Pace Law Review

Volume 30
Issue 1 *Fall 2009*
Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms

Article 17

September 2009

Unsafe Loans in a Deregulated U.S. Mortgage Market

Vincent Di Lorenzo
St. John's University

Follow this and additional works at: http://digitalcommons.pace.edu/plr

Part of the Banking and Finance Commons, and the Property Law and Real Estate Commons

Recommended Citation
Vincent Di Lorenzo, *Unsafe Loans in a Deregulated U.S. Mortgage Market*, 30 Pace L. Rev. 154 (2009)
Available at: http://digitalcommons.pace.edu/plr/vol30/iss1/17

This Article is brought to you for free and open access by the School of Law at DigitalCommons@Pace. It has been accepted for inclusion in Pace Law Review by an authorized administrator of DigitalCommons@Pace. For more information, please contact cpittson@law.pace.edu.

EFFECTS ON THE GROUND: SOCIAL UPHEAVAL OR NET SOCIETAL BENEFITS?

Unsafe Loans in a Deregulated U.S. Mortgage Market

Vincent Di Lorenzo*

This Article explores actual market outcomes in a deregulated mortgage market to ascertain if market discipline can be relied upon to ensure safe and sound loan products. In Part I of this article, the bank regulators' decisions to deregulate the mortgage market are set forth. In Part II, the outcomes generated by such a legal environment are presented. Such outcomes reveal steadily increasing availability and acceptance of risky loan products, resulting in equity stripping due to subsequent defaults. In Part III of the article, an alternative regulatory approach is offered—one that imposes a minimum required level of safety for all loan products.

I. Regulatory Reliance on Market Discipline

In 1982, Congress lifted statutory requirements for mortgage loans originated by federally chartered banks and thrifts.[1] Titles III and IV of the Garn-St. Germain Act replaced requirements such as maximum loan-to-value ("LTV") ratios with a general authorization to make real estate loans subject to the restrictions and requirements that federal banking

---

* Professor of Law and Senior Fellow, Vincentian Center, St. John's University. Copyright © 2009 by Vincent Di Lorenzo.

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

regulators may prescribe.[2] Most state legislatures followed the lead of the Congress, either by also lifting rigid statutory requirements or by relying on state wild-card statutes to achieve the same result.[3] In addition, Title VIII of the Garn-St. Germain Act allowed non-federally chartered housing creditors to offer alternative mortgage instruments to the same extent authorized by federal regulators.[4]

After Congress lifted rigid statutory constraints on mortgage lending by banks and thrifts in 1982, the regulators were faced with three possible options as the new form of mortgage market regulation. The Office of the Comptroller of the Currency summarized its options in 1983 as follows:

> 1. Adopt a regulation that reaffirms the limitations that existed under 12 U.S.C. 371 before the 1982 amendment . . .
> 2. Adopt a regulation that modifies the limitations that existed under 12 U.S.C. 371 before the 1982 amendment and currently exist in the interpretive rulings.
> 3. Adopt a regulation that imposes no limitations on national banks' real estate lending and rescinds current regulations which do impose limitations.[5]

It chose the third option. The Comptroller justified this decision in the following terms: "The Office believes that aside from the regulations, factors such as market forces and management philosophies are the real determinants of banks' real estate lending practices. . . . [D]ecisions concerning the forms and terms of national bank lending are properly the responsibility of each bank's directorate and management."[6] Similarly, after initially proposing to retain some regulatory requirements such as LTV ratios, the Federal Home Loan

2. *Id.* §§ 322, 403, 96 Stat. 1469, 1499, 1510-11 (codified at 12 U.S.C. §§ 371(a), 1464(c)(1)(B)).

3. *See, e.g.*, N.Y. BANKING LAW § 103(4) (McKinney 2009).

4. § 804, 96 Stat. at 1546-47 (codified at 12 U.S.C. § 3803).

5. Real Estate Lending by National Banks, 48 Fed. Reg. 40,698, 40,699 (Sept. 9, 1983) (codified at 12 C.F.R. pt. 7).

6. *Id.* at 40,699-700.

Bank Board removed most regulatory requirements for real estate loans except for two—a loan could not exceed 100 percent of the appraised value of the real estate, and a home loan could not have a maximum term longer than 40 years.[7] By 1996, even these limited requirements were lifted. In 1996 the U.S. Office of Thrift Supervision ("OTS"), as successor to the Federal Home Loan Bank Board, embraced the same, largely free-market, approach that was earlier embraced by the Comptroller of the Currency.[8] At that time, it converted its earlier regulations into "handbook guidance."[9]

In response to the 1991 Federal Deposit Insurance Corporation Improvement Act,[10] the federal regulators were forced to "adopt uniform regulations prescribing standards" for real estate lending by insured depository institutions.[11] The regulators made two decisions that confirmed their preference for a free-market approach to the extent governing statutes would permit. The first decision was to issue "guidelines" for real estate lending, rather than impose regulations setting minimum requirements for real estate lending operations for all banks and thrifts.[12]

The second decision that the regulators made after the 1991 Act was to employ a principles approach in their guidelines, rather than requiring or prohibiting particular practices. While initially proposing specific LTV ratio limits, for example, the agencies ultimately adopted a principles approach—listing general principles such as "prudent" underwriting that should guide bank management in authorizing specific loan products and practices.[13] This was a

---

7. Implementation of New Powers; Limitation on Loans to One Borrower, 48 Fed. Reg. 23,032, 23,035-37 (May 23, 1983) (stating that for home loans in excess of ninety percent of the property's appraised value, private mortgage insurance was required for the part of the loan balance that exceeded eighty percent of the value).

8. *See* Lending and Investment, 61 Fed. Reg. 50,951, 50,952-53 (Sept. 30, 1996) (codified at 12 C.F.R. pts. 545, 556, 560, 563, 566, 571, 590).

9. *Id.* at 50,952.

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

11. 12 U.S.C. § 1828(o)(1) (2006).

12. *See infra* note 13 and accompanying text.

13. Real Estate Lending Standards, 57 Fed. Reg. 62,890, 62,893, 62,897 (Dec. 31, 1992) (codified at 12 C.F.R. pts. 34, 208, 365, 545, 563).

free-market approach to the extent the 1991 Act would permit it. The 1992 agency standards relied on bank management to determine permitted products and practices. They required that banks and thrifts establish and maintain written *internal* real estate lending policies which were consistent with safe and sound banking practices, including prudent underwriting standards.[14]

Abusive practices again surfaced after the 1992 and 1996 revisions to the real estate lending standards. Between 1999 and 2001, the federal bank regulatory agencies issued three guidances on real estate lending. The first concerned subprime lending, and it was motivated by actions of insured depository institutions, who were increasingly originating subprime loans to increase their profits—loans which exhibited significantly higher risks of default than traditional bank lending.[15] The second concerned high LTV residential real estate lending, and its publication was motivated by the fact that insured depository institutions were increasingly originating residential real estate loans in amounts exceeding eighty percent of appraised value in order to increase their profits—which created great risks of default and severe losses associated with such loans.[16] The third was an Expanded Guidance on Subprime Lending, and it was motivated, again, by the higher risks inherent in subprime lending programs, as well as, for the first time, by recognition that some forms of subprime lending may be abusive or predatory.[17] Despite recognition of the emergence of risky loan products, all three "guidances" continued to rely on bank management to set

---

14. *Id.* at 62,897. The guidelines did contain LTV ratios for different types of real estate loans. *See id.* at 62,891-93. However, even the guidelines specified no LTV limits for mortgages on owner-occupied one-to-four family residential property and for home equity loans. *Id.* at 62,893. Other requirements, such as maximum maturity limits, amortization requirements, and documentation requirements, were rejected. *See* 57 Fed. Reg. 36,911, 36,912 (proposed Aug. 17, 1992).

15. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., FDIC INTERAGENCY GUIDANCE (Mar. 1, 1999), http://www.fdic.gov/news/news/financial/1999/FIL9920a.html.

16. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., INTERAGENCY GUIDANCE ON HIGH LTV RESIDENTIAL REAL ESTATE LENDING 1-2 (1999), *available at* http://www.fdic.gov/news/news/financial/1999/FIL9994.pdf.

17. Press Release, Office of the Comptroller of the Currency et al., Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001), *available at* http://www.fdic.gov/news/news/press/2001/pr0901a.html.

policies to control the risks inherent in subprime and high LTV lending programs, and to avoid possible violations of consumer protection laws.[18]

In January 2004, the Comptroller's Office did finally prohibit loans made without regard to ability to repay.[19] This is the only regulatory prohibition that a federal agency has issued regarding real estate lending standards. The timing is revealing because it was done at the same time and in the same regulation that preempted state predatory lending laws.[20] Thus, the net effect was to impose far fewer prohibitions on

---

18. See, for example, BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., *supra* note 15, which stated that:

> Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks.

It also provided, with respect to consumer compliance issues, that:

> Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending.

Id.

19. Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1950 (Jan. 13, 2004) (codified at 12 C.F.R. pts. 7, 34) (enacting a prohibition that applies to national banks and their operating subsidiaries).

20. *See id.* at 1906, 1908, 1913-14. Community and consumer advocates expressed concern that preemption would expose consumers to widespread predatory and abusive practices by national banks. *Id.* at 1906. The Comptroller's Office, however, was concerned about the costs and burdens that state predatory lending laws imposed on national banks, *id.* at 1908, and concluded that enforcement actions under federal law, such as the Federal Trade Commissions Act of 1914, § 5, 15 U.S.C. 45(a)(1) (2000), can ensure fair treatment of consumers, *id.* at 1913-14.

possible abusive lending practices by national banks.

There is one final point regarding the regulatory viewpoint that should be noted. All of the agencies' guidances applied only to the banks or thrifts themselves and their operating subsidiaries. They did not apply to mortgage affiliates of these institutions. This failure to extend the regulatory guidance to bank and thrift affiliates was not explainable by a lack of supervisory power over mortgage affiliates. This was demonstrated by the fact that in 2006, the agencies again issued new guidelines on real estate lending and, for the first time, imposed some of those guidelines on bank and thrift affiliates.[21]

The agencies' last revisions of their uniform real estate lending standards came in 2006 and 2007. An interagency guidance on nontraditional mortgage products was issued in October 2006.[22] The guidance was motivated by the increased offering of loans that allowed borrowers to defer payment of principal and, sometimes, interest (i.e., interest-only and payment-option adjustable rate mortgages), as well as by reduced documentation requirements.[23] The guidance continued to rely on bank management to decide the policies and products that would serve to minimize risks to the banks and thrifts.[24] It made only two changes to its earlier, complete reliance on bank management and narrow scope of coverage. First, it cautioned banks to include an evaluation of the borrower's ability to repay the debt at final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.[25] It also advised banks to demonstrate mitigating factors supporting the underwriting decision in the event of risk layering, such as reduced documentation loans.[26] Second, for the first time, the agencies applied the guidance to bank and thrift affiliates.[27]

While the agencies recognized the consumer protection issues raised by many product offerings, they continued to rely

---

21. *See* Notice, Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

22. *Id.*

23. *Id.* at 58,609.

24. *Id.* at 58,615.

25. *Id.* at 58,614.

26. *Id.*

27. *Id.* at 58,616.

on disclosure to address such concerns.[28] Thus, a largely free-market approach continued to be favored with bank management determining the appropriate policies to employ, and products to offer, and consumers determining the risks such products pose.

The last interagency guidance on real estate lending was issued in July 2007. It was motivated by concern over the increasing use of adjustable rate mortgage products with low initial payments based on an introductory rate that expires after a short period.[29] The final guidance also applies to bank and thrift affiliates.[30]

The 2007 guidance reiterates the principles that were announced in the earlier guidances dating back to 1993.[31] In addition, it includes a statement that prudent underwriting standards "should include an evaluation of a borrower's ability to repay the debt by [the loan's] final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule."[32] The guidance does not prohibit stated income and reduced documentation loans, but cautioned that such loans should be made to subprime borrowers only if there are

---

28. *See id.* at 58,612. "More than traditional [adjustable rate mortgages ("ARMs")], mortgage products such as payment-option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers." *Id.* at 58,616. "Communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution." *Id.* at 58,617. *See also* Notice, Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,255 (proposed Dec. 29, 2005) (stating that "Institutions should also ensure that consumers have information that is timely and sufficient for making a sound product selection decision.").

29. Notice, Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,572 (July 10, 2007). The agencies stated their concern that:

> [T]hese products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalties that extend beyond the initial fixed interest period.

Id. at 37,569.

30. *See id.* at 37,570.

31. *See id.* at 37,573.

32. *Id.*

mitigating factors, such as substantial liquid reserves or assets.[33]

With respect to consumer protection concerns, apart from cautioning that loan underwriting should consider the borrower's ability to repay, disclosure was once again relied upon to protect consumers in the final 2007 interagency guidance.[34]

In summary, after the lifting of statutory requirements for mortgage loans in 1982, regulatory requirements were lifted as well. The federal regulators relied on bank management to ensure sound operations, and on consumers to protect themselves against abusive loan practices. The only loan products that were actually prohibited in the period from 1983 to 2007 were loans made without regard to the ability to repay, and even this prohibition was embraced only by the Comptroller of the Currency, and only for national banks and their subsidiaries—not for bank affiliates. Other regulators merely cautioned banks and thrifts, through regulatory "guidances", against making loans without regard to the borrower's ability to repay. Thus, from 1982 to 2007, the regulatory agencies' dominant viewpoint was a reliance on free-market forces.

II. Expected Versus Actual Outcomes in a Deregulated Environment

In lifting rigid statutory requirements in 1982, Congress had two immediate purposes in mind: (1) to ensure an adequate supply of credit for home mortgage transactions by

---

33. *Id.*

34. *Id.* at 37,572. The guidance also noted that:

> Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:
>
> - Approving loans based on the borrower's ability to repay the loan according to its terms; and
> - Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Id. at 37,574. These were the only two principles announced.

allowing more creative and flexible financing, and (2) to allow banks and thrifts to become stronger participants in the home financing market.[35]

However, these immediate purposes must be understood as qualified by the long-standing federal policy of ensuring the safety and soundness of bank and thrift institutions.[36] In addition, these immediate purposes must also be understood in the context of a series of enactments that occurred in 1974,[37] 1988,[38] and 1994,[39] all of which were aimed at eliminating abusive practices in the residential real estate lending process.

Thus, Congress's legislative enactments over the entire 1974 to 1994 period reveal a desire to achieve three outcomes: (1) to ensure an adequate supply of credit for home mortgage loans, (2) to ensure that such loans are provided in a safe and sound manner by banks and thrifts, among other institutions, and (3) to ensure that such loans do not contain terms and are not offered through practices that are potentially abusive toward consumers. As discussed in Part I of this Article, the means that the regulators embraced to achieve these goals relied upon market discipline rather than regulatory restriction.

---

35. *See* S. REP. NO. 97-536, at 27 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3054, 3081.

36. *See, e.g.*, 12 U.S.C. § 1818 (2006 & Supp. 2008) (stating that failure to conduct safe and sound operations is a basis for regulatory sanctions); 12 U.S.C. § 1831p-1 (2006) (detailing the safety and soundness standards).

37. *See* Real Estate Settlement Procedures Act of 1974, Pub. L. No. 93-533, 88 Stat. 3164 (codified as amended at 12 U.S.C. §§ 2601-2616 (2006)). The Act was aimed at eliminating "[a]busive and unreasonable practices within the real estate settlement process." S. REP. NO. 93-866, at 2 (1974), *reprinted in* 1974 U.S.C.C.A.N. 6546, 6547.

38. *See* Home Equity Loan Consumer Protection Act of 1988, Pub. L. No. 100-709, 102 Stat. 4725 (codified as amended in scattered sections of 15 U.S.C.).

39. *See* Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, § 151, 108 Stat. 2160, 2190 (codified as amended at 15 U.S.C. § 1601) (aiming to avoid potentially abusive terms in high-cost mortgages as well as instances when lenders act in a predatory fashion by targeting unsophisticated, low-income homeowners). *See also* S. REP. NO. 103-169, at 2, 22 (1993), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1886 (expressing similar concerns).

A. *Expected Outcomes*

Regulators expected that market-based decisions would lead to innovative loan products, which would maximize availability of credit and which were also "safe" products and practices. Lender self-interest, bounded by the legal mandate of "safety and soundness," was relied upon to ensure safe offerings.[40] Consumer self-interest was also relied upon to weed out unsafe products and practices.[41]

Bank regulators were trained in the economic sciences. This expectation was in line with the prevailing view in the legal and economic communities.[42]

B. *Actual Outcomes*

Did banks and thrifts, as well as the rest of the mortgage loan industry, choose to offer only loans that the industry considered "safe and sound?" Similarly, did consumers avoid loans that were "unsafe" or "unsound" from the institution's perspective? This was the predicted outcome based on a reliance on market discipline. But what was the actual outcome?

1. Unsafe Products and Practices

The most revealing outcome is one that examines the mortgage practices of regulated banks and thrifts. These institutions were subject to the general prohibition against "unsafe and unsound" banking practices,[43] as well as the uniform guidelines cautioning against unaffordable loans, including loans made without regard to the borrower's ability to repay.[44] If these general "constraints" coupled with market

---

40. *See supra* notes 6, 18, 24 and accompanying text.

41. *See supra* notes 28, 34 and accompanying text.

42. This view assumes that every individual is a rational maximizer of his self-interest. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3-4 (7th ed. 2007). *See also* Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1476 (1998) (discussing Gary Becker's account of utility maximization).

43. *See supra* note 36 and accompanying text.

44. *See supra* note 17 and accompanying text (the 2001 guidance identified loans based on the borrower's assets rather than ability to repay as

discipline did not prevent unsafe lending practices by these institutions, then they certainly would not prevent unsafe lending practices by non-affiliated and less-regulated mortgage companies.

The mortgage products and practices that emerged were: (a) adjustable rate mortgages ("ARMs") with low initial rates that lead to substantial increases in loan payments after the expirations of the initial "teaser" rates; (b) payment-option loans in which the borrower could choose an amount to pay, including a minimum payment that did not include all accrued interest, until a recast of the payments at a later point, which would significantly increase loan payments; (c) loans made without regard to borrowers' ability to repay, including limited-documentation or no-documentation loans; and (d) loans made requiring very little or no borrower equity, including first lien mortgage loans that tolerated piggyback loans.

ARMs introduce the risk of sticker shock after the expiration of low, initial "teaser" interest rates.[45] For example, an analysis of 2/28 subprime ARMs in 2006 indicated "an average 'payment shock' of 29 percent over the teaser-rate payment, even if short-term interest rates remained unchanged."[46] However, since interest rates increased in 2006, the payment shock was estimated to be 50 percent.[47] Payment-option loans introduce the risk of another form of sticker shock, namely an increase in monthly payments upon recast of the loan.[48] In payment-option loans, the borrower can choose to pay a minimum payment which does not include all accrued interest and does not include payment of principal.[49] The

---

a potentially abusive lending practice). *See also supra* notes 19, 25, 32 and accompanying text.

45. *See* STAFF OF JOINT ECON. COMM., 110TH CONG., SHELTERING NEIGHBORHOODS FROM THE SUBPRIME FORECLOSURE STORM 2 (2007), *available at* http://jec.senate.gov/archive/Documents/Reports/subprime11apr2007revised.pdf.

46. *Id.*

47. *Id.* The figures were based on a 2006 analysis by Fitch Ratings. *Id.* 2/28 ARMs have a low initial interest rate that is in effect during the first two years of the loan. *Id.*

48. Bob Tedeschi, *New Rules for "Exotic" Loans*, N.Y. TIMES, Oct. 15, 2006, at J13.

49. Jay Romano, *Pluses and Minuses of Option ARM's*, N.Y. TIMES, Oct. 9, 2005, at L10.

accrued and unpaid interest is then added to the principal.[50] However, when the outstanding balance reaches a certain threshold—typically 125% of the property's value—then the payment option expires and the loan is recast to require monthly payments of both interest and principal.[51]

No-documentation or low-documentation loans add the risk that the lender has no assurance that the borrower is able to afford the loan, either initially or after a reset of interest rates or recast of payments. From 2000 to 2005, the number of subprime loans made without full documentation of income climbed from twenty-six percent of subprime mortgages in 2000 to forty-four percent in 2005.[52]

Finally, piggyback loans add the risk that the borrower has very little equity in the home.[53] In the event of a significant decline in the fair market value of the property, refinancing becomes difficult or impossible.[54] Moreover, the risk of default increases since the borrower's equity has already been lost due to the market decline.[55] By the end of 2006, thirty-two percent of home purchase borrowers relied on piggyback loans to finance their purchases.[56]

The widespread offering of these risky loan products was documented by research analysts at Credit Suisse.[57] Focusing on the subprime market at the end of 2006, Credit Suisse found that 1) "[r]oughly 50% of all subprime borrowers in the last two

---

50. *Id.*

51. *Id.* (recast occurs at five years or when the outstanding balance exceeds property value by 125 percent).

52. Wei Li & Keith S. Ernst, *Do State Predatory Lending Laws Work? A Panel Analysis of Market Reforms*, 18 HOUSING POL'Y DEBATE 347, 361 (2007).

53. FURMAN CTR. FOR REAL ESTATE & URBAN POLICY, DECLINING CREDIT & GROWING DISPARITIES: KEY FINDINGS FROM HMDA 2007, at 2 (2008), *available at* http://furmancenter.org/files/KeyFindingsfromHMDA2007FurmanCenterReport.pdf. Piggyback loans are "junior liens issued to a homebuyer at the same time as a first mortgage to bridge the gap between the purchase price and his or her first mortgage." *Id.*

54. *Id.*

55. *Id.*

56. *Id.* *But cf. infra* text accompanying note 64 (citing a forty percent figure found by Credit Suisse in its sample of loans through the third quarter of 2006).

57. CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE (2007), *available at* http://billcara.com/CS%20Mar%2012%202007%20Mortgage%20and%20Housing.pdf.

years had provided limited documentation regarding their incomes,"[58] and 2) that "[i]n 2006, 2/28 ARMs [resetting after 2 years] represented roughly 78% of all subprime purchase originations . . . . [H]ome buyers were primarily qualified at the introductory teaser rate rather than the fully amortizing rate . . . ."[59]

Focusing on the Alt-A market at the end of 2006, Credit Suisse found that 1) 55% of borrowers in Alt-A purchase originations had taken simultaneous second mortgages, or piggybacks, at the time of purchase;[60] 2) "low/no documentation loans . . . represented . . . 81% of total Alt-A purchase originations";[61] 3) "interest only and option ARM loans represented approximately 62% of Alt-A purchase originations";[62] and 4) "adding to the risk is the fact that 1-year hybrid ARMs represented approximately 28% of Alt-A purchase originations . . . setting the stage for considerable reset risk."[63]

Focusing on the overall market for mortgage products, Credit Suisse found that 1) "approximately 40% of home purchase mortgages [made through the third quarter of 2006] involved piggyback loans . . . , compared with 20% in 2001";[64] 2) approximately "23% of total purchase originations in 2006 were interest only or negative amortization mortgages";[65] and 3) "[l]ow/no documentation loans increased from . . . 18% of total purchase originations in 2001 to 49% in 2006."[66]

A pattern of engaging in risky practices by offering loan products that layered risks was evident in the industry generally. For example, "[a]bout 83 percent of the payment-option ARMs issued from 2004 to 2007 were underwritten without full documentation of the borrowers' incomes."[67]

---

58. *Id.* at 4.

59. *Id.* at 5. The subprime market constituted twenty percent of total originations in 2006. *Id.* at 4.

60. *Id.* at 17-18.

61. *Id.* at 17.

62. *Id.* at 36.

63. *Id.* at 4. The Alt-A market constituted twenty percent of total originations in 2006, rising from just five percent in 2002. *Id.*

64. *Id.* at 5.

65. *Id.*

66. *Id.*

67. Bob Ivry & Linda Shen, *Washington Mutual Hobbled by Increasing Defaults on Option ARMs*, BLOOMBERG.COM, Sept. 15, 2008,

Not only were individually risky products introduced, but there was also a layering of risks. Payment-option ARMs are especially risky due to a layering of two sets of sticker shock: one due to the interest rate reset and another due to the recast of payments. A no-documentation payment-option ARM then adds a third layer of risk due to an inability to assess borrowers' repayment ability. Industry surveys reveal that banks and thrifts, either directly or through affiliates, became primary originators of payment-option ARMs.[68] Vague legal constraints in the form of "safety and soundness" requirements and regulatory guidelines warning against making loans without regard to ability to repay did not prevent these practices at federally regulated financial institutions.[69] Certainly, market discipline alone would not prevent these practices at non-federally regulated mortgage lenders. Beginning in 2005 and continuing into 2007, the mortgage industry newsletter, National Mortgage News, periodically collected data on residential payment-option ARM originations.[70] Such data revealed the following levels of participation by banks or thrifts and their affiliates in originations of payment-option ARMs:

---

http://www.bloomberg.com/apps/news?pid=20601087&sid=aNSwdt57nTBI.

68. *See infra* notes 71-98 and accompanying text.

69. Paul Muolo, *Option ARMs in Sevenfold Rise*, NAT'L MORTGAGE NEWS, Dec. 5, 2005, at 1.

70. *Id.* (stating that "[m]ortgage bankers funded almost $73 billion in payment-option ARMs in the third quarter [of 2005], a more than sevenfold increase from the same period last year"). The figures reported payment-option ARM production disclosed to National Mortgage News by lenders. *Id.* The disclosed figures were estimated to represent approximately sixty percent of the payment-option ARM market. *Id.*

Time Period	Market Share – Residential Payment-Option Loans Originated by Banks, Thrifts or Affiliates
Second Quarter 2007	52.39 percent[71]
Second Quarter 2006	51.1 percent[72]
First Quarter 2006	55.77 percent[73]
Fourth Quarter 2005	60.3 percent[74]

The mortgage practices of four large banks and thrifts—Countrywide, Washington Mutual, Wachovia and IndyMac—illustrate the failings of a reliance on vague legal standards and market discipline to avoid unsafe mortgage lending practices.

Countrywide was the country's largest mortgage lender as of 2008.[75] It originated $73 billion in mortgage loans in the first quarter of 2008 alone.[76] It was also a significant originator of subprime mortgages. By the first quarter of 2007,

71. *Residential Option ARMs Lenders in Q2 '07*, NAT'L MORTGAGE NEWS, Oct. 1, 2007, at 1. The bank or thrift lenders, or their affiliates, were Washington Mutual, Countrywide, Wachovia, IndyMac, Greenpoint Mortgage, Mortgage IT (a subsidiary of Deutsche Bank), Flagstar Bank, 1st National Bank of Arizona, Downey Savings and Loan, and Sun Trust Mortgage. *Id.*

72. *Residential Option ARM Lenders in Q2 '06*, NAT'L MORTGAGE NEWS, Sept. 15, 2006, at 1. The bank or thrift lenders, or their affiliates, were Countrywide, Washington Mutual, IndyMac, Greenpoint Mortgage, EMC Mortgage (a subsidiary of JP Morgan Chase), Mortgage IT, Downey Savings and Loan, 1st National Bank of Arizona, Bank of America, First Horizon, Sun Trust Mortgage, and American Mortgage Network (a subsidiary of Wachovia). *Id.*

73. *Residential Option ARM Lenders in Q1 '06*, NAT'L MORTGAGE NEWS, July 24, 2006 at 1. The bank or thrift lenders, or their affiliates, were Countrywide, EMC Mortgage, IndyMac, Goldenwest Financial, Greenpoint Mortgage, Downey Savings & Loan, Mortgage IT, 1st National Bank of Arizona, Bank of America, First Horizon, Sun Trust Mortgage, and American Mortgage Network. *Id.*

74. *Residential Option ARM Lenders in Q4 '05*, NAT'L MORTGAGE NEWS, Mar. 27, 2006, at 1. The bank or thrift lenders, or their affiliates, were Countrywide, EMC Mortgage, IndyMac, Greenpoint Mortgage, Downey Savings & Loan, Bank of America, American Mortgage Network, First Horizon, Flagstar Bank, and Sun Trust Mortgage. *Id.*

75. Complaint at 9, People v. Countrywide Fin. Corp., No. 08-CH-22994 (Ill. Cir. Ct. June 25, 2008), *available at* http://www.illinoisattorneygeneral.gov/pressroom/2008_06/countrywide_complaint.pdf.

76. *Id.*

Countrywide had become the largest originator of subprime loans with a total subprime loan volume of over $7.8 billion.[77]

The evidence that has emerged indicates layering of several types of risky loans in the industry generally, as well as at Countrywide—namely, ARMs with a payment option, made with little or no documentation of income, and requiring little money down. Thus, the Wall Street Journal reported in 2007:

> By 2005, option ARMs accounted for $238 billion of loan volume, or about 8% of loans originated that year, according to Inside Mortgage Finance, a trade publication. At Countrywide, these loans accounted for $93 billion, or 19%, of the company's loan volume by 2005, making it the top option ARM lender that year.
>
> . . . .
>
> Of the option ARMs [Countrywide] issued [in 2006], 91% were "low-doc" mortgages in which the borrower didn't fully document income or assets, according to UBS, compared with an industry average of 88% that year. In 2004, 78% of Countrywide's option ARMs carried less than full documentation.
>
> Countrywide also allowed borrowers to put down as little as 5% of a home's price and offered "piggyback mortgages," which allow borrowers to finance more than 80% of a home's value without paying for private mortgage insurance. By 2006, nearly 29% of the option ARMs originated by Countrywide and packaged into mortgage securities had a combined loan-to-value of 90% or more, up from just 15% in 2004, according to UBS.[78]

---

77. *Id.* at 9-10. "[I]n 2002, Countrywide originated roughly $9 billion in subprime loans. In 2005, that number shot up to over $44 billion." *Id.* at 13.

78. Ruth Simon & James R. Hagerty, *Countrywide's New Scare: 'Option ARM' Delinquencies Bleed Into Profitable Prime Mortgages*, WALL ST. J., Oct. 24, 2007, at C1.

Cases brought by State Attorneys General also uncovered a pattern of unsafe lending practices at Countrywide. For example, in its lawsuit against Countrywide, the State of Illinois filed a complaint that indicated that:

- "From 2005 through the first half of 2007, a majority of the Countrywide mortgages sold in Illinois were reduced documentation loans, often called 'stated-income' or 'liar's loans.'"[79]
- "Countrywide . . . became a leader in th[e] profitable" Option ARM loan market.[80] "Option ARMs increased from approximately 3% of the company's loan production during the quarter ended June 30, 2004, to approximately 21% of its production during the quarter ended June 30, 2005."[81]
- "Of the option ARMs Countrywide sold in 2007, 82% were reduced documentation mortgages in which the borrower did not fully document income or assets."[82]
- Countrywide offered interest-only loan products in which the interest-only payment feature existed only "during the first years of the loan, usually the first 3, 5, 7 or 10 years."[83] It became "the second leading originator of interest-only loans from 2006 through the second quarter of 2007."[84] When it qualified borrowers' ability to repay, such qualification was often not at the payment due on a fully amortizing mortgage.[85] Countrywide qualified its borrowers at the minimum or the lower non-amortizing interest-only payment at least part of the time during the period 2003 through 2007.[86]
- Countrywide "acknowledged in a May 7, 2007 letter to the Office of Thrift Supervision . . . that . . . looking at originations in the fourth quarter of 2006, . . . almost

79. Complaint, *supra* note 75, at 23.
80. *Id.* at 35.
81. *Id.*
82. *Id.* at 40.
83. *Id.* at 29.
84. *Id.*
85. *Id.* at 30.
86. *Id.*

> 60% of the borrowers who obtained subprime hybrid ARMs," including interest only loans, from Countrywide "would not have qualified at the fully indexed rate."[87]

Indeed, Countrywide decided to switch from a national bank to a thrift charter in 2006 precisely because the OTS applied the interagency guidelines on alternative mortgage products with "more restraint."[88]

The system of embracing risky loan practices was equally evident at Washington Mutual ("WaMu"). Between 2004 and 2007, WaMu increasingly originated subprime loans and short-term adjustable-rate mortgages, especially payment-option ARMs.[89] "In 2005 and 2006, WaMu funded a total of $107 billion in payment option adjustable rate mortgages . . . , and, by the end of 2007, it held $48 billion in [payment option adjustable rate mortgages] that resulted in negative amortization . . . ."[90] In addition, "into 2007, WaMu underwrote pay option ARM loans based on the borrowers' ability to afford the low 'teaser' payment."[91] It also increasingly originated loans with limited or no documentation of income or assets.[92]

Wachovia was similarly in the business of making risky

---

87. *Id.* at 32. (internal quotation marks omitted). In addition, "almost 25% of the borrowers" for subprime hybrid ARMs, which may include reduced documentation and high loan-to-value ratios, "would not have qualified for any other [Countrywide] product." *Id.* at 32-33 (internal quotation marks omitted).

88. Barbara A. Rehm, *Countrywide to Drop Bank Charter in Favor of OTS*, AM. BANKER, Nov. 10, 2006, at 1.

89. Drew Desilver, *Is the Sky Falling? Big Dreams of WaMu Dashed by Risky Loans*, SEATTLE TIMES, Sept. 21, 2008, at H1. WaMu made $452.5 billion in subprime loans, home equity loans, and short-term adjustable rate mortgages between 2004 and the end of 2007. *Id.*

90. MICHAEL HUDSON & JIM OVERTON, CTR. FOR RESPONSIBLE LENDING, THE SECOND S&L SCANDAL 8 (2009), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/the-second-s-l-scandal.pdf (figures collected from WaMu's filings with the SEC).

91. *Id.*

92. Desilver, *supra* note 89. For example one individual analyzed a bundle of loans made by WaMu in May 2007 that consisted of 1,765 loans totaling $519 million. Mark Gimein, *Inside the Liar's Loan*, SLATE, Apr. 24, 2008, http://www.slate.com/id/2189576/. In this bundle of loans, eighty-eight percent did not request verification of income. *Id.* By March 2008, eighteen percent of the loans were in foreclosure. *Id.*

loans in recent years. It was the largest originator of pay-option ARM loans in the second quarter of 2007, followed by WaMu, and held $122 billion of such loans.[93] The biggest originators of such loans at the time were Wachovia, WaMu, Countrywide, Downey Financial Corporation (a savings and loan), and IndyMac.[94] Wachovia was the largest holder of option ARMs.[95] According to its own website, these mortgages represented seventy-three percent of Wachovia's loan portfolio.[96] Indeed, one of the very reasons Wachovia purchased Golden West Financial Corporation in 2006 was Golden's focus on option adjustable-rate mortgages, which it hoped to cross-sell to Wachovia customers.[97]

The same practice of making risky loans was uncovered at IndyMac. IndyMac was one of the largest holders of payment-option ARM loans.[98] In addition, as recently as the first quarter of 2007, only twenty-one percent of IndyMac's total loan production was in the form of full-documentation mortgages.[99] Finally, some of the loans that IndyMac labeled as full-documentation loans may have been supported, not by verification of income, but rather only by verification of employment.[100]

---

93. Ivry & Shen, *supra* note 67.

94. *Id.*

95. *Id.*

96. Bob Ivry, *Wachovia Option-ARM Mortgage Losses May Force Merger*, BLOOMBERG.COM, Sept. 29, 2008, http://www.bloomberg.com/apps/news?sid=af4TVTdVFB1s&pid=20601087.

97. Matthias Rieker, *What's Driving Latest Deals? (It's Not Costs)*, AM. BANKER, May 15, 2006, at 1.

98. *See* Ivry, *supra* note 96; Ivry & Shen, *supra* note 67. When seized by regulators, IndyMac held $3.5 billion of option ARMs, the fifth highest amount behind Wachovia, WaMu, Countrywide, and Downey Financial. Ivry & Shen, *supra* note 67.

99. MIKE HUDSON, CTR. FOR RESPONSIBLE LENDING, INDYMAC: WHAT WENT WRONG? 3 (2008), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/indymac_what_went_wrong.pdf. Figures are based on filings with the SEC. *Id.* at 3 n.6. One year later, IndyMac had charged this reliance on limited- or no-documentation loans, but by March 2008, sixty-nine percent of its loan volume involved full-documentation mortgages, leaving almost one-third of its loan volume still in the form of limited- or no-documentation mortgages. *Id.*

100. *Id.* at 8.

2. Equity Stripping

The greatest loss of equity results from unsafe lending practices that lead to foreclosure. This is a loss faced by borrowers not only due to the overly aggressive and unsafe lending practices of recent years, but also, to a lesser extent, in prior time periods. Recent foreclosures have come in three waves, representing three stages of risk that result from the mortgage practices of recent years. The first wave of foreclosures, occurring in 2007 and 2008, resulted from adjustable-rate subprime loans in which borrowers were unable to afford the reset interest rates and were unable to refinance their mortgages.[101] The second wave is expected in 2009 and 2010, and will result from payment-option ARMs that recast and five-year adjustable-rate hybrid ARMs.[102] Such loans were made in both the subprime and the Alt-A markets. A third wave of foreclosures has actually overlapped with these first two causes of financial difficulty. This resulted from the unavailability of credit in the tightened mortgage market in late-2008 and 2009, job losses resulting from a downturn in the economy triggered by mortgage loan losses of financial institutions, and a sharp drop in housing prices making refinancing of a large outstanding mortgage balance impossible.[103]

Total loans in foreclosure averaged 455,000 annually from

---

101. *See* Kelly D. Edmiston & Roger Zalneraitis, *Rising Foreclosures in the United States: A Perfect Storm*, 2007 FED. RESERVE BANK OF KANSAS CITY ECON. REV. 115, 130-32 (2007), *available at* http://www.kansascityfed.org/PUBLICAT/ECONREV/PDF/4q07Edmiston.pdf (discussing increases in short-term interest rates and payment resets on nontraditional mortgages being responsible for the increase in foreclosure rates on ARMs, especially subprime ARMs); John Leland, *Loans that Looked Easy Pose Threats to Recovery*, N.Y. TIMES, Aug. 27, 2009, at A12 (discussing difficulty of refinancing).

102. *See* Leland, *supra* note 101; Ruth Simon, *The Financial Crisis: Loan Delinquencies Rear Their Ugly Head Again*, WALL ST. J., Sept. 20, 2008, at A3 [hereinafter Simon, *The Financial Crisis*]; Ruth Simon, *FirstFed Grapples With Payment—Option Mortgages*, WALL ST. J., Aug. 6, 2008, at A3 [hereinafter Simon, *FirstFed*].

103. *See* JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 1-2 (2009), *available at* http://www.jchs.harvard.edu/publications/markets/son2009/son2009.pdf (discussing declining housing prices and tightening of the credit market); Simon, *The Financial Crisis*, *supra* note 102 (discussing tight lending standards and job losses).

2002 through 2006, and then more than doubled to nearly 940,000 by the fourth quarter of 2007.[104] This was a jump from less than one percent of all loans in the earlier period to more than two percent by the end of 2007.[105] As for subprime loans, the foreclosure rate exceeded five percent from 2001 through 2003, and then again in the first quarter of 2007, and never dropped below three percent from 2001 through 2007.[106]

Defaults and foreclosures increased in 2008 and continued to do so in 2009. In October 2007, the Joint Economic Committee reported that in the 2007-09 period, subprime foreclosures would total two million, causing "$71 billion in housing wealth [to] be directly destroyed through the process of foreclosure," and another "$32 billion . . . indirectly destroyed by the spillover effect of foreclosures."[107] In fact, the number of foreclosure filings has been greater than expected. Thus, during 2008, foreclosure filings actually occurred against 2,330,483 properties.[108] In addition, it was expected that there would be 2.4 million new foreclosure filings in 2009.[109]

Two troubling characteristics have become apparent regarding the incidence of foreclosures in recent years. First, foreclosures are heavily concentrated in low-income communities[110] and in communities that are predominantly

---

104. JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., *supra* note 103, at 20 (compiling data from the Mortgage Bankers Association).

105. *Id.*

106. DARRYL E. GETTER, CONG. RESEARCH SERV., UNDERSTANDING MORTGAGE FORECLOSURE: RECENT EVENTS, THE PROCESS, AND THE COSTS 3 (2007), *available at* http://assets.opencrs.com/rpts/RL34232_20071105.pdf. The foreclosure rate exceeded seven percent from 2001 through the second quarter of 2003. *Id.*

107. STAFF OF JOINT ECON. COMM., 110TH CONG., THE SUBPRIME LENDING CRISIS 1 (2007), *available at* http://jec.senate.gov/archive/Documents/Reports/10.25.07OctoberSubprimeReport.pdf (estimating an aggregate cumulative subprime foreclosure rate of 18 percent during the 2007-09 period).

108. Press Release, RealtyTrac, Foreclosure Activity Increases 81 Percent in 2008 (Jan. 15, 2009), *available at* http://www.realtytrac.com/ContentManagement/PressRelease.aspx?channelid=9&ItemID=5681.

109. CTR. FOR RESPONSIBLE LENDING, UNITED STATES FORECLOSURES: IMPACT & OPPORTUNITIES 1 (2009), *available at* http://www.responsiblelending.org/mortgage-lending/tools-resources/factsheets/us-foreclosure-fact-sheet.pdf. More than eight million foreclosures are expected during the next four years based on Credit Suisse analysts' forecasts. *Id.* at 1, 2 n.b.

110. *See, e.g.*, *External Effects of Concentrated Mortgage Foreclosures:*

black or Hispanic.[111]

The argument that has been made in favor of "innovative" mortgage products is that they increase rates of homeownership and thus provide a net societal benefit.[112] Given the high-risk nature of the products which can, and have, led to default and foreclosure for many low-income and minority homeowners, embracing an outcome in which vulnerable homeowners' substantial losses are deemed justified because there is an overall net gain in level of homeownership is an ethically troubling viewpoint. However, the evidence has actually revealed that there were no net societal benefits in the form of increased levels of homeownership in the long-term. For instance, the Center for Responsible Lending ("CFRL") analyzed the claimed net gain in homeownership resulting from subprime lending from 1998 through 2006.[113] It concluded that: "Subprime loans made during 1998-2006 have led or will lead to a net loss of homeownership for almost one

---

Evidence from New York City: Hearing Before the H. Subcomm. on Domestic Policy, *Comm. on Oversight and Government Reform*, 110th Cong. 2, 22 (2008) [hereinafter *External Effects*] (statement of Vicki Been, Professor of Law and Director of New York University Furman Center for Real Estate and Urban Policy), *available at* http://domesticpolicy.oversight.house.gov/documents/20080522105505.pdf; Press Release, Jeffrey D. Klein, N.Y. Senator, Klein and Senate Dems Unveil Updated Analysis of Sub-Prime Mortgage Crisis (Aug. 27, 2007), *available at* http://www.nysenate.gov/news/klein-and-senate-dems-unveil-updated-analysis-sub-prime-mortgage-crisis. Professor Been of New York University School of Law testified before the House Subcommittee on Domestic Policy that:

> Foreclosures in New York City are highly concentrated in specific neighborhoods. . . . [H]igh-exposure neighborhoods tend to have a greater proportion of black and Hispanic residents, lower median incomes, lower median sales prices and higher rates of subprime lending than low-exposure neighborhoods.

External Effects, *supra*, at 4.

111. *External Effects*, *supra* note 110, at 4.

112. Edmund L. Andrews, *Fed and Regulators Shrugged as the Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, at A1 (before this year "officials praised subprime lenders for helping millions of families buy homes for the first time").

113. CTR. FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 2 (2007), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/Net-Drain-in-Home-Ownership.pdf.

million families. In fact, a net homeownership loss occurs in subprime loans made in every one of the past nine years."[114]

The data showed that between 1998 and 2006, about 1.4 million first-time home buyers used subprime loans to purchase their homes, but an estimated "2.2 million borrowers who obtained subprime loans will lose or have already lost their home to foreclosure."[115] The calculations made by the CFRL do not take into account the even greater number of foreclosures that occurred after 2006.

The analysis performed by the CFRL focused on subprime loans, in which "innovative" and risky loan products and practices prevailed in recent years. The Joint Center for Housing Studies of Harvard University analyzed the effect on homeownership rates of all loans.[116] It reviewed homeownership rates through the end of 2007 and concluded:

> The expansion of mortgage credit in the 1990s was therefore accomplished with traditional products and without adding much to risk. The growth in mortgage credit after 2003, in contrast, came largely from gains in much riskier subprime, interest-only, and payment-option loans. These novel mortgage products provided only a temporary lift to homeownership. Indeed, the national homeownership rate peaked in 2004 and has since retreated below its 2003 level.
>
> For the rate to fall below its 2000 level, the number of homeowners would have to dip by another million—a real possibility given the rising tide of foreclosures.[117]

This experience demonstrates that safe underwriting

114. *Id.*

115. *Id.* A majority of the subprime loans that were acquired were for refinancing and not for the purchase of a home. *Id.* at 3. Moreover, a significant proportion of subprime purchase mortgages are obtained by existing homeowners who buy additional homes—not first-time home buyers—and therefore do not increase homeownership levels. *Id.*

116. JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., *supra* note 103, at 3-4.

117. *Id.* at 4 (internal citation omitted).

practices can help to achieve the goal of access to credit and expansion of homeownership opportunities. Mandating such practices is the proposal presented below.

III. An Alternative Approach: Bounded Decision-Making

In recent years, commentators and even some federal regulators have recognized the deficiencies of relying on a market-based decision-making approach. From the industry's perspective, a vague mandate to avoid unsafe and unsound mortgage products and practices often is ignored when the originator can generate substantial profits from potentially unsafe offerings.[118] From the consumer's perspective, many consumers seem unable to judge the safety of mortgage loan offerings.[119] Thus, an alternative to relying on market-based decisions is necessary. The alternative I propose is based on principles of complexity theory, and is one I have earlier advanced in my study of business ethics.[120]

As applied to the United States mortgage market, an outer legal boundary must be imposed that requires a clear, fixed, minimum level of safety for every mortgage loan. The outer boundary of safety proposed as a statutory mandate is twofold. First, a maximum LTV ratio for all residential real estate loans would be mandatory, and this would include a required equity investment by the borrower. This could be eighty percent, or perhaps slightly higher, and would prohibit secondary financing and require mortgage insurance if any loan exceeded

---

118. *See generally* Vincent Di Lorenzo, *Business Ethics: Law as a Determinant of Business Conduct*, 71 J. BUS. ETHICS 275 (2007) (documenting case studies of the securities, automobile, pharmaceutical, and mortgage banking industries, and drawing the conclusion that a vague legal mandate is typically associated with corporate conduct that ignores the legal mandate).

119. The Federal Reserve Board embraced this conclusion in 2008. *See* Truth in Lending, 73 Fed. Reg. 44,522, 44,525-26 (July 30, 2008) (codified at 12 C.F.R. pt. 226).

120. Vincent Di Lorenzo, *Does the Law Encourage Unethical Conduct in the Securities Industry?*, 11 FORDHAM J. CORP. & FIN. L. 765, 794-98 (2006) (discussing the legal outer-boundary based on complexity theory's principle of a strange attractor). In that research, I focused on the sanctions that can shape actual outcomes. *Id.* at 797. In this Article, I focus on the type of legal mandate that can assist in shaping those outcomes. A detailed discussion of the concept of a strange attractor as applied to a legislative scheme is found in Vincent M. Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium*, 71 U. COLO. L. REV. 51, 80-84 (2000).

eighty percent of value. It would be mandatory for each residential mortgage loan made by a bank, thrift, affiliate of a bank or thrift, or any non-affiliated mortgage lender. Second, a maximum debt-to-income ratio would similarly be mandatory. This could be thirty-one percent, or perhaps slightly higher, and it would require documentation of income and be underwritten at the maximum interest rate permitted under the loan, with payments that fully amortize the loan over its term.

In July 2008, the Federal Reserve Board issued new regulations, effective October 1, 2009, that apply to a new category of loans called "high-priced mortgage loans," which the regulations define in a manner intended to cover all subprime mortgages and most Alt-A mortgages.[121] Under the new regulations, lenders are prohibited from making loans without regard to borrowers' ability to repay, and they must assess that ability based on the highest scheduled payment in the first seven years of the loan.[122] This new approach recognizes the need for a minimum level of safety in mortgage transactions. However, the Federal Reserve Board's action differs from my proposal in four important respects. First, it does not apply to all mortgage loans—it applies only to high-priced mortgage loans. Second, it states no clear standard that defines a borrower's "ability to repay." There is no maximum debt-to-income ratio stipulated, which once again leaves too much discretion in the hands of bank management. Third, it is missing the other component of safe underwriting that I have proposed—a maximum LTV ratio.[123] Finally, the fourth difference is that my proposed safety standard is statutory. There is a risk in relying on the Federal Reserve Board's regulation to avoid a recurrence of unsafe mortgage loans in the long-term. The Federal Reserve Board issued the regulation under its authority to determine which "unsafe" mortgage practices should be regulated.[124] However, the

121. Truth in Lending, 73 Fed. Reg. at 44,522. A loan is a high-priced mortgage loan if it is a first-lien mortgage and has an annual percentage rate that exceeds by 1.5 percentage points the "average prime offer rate" published by Freddie Mac. *Id.* at 44,522-23.

122. *Id.* at 44,523.

123. *See also* Edmiston & Zalneraitis, *supra* note 101, at 130-32 (discussing the extra risk of default caused by high loan-to-value ratios).

124. *See* 15 U.S.C. § 1639 (2006).

Federal Reserve Board's viewpoint has always been that it will intervene in the mortgage market by defining a practice as an "unsafe" mortgage practice only when the net societal costs of non-regulation outweigh its benefits.[125] Currently, this is the case due to the very high levels of mortgage defaults and the serious economic repercussions they have produced. However, when this crisis passes, the Federal Reserve Board might rescind its regulation because its "net societal benefits" threshold will no longer demand government intervention. In my view, it is preferable to have a statutory standard of safety to avoid that possible regulatory change.

The required boundaries of safety proposed in this Article avoid unfettered individual bank and consumer discretion as to what products and practices are "safe," since experience has taught us that we cannot rely on market discipline to ensure safety and soundness. Such statutory boundaries do not eliminate all discretion or freedom. Within these outer boundaries, lenders and consumers are free to structure the terms of their mortgage products in order to achieve Congress's aim of an adequate supply of credit provided in a safe manner.

125. *See* Truth in Lending, 73 Fed. Reg. 1672, 1674, 1679-80 (proposed Jan. 9, 2008) (to be codified at 12 C.F.R. pt. 226).