality the agencies face a low risk of legal exposure because their ratings are couched as opinions. See, e.g., Husisian (1990); Partnoy (1999, p. 641 n.27); Rhodes (1996, n. 224); Schwarcz (2002, n.78).

[127] Engel & McCoy (2007b, p. 161).

[128] Engel & McCoy (2007b, pp. 2062, 2068-2069).

[129] Barclays Capital Research (2003); Hsu & Mohebbi (1996, pp. 278-280); McNichols (2003, p. 234) (this “insurance guarantee is irrevocable and unconditional”); Schwarcz (3d ed. 2003, §§ 2:3, 2:4).

[130] Barclays Capital Research (2003, p. 11); Brettell (2007); McNichols (2003, p. 250); Standard & Poor’s (2007a); Standard & Poor’s (2007b). Despite higher premiums in 2005 and 2006, the financial press has aired doubts regarding whether bond insurers all reserved sufficient capital in 2005 through 2007 against possible claims from defaults on subprime mortgage-backed securities and collateralized debt obligations. By January 2008, after subprime exposure caused Ambac to become the first bond insurer to lose its AAA rating, New York insurance commissioner Eric Dinallo solicited banks to bail out the bond insurance industry. Pleven & Craig (2008), Richardson & Lucchetti (2008); see also Davies & Thomas (2007).

loan modifications with distressed borrowers. PSAs also specify the number of votes needed by investors to approve the sale of the loan pool. As we discuss, the restrictions in PSAs vary considerably from deal to deal and servicer to servicer.

Servicers may be subject to other limitations on their ability to collect and forbear on collection of loans.[131] These companies often have their own internal collection policies. In addition, the rating agencies rate servicers. As part of the ratings process, the rating agencies measure a servicer's financial strength and performance against collection guidelines established by the rating agencies.[132] These collection guidelines are designed with investors in mind and seek to maximize the cash flow to the securitized trust.

Actions Upon Loan Default: Collection and Loss Mitigation Strategies

The trust protections surrounding securitized trusts and the limitations contained in PSAs have important implications for borrowers whose loans are securitized. These protections and limitations complicate the workout of delinquent loans and make it more difficult for distressed borrowers to head off foreclosure.

When home mortgages go into default,[133] servicers have two main ways of resolving those loans. First, they may pursue formal creditors' remedies, primarily consisting of foreclosure or sometimes collection. Alternatively, servicers may employ loss mitigation strategies that are designed to maximize future cash flows from borrowers while keeping them in their homes.[134]

From a reputable lender's perspective, foreclosure is rarely an attractive economic option. Most lenders or holders of home mortgages sustain large losses when they institute foreclosure. The outstanding balance on the loan may exceed the borrower's equity. This issue is painfully real today, with home values falling nationwide. In addition, foreclosure, eviction, and selling

[131] The Fair Debt Collection Act does not apply to a servicer unless a debt has been transferred to that servicer after the borrower went into default.

[132] See, e.g., Standard & Poor's (2004); Standard & Poor's (2007o).

[133] Normally, one missed payment does not trigger default on a home mortgage. Rather today, industry convention defines default as three or more missed payments.

[134] Borrowers who file for Chapter 7 bankruptcy receive no special relief in restructuring their primary mortgages. Instead, delinquent borrowers who file for Chapter 7 bankruptcy continue to owe their loans in full and face foreclosure once the court discharges their non-mortgage personal debts. Similarly, Chapter 13 bankruptcies do not forgive mortgage debt, although they do permit borrowers to confirm repayment plans to cure the arrearages in their mortgages. If those borrowers fail to cure their arrearages, however, they may subsequently face foreclosure. Bahchieva et al. (2007, pp. 23-25); Lohr (2007).

the property are costly, particularly in areas with a large number of foreclosed homes on the market. During foreclosure, moreover, no income is coming in, only costs.[135]

In order to avoid the high losses associated with foreclosure, lenders and servicers may find it prudent to consider loss mitigation strategies that can increase recovery while avoiding foreclosure. Loss mitigation can take several forms, including:

1. *Refinancing the loan*. The servicer may urge the borrower to refinance the delinquent loan in full and replace it with a new loan. Alternatively, a third party may solicit the borrower to refinance. Some foreclosure rescue scams have falsely promised refinancings while unknowingly inducing homeowners to transfer the deeds to their homes.[136]

2. *Repayment through sale of the home:* The servicer may attempt to persuade the borrower to sell the home and use the sales proceeds to pay off the loan in full.

3. *Short sale*: In rare cases, if a sale will not pay off the loan balance in full, the servicer may nevertheless agree to retire the full debt in return for a "short sale" in which the borrower sells the house for less than the balance owed on the loan.

4. *Deed-in-lieu*: Here, the borrower surrenders the deed to the noteholder in lieu of foreclosure. In a variant on this technique, a third party may persuade the homeowner – often fraudulently – to sign over the deed thinking that he or she will be able to rent the house and eventually buy it back.[137]

5. *Loan forbearance:* The servicer may exercise forbearance on the loan by retaining the original loan terms, but stretching out the payment schedule.

6. *Loan modification:* Finally, the servicer may agree to a loan modification in which it reduces the interest rate, the loan balance or the maturity of the loan with the expectation that the borrower will pay a steady, although lower, level of cash flow.[138]

Debates about loss mitigation strategies hit the headlines in mid-2007, when the subprime market imploded. In 2005 and 2006, lenders made millions of hybrid, interest-only, and option payment adjustable-rate mortgages with relaxed underwriting guidelines, in many cases to borrowers with tight incomes and weak credit.[139] Many of these loans were underwritten only to artificially low teaser rates and high combined loan-to-value ratios with low or no documentation

[135] Credit Suisse (2007, p. 17).
[136] Tripoli & Renuart (2005, pp. 8-9).
[137] Tripoli & Renuart (2005, p. 8).
[138] See, e.g., Credit Suisse (2007, pp. 3, 8); FitchRatings (2007a, pp. 1, 5-10).
[139] See, e.g., Standard & Poor's (2007p, at 1).

of borrowers' income.[140] In late 2006, as the first wave of those loans came due to reset, at significantly higher interest rates and monthly payments,[141] defaults mounted and so did foreclosures, culminating in a full-blown crisis in 2007.[142]

During the 2007 crisis, the first four loss mitigation strategies – refinancing mortgages, sales of homes, and deeds in lieu of foreclosure -- became difficult or economically unviable due to deteriorating credit market conditions. Since the time when many distressed borrowers had taken out their original loans, interest rates on mortgages had risen, tightening credit. Between July 2004 and July 2006, the Federal Reserve Board raised the federal funds target rate by four hundred basis points (four percent) and kept it there for over a year, making mortgages more expensive and pushing up the index rates on adjustable mortgages.[143] In the meantime, defaults mounted on subprime loans and Alt-A loans while lenders tightened their underwriting standards and eliminated many loan products with relaxed requirements designed for borrowers with scant home equity or blemished credit profiles. Many borrowers who had originally taken out loans based on loose underwriting terms found they could not qualify for new loans under the stricter standards. To make matters worse, home values stagnated or dipped in many parts of the country, eroding borrowers' equity and precluding many of them from qualifying for traditional refinance loans with lower loan-to-value caps, often of ninety percent or less. Rising foreclosure inventories and falling home values also made it difficult for many delinquent borrowers to retire their loans by selling their homes.[144]

When refinancing or recovering the loan through a deed transfer or home sale does not make economic sense, whether to grant forbearance or loan modification or instead proceed to foreclosure is partly a function of cost-benefit analysis and partly a function of other constraints on loss mitigation.[145] From the standpoint of the servicer or the lender, forbearance or loan

[140] Office of the Comptroller of the Currency et al. (2006, p. 6).

[141] Cagan (2006); J.P. Morgan Securities Inc. (2007, p. 3).

[142] For the third quarter of 2007, the Mortgage Bankers Association reported that the "rate of foreclosure starts [stood] at the highest levels ever" in the history of its delinquency survey. The problem was not limited to subprime loans; prime adjustable-rate mortgages also contributed significantly to the overall results. Mortgage Bankers Association (2007). For subprime loans that quarter, the delinquency rate shot up 375 basis points from the third quarter of 2006. *Id.*

[143] Moneycafe.com (2007). The Board did not cut interest rates until September 18, 2007, when in response to the mortgage crisis, it lowered the federal funds and discount rates by one-half of one percent. Federal Reserve Board (2007b).

[144] See, e.g., Credit Suisse (2007, p. 4); FitchRatings (2007a, p. 2); Mortgage Bankers Association (2007, p. 1); Schwartz (2007), at 1.

[145] For a flowchart of this decisionmaking process, see FitchRatings (2007a, p. 5).

modification only makes sense when the present value of the expected future cash flow from the workout exceeds the present value of instituting foreclosure. That will not be true when underwriting indicates that the borrower is likely to default a second time; then, the servicer may conclude that it would be better off cutting its losses before those losses continue to mount.[146] In contrast, when the borrower can manage a new schedule of payments, then forbearance or loan modification is more likely to appeal to the servicer.[147]

Servicers prefer forbearance to loan modification or foreclosure when the borrowers have temporary financial problems that are likely to resolve and can make up the missed payments over time. Nevertheless, a loan modification may make more sense if the borrower can make lower monthly payments indefinitely, just not the original loan payments. Even a lower interest rate of 300 basis points per year may make sense if foreclosure would result in a loss severity of forty to fifty percent.[148] In a 2007 analysis of modified loans, Credit Suisse concluded that loan modifications are often an effective form of workout.[149]

Notwithstanding the economics of a workout, negotiating one becomes significantly harder when a loan has been securitized. This is the rule rather than the exception, because up to eighty percent of subprime home mortgages were securitized at the height of the subprime market.[150] When a distressed loan is securitized, the servicer's ability to negotiate a workout is subject to a number of constraints, most notably the pooling and servicing agreement. Most

[146] Credit Suisse (2007, p. 17); FitchRatings (2007a, pp. 6-10); J.P. Morgan Securities Inc. (2007, p. 3). Delaying foreclosure may also have other negative effects on the structure and creditworthiness of the securitization, including reduced excess spread and unwarranted step-downs of overcollateralization, thereby placing the junior tranches at heightened risk of loss. Credit Suisse (2007, p. 17); FitchRatings (2007a, pp. 10-11); FitchRatings (2007b, p. 2). In addition, when loans are modified, servicers commonly report the borrowers' payment status under the new loan terms, which masks their prior default history from the trustee. FitchRatings (2007b, p. 1).

[147] On September 4, 2007, state and federal banking regulators issued a statement on loss mitigation strategies that was supportive of forbearance and loan modifications. The statement recommended the following techniques for evaluating loss mitigation (Federal Deposit Insurance Corporation (2007b, p. 2)):

> [S]ervicers should consider the borrower's ability to repay the modified obligation to final maturity according to its terms, taking into account the borrower's total monthly housing-related payments (including principal, interest, taxes, and insurance, commonly referred to as 'PITI') as a percentage of the borrower's gross monthly income . . . . Attention should also be given to the borrower's other obligations and resources, as well as additional factors that could affect the borrower's capacity and propensity to repay. Servicers have indicated that a borrower with a high [debt-to-income] ratio is more likely to encounter difficulties in meeting mortgage obligations.

See also Board of Governors of the Federal Reserve System (2007).

[148] Credit Suisse (2007, pp. 7-8, 17).

[149] Credit Suisse (2007, pp. 11, 15).

[150] Standard & Poor's (2005, p. 7).

PSAs permit some sort of workout when default has occurred or is "reasonably foreseeable." This gives servicers latitude to contact borrowers prior to a reset date to determine the borrower's ability to handle the new payments and, if not, to explore other options. Similarly, most PSAs give servicers broad discretion to negotiate forbearance that temporarily extends delinquent payments but does not require any change of loan terms so long as the servicer timely forwards the missed payments to investors.[151]

Not surprisingly, PSAs are usually stricter about loan modifications, although they vary from deal to deal.[152] Some PSAs impose a flat prohibition on loan modifications. Numerous other PSAs do permit loan modifications, but only when they are in the best interest of investors.[153] In such cases, the servicer's latitude to negotiate a loan modification depends on the PSA. Some PSAs permit modification of all loans in the loan pool, while others limit modifications to five percent of the loan pool (either by loan number or loan amount). PSAs often contain one or more other restrictions on loan modifications. Examples include mandatory modification trial periods, use of specific resolution procedures, caps on interest rate reductions, restrictions on the types of eligible loans, and limits on the number of modifications in any year. Certain PSAs require servicers to maximize the net present value of the borrowers' payments in a timely and complete manner. Due to uncertainty about the proper way to calculate net present value, some servicers may interpret these provisions as requiring foreclosure.[154]

The PSA is not the only limitation on workouts. The servicer's own loan resolution policies may impose new and different constraints.[155] In addition, where a proposed workout exceeds the servicer's latitude under the PSA, the servicer will need to get permission for the workout from a multitude of parties, including the trustee for the securitized trust, the bond insurers,[156] the rating agencies who originally rated the bond offering, and possibly the investors themselves. In a further twist, often the underlying loan pool was the subject of multiple

[151] Credit Suisse (2007, p. 6).
[152] See generally Eggert (2007).
[153] This language alone may drive the servicer to file for foreclosure (FitchRatings (2007a, p. 1)):

> Foreclosure liquidation is generally seen as the least beneficial option. However, as the servicer is responsible to RMBS investors to minimize losses and, therefore, maximize returns, foreclosure may be the only recourse.

[154] Credit Suisse (2007, pp. 6-7, 20).
[155] Credit Suisse (2007, p. 5).
[156] Barclays Capital Research (2003, p. 11).

securitizations: an initial securitization of principal and interest payments, a net interest margin securitization of any prepayment penalties, and a collateralized debt obligation (CDO) offering that securitized the residual tranches of the initial securitization.[157] Each of these results in a new PSA whose terms may be different from and inconsistent with the other PSAs controlling the loan pool.[158] In sum, when the servicer wants authority to exceed the limits on its loan modification discretion under the PSA, it is generally neither cost-effective nor practically possible for it to obtain the myriad needed permissions, especially for one loan amidst a loan pool.

These and other reasons explain why a servicer might not agree to loan modification or forbearance. A servicer might conclude that refinancing the loan, selling the home, or accepting a deed in lieu of foreclosure would produce a higher recovery for investors. Even when such loss mitigation strategies make economic sense, a servicer might rebuff loan workout attempts because the PSAs forbid those workouts, the servicer would have to advance all missed payments to investors,[159] the rating of the securitized tranche or the servicer would fall, the loan modification would trigger a recourse obligation by the lender (where the servicer is an affiliate of that lender),[160] the borrowers are so strapped that they cannot service the reduced debt, the servicer cannot recoup the added costs of negotiating a loan modification (either because the loan size is small or it is paid on a fixed-fee schedule), or the servicer bought a credit default swap as protection and would profit from foreclosure.[161] Given these many impediments, it is no surprise that few loan modifications are actually granted, and usually after only months of negotiations.[162] According to a survey conducted by Moody's of sixteen major subprime servicers, most of them had only modified one percent of loans originated in 2005 that had reset in January, April and July 2007. Noting that small percentage, Moody's expressed concern "that the number of modifications that will be performed in the future by subprime servicers on loans facing reset

[157] Engel & McCoy (2007b, pp. 128-129, 140).
[158] Credit Suisse (2007, pp. 5, 7).
[159] Note that the servicer would only have to advance payments out of its pocket if it had exhausted the excess spread account. For a description of excess spread accounts, see Engel & McCoy (2007b, p. 110).
[160] That was the case with many Countrywide loans, for instance. Morgenson (2007).
[161] See, e.g., Credit Suisse (2007); FitchRatings (2007a, p. 3); International Monetary Fund (2007, p. 47); J.P. Morgan Securities Inc. (2007, pp. 3-4). Restrictions imposed by the Internal Revenue Code's REMIC provisions or accounting issues under FASB 140 can also impede workouts. FitchRatings (2007a, p. 3). But see Federal Deposit Insurance Corporation et al. (2007b, p. 2 & n.3) (reporting that the Department of the Treasury had confirmed that servicers may modify loan terms when default is reasonably foreseeable, consistent with the REMIC tax rules).
[162] Berry (2007).

may be lower than needed to mitigate losses."[163] Alarmed by the low number of modifications, FDIC chairman Sheila Bair pressed lenders to lock in the initial rate on hybrid ARMs for the full term of those loans.[164]

Finally, before 2008, even if a distressed borrower succeeded in winning forgiveness of principal or interest, he or she faced adverse tax consequences under current Internal Revenue Service rules. Any cancelled debt was taxable to the borrower as ordinary income.[165] This could result in an unexpected added tax bill of thousands of dollars. As the enormity of the mortgage crisis became apparent, Congress authorized a three-year moratorium on that tax liability in the Mortgage Forgiveness Debt Relief Act of 2007.[166]

In short, the rigid legal protections surrounding securitized trusts, the restrictions found in PSAs, and the financial incentives of servicers impede pursuing sensible foreclosure avoidance strategies for many distressed loans and borrowers. By early 2008, this problem was so large that it threatened to catapult the U.S. economy into a recession by dumping hundreds of thousands of foreclosed homes for sale onto already depressed real estate markets.

Assignee Liability of Securitized Trusts

Finally, in many instances, securitization often strips borrowers of otherwise valid defenses to collection and foreclosure. This doctrine – known as the "holder-in-due course rule" -- shields securitized trusts from most claims and defenses to nonpayment that the borrower has against the lender based on unconscionability, breach of contract, and most types of fraud.[167]

To qualify for protection as a holder in due course, the trust – known in legal parlance as the "assignee" -- must meet four requirements.[168] First, it must meet the definition of a "holder" of a negotiable note.[169] In addition, the trust must have taken the note: (2) for value; (3) in good

[163] Moody's (2007). See also California Reinvestment Coalition (2007) (survey of mortgage counseling agencies in California reported that few servicers modified loan terms and those who did generally only reduced interest rates for one year); Hopkins (2008a); Mortgage Bankers Association (2008).

[164] Terris (2007).

[165] See, e.g., Federal Deposit Insurance Corporation (2007b, p. 2); Internal Revenue Service, 4.4 Interest/Dividends/Other Types of Income: 1099 Information Returns (All Other) (2007), http://www.irs.gov/faqs/faq4-4.html**.**

[166] Pub. L. No. 110-142 (signed into law on Dec. 20, 2007).

[167] White & Summers (2000, §§ 14-1, 14-2).

[168] Uniform Commercial Code (2005, § 3-302). See Engel & McCoy (2007b, pp. 115-116) for factual scenarios where an assignee might fail this test.

[169] Specifically, to qualify as a "holder," the assignee must possess the note and the note must be "issued or indorsed to him or to his order or to bearer or in blank." White & Summers (2000, § 14-3).

faith; and (4) without notice that the note contained certain defects. With minor exceptions, this is the law today in the vast majority of states.[170]

When home loans are securitized, the plaintiff in any foreclosure action is generally the securitization trustee, not the lender. As a result, a borrower who received a fraudulent or illegal loan from a lender cannot raise those defenses to foreclosure unless some other law creates an exception to the holder-in-due course rule. In theory, of course, borrowers could file suit against their lenders and litigate their claims or defenses against the lenders in separate lawsuits. This will not result in relief for the borrowers if their lenders are bankrupt or have gone out of business. More importantly, these separate lawsuits against the lenders will not stop borrowers from losing their homes if assignees sue them for foreclosure.

The holder-in-due course rule also affects the outcome of loan workout negotiations. The success of these negotiations may depend on the borrower's ability to raise claims and defenses of illegal lending by the lender against the trust. While this basic bargaining principle might seem obvious, the immunity afforded by the holder-in-due course rule deprives many borrowers of the bargaining leverage that their claims and defenses against the lender would otherwise afford.

While the holder-in-due course rule applies to many loans, it does not apply to them all. Federal law contains three partial exceptions to the holder-in-due course rule. Under the Truth in Lending Act (TILA), assignees are liable to borrowers in damages actions for any TILA violations that are "apparent on the face of" federal disclosure forms and face full assignee liability in actions by borrowers for rescission.[171] In home mortgages involving the sale of goods or services, the rules implementing the Federal Trade Commission Act similarly impose liability on assignees for "all claims and defenses which the debtor could assert against the seller."[172] Lastly, HOEPA makes assignees who hold HOEPA loans "subject to all claims and defenses . . . that the borrower could assert against the originator of the mortgage," unless an assignee can prove by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not have known that the mortgage was a HOEPA loan.[173] All of these federal

[170] The California Financial Code goes further and expressly shields assignees from any claims arising under its anti-predatory lending law so long as they are holders in due course or "chartered by Congress to engage in secondary mortgage market transactions." Cal. Fin. Code § 4979.8.

[171] 15 U.S.C. § 1641(a), (e)(2). For non-purchase money mortgage loans, if the lender violates a small subset of TILA's rules, the borrower has is entitled to an extended right of rescission against the assignee even if the TILA violation is not apparent on the face of the loan documents. *Id.* § 1641(c).

[172] 16 C.F.R. § 433.2.

[173] 15 U.S.C. § 1641(d)(1).

assignee liability statutes are fairly narrow, either because they require proof of specific violations (as in TILA) or only cover a limited set of loans (as in the FTC Act and HOEPA).

Some states have similarly abolished the holder-in-due course rule for certain home mortgages. As of January 1, 2007, twenty-one states had adopted mini-HOEPA laws imposing some sort of assignee liability.[174] For the most part, similar to HOEPA, these provisions only create assignee liability for "high-cost" loans, as defined by statute. The provisions vary widely, both as to the available remedies against assignees and the circumstances under which assignees are liable. The mildest assignee liability provisions restrict injured borrowers to raising any defenses (including recoupment claims) that they had against their lenders against assignees in foreclosure and/or collection cases. New York and South Carolina have such laws. Other states excuse assignees from liability if they engage in due diligence to keep "high-cost" loans out of the loan pools. This group of states includes Arkansas, Colorado, Florida, Georgia, Ohio, Oklahoma, Texas, and the District of Columbia. Other states impose liability on all assignees, but cap liability for assignees who conducted due diligence. Illinois, Indiana, Maine, Massachusetts, New Jersey, New Mexico, and West Virginia take this approach. Finally, Connecticut, Kentucky, Nevada, and Pennsylvania make assignees liable for enumerated types of lender misconduct, regardless whether the assignees performed due diligence.[175]

In states that have legislated assignee liability, there is a question whether that liability attaches to all loans. Assignees would likely argue that as a result of agency preemption orders under HOLA and the National Bank Act, loans originated by national banks, federal savings associations, and their mortgage lending subsidiaries are exempt from state assignee liability laws.

Borrowers do not have control over whether their loans are securitized or held by their lenders in portfolio. In the latter case, the holder-in-due course rule does not apply and borrowers can raise all of their claims and defenses to nonpayment if their lenders sue them for

[174] *See, e.g.*, N.J. Stat. Ann. § 46:10B-27(b)-(e) (West Supp. 2006); N.Y. Banking Law § 6-l(7), (11)-(13) (McKinney Supp. 2007). *See generally* Azmy (2005) (surveying state laws). Increasingly, federal regulators have preempted state anti-predatory lending laws that impose assignee liability. *See* Office of the Comptroller of the Currency (2004) (codified at 12 C.F.R. pts. 7, 34) (ruling that OCC enforcement preempts state anti-predatory lending laws' application to national banks). On a parallel front, states have preempted many local lending ordinances that contemplate assignee liability. *See, e.g.*, Mayor of New York v. Council of New York, 780 N.Y.S.2d 266 (Sup. Ct. 2004) (holding New York City's anti-predatory lending ordinance preempted by state and federal law).

[175] Rating agencies have been able to rate most parts of these assignee liability laws. The ability to rate depends on two key issues: (1) whether liability under an assignee liability statute is limited to quantifiable amounts; and (2) whether the bond offering contains sufficient credit enhancements to cover the legal exposure. In the rare instances when rating agencies declined to rate loans covered by state assignee liability laws, it was because the laws created indeterminate amounts of financial exposure. Engel & McCoy (2007, pp. 160-161).

collection or foreclosure. If their loans are securitized, however, borrowers' ability to assert such claims and defenses against securitized trusts in collection or foreclosure proceedings largely depends on whether some other source of law suspends the holder-in-due course rule for the loan in question. When the holder-in-due course rule does apply, the law countenances loan purchases by assignees despite inadequate due diligence, in the knowledge that they can collect on the loans free from most claims and defenses by the borrower, even when those loans were illegal or fraudulent.

To summarize, in many states where borrowers have valid claims and defenses to foreclosure vis-à-vis their lenders, when their loans are securitized, the holder-in due course rule unilaterally strips them of the ability to raise those claims and defenses against assignees who sue them for collection or foreclosure. For the same reason, borrowers in this situation had reduced leverage when attempting to negotiate loan workouts. Pooling and servicing agreements and other constraints on servicers for securitized trusts further impede the ability to negotiate constructive workouts of distressed loans. These dynamics of securitization and the outmoded legal structure that girds it have further frayed the legal safety net for borrowers who are saddled with abusive subprime and nontraditional mortgages.

Conclusion

The dialectic of federal deregulation, state re-regulation, and federal preemption has produced a dual system of regulation in which increasing numbers of aggrieved borrowers are stripped of defenses to foreclosure. This same dialectic explains why major lenders have flocked to federal preemption under the national bank and federal savings association umbrellas.

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