Lessons From The
Subprime Mortgage Debacle

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The practical mortgage mess affects more than just borrowers and financial institutions—it will also affect your practice.

THE LAST YEAR has produced a debacle in the residential mortgage market of worldwide proportions. A few years ago, it would have been preposterous to believe that the real estate market in the United States could have such a significant impact on world financial markets. As the real estate bubble inflated, and creative mortgage methods were invented, typical to financial bubbles, all the rules were ignored. The questions to ask are: Where were the regulators? Where were the legislators? It became apparent as early as 2004 that consumers were getting mortgages that made no rational sense. But no one stepped up to tell them “No.” A new breed of people, calling themselves mortgage brokers, were driving the frenzy in order to produce outsized fees. Consumers, ignoring basic financial advice, were entering into mortgages they couldn’t pay. Wall Street was creating new financial vehicles, mortgage-backed securities, at a frightening pace. Investors, not only in the United States, but also worldwide, were eagerly buying these high-yielding mortgage-backed securities. Appraisers were willing to ignore their own rules to meet the growing pace of mortgage applications. And, possibly the most important player, the Federal Reserve Board, did nothing. While a bubble is being formed, and prices are rising, as in a Ponzi scheme, no-
body gets hurt. Then as the bubble bursts, there is the necessary reckoning, the collapse of prices. We all heard the experts opining that real estate prices in the United States never decline. New rationales were developed to describe why the increase in values was sustainable. This is a tale of greed and irresponsibility. People got hurt financially, and corporations were destroyed or brought to their knees. Lawsuits inevitably follow financial wreckage. People need to learn from this event, and make certain they don’t fall into these traps in the future.

This article will describe the reasons behind the collapse of the mortgage market, the people who should be faulted, and the too-late responses by the regulators and legislators. A new market is being created, and all real estate practitioners need to understand how it affects them and increases their exposure to liability.

CAUSES OF THE PROBLEM • The mortgage debacle was driven by purchasers of residential mortgages entering into mortgages they couldn’t afford. Ultimately, this led to mortgage defaults and increased foreclosures. In addition, the mortgages often had (and have) balances exceeding the value of the property. In a traditional debt analysis, there are two safety features: the borrower should have the proven capability to pay and the secured property should have sufficient value to satisfy the debt. If these conditions are met, defaults on loans are very rare. Both of these conditions have been ignored, fueling an explosion of defaults. Because the foreclosed properties do not have sufficient value to repay the loan, the lender suffers a loss. Because the lender sold the mortgage to a third party, the third party has an asset that has decreased in value. The people who made money on these transactions, the so-called mortgage brokers, took their money and are out of the picture. Many are now employed in other endeavors.

Ultimately, the subprime mortgage crisis is a failure of responsibility at every level—borrowers, lenders, investors, investment banks, rating agencies, regulators, and appraisers. It was also a failure of attorneys to properly advise their clients. In the rush to follow greed at every level, all the normal protections broke down.

TYPES OF MORTGAGES • Mortgages have three broad credit quality categories. The most prevalent type of residential mortgage is what is known as a “conforming” mortgage. Mortgages made to people who have less than stellar credit, or for more of the purchase price as is prudent, are called “subprime” mortgages. Mortgages involving risks somewhere between these two categories are called “Alt. A” mortgages.

Conforming Mortgages

A conforming mortgage is called that because it denotes a mortgage which either Fannie Mae or Freddie Mac are allowed to purchase. Conforming designation can only apply to mortgages with an initial principal amount of less than $417,000. ($729,750 until December 31, 2008.) Mortgages in excess of this limit are called jumbo mortgages. Less than one percent of conforming mortgages go into default. Conforming mortgages must meet these tests:

• Income is verified;
• The borrower has good credit (a credit score higher than 720);
• The mortgage principal is less than 80 percent of the value that the home is appraised at;
• The monthly payment plus the monthly real estate tax bill does not exceed 28 percent of the borrower’s gross monthly income;
• The borrower does not have excessive other outstanding loans or debt; and
• Total debt payments, including this mortgage, do not exceed 35 percent of the borrower’s gross monthly income.
Alt. A Mortgages

The second type of mortgage credit category is what is known as “Alt. A.” Alt. A loans generally fail to meet the rules for conforming loans. These loans made up about 16 percent of the mortgage loans made in 2006. Typically, they fall short in one of the necessary areas. For example, the credit score may be below conforming standards, but not to the point of making the mortgage a subprime loan. Credit scores from 580-700 would fit in this category. If the mortgage amount exceeds 80 percent of the value of the home, it would be an Alt. A loan. Other reasons would be a lack of income documentation or a borrower with high outstanding credit card debt. These loans are made at less favorable terms than conforming loans. Usually, this means that an Alt. A borrower will pay a higher interest rate, and more fees. These loans are questionable, but are generally expected to perform. The default rate of Alt. A loans in 2006 was 2.4 percent. Mortgage companies and mortgage brokers earn higher fees from placing Alt. A loans than would be received for a similar conforming loan.

Subprime Mortgages

Subprime mortgages are nonconforming mortgages that do not meet the standard for conforming loans by a substantial amount. Many times these loans were made with no income verification. Many were made for 100 percent of the value of the home. Many more were obtained by borrowers with the worst credit history, a credit score below 580. The majority of these loans will continue to perform and will avoid default. However, as lending practices became more lax, more loans were made with increasing risk. In addition, many were made to well-qualified speculators who were avoiding the normal rules to highly leverage the purchase of homes and condominiums in the hope that they could be quickly “flipped” for an easy profit. When no income or debt verification was required, many purchasers used these easy mortgages to buy a number of units. In 2006, subprime mortgages made up 24 percent of the mortgage market. The default rate on subprime mortgages is 10.5 percent. Subprime borrowers pay significantly higher interest rates, and significantly higher fees. Because many of these borrowers were simply happy to be offered a mortgage, they were willing to accept very onerous terms. It is not unusual to see loans made at a 10-11 annual percentage rate (“APR”). Typical placement fees to mortgage brokers were $10,000 or more. The people who could not qualify for conforming loans were given mortgages when it was unlikely that they could pay. What many people misunderstood was exactly how bad many subprime mortgages actually were. For a large number of these mortgages, any rational person could see that they were very unlikely to be repaid.

Predatory Lending

Another group of mortgages fall under the description of predatory lending. Predatory lending involves promoters of mortgages using fraudulent tactics to induce a borrower to enter into a loan. These loans typically involve excessive fees and outrageous interest terms. For example, some of these loans have a low one-month “teaser” interest rate which readjusts in the second month to a far higher interest rate. Predatory loans are based upon a failure to fully disclose the loan terms. Many of these loans are used as a pretense simply to acquire a person’s home fraudulently, and the poor and the elderly are often targeted. Many states have enacted predatory lending laws, but they have proven difficult to enforce. Many prosecuting attorneys do not have the resources to find and penalize those who engage in these lending practices, and many prosecutors find that they can only successfully pursue the most egregious of these loans. It is not unusual for a predatory lender to charge 30-50 percent of the loan principal in fees.

Adjustable Rate Mortgages

Many people have blamed adjustable rate mortgages for...