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Federal Regulation and Legislation in the Wake of the Subprime Mortgage Meltdown: A Legal Philosophical Analysis of Federal Government Responses to Market Bubbles

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NOTES

FEDERAL REGULATION AND LEGISLATION IN THE WAKE OF THE SUBPRIME MORTGAGE MELTDOWN: A LEGAL PHILOSOPHICAL ANALYSIS OF FEDERAL GOVERNMENT RESPONSES TO MARKET BUBBLES

Joshua Wirth[*]

PREAMBLE

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The regulatory environment surrounding subprime mortgages, workouts and foreclosures and bank liquidity is constantly changing. For example, Republican presidential candidate Senator John McCain (R-AZ) has recently announced a plan implementing proposals formally touted by Democratic primary candidate Senator Hillary Clinton (D-NY).[1] Proposed legislation that would allow bankruptcy judges to alter the terms of subprime mortgages, essentially dead in Congress as of the

* J.D. Candidate, Fordham University School of Law. I wish to thank Professor David Schmudde for his guidance and encouragement in taking on this project. I would also like to thank my mother, Leslie Franzblau, for boldly embracing the daunting task of teaching me how to write, and specifically for her valuable suggestions concerning this Note. Finally, I wish to thank the editorial staff at the Fordham Journal of Corporate and Financial Law for their valued advice and meticulous revisions.

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1. *See* McCain-Palin 2008, Immediate Relief for American Families – HOME plan, http://www.johnmccain.com/Issues/JobsforAmerica/relief.htm (last visited Oct. 22, 2008) (discussing McCain's plan to require "participating lenders to forgive part of the loan principal and then write a new loan that would be backed by the federal government . . . ."); *infra* Part II.D.

spring of 2008, regained new life and was in contention for inclusion in the bailout package passed this fall.[2]

As regulation continues to develop, scholarly debate concerning the federal government's responses is ongoing. Yet, while underscoring the federal government's responses, the legal philosophies discussed herein have seldom been explicitly mentioned in the scholarly analyses to date. Thus, in discussing the legal philosophical bases of the federal government's proposed regulations and legislation, this Note brings to the forefront important considerations which so far have been absent in scholarly commentary and public press.

INTRODUCTION

"You only learn who has been swimming naked when the tide goes out – and what we are witnessing at some of our largest financial institutions is an ugly sight."[3] Given the losses tied to subprime mortgages[4] by top U.S. financial institutions,[5] few could argue the cogency of these words in Warren Buffett's annual letter to the shareholders of Berkshire Hathaway Inc. on March 8, 2008.[6] Perhaps "ugly" was even an understatement: Bear Stearns Cos., once the fifth largest investment bank,[7] saw its share price drop from a 52-week high above $156 to a stock-for-stock acquisition price by J.P. Morgan valued at just $2 per share.[8]

Faced with a "credit crunch" causing the collapse of Bear Stearns[9] and widespread fear that other U.S. financial institutions may soon follow, a decline in wealth for American households for the first time since 2002[10] and economists' claims of recession, the Board of Governors of the Federal Reserve System (the "Fed") reacted in the Spring of 2008 by cutting the cost of short-term borrowing to add liquidity to the global financial market.[11] In direct response to the securities losses tied to subprime mortgages, the Fed also issued changes to Regulation Z, a federal regulation governing home mortgages.[12] Further, home value depreciation and mounting foreclosures on homes owned by subprime borrowers prompted federal legislation to reform the U.S. residential mortgage lending industry.[13] In addition to supporting the proposed legislation, former Democratic presidential primary candi-

2. Sarah Lueck et al., *Bailout Plan Rejected, Markets Plunge, Forcing New Scramble to Solve Crisis*, WALL ST. J., Sept. 30 2008, at A1; *infra* Part II.C.

dates Hillary Clinton and President-elect Barack Obama vowed to allocate future federal funds to help owners who are unable to make the monthly payments on their subprime mortgage loans.[14]

From an economic standpoint, debate among politicians and

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3. Letter from Warren E. Buffett, Berkshire Hathaway Inc., to Shareholders (Feb. 2008), at 3, *available at* http://www.berkshirehathaway.com/letters/2007ltr.pdf.

4. Subprime borrowers generally have credit profiles that may include one or more of the following: (1) multiple delinquencies in payments in the previous 12-24 months, (2) a judgment, charge-off, repossession or foreclosure, (3) bankruptcy, (4) "a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood," or (5) total minimum monthly debt payments greater than 50% of gross income. Office of the Comptroller of the Currency, Interagency Guidance on Subprime Lending, Bulletin BL 99-10 (Mar. 1, 1999), at 3, *available at* http://www.federalreserve.gov/boardDocs/SRletters/2001/sr0104a1.pdf.

5. For an overview of the losses experienced by U.S. financial institutions due to investments in subprime mortgages, *see infra* Part I.

6. *See* Gordon T. Anderson, *Buffett Speaks*, CNNMoney.com, Mar. 8, 2004, http://money.cnn.com/2004/03/06/pf/buffett_letter/index.htm (providing a brief summary of Buffet's letter and confirming the date of release).

7. *See* Kate Kelly, et al., *Fed Races to Rescue Bear Stearns In Bid to Steady Financial System*, WALL ST. J., Mar. 15, 2008, at A1.

8. Robin Sidel, et al., *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis*, WALL ST. J., Mar. 17, 2008, at A1. Morgan Stanley later increased its bid to near $10 per share. Andrew Ross Sorkin, *JPMorgan Raises Bid for Bear Stearns to $10 a Share*, N.Y. TIMES, Mar. 24, 2008, at A1, *available at* http://www.nytimes.com/2008/03/24/business/24deal-web.html.

9. The sudden collapse of Bear Stearns resulted in what many investors considered a "fire sale." *See* Sidel*, supra* note 8.

10. Total wealth of American households slipped approximately $533 billion in the fourth quarter of 2007 to $57.7 trillion, the first drop since 2002. Sudeep Reddy & Sara Murray, *Housing, Bank Troubles Deepen*, WALL ST. J., Mar. 7, 2008, at A1, *available at* http://online.wsj.com/article/SB120485071664018195.html.

11. For an analysis of the Federal Reserve's role in the sale of Bear Stearns and its actions following the sale, *see* Bob Davis, et al., *U.S. Mulls Next Steps in Crisis*, WALL ST. J., Mar. 18, 2008, at A1, *available at* http://online.wsj.com/article/SB120580840784044347.html; Greg Ip & Greg Hitt, *Mortgage Securities Back Fed Loan to Bear Stearns*, WALL ST. J., Apr. 2, 2008, at C2, *available at* http://online.wsj.com/article/SB120709943050782205.html; Kara Scannell & Sudeep Reddy, *Officials Say They Sought to Avoid Bear Bailout*, WALL ST. J., Apr. 4, 2008, at A1, *available at* http://online.wsj.com/article/SB120722972567886357.html?mod=hpp_us_whats_news.

12. *See infra* Part II.B.

13. *See infra* Part II.C.

14. *See infra* Part II.D.

scholars concerning the degree to which the federal government should respond to dramatic changes occurring in the financial marketplace has been robust.[15] This Note seeks to approach the question from a different angle, addressing the federal government's response from a legal philosophical perspective. Further, while this Note will not address the issue of preemption, a parallel debate concerning preemption and state versus federal regulation of mortgage lending standards is ongoing.[16]

Part I of this Note will summarize the extent of the blow sustained thus far by financial institutions and investors brought about by subprime mortgage defaults. Part II.A will then list the steps taken by the executive administration under President George W. Bush and Treasury Secretary Henry Paulson, Jr. to increase regulation of the residential mortgage lending industry. Part II.B will discuss the steps

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15. *See, e.g.*, Scannell & Reddy, *supra* note 12; David Wessel, *Ten Days that Changed Capitalism*, WALL ST. J., Mar. 27, 2008, at A1, *available at* http://online.wsj.com/public/article/SB120657397294066915-kps7JpgtZ94AzNLCc8q064xrf9s_20090327.html. For analysis of the "moral hazard" issue featured by Scannell & Reddy, see *infra* Part III.A.

16. *See, e.g.*, G. Marcus Cole, *Markets and the Law: Protecting Consumers From Consumer Protection:* Watters v. Wachovia Bank, 2006-07 Cato Sup. Ct. Rev. 251, 252 (2006 /2007) ("The central issue was whether federalism demanded that a state be permitted to continue to impose regulations on a state mortgage lender, including visitation, when a national bank acquires the state mortgage lender, or whether such state regulation was now preempted by federal law."); Jonathan L. Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 Fordham Urb. L.J. 757 (2007) (discussing city efforts to regulate predatory lending pursuant to state laws and federal regulations); Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. Cin. L. Rev. 1303 (2006) (examining the preemption debate, particularly in the context of federally supported lenders); Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effects on Predatory Lending Regulation*, 88 Minn. L. Rev. 518, 520 (2004) ("Assuming the consumer credit market requires some statutory regulation, are state or federal laws more effective?"). *See* Eric C. Bartley, Comment, *. . . And Federal Regulation for All: Federally Regulating the Mortgage Banking Industry*, 2006 Mich. St. L. Rev. 477, 478, for an overview of federal acts regulating mortgage lending practices and standards. *See also* Richard Cowden, 90 BUREAU NAT'L AFF. 291 (Feb. 18, 2008), ("The OCC [Office of the Comptroller of Currency] issued regulations in 2004 asserting that it has preemptive jurisdiction over certain mortgage lending consumer protections as they apply to national banks and their operating subsidiaries. The agency has successfully fought off litigation by states that have challenged the OCC's preemptive powers . . . .").

the Fed has taken under Chairman Ben Bernanke.[17] Part II.C will compare several proposed bills under review by Congress as of the spring of 2008 and Part II.D will discuss plans for increased federal aid by Clinton and Obama. Finally, by analyzing the federal government's responses under widely-recognized legal philosophies, Part III will argue that valuable and necessary considerations may thus far have been overlooked in the public debate concerning what the federal government should do to stem foreclosures and ease the subprime fallout.

I. THE EXTENT OF THE SUBPRIME FALLOUT

On October 4, 2006, the Office of the Comptroller of the Currency, the Fed, the Federal Deposit Insurance Corporation (the "FDIC"), the Office of Thrift Supervision, and the National Credit Union Administration (together, the "Agencies") issued the Interagency Guidance on Non-Traditional Mortgage Products (the "2006 Guidance").[18] Recognizing the possibility of increased risk of mortgage defaults due to the growing popularity of "Nontraditional Mortgage Loans,"[19] the 2006 Guidance required greater interest rate and principal amount underwriting standards for those kinds of mortgages. Although the Agencies acknowledged that several of the comments they received in response to their initial draft of the 2006 Guidance – including those from several community and consumer organizations, banks, and financial industry associations – unambiguously indicated that reduced documentation loans[20] should not be offered to subprime borrowers,[21] the Agencies

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17. This part will be limited to regulations explicitly addressed as responses to subprime mortgage lending. To the extent that the problems spurring from U.S. subprime mortgage lending have contributed to a global credit crisis, broader efforts by the Fed to add liquidity and lower short-term interest rates and a broader increase in regulatory oversight of financial markets in general largely fall outside the scope of this Note.

18. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

19. The Guidance defined nontraditional mortgage loans "as 'interest-only' mortgages where a borrower pays no loan principal for the first few years of the loan and 'payment option' adjustable-rate mortgages ("ARMs") where a borrower has flexible payment options with the potential for negative amortization." *Id.* at 58,613.

20. "Reduced documentation loans" refers to the practice of underwriting a mortgage loan based on a level of income and/or financial assets that is stated on the application but not duly verified or documented, *id.* at 58,611.

largely ignored the advice and specifically "declined to provide guidance recommending reduced documentation loans be limited to any particular set of circumstances."[22] As the ensuing year illustrated, however, the 2006 Guidance was insufficient to quell the Agencies' fears concerning popular, yet risky, mortgage practices.

Fueled by the same fears as in 2006, the Agencies next published the Statement on Subprime Mortgage Lending[23] on June 29, 2007 (the "2007 Statement"), addressing risks associated with lending adjustable rate mortgages ("ARMs") to subprime borrowers. The Agencies stated that ARMs offered to subprime borrowers typically have one or more of the following characteristics: (1) "[l]ow initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan," (2) "[v]ery high or no limits on how much the payment amount or the interest rate may increase," (3) "[l]imited or no documentation of borrowers' income," (4) "[p]roduct features likely to result in frequent refinancing to maintain an affordable monthly payment," and (5) "[s]ubstantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period." [24] The 2007 Statement reiterated the enhanced underwriting guidelines of the 2006 Guidance and further instructed lenders: "Stated income and reduced documentation loans to subprime borrowers should be accepted only if there are *mitigating factors* that clearly minimize the need for direct verification of repayment capacity."[25] The Agencies' 2006 Guidance and 2007 Statement proved to be too little, too late.

By the end of 2007, a group of twenty-eight of the largest financial institutions participating in the secondary mortgage market had written down $132.6 billion from their balance sheets due to losses in investments tied to U.S. mortgages.[26] The delinquency rate for home loans

21. *Id.*

22. *Id.*

23. Fed. Res. Sys. Docket No. OP-1278, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070629a1.pdf.

24. *Id*. at 9-10.

25. *Id.* at 12 (emphasis added). "Mitigating factors" include "substantial" liquid reserves that are verified by the lender, or when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated.

26. *Credit-Crunch Toll: $133 Billion of CDO, MBS Writedowns*, ASSET-BACKED

rose nearly a quarter of a percentage point to 5.82 percent in the fourth quarter of 2007, its highest mark since 1985.[27] Seemingly every day, tales of entire neighborhoods succumbing to foreclosures due to this unshakable leech known as "Subprime" flooded the nation's newspapers.[28] Approximately one out of five subprime loans were past due in the fourth quarter of 2007 and a devastating 13 percent had already entered foreclosure proceedings.[29]

Perhaps not as emotionally jarring, but equally dismaying, is that economists' views forecasting the limit for potential future subprime losses vary to a wide degree, and seem to be continually changing.[30] One would be hard-pressed to find any authority today willing to concede that this leech, Subprime, has sucked its last drop of blood.

II. THE FEDERAL GOVERNMENT RESPONSE

A. The Bush Administration: Market Guidance and Market Encouragement

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ALERT, Jan. 18, 2008.

27. *See* Reddy & Murray, *supra* note 10.

28. *See* Gretchen Morgenson & Jonathan D. Glater, *Foreclosure Machine Thrives on Woes*, N.Y. TIMES, Mar. 30, 2008, at BU, *available at* http://www.nytimes.com/2008/03/30/business/30mills.html (citing a study by RealtyTrac that found 225,000 U.S. homes in foreclosure as of the end of February 2008, up 60 percent from a year earlier). I also credit Ms. Morgenson with associating subprime mortgage losses with the characteristics of a leech, although I am not sure if she was the first to coin the term.

29. *Id.*

30. *Compare* Janet Morrissey, *How Bad Will the Mortgage Crisis Get?*, TIME, Feb. 19, 2008, *available at* http://www.time.com/time/business/article/0,8599,1714725,00.html (citing analyst Bose George with a prediction of $250 billion in total losses and Columbia University Professor Charles Calomiris estimate of between $300 and $400 billion), *and* Rick Chung & Sonia Persaud, *Foreword: A Year of Uncertainty and Turmoil – Overview of the Subprime Mortgage Crisis and Its Effects in the Markets*, Special Edition Subprime 2007, BLOOMBERG LAW REPORTS – BANKING & FINANCE 2 (estimating that future losses could reach $300 billion), *with* Greg Ip, *Study Finds Wider Impact of Mortgage Losses*, WALL ST. J., Mar. 1, 2008, at A2, *available at* http://online.wsj.com/article/SB120433882809904921.html?mod=rss_whats_news_us_business (citing a study conducted by David Greenlaw of Morgan Stanley, Jan Hatzius of Goldman Sachs Group Inc., Anil Kashyap of the University of Chicago and Hyun Song Shin of Princeton University which estimates futures losses of approximately $400 billion).

In the spring of 2008, Treasury Secretary Henry Paulson and President George W. Bush were the strongest advocates for the position that the federal government should allow the market to correct itself, consistently warning against the consequences of over-regulation.[31] Their primary concern, which they both reiterated constantly throughout the fall of 2007, was that "[a] federal bailout of lenders would only encourage a recurrence of the problem. It's not the government's job to bail out speculators, or those who made the decision to buy a home they knew they could never afford."[32] The President summarized steps he encouraged, which included (1) short term changes to the Federal Housing Administration (FHA) allowing "qualified borrowers who are delinquent because of an interest rate reset the opportunity to refinance into an FHA-insured mortgage,"[33] (2) reforming the federal tax code to ensure that homeowners whose mortgages are modified are not taxed for the forgiven indebtedness,[34] (3) a "foreclosure avoidance initiative" offering foreclosure counseling and refinancing, and (4) "a variety of

31. George W. Bush, President of the United States of Am., Address to the Economic Club of New York (Mar. 14, 2008), http://www.whitehouse.gov/news/releases/2008/03/print/20080314-5.html (explaining the Bush administrations passage of a one time tax rebate to induce growth in the U.S. economy and warning against "law and regulation that will make it harder for the markets to recover – and when they recover, make it harder for this economy to be robust."). *See* Michael M. Phillips & John D. McKinnon, *Bush Warns Congress Over Mortgage Plans*, WALL ST. J., Mar. 15, 2008, at A2.

32. George W. Bush, President Bush Discusses Homeownership Financing (Aug. 31, 2007), *available at* http://www.whitehouse.gov/news/releases/2007/08/print/20070831-5.html; *see* George W. Bush, *Bush Blasts Congress for Not Doing More for Homeowners*, WASHINGTON WIRE: WSJ.COM (Dec. 6, 2007), http://blogs.wsj.com/washwire/2007/12/06/bush-blasts-congress-for-not-doing-more-for-homeowners/.

33. However, eligibility requirements, such as the borrower needing some equity in the property, have limited the program. *See* Economic Stimulus Act of 2008, 122 Stat. 613, § 202 (temporarily increasing the maximum limitation for FHA loans); Ben S. Bernanke, Chairman, U.S. Fed. Res., Speech At the Independent Community Bankers of America Annual Convention (March 4, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm [hereinafter Bernanke ICB Speech]. Additional FHA modernization bills have been passed by the House and proposed in the Senate. *See* Security Against Foreclosures and Education Act of 2008, 110 S. 2734 (proposed in the Senate March 7, 2008); Expanding American Homeownership Act of 2007, 110 H.R. 1852 (passed in the House on September 18, 2007).

34. *See* Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007).

actions to make the mortgage industry more transparent, more reliable and more fair . . . ."[35]

In October 2007, President Bush's administration, led by Secretary Paulson, launched the HOPE NOW Alliance, consisting of mortgage servicers (companies who accept mortgage payments and eventually distribute them to investors), lenders, and other participants in the mortgage market.[36] The mission of HOPE NOW is to find ways for homeowners who want to stay in their homes avoid foreclosure.[37] The number of participants in the alliance grew to 94 percent of the subprime mortgage servicing market, and Paulson subsequently announced an additional initiative, Project Lifeline, specifically targeting foreclosure avoidance. Commentators' immediate responses to the industry initiatives were mixed.[38] Still, encouraged by increasing voluntary coalition

35. *See* Bush, *supra* note 32.

36. *See* Statement by Sec'y Henry M. Paulson, Jr., Announcement of New Private Sector Alliance – HOPE NOW, (Oct. 10, 2007), http://www.treasury.gov/press/releases/hp599.htm [hereinafter Paulson HOPE NOW Speech]. HOPE NOW is "an alliance between counselors, servicers, investors, and other mortgage market participants to maximize outreach efforts to at-risk homeowners and help them stay in their homes." HOPE NOW Frequently Asked Questions, http://www.hopenow.com/site_tools/faqs.php.

37. *See* Paulson HOPE NOW Speech, *supra* note 36. For a detailed description of the HOPE NOW streamlined response and metrics tracking the program's results, see American Securitization Forum, Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans, Dec. 6, 2007, http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf.

38. *Compare* Michael M. Phillips et. al., *Battle Lines Form Over Mortgage Plan*, Wall St. J., Dec. 7, 2007, at A1 (confirming that many democrats view the HOPE NOW initiative as not going far enough to help homeowners avoid foreclosure) *with* Sudeep Reddy et. al, *Some Cry Foul Over Relief Plan for Borrowers*, WALL ST. J., Dec. 4, 2007, at D1, *available at* http://online.wsj.com/article/SB119673435431012677.html?mod=hps_us_whats_news ("[S]ome would-be homeowners who have been waiting for house prices to fall say the government proposal would prop up prices, and thus keep them out of the market."). *See* Henry M. Paulson, Jr., U.S. Treasury Secretary, Remarks on Housing and Capital Markets before the New York Society of Securities Analysts, (Jan. 7, 2008), http://www.ustreas.gov/press/releases/hp757.htm ("[HOPE NOW] has also received the most criticism due to the mistaken perception that it abrogates contracts. It does not. . . . Servicers will pursue the[ir] contractual obligations by pursuing all loss-mitigation options when it is in the best interest of investors, as they normally would. Investors are part of this industry-wide solution . . . .").

by market participants, Secretary Paulson continued to warn against overreaching regulation.[39]

B. The Fed: Proposed Amendments to Regulation Z

As the evidence of the scope of the fallout from subprime mortgage loan defaults continued to mount in the fall of 2007, the Fed announced its intention to actively mitigate losses.[40] In November 2007, it identified several causes of the subprime fallout, including: unemployment;[41] loosening of underwriting standards; the originate-to-distribute model enabled by investors purchasing securities backed by subprime mortgages in the secondary market;[42] resets on adjustable rate subprime

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39. *See* Comments by Secretary Paulson on Economy and Housing, Feb. 28, 2008, http://www.treasury.gov/press/releases/hp847.htm ("Homeowners who gambled in the housing market and viewed their purchase as a short term investment may choose to walk away. Those who do this are nothing more than speculators, and they are not the focus of our efforts.").

40. *See* Randall S. Kroszner, Speech At the Consumer Bankers Association 2007 Fair Lending Conference, (Nov. 5, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20071105a.htm [hereinafter Fair Lending Conf. Speech] ("These circumstances call for high degree of collaboration and innovation to identify solutions that can keep borrowers confronting foreclosure in their homes. . . . It is imperative that we work together as a financial services community to look for ways to help borrowers address their mortgage challenges . . . ."); *see also* Kroszner, Speech At the American Securitization Forum 2008 Conference, (Feb. 6, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20080204a.htm [hereinafter ASF Conf. Speech] (stating the Fed's aim to protect subprime mortgage borrowers and preserve borrower choice).

41. Kroszner, Fair Lending Conf. Speech, *supra* note 40.

42. *Id.*; Frederic S. Mishkin, Speech At the U.S. Monetary Policy Forum (Feb. 29, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm; Ben S. Bernanke, Speech at the Women in Housing and Finance Exchequer Club Joint Luncheon (Jan. 10, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm. A thorough review and analysis of the secondary market for subprime mortgage loans is beyond the scope of this Note. However, an understanding of the secondary market and its impact on the growth of subprime mortgages is critical. For an extremely helpful analysis of how securitization of subprime mortgages works and its effect on the interests of market participants see Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007). For views on rating agencies' roles in structured products, including securities backed by subprime mortgage loans, see David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory*

mortgage loans;[43] and flawed underwriting standards based on the premise that "house prices would continue to rise rapidly."[44] Additionally, Fed Chairman Ben S. Bernanke noted that the increase in supply of homes for sale and subsequent falling home prices limited subprime borrowers' ability to avoid foreclosure.[45]

In January 2008, the Fed proposed rule changes to Regulation Z[46] ("Reg Z"), which implements federal legislation already governing the mortgage market, including the Truth in Lending Act ("TILA")[47] and the Home Ownership and Equity Protection Act ("HOEPA").[48] The proposed Reg Z amendments seek to: (1) protect borrowers from "unfair, abusive, or deceptive lending and servicing practices while preserving responsible lending and sustainable homeownership"; (2) ensure that mortgage advertisements "provide accurate and balance information and do not contain misleading or deceptive representations"; and (3) provide consumers who are purchasing or refinancing homes with "transaction-specific disclosures early enough to use while shopping for a mortgage."[49] To achieve these aims, the proposed amend-

Lending to Flourish in the Secondary Mortgage Market, 33 FLA. ST. U. L. REV. 985 (2006).

43. Bernanke, *supra* note 42.

44. *Id.*

45. Bernanke ICB Speech, *supra* note 33.

46. 12 C.F.R § 226 (2003).

47. 15 U.S.C § 1601 (2001).

48. Riegle Community Development & Regulation Information Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160 (1994).

49. 73 Fed. Reg. 1672, 1672 (Jan. 9, 2008); *see* Bernanke, Speech At the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008), *available at* http://federalreserve.gov/newsevents/speech/bernanke20080314a.htm [hereinafter Bernanke NCRC Speech] ("We believe these proposed rules will help protect mortgage borrowers from unfair and deceptive practices. At the same time, we did not want to create rules that were so open-ended or costly to administer that responsible lenders would pull out of the subprime market."); Kroszner, ASF Conf. Speech, *supra* note 40 (summarizing the causes of increased defaults on subprime mortgages and explaining the goals of the Fed's changes to Regulation Z); Rick Chung & Sonia Persaud, *Federal Reserve Board Proposes Regulations to Curb Unfair or Deceptive Mortgage Lending Practices*, 1 Bloomberg Law Reports – Banking & Finance 1, 1, Feb. 2008; *see also* Sue Kirchhoff & Noelle Knox, *Fed Plan Reins In Dicey Mortgage Loans*, USA TODAY, at 3B (Dec. 18, 2007), *available at* http://www.usatoday.com/money/economy/housing/2007-12-18-fed-impact_N.htm?csp=34.

ments outline new standards for higher-priced mortgage loans.[50] If enacted, the proposed amendments would prohibit a pattern or practice[51] of lending higher-priced mortgage loans without considering the borrower's ability to repay.[52] The Fed also proposed new standards applicable to all mortgages which would limit mortgage broker compensation,[53] explicitly prohibit coercion by appraisers to inflate property values, and prohibit certain servicing practices deemed abusive.[54] Finally, the proposed amendments to Reg Z would create new standards for advertising mortgage rates and products.[55] But, what would the proposed Reg Z amendments accomplish for Americans who

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50. Higher-priced mortgage loans are closed-end home mortgages (not Home Equity Lines of Credit) with an annual percentage rate (APR) that exceeds the comparable Treasury security by 3 percent for first-lien loans or 5 percent for subordinate-lien loans. 73 Fed. Reg. at 1680; Press Release, Bd. of Governors of the Fed. Res. System (Dec. 18, 2007), http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm [hereinafter Fed. Res. Press Release].

51. "Whether a creditor had engaged in the prohibited pattern or practice would depend on the totality of the circumstances . . . . [T]he Board is not proposing to adopt a quantitative standard for determining the existence of a pattern or practice." 73 Fed. Reg. at 1688.

52. *Id.* at 1686. Consideration of repayment ability includes the borrower's current and reasonably expected income and obligations, employment and assets other than the collateral used to secure the mortgage. *Id.*; Chung & Persaud, *supra* note 49, at 2. Consideration of repayment ability should extend at least seven years from the time of origination based on fully-amortizing payments at the fully-indexed rate and income and assets that have been verified by the lender. *See* 73 Fed. Reg. at 1689-90; Chung & Persaud, *supra* note 49, at 2. The Fed has asked for comment whether lending higher-priced mortgage loans to borrowers with debt-to-income ratios at or above 50 percent should create a rebuttable presumption that the lender failed to adequately consider the borrowers ability to repay. 73 Fed. Reg. at 1689. Finally, the proposed amendments would require automatic property tax and insurance payments into an escrow account and mandate restrictions on prepayment penalties for higher-priced mortgage loans. *Id.* at 1693-98.

53. "The Board proposes to prohibit a creditor from paying a mortgage broker in connection with a covered transaction unless the payment does not exceed an amount the broker has agreed with the consumer in advance will be the broker's total compensation." 73 Fed. Reg. at 1699. Additionally, brokers would have to disclose that the consumer is paying for the broker's compensation even if all or part of the compensation comes directly from the lender and that the broker's interest may conflict with the consumer's interest. *Id.*

54. *Id.* at 1700-03.

55. *Id.* at 1704-14; Chung & Persaud, *supra* note 49, at 4-6; Fed. Res. Press Release, *supra* note 50.

are already stuck with a mortgage they cannot afford, or even worse, already face foreclosure? As Part II.C illustrates, many federal legislators believe that the Fed's response does absolutely nothing in this regard.

C. Congress: Reining in Loose Lending Standards and Stemming the Tide of Foreclosures

Federal legislators have attacked the responses of both the Fed and the Bush administration for not going far enough to aid mortgage borrowers facing foreclosure. In March 2008, Christopher J. Dodd (D-CT), Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, asserted, "Put simply, these people need help now – not just 'Hope Now.' Unfortunately, the Administration, whose lax oversight led to this crisis, has put only a flimsy plan in place that fails to offer enough of either."[56] Dodd further admonished the Bush administration for offering "only timid measures that have done little to help families keep their homes or restore confidence to financial markets. It is time for the Administration to embrace a more comprehensive, bold, and effective approach that goes to the heart of the current financial crisis – the mortgage markets."[57]

To address gaps in the federal government's response, in the spring of 2008 Dodd announced future legislation unofficially titled The Foreclosure Prevention Act of 2008.[58] The Foreclosure Prevention Act offered a bolder approach aimed at reforming the FHA by counseling homeowners facing foreclosure and helping communities deal with local abandoned or foreclosed properties.[59] Dodd proposed a further expan-

56. Release from Christopher J. Dodd, U.S. Sen. for Conn., Dodd: Foreclosure Data Deeply Disturbing (Mar. 6, 2008), http://banking.senate.gov/public/index.cfm?FuseAction=Articles.Detail&Article_id=8ff25f26-7ee3-4276-97c7-1e34e41190af&Month=3&Year=2008.

57. Statement of Christopher J. Dodd, U.S. Sen. for Conn., Dodd Statement on Markets, Fed Action (Mar. 17, 2008), http://banking.senate.gov/public/index.cfm?FuseAction=Articles.Detail&Article_id=47540c2a-9c6a-455e-919a-a032fb6d7255&Month=3&Year=2008.

58. This is the same title as a bill introduced by Senator Harry Reid (D-NV) on February 13, 2008. *See* S. 2636, 110th Cong. (as introduced by Sen. Reid, Feb. 13, 2008). Reid's proposed bill and Dodd's forthcoming proposed bill are not identical. This Part focuses on Dodd's Foreclosure Prevention Act; however, other proposed legislation by Reid will be analyzed as well.

59. Christopher J. Dodd, U.S. Sen. for Conn., and Richard Shelby, U.S. Sen. for

sion of the FHA loan program to a maximum of 110% of the area median home price or 132% of the Fannie Mae or Freddie Mac (GSE) loan limit, whichever is lower.[60] The Foreclosure Prevention Act also sought $10 billion for Federal tax-exempt private activity bonds to refinance subprime loans, $4 billion in Community Development Block Grant Funds to assist communities hardest hit by foreclosures, $100 million for additional foreclosure avoidance counseling, and further assistance to homeowners and homebuilders in the form of tax modifications.[61]

Echoing Dodd's call for greater federal government response, [62] in March 2008 Barney Frank (D-MA), Chairman of the House Committee on Financial Services, announced the proposed FHA Housing Stabilization & Homeownership Retention Act,[63] providing, according to Frank's estimates, sufficient funds to allow the FHA to refinance up to $300 billion of mortgages on homes at risk of foreclosure.[64] Frank's bill would also provide $10 billion in non-recourse, zero-interest loans and grants to the state for the purchase of vacant and foreclosed homes.[65] It would require existing lenders to accept "a substantial write-down of principal," and that the new FHA loan be one that the borrower can "reasonably be expected to pay."[66] Upon the sale of the property or refinancing of the mortgage, the FHA would be entitled to a minimum

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Ala., Dodd, Shelby Announce Bipartisan Housing Stimulus Package (Apr. 2, 2008), http://dodd.senate.gov/index.php?q=node/4351.

60. *Id.*

61. *Id.*

62. "I am pleased that Secretary Paulson and the Administration continue to encourage the private sector to take reasonable steps to minimize foreclosures. Obviously much more is needed, but I welcome the progress that has been made." Press Release, Barney Frank, Chairman of H. Comm. on Fin. Servs., Frank Statement on HopeNow Alliance Announcement (Jan. 18, 2008), http://www.house.gov/apps/list/press/financial svcs_dem/press011807.shtml.

63. FHA Housing Stabilization & Homeownership Retention Act of 2008, H.R. 5830, 110th Cong (2008) [hereinafter Housing & Homeownership Act].

64. Press Release, H. Comm. on Fin. Servs. Frank Announces New Economic, Mortgage and Housing Rescue Proposal (Mar. 13, 2008), http://www.house.gov/frank/fha0308.html (last visited Apr. 5, 2008).

65. The non-recourse, zero-interest loans would be required to go to families with incomes no greater than 140 percent of the area median income and in the case of owner-occupied properties the loan must be repaid with two years. Housing & Homeownership Act, *supra* note 63.

66. *Id.*

exit fee of 3.0 percent of the FHA loan balance.[67] Eligibility for the FHA mortgage, however, could be limited by the date the mortgage was obtained, mandatory income documentation on the new FHA mortgage, and other factors.[68] Frank's bill would also require additional funds for new oversight, annual audit, and semi-annual reporting capacity.[69]

In assessing the Frank-Dodd FHA Acts,[70] one should certainly consider the economic impact the legislation could have on mortgage borrowers who are facing foreclosure, as well as the potential economic impact on the nation as a whole. Part IV of this Note suggests, however, that in analyzing the Frank-Dodd FHA Acts and the other responses summarized in this Part, perhaps the very nature of law in America requires the federal government's responses to extend beyond economic considerations. Should the soundness of the Frank-Dodd FHA Acts be judged on whether they accomplish a morally just result, even if such a result comes at a tremendous economic cost? If so, what is the morally optimal result these and the other federal responses should aim to achieve? The remainder of this Part will discuss several other federal responses to the subprime meltdown. Part IV will then attempt to shed light on these questions.

Taking a forward-looking approach similar to the Fed's, Representative Bradley Miller (D-NC) introduced the Mortgage Reform and Anti-Predatory Lending Act of 2007[71] (the "Miller Act"). The Miller Act, passed by the House of Representatives on November 15, 2007, sought to significantly expand on the Fed's amendments to Regulation Z.[72] The Miller Act would: (1) establish a national Mortgage

67. *Id.* The FHA may be entitled to an additional percentage of profits if the sale or refinancing occur within five years of origination of the FHA loan.

68. Proposed eligibility criteria included: (1) the property must be a owner-occupied primary residence; (2) the refinanced mortgage must have been originated between January 1, 2005 and July 1, 2007; (3) the borrower's debt-to-income ratio must have been at least 40 percent as of March 1, 2008; (4) existing lenders must write-down enough to allow a loan loss reserve amount of at least 5 percent for the FHA; (5) FHA loans must underwritten using the current appraised home values and fully documented income of the borrower; and (6) no private liens may be subordinated behind the new FHA loan. *Id.*

69. *Id.*

70. I will refer to the proposed FHA legislation by Frank and Dodd as the Frank-Dodd FHA Acts.

71. H.R. 3915, 110th Cong. (as passed by House, Nov. 15, 2007).

72. Chung & Persaud, *supra* note 49, at 1. H.R. 3915 was passed by the House of

Licensing System and Registry;[73] (2) impose a minimum duty of care on all "loan originators"[74] to present to clients mortgages that they have "a reasonable ability to repay"[75] and that provide a "net tangible benefit" for borrowers who are refinancing;[76] and (3) establish further restrictions on all mortgages that are not a "qualified mortgage"[77] or "qualified safe harbor mortgage."[78] Mortgages that are not qualified mortgages or qualified safe harbor mortgages would not be allowed to contain prepayment penalties; nor would originators be permitted to receive or pay, directly or indirectly, any incentive compensation that is based on or varies with

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Representatives on November 15, 2007 and then referred to the Senate Committee on Banking, Housing and Urban Affairs. As of March 29, 2008 no further action on the bill has been published.

73. Requires all "loan originators," defined as any person who takes a residential mortgage application, assists a consumer in the applying for a mortgage, or offers or negotiates terms of a mortgage for direct or indirect compensation, to first obtain registration as a loan officer or State-licensed loan originator. *Id.* §§ 101, 103. Mandates waiting periods for license renewal following revocation or conviction of a felony and minimal education requirements for registrants. *Id.* §§ 104, 129A.

74. *See* definition cited *supra* note 73.

75. *Id.* § 129A(2)(B)(i). Ability to repay shall be based on consideration of duly verified: (1) credit history, (2) present and reasonably certain future income, (3) debt, (4) employment, and (5) "other financial resources" other than equity in the home used as collateral to obtain the mortgage. *Id.* § 129B(a)(3). Further, a "good faith determination based on verified and documented information" that the borrower has a reasonable ability to repay the mortgage, plus all applicable taxes, insurance and assessments, must be based on the mortgage's "fully indexed rate" and fully amortizing payments. *Id.* §§ 129B(a)(1), 129B(a) (4)(D)(iii). "Fully indexed rate" is defined as prevailing rate plus the margin that will apply after any introductory rate has expired. *Id.* § 129B(a)(5).

76. The Fed shall be called upon to proscribe regulations to define the term "net tangible benefit." *Id.* § 129B(b).

77. "Qualified mortgages" are first lien mortgages with a rate less than or equal to: (1) the yield on a treasury security with a comparable maturity plus 300 basis points, or (2) the "most recent conventional mortgage rate," as establish by federal regulation, plus 175 basis points. *Id.* § 129B(c)(3). The thresholds listed above are increased by 200 basis points for all subordinate liens. *Id.*

78. "Qualified safe harbor mortgages" are any residential loans: (1) for which the borrower's income is fully documented and verified, (2) underwriting is based on the "fully indexed rate," (3) allow no opportunity for negative amortization at time over the term of the loan, (4) require a fixed payment of principal and interest for at least five years, (5) have a margin of no greater than 300 basis points over a "single generally accepted interest rate index" and (6) are issued to borrowers whose proposed debt coverage ratio does not exceed a threshold to be determined by federal regulators. *Id.*

the terms of any mortgage that is not a qualified mortgage.[79] Therefore, for any mortgage that fails to meet the criteria of a qualified mortgage, lenders would no longer pay higher commissions to brokers for loans with higher interest rates. This would eliminate the broker's interest in directing the borrower toward a loan with a higher interest rate simply so that the broker may receive a higher commission from the lender.

Any creditor that is found to violate the Miller Act would be allowed ninety days to cure.[80] Failure to cure would provide the borrower with a defense to foreclosure and allow the borrower to bring a civil action against the creditor with a statute of limitations of three years for fixed-rate mortgages, or up to six years for adjustable rate mortgages.[81] However, if the seller or assignor makes representations or warranties that no mortgages being assigned or securitized are not qualified mortgages or safe harbor mortgages, liability would not attach to the assignee or securitizer where they exercise reasonable due diligence in verifying these representations and warranties.[82] The Miller Act also sought new disclosure requirements and new restrictions on "high-cost mortgages," including mandatory pre-loan counseling.[83] The requested funding for the Miller Act was $160 million spread over five

79. *Id.* §§ 129B(f), 129A(b)(1).

80. *Id.* § 129B(d)(1)(B).

81. Civil action could result in the rescission of the loan, plus the borrower's costs "as a result of the violation and in connection with obtaining a rescission," and reasonable attorney's fee. *Id.* at § 129B(e) (describing the borrower's defense to foreclosure in the event of a violation).

82. *Id.* § 129B(d).

83. Required disclosures included the rate, monthly mortgage payment and payment to any escrow account for property taxes and insurance, all settlement charges, any fees paid to the originator by the borrower and any compensation received by the originator from the creditor based on the interest rate of the mortgage. *Id.* § 213. The Miller Act defined "high cost mortgages" as those which, among other criteria, either: (1) exceed a rate greater than the yield on a treasury security with a comparable maturity plus 800 basis points for first lien mortgages or 1000 basis points for subordinate lien mortgages, (2) the points and fees, including all compensation paid directly or indirectly to a mortgage broker and prepayment penalties payable under the loan, associated with the mortgage exceed five percent of the total transaction, or (3) have prepayment penalties that exceed 36 months in duration or exceed two percent of the amount prepaid. *Id.* § 301; Chung & Persaud, *supra* note 49, at 7, n.8. A creditor would not be allowed to extend a "high-cost mortgage" to any borrower before certifying that the borrower has received counseling from an approved mortgage counselor. *Id.* § 303.

years.

On December 12, 2007 Senator Harry Reid (D-NV) introduced the "Home Ownership Preservation and Protection Act of 2007"[84] (the Reid Act) to the Senate. Similar to the Miller Act, for all "subprime"[85] and "nontraditional"[86] mortgages, the Reid Act would: (1) create a rebuttable presumption that a lender failed to make the required reasonable assessment of the borrower's ability to repay the loan if the proposed total monthly debt exceeds 45% of the borrower's monthly gross income;[87] (2) prohibit any prepayment penalty provision;[88] (3) prohibit offering any compensation directly or indirectly to the originator that varies with the terms of the loan, including the rate;[89] and (4) require a "net tangible benefit" to the borrower.[90]

Reid, like Miller, sought to eliminate any conflict of interest between the broker and the borrower that could result in the borrower obtaining a mortgage with a higher interest rate or other non-optimal terms. The Reid Act would also impose a fiduciary duty on mortgage brokers for all mortgage loans requiring brokers to "act in the best interest of the borrower and in the utmost good faith toward the borrower, and refrain from compromising the rights or interests of the borrower in favor of the rights or interests of another, including a right or interest of the mortgage broker . . . ."[91] Further, the Reid Act would impose a duty on lenders and loan servicers to mitigate losses before

84. S. 2452, 110th Cong. (2007).

85. "Subprime mortgage loan" is defined in the Reid Act as a "home mortgage loan in which the annual percentage rate exceeds the greater of the thresholds determined" by the Treasury Securities Rate Spread (defined therein) or the Conventional Mortgage Rate Spread (defined therein). *Id*. § 2.

86. "Nontraditional mortgage loan" is defined in the Reid Act as a "home mortgage loan that allows consumers to defer payment of principle or interest." *Id.*

87. S. 2452, 110th Cong. § 129A(a) (2007).

88. *Id.* § 129A(c).

89. *Id.* § 129A(d). Compensation that varies with the amount of the loan is permissible, however. *Id.*

90. *Id.* § 129A(e). "Net tangible benefit" shall be defined by federal regulation.

91. *Id.* § 129B(b). For all mortgage loans, all mortgage originators shall also "act in good faith and with fair dealing in any transaction, practice, or course of business in connection with the originating of any home mortgage loan" and "make *reasonable efforts* to secure a home mortgage loan that is *appropriately advantageous to the borrower* . . . ." *Id.* § 129B(a) (emphasis added). In connection with the imposed duties to act in the borrower's interests, originators would be required to verify all sources of the borrower's income for all mortgage loans. *Id.* § 129B(d).

initiating foreclosure.[92] Failure to mitigate losses would constitute a defense to any foreclosure and establishes liability for the lender or loan servicer of any actual damages plus a reasonable attorney's fee.[93]

Moreover, in contrast with the Miller Act, assignees and holders of security interests in connection with subprime or nontraditional mortgages would be liable under any action that the borrower may bring against the creditor or originator for breach of fiduciary duty or failure to mitigate losses.[94] Violation of the Reid Act could result in rescission for up to six years from the date of consummation and civil liability for up to three years from consummation.[95] In lieu of rescission, the borrower would have the option to force the lender, servicer, or assignee to modify or refinance the mortgage under terms that would not breach the imposed fiduciary duty at the time of the transaction, plus pay all costs and reasonable attorney's fees.[96] Finally, the Reid Act would allow for transitive liability to lenders for the acts of mortgage brokers.[97] The requested funding for the Reid Act was equal to that of the Miller Act: $160 million spread over five years.[98]

In September 2007, Miller also introduced the Emergency Home Ownership and Mortgage Equity Protection Act of 2007 (the "Miller Bankruptcy Act") to the House of Representatives.[99] The Miller Bankruptcy Act would allow bankruptcy judges to modify certain loans to subprime homeowners facing foreclosure.[100] Similar legislation was also introduced in the Senate.[101] However, as of the spring of 2008 the

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92. *Id.* § 129D(h) ("A lender or loan servicer shall not initiate a foreclosure of a home mortgage loan unless that lender or loan servicer has . . . offered, *whenever feasible*, a repayment plan, forbearance, loan modification, or other option to assist the borrower in bringing his or her delinquent account into arrears.") (emphasis added).

93. *Id.* § 129D(h), (j).

94. *Id.* § 704(f).

95. *Id.* §§ 702(a), 703(b) and (d).

96. *Id.* § 705(h).

97. *Id.* § 707(i). This provision is limited to subprime, nontraditional and "high-cost mortgages." High-cost mortgages are defined in the Reid Act as "consumer credit transaction[s] that [are] secured by the principle dwelling of a consumer, other than a reverse mortgage transaction." *Id.* § 101.

98. *Id.* § 901.

99. H.R. 3609, 110th Cong. (2007).

100. *Id.* § 3.

101. *See* S. 2133, 110th Cong. (2007); S. 2136, 110th Cong. (2007).

proposed bankruptcy legislation had not passed the House or the Senate and did not appear to be gaining much traction in either.

D. Clinton and Obama: Federal Funds to Those Hardest Hit

In the spring of 2008, Democratic presidential primary candidate Hillary Clinton and President-elect Barack Obama each proposed plans to help homeowners avoid foreclosure.

Senator Clinton consistently has voiced her intention to allocate federal funds to help borrowers and local governments avoid foreclosures.[102] Indeed, Clinton has done more than just voice strong support for the Frank-Dodd FHA Acts. On March 24, 2008, she proposed the immediate appointment of an Emergency Working Group on Foreclosures comprised of non-partisan economists, a ninety-day moratorium on foreclosures, and new legislation to clarify legal liability for mortgage servicers who modify subprime loans to help avoid foreclosures.[103] Clinton's previous plan called on Wall Street banks to adopt a five-year freeze on interest rates for all subprime mortgages.[104] Her revised plan, called Protect American Homeowners, did not explicitly

102. *See* Press Release, Hillary for President, Hillary Clinton Calls on Wall Street to Shoulder Responsibility for the Foreclosure Crisis (Dec. 5, 2007), http://www.hillaryclinton.com/news/release/view/?id=4532 [hereinafter Clinton Foreclosure Crisis Press Release] (calling for a Community Support Fund of up to $5 billion to "help hard-hit communities and distressed homeowners endure the foreclosure crisis . . . ."). Senator Clinton has since revised that number, and it now stands at a proposed $30 billion in funds for states and localities "hard hit by this crisis." Press Release, Hillary for President, Hillary Clinton Delivers Remarks on Halting the Housing Crisis (Mar. 24, 2008), http://www.hillaryclinton.com/news/release/view/?id=6700 [hereinafter Clinton Housing Crisis Press Release] ("This money could be used to purchase foreclosed or distressed properties, which cities and states could then resell to low-income families or convert into affordable rental housing."); *see* Press Release, Hillary for President, A Second Stimulus Package Focused on Housing (Mar. 20, 2008), http://www.hillaryclinton.com/news/release/view/?id=6644 [hereinafter Clinton Stimulus Press Release] ("Senator Clinton's $30 billion Emergency Housing Fund is designed to administer funds quickly and effectively to state, local and community groups to stem further foreclosures and counteract negative economic impacts in these communities.").

103. Clinton Housing Crisis Press Release, *supra* note 102.

104. In December 2007, Clinton called on Wall Street to adopt a 90-day foreclosure moratorium and a five year freeze on the interest rates of subprime adjustable rate mortgages, and to provide status reports on loan modifications. Clinton Foreclosure Crisis Press Release, *supra* note 102.

call for a voluntary five-year rate freeze provision.[105] However, she has called for legislation ensuring that servicers who modify subprime loans to avoid foreclosure will not be found liable. This may be an attempt to push the rate-freeze onto investors who have not been volunteering. I will refer to Clinton's responses as the Clinton Plan.[106]

Not going as far as Clinton purportedly would, Obama proposed a plan that "will create a fund to help people refinance their mortgages and provide comprehensive supports to innocent homeowners."[107] Obama's plan also called for funds to assist homeowners in selling homes that are "simply too expensive for their income levels."[108] New disclosure requirements, criminal penalties for mortgage professionals who commit fraud, and foreclosure counseling for homeowners were also included in Obama's plan.[109] Obama would partially pay for his fund by increasing "penalties on lenders who acted irresponsibly and committed fraud."[110] Obama, however, must therefore assume that such lenders will still be solvent when his plan goes into effect. Further, any remaining funds necessary to implement his plan were not expressly accounted for as of the spring of 2008.

III. A LEGAL PHILOSOPHICAL ANALYSIS: TOO FAR OR NOT FAR ENOUGH?

Senator Clinton has been one of the loudest proponents of the

105. *See* Press Release, Hillary for President, Hillary Clinton's Plan to Protect American Homeowners (Mar. 24, 2008), http://www.hillaryclinton.com/news/release/view/?id=6691.

106. Clinton Foreclosure Crisis Press Release, *supra* note 102. ("If Wall Street does not voluntarily agree to the three-step plan, and the crisis builds, Hillary will consider legislation that offers protection to mortgage servicers and others who work with borrowers to modify their mortgages.").

107. BarackObama.com, Barack Obama's Economic Agenda: Keeping America's Promise, http://obama.3cdn.net/8f478c5e1bb07ca0b1_sh1umv2zy.pdf [hereinafter Obama Economic Agenda] (last visited Mar. 29, 2008); BarackObama.com, Protecting Homeownership & Cracking Down on Mortgage Fraud, http://www.barackobama.com/pdf/MortgageFactSheet.pdf [hereinafter Obama Protecting Homeownership] (last visited Mar. 29, 2008).

108. Obama Economic Agenda, *supra* note 107; Obama Protecting Homeownership, *supra* note 107.

109. Obama Economic Agenda, *supra* note 107; Obama Protecting Homeownership, *supra* note 107.

110. Obama Economic Agenda, *supra* note 107; Obama Protecting Homeownership, *supra* note 107.

Dodd-Frank FHA Bills.[111] According to Clinton, that legislation "is not a bailout. It is a sensible way for all actors – lenders, investors, servicers and borrowers – to share responsibility, keep families in their homes and stabilize our communities and our economy."[112] Clinton rejected the most common reason for disapproval of the federal government's responses thus far – the fear of moral hazard stemming from a government bailout of market participants who bet wrong. Part III.A will flesh out the moral hazard argument further. The remaining sections of Part III will then illustrate that if the debate over the federal government's responses is limited to the issue of economic moral hazard in the future, a failure to consider valuable and well-developed theories of what the law is, and what the law ought to achieve, may result.

A. Moral Hazard and Market Efficiency

According to Fed Chairman Ben Bernanke, when the government "overly interferes" with the marketplace, there is a potential for:

> [a] so-called moral hazard that can affect future economic decisions and transactions. It is very plausible to suggest that if the government bails everyone out of this mess, that we will continue to bail out bad actors in the future, and any market discipline that currently remains will further erode.[113]

Bernanke's has been one of the loudest voices warning that government intervention may lead to moral hazard.[114]

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111. *See, e.g.*, Press Release, Hillary for President, Hillary Clinton Announces Support for New Action on the Housing Crisis (Mar. 13, 2008), http://www.hillaryclinton.com/news/release/view/?id=6515 [hereinafter Clinton New Action Press Release]; Clinton Housing Crisis Press Release, *supra* note 102; Press Release, Hillary for President, Clinton Calls For Bold Action To Halt Housing Crisis (Mar. 24, 2008), http://www.hillaryclinton.com/news/release/view/?id=6693.

112. Clinton New Action Press Release, *supra* note 111.

113. *The Near-Term Economic Outlook For The U.S. Economy: Hearing Before the H. Comm. on the Budget*, 110th Cong. 20 (2008) (testimony of Ben S. Bernanke, Chairman, Fed. Res. Bd.).

114. *See, e.g.*, *id.* ("It's not our intention – either as a central bank or as a regulator – to protect those who made mistakes from the consequences of those mistakes."); Bernanke ICB Speech, *supra* note 33 ("Concerns about fairness and the need to minimize moral hazard add to the complexity of the issue; we want to help borrowers in trouble, but we do not want borrowers who have avoided problems through responsible

In fact, moral hazard may be presented as a counter-argument to every congressional bill proposed to help subprime borrowers. Economist David C. John[115] has criticized the Frank-Dodd FHA Bills for creating a moral hazard by eliminating consequences for poor lending practices, forcing taxpayers to pay for increases in future FHA mortgage defaults, rewarding homeowners who made speculative investments, and creating the perception that "it is acceptable to renege on an obligation because a government buyout will cut your losses."[116] John claims that all legislation that has been proposed to date would create moral hazard; Congress should resist the pressure to "do something" and instead allow the market to correct itself.[117]

Analysis of potential moral hazard tends to be largely economic in nature, with the promotion of market efficiency as the primary objective.[118] Scholars present arguments for more or less government regulation based on efficiency grounds. On the one hand, greater regulation may increase efficiency by deterring fraud and misleading trading practices, redistributing information more evenly across market participants, and creating compulsory disclosure duties.[119] Promoting market efficiency and maintaining market integrity have been key motivating factors in the Fed's response to subprime mortgage losses.[120]

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financial management to feel that they are being unfairly penalized.").

115. David C. John – Staff Page, http://www.heritage.org/about/staff/DavidJohn.cfm.

116. *See* David C. John, *Frank-Dodd Approach Won't Fix the Mortgage Mess*, The Heritage Foundation, Mar. 24, 2008, http://www.heritage.org/Research/Economy/wm1865.cfm.

117. *Id.*

118. *See, e.g.*, Varouk A. Aivazian et al., *The Law of Contract Modifications: The Uncertain Quest for a Benchmark of Enforceability*, *in* READINGS IN THE ECONOMICS OF CONTRACT LAW 201-06 (Victor P. Goldberg ed., 1989) (government intervention in private contracts allows parties "to realize the static efficiency gains from recontracting relative to breach, [and] creates long-run or dynamic efficiency losses as a result of the attenuation of incentives to efficient risk reduction or insurance, as well as generating transaction cost on recontracting.").

119. HUGH COLLINS, REGULATING CONTRACTS 279; *see* JULES L. COLEMAN, MARKETS, MORALS, AND THE LAW 68 (1988) ("Normative law-and-economics is the home of reformers. Existing legal rules are evaluated and new ones fashioned in terms of their economic efficiency.").

120. *See* Kroszner, Speech At the American Securitization Forum 2008 Conference (Feb. 4, 2008), http://www.federalreserve.gov/newsevents/speech/kroszner20080204a.htm [hereinafter ASF Conf. Speech] ("Protecting borrowers with responsible under-

Yet, efficiency arguments are also used in opposition to bright-line regulations that restrict markets, such as requiring documentation of income and minimum debt-to-income ratios.[121] Firms may modify contracts on their own rather than attempt to rely on the precise terms originally bargained for due to concerns about their reputation, making government regulation unnecessary.[122] Accordingly, many argue that the government should step back and allow markets to fix themselves through firm-initiated approaches, such as the HOPE NOW alliance,[123] adding that increased regulation will only prolong losses and market inefficiency.[124]

In Parts III.B, III.C and III.D, this Note will assess whether the economic moral hazard and market efficiency inquiry disregards necessary considerations in determining how the federal government should respond to the subprime mortgage meltdown.

B. The Economic Approach to Law: Efficiency is King

For followers of the Economic Approach, the efficiency analysis independently satisfies the inquiry into what the law is and what the law should be. According to Seventh Circuit Chief Judge Richard Posner:

The rules assigning property rights and determining liability, the procedures for resolving legal disputes, the constraints imposed on law enforcers, methods of computing damages and determining the availability of injunctive relief – these and other important elements of the legal system can best be understood as attempts, though rarely

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writing standards also protects the integrity and proper functioning of the mortgage market by increasing investor confidence."); Bernanke ICB Speech, *supra* note 33 ("A major thrust of our efforts is sharing relevant and timely data analysis of mortgage delinquencies with community groups and policymakers to efficiently target resources to areas most in need."); Bernanke NCRC Speech, *supra* note 49 (summarizing the Fed's "community affairs" effort to stem foreclosures by providing research, data analysis and contact information to local organizations).

121. *See, e.g.*, Collins, *supra* note 119, at 176 ("[T]he efficient and efficacious implementation of regulation against unfairness and unjust power relations in contracts tends to require more open-ended standards.").

122. *See* Collins, *supra* note 119, at 174.

123. *See* John, *supra* note 116.

124. The Bush administration championed this view throughout 2007 and the spring of 2008. *See supra* Part II.A and corresponding footnotes.

acknowledged as such, to promote an efficient allocation of resources.[125]

Posner asserts that most areas of law, including common law and statutory fields, are driven by a consistent economic logic.[126] This Note does not seek to evaluate the adequacy of Posner's philosophy of law. It does assert, however, that those who use economic efficiency grounds as the basis for their attacks or defenses of the federal responses must explicitly align themselves with Posner's Economic Approach. To the best of my knowledge, this step has not been taken in the scholarly analyses to date. The remainder of this Note will examine whether the public debate has thus far overlooked several fundamental questions in determining the degree to which the federal government should respond to the subprime crisis.

C. Legal Formalism: Certainty and the Bedrock Principal of Freedom of Contract

The philosophy of law known as Legal Formalism promotes the theory that clear rules let parties know where they stand, thereby allowing for planning by market participants and expeditious dispute resolution.[127] Market participants seek maximum certainty under the law, "so that it should be clear when a binding contract has been made, and what precise obligations have been incurred."[128] Legal philosopher Lon Fuller claims that laws promoting certainty and autonomy in private contract are natural results of human social interaction.[129] Fuller further states, "This is particularly true in the area of commercial transactions where repetitive dealings tend to create standardized expectations."[130]

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125. Richard A. Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757, *in* THE ECONOMIC STRUCTURE OF THE LAW: THE COLLECTED ECONOMIC ESSAYS OF RICHARD A. POSNER VOLUME ONE 44, (Fancesco Parisi ed., 2000) (citing Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974)).

126. *See id*. at 45.

127. *See* Collins, *supra* note 119, at 175.

128. *Id.*

129. *See* Lon L. Fuller, *The Role of Contract in the Ordering Processes of Society Generally*, *in* THE PRINCIPLES OF SOCIAL ORDER 173-74 (Kenneth I. Winston ed., 1981) ("In confronting perplexities of this sort there is a natural tendency for the mind to seek out simplistic formulas that will shape our language, and with it our thought, in ways offering some reassurance that things are not, after all, utterly chaotic or so complicated as to be inaccessible to analysis.").

130. *Id.* at 176.

Even under a strictly Formalist system of law, the losing parties in any dispute may claim that the government has treated them unfairly by adjudicating against them under authority of a rule or law that, while purportedly formal, did not give sufficient notice that their actions were unlawful. As Fuller points out, "the disadvantaged applicant will feel that government has cheated on its own rules while the allocative agency will conceive of itself as discharging a function that simply cannot be rule-bound but requires a broad discretion to meet shifting contingencies and changed conditions."[131] But, Fuller continues, a shift in contingencies or change in circumstances ultimately enforces the notion that "the lawgiver is properly regarded as promising to judge the citizen's actions by rules he has announced in advance as governing those actions."[132] Therefore, one may consider how the proposed federal responses rank in creating clear rules that, announced in advance, enforce the expectations of the various parties in the subprime mortgage market.

Under a Legal Formalist philosophy, opponents of the discussed federal government responses may claim that the proposed legislation and regulation would introduce an unacceptable level of uncertainty into the mortgage market. This uncertainty would derive from various sources, including the creation of (1) "reasonable" standards,[133] (2) duties to act in "good faith,"[134] (3) rebuttable presumptions,[135] and (4) rate freezes.[136] Thus, proponents of Legal Formalism would argue that, regardless of whether these indeterminates are economically efficient, the federal government's responses stray from what the law should hold as primary objectives – certainty and clarity.

D. Legal Positivism: "Open Texture" and the Need for Morality in Law?

Standing in stark contrast to Fuller's Legal Formalism, professor and renowned legal philosopher H.L.A. Hart, has identified "two connected handicaps whenever we seek to regulate, unambiguously and in advance, some sphere of conduct by means of general standards to be

131. *Id.* at 179.
132. *Id.*
133. *See* H.R. 3915 § 129B(a),(d) (2007); S. 2452 §§ 129B(d), 707(i) (2007).
134. *See* S. 2452 § 129B(b) (2007).
135. *See* S. 2452 § 129A(a) (2007).
136. Clinton Foreclosure Crisis Press Release, *supra* note 102.

used without further official direction on particular occasions. The first handicap is our relative ignorance of fact: the second is our relative indeterminacy of aim."[137] Hart claims that these handicaps will prevent Legal Formalism from ever attaining the "certainty" it seeks. Rather, Hart argues that the law must be characterized by an "open texture" ("Hart's Open Texture"):[138]

> [A]ll [legal] systems, in different ways, compromise between two social needs: the need for certain rules which can, over great areas of conduct, safely be applied by private individuals to themselves without fresh official guidance or weighing up of social issues, and the need to leave open, for later settlement by an informed, official choice, issues which can only be properly appreciated and settled when they arise in a concrete case.[139]

Dismissing Fuller's aspirations for certainty and clarity, Legal Positivists may claim that the Reg Z amendments, the Miller Act and the Reid Act, while creating new rules[140] and duties[141] in the marketplace, satisfy Hart's Open Texture test. Under Hart's approach, then, the federal government's responses, even while failing to deliver strictly concrete rules, rightfully constitute a "settlement by an informed, official choice"[142] and exemplify "a need for the further exercise of choice in the application of general rules to particular cases."[143] Legal Formalists may counter that the uncertainties introduced by the federal government's responses fail to uphold the law's fundamental objective of providing transparent rules upon which parties may rely.[144] Hart claims, however, that the need to exercise such a choice is unavoidable.

137. H.L.A. HART, THE CONCEPT OF LAW 128 (Oxford Univ. Press Inc. 2d Ed., 1961).

138. *Id.* at 127-28 ("Whichever device, precedent or legislation, is chosen for the communication of standards of behaviour, these, however smoothly they work over the great mass of ordinary cases, will, at some point where their application is in question, prove indeterminate; they will have what has been called an *open texture*.").

139. HART, *supra* note 137, at 130.

140. Such as minimum debt-to-income ratios and mandatory verification of income. *See* discussion *supra* Part II.B and Part II.C.

141. Such as new duties of care and liability for assignees of mortgages. *See* discussion *supra* Part II.C.

142. HART, *supra* note 137, at 130.

143. *Id.* at 129.

144. *See* note 138 *et seq.* and corresponding text.

Formalism, Hart asserts, "seeks to disguise and to minimize the need for such choice, once the general rule has been laid down."[145]

Therefore, Positivists may direct Hart's arguments at those who oppose the federal government's responses on certainty grounds, claiming that the certainty argument fails to account for the need to exercise further choice when unforeseen cases, or mounting foreclosures, present themselves. But if certainty and clarity are not the law's purpose – or at least not the law's only purpose – what else is there?

While Hart's Open Texture may be considered the backbone of Legal Positivism, what Legal Positivism actually entails in practice has been debated for decades.[146] The role of morality in determining what the law is and what it ought to be has divided Legal Positivists into two factions.[147] Inclusive, or Soft, Legal Positivism "accepts that moral terms can be part of the necessary or sufficient criteria for legal validity in a legal system, but insist[s] that the use of moral criteria is *contingent* – and derived from the choices or actions of particular legal officials – rather than part of the nature of law . . . ."[148] Hart acknowledged that his doctrine "may incorporate as criteria of legal validity conformity with moral principles or substantive values . . . ." and therefore may be aligned with Soft Positivism.[149] Hard Legal Positivism, in contrast,

145. HART, *supra* note 137, at 129. Hart claims that Legal Formalism is an attempt "to secure a measure of certainty or predictability at the cost of blindly prejudging what is to be done in a range of future cases, about whose composition we are ignorant." *Id.* at 129-30.

146. Brian H. Bix, *Legal Positivism*, *in* THE BLACKWELL GUIDE TO THE PHILOSOPHY OF LAW AND LEGAL THEORY 31 (Martin P. Golding & William A. Edmundson eds., Blackwell Publishing Ltd, 2005) ("[L]egal positivism's distinctiveness and its point have become more elusive, even as it has become more established with English-language analytical jurisprudence – perhaps *because* it has become more established in analytical jurisprudence.").

147. *See* Scott J. Shapiro, *The "Hart-Dworkin" Debate: A Shore Guide for the Perplexed*, *in* RONALD DWORKIN CONTEMPORARY PHILOSOPHY IN FOCUS 23-50 (Arthur Ripstein ed., Cambridge Univ. Press 2007); Bix, *supra* note 146, at 42-44 (citing Ronald Dworkin, LAW'S EMPIRE, at 31-150, and Ronald Dworkin, TAKING RIGHTS SERIOUSLY, at 22-28).

148. Bix, *supra* note 146, at 38.

149. HART, *supra* note 137, at 250. Hart has also claimed that a penumbra of uncertainty surrounds all legal rules, therefore application of a rule to specific cases in the "penumbral area" cannot be a matter of logical deduction, but rather "The intelligent decision of penumbral questions is one made not mechanically but in light of aims, purposes, and policies though not necessarily in light of anything we would call moral

holds that "moral criteria can be neither sufficient nor necessary conditions for the legal status of a norm."[150] This split among Legal Positivists introduces a critical question when considering the millions of Americans facing foreclosure on homes they purchased but could not afford: should morality considerations matter when determining the propriety of the federal government's responses? How might any of the proposed federal regulations and legislation be defended on morality grounds?

Of course, there will always be debate over what "morality" means.[151] According to Hart, "[t]he equal extension to all of the fundamental legal protections of person and property is now generally regarded as an elementary requirement of the morality of political institutions, and the denial of these protections to innocent persons, as a flagrant injustice."[152] Thus, proponents of new disclosure requirements in the Reg Z amendments[153] and proposed legislation[154] may assert that the government's responses, by requiring information to be disclosed equally, achieve the moral aim of fairly protecting all parties' interests.

However, Hart further asserts that "no man could regard as morally acceptable the withholding from others, with needs and in circumstances similar to his own, of those benefits which he would not wish to be withheld from himself."[155] Therefore, perhaps it is here, in the realm of morality, that opponents may present the strongest argument against the

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principles." H.L.A. HART, ESSAYS IN JURISPRUDENCE AND PHILOSOPHY 64, 67-71 (Oxford Univ. Press 1983). Therefore, Hart argues that morality may be a factor in deciding what the law ought to be, but is not necessarily always a factor.

150. Bix, *supra* note 146, at 36.

151. *See, e.g.*, HART, ESSAYS IN JURISPRUDENCE AND PHILOSOPHY, *supra* note 149, at 343-64.

152. *Id.* at 116. Even when equal protection is denied, Hart claims "lip service is often paid to the principle of equal distribution by the pretence that the persons discriminated against are either criminal in intention, if not in deed, or are like children who are incapable of benefiting from the freedom which laws confer and are in need of some more paternalistic regime." *Id.*

153. *See* 12 C.F.R. § 226, *supra* note 46 (limiting broker compensation to an amount that does not exceed the amount the broker has agreed with the consumer in advance the broker will receive).

154. *See* H.R. 3915 § 301, *supra* note 71.

155. HART, ESSAYS IN JURISPRUDENCE AND PHILOSOPHY, *supra* note 149, at 117. Hart continues, "If this principle is admitted, it follows that it cannot be a sufficient moral ground for accepting legal arrangements that the advantages they give to some outweigh the disadvantages for others." *Id.*

federal government's calling for more than just added disclosure – not because the responses would cause market participants to act inefficiently, but rather because the government's responses are morally unfair and unequal. The Frank-Dodd FHA Bills do not apply to all borrowers equally. Instead, the bills would allow the FHA to offer lower interest rates only to those borrowers who have failed to pay on time.[156] The Clinton Plan[157] and the Obama Plan[158] do not profess to apply taxpayer money equally across all homeowners, but rather only to those who are "hardest-hit" and "innocent." Is this fair? Do these responses, in addition to introducing a "moral hazard" from an economic standpoint, fail to achieve the purpose of law because they are morally *unjust*?

Josh Zinner, Co-Director of the Neighborhood Economic Development Advocacy Project ("NEDAP"), says absolutely not. Zinner believes that the great profits Wall Street banks experienced over the last five years by securitizing subprime loans (regardless of whether these profits have now been wiped out) came at the expense of innocent, low-income borrowers, many of whom come from minority communities and were specifically targeted in a process known as "reverse redlining."[159] Zinner claims that the federal government must respond with regulations and legislation that simultaneously hold Wall Street banks accountable and help distressed borrowers avoid foreclosure.

CONCLUSION

As usual, Mr. Buffett's words have proven true. The tide has gone out and the subprime fallout we continue to witness is both distressing and nauseating. Republicans and Democrats, proponents of big government and small, homeowners struggling to make their monthly mortgage payments and politicians answering to their constituencies continue to

156. *See supra* note 116.

157. *See* Clinton Stimulus Press Release, *supra* note 102.

158. *See* Obama Economic Agenda, *supra* note 107.

159. *See Effects of the Subprime Mortgage Crisis and Efforts to Help Struggling Homeowners: Hearing Before the H. Fin. Servs. Subcomm. on Fin. Insts. and Consumer Credit*, 110th Cong. 89 (2008) (Statement of Josh Zinner, Co-Director, Neighborhood Economic Development Advocacy Project) ("There was certainly never any consideration in this process for the plight of borrowers – the mortgages which put so many families at risk were commodified in such a way that they were seen as little more than pork bellies to be traded and profited from.").

watch with a woeful eye. By illustrating that federal lawmakers may now be operating under presumptions of what the law *ought* to be, this Note asserts that such presumptions should be explicitly stated. Without this information, important considerations in assessing the responses may be blatantly overlooked or materially misunderstood. As a twenty-six year-old, I hope to look back on this time and say, "Under the leadership of my parents' generation, we somehow found a way to deal with this awful leech called Subprime. More importantly, we dealt with it the *right* way." And as I say these words, I do not think *only* about "economic efficiency." I hope I am not alone.