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# Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms

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# Symposium
# Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms
## March 20, 2009

# Foreword

**Shelby D. Green**[*]

The American dream turned into a nightmare. Since early in the last century, the goal of homeownership played a prominent part in the American dream—one that the Federal Government encouraged through various policies and programs, including subsidies, tax benefits, mortgage insurance, and the creation of the secondary mortgage market. These programs facilitated home ownership by, among other things, increasing liquidity to loan originators. The rate of homeownership climbed slowly, albeit steadily and safely. But then came the subprime market. Homeownership leaped—but with dire consequences. What drove this market was not the provision of the stability and security of a home, but profits at the expense of the dreamers. Loans with onerous terms were offered to the most precarious and least sophisticated borrowers. The millions of defaults by these hapless borrowers roiled the mortgage and financial markets. Scores of commercial banks that had originated the improvident and poorly secured loans failed. Venerable investment banks—such as Merrill Lynch, Lehman Brothers, and Bear Stearns—that had invested heavily into mortgage-backed securities collapsed. The packaging of mortgage-backed securities and derivatives by these investment

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banks, together with promises of high returns and guarantees, was laudable, to be sure. But with the collapse, these issuers defaulted on billions of dollars of promised investment returns—and investors lost billions. Those we trusted, those with expertise and insight—the economists, the regulators, and the bankers—failed to see the signs of the impending disaster and thus failed to divert us from this course. The role of human judgment waned as mathematical models designed to predict market outcomes seemed infallible. Few suspected that the housing bubble would burst. Even as foreclosures accelerated and housing prices slipped, the regulators merely shrugged. They did not see or feel the fateful vortex of ruin swirling.

There are obvious parallels in history, situations where a confluence of greed, excess, and misguided philosophy also brought the nation to its knees. The Great Depression and the savings and loan association debacle of the 1980s stand out. In each of these prior instances, legislators and regulators were each determined to put into place safeguards against a recurrence. Yet each time, after a period of relative stability, the regulators relaxed their safeguards, believing that we could once again trust in the integrity of market actors and the rationality of the market itself. The actors, for their part, seemed to have all labored under a common myopia. They acted without the prudence of knowing the underlying worth of their purchases, without the constraints of traditional capital and risk requirements, and without regard for market history.

The Symposium, *Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms*, presented jointly by the PACE LAW REVIEW and the Pace University School of Law, L.L.M. Program in Real Estate Law on March 20, 2009, offered a dialogue on the existing philosophies underlying the regulation of the economy in general and the mortgage financing industry in particular, and discussed the need for a new ethic to govern and motivate participants in the lending industry. We considered ways that the economy might escape the ruthless vortex that was created by hope, fear, and cupidity.

In this Symposium issue of PACE LAW REVIEW, the articles set out to examine how we got to this point, yet again, and to ponder how to set us on a safe course far away from another near ruin. My own article[1] attempts to set the stage for the other articles presented herein. It describes the frightening magnitude of the crises—in the mortgage market, the courts, and the financial markets—affecting our nation, as well as the world, and it identifies the three ends that should be the focus of our national response: preserving homeownership, protecting the integrity of the markets, and avoiding the moral hazard. The themes underlying these goals, now seemingly obvious to many, yet elusive to most in the last few years, are taken up in various ways by the other authors in this issue.

Professor Mark A. Edwards[2] examines the history of banking in the United States and reveals how our regulatory schemes—such as the tightening and loosening of constraints on banks and other market participants—have almost mechanically responded to the competing forces of ideology on the one hand, and pragmatism on the other. The ideology of free markets had reigned until some crisis requiring pragmatic responses occurred. Understanding these historical patterns should inform the development of a regulatory scheme that reflects a constant and consistent strategy that considers the imperatives and lessons of history.

Professor Vincent Di Lorenzo[3] brings home these concerns and explains in real terms how Congress's aim to create a more-or-less free market in mortgages by lifting regulatory constraints on national banks and thrifts, and by moving toward offering only "guidances," did not fully consider the avenues for the self-interested and opportunistic conduct that such a policy would create. Banks almost uniformly ignored the guidances and made loans without consideration of a borrower's ability to repay, employing a whole range of exotic and inscrutable mortgage products. Not only did this hands-off regulatory model not work to improve homeownership, with the millions of foreclosures and the ripple effects of this phenomenon throughout the economy—including a drop in the gross

1. Shelby D. Green, *Disquiet on the Home Front: Disturbing Crises in the Nation's Markets and Institutions*, 30 PACE L. REV. 7 (2009).

2. Mark A. Edwards, *Nationalization, De-Nationalization, Re-Nationalization: Some Historical and Comparative Perspective*, 30 PACE L. REV. 124 (2009).

3. Vincent Di Lorenzo, *Unsafe Loans in a Deregulated U.S. Mortgage Market*, 30 PACE L. REV. 154 (2009).

domestic product, consumer spending, and high unemployment—it created a net loss.

Navid Vazire[4] continues with an analysis of the securitization process, explaining how it provided liquidity which enabled lenders to make loans to a greater number of people and to people who otherwise would have been shut out of the market. He also explains how the securitization process radically changed the incentives of lenders—from expecting returns from safe investments over time, to expecting immediate gains from up-front processing fees. As a consequence, lenders engaged in practices that are now described as predatory. They targeted the most vulnerable and precarious borrowers, who already posed a risk of likely default, and this risk passed onto investors in the securitization products.

Something other than sheer greed and short-sightedness must account for the financial near-collapse. Professor Robin Paul Malloy[5] considers the extent to which there are systemic flaws and fallacies in economic philosophy. He comments that the reliance upon Adam Smith's "invisible hand" philosophy has decidedly been shown as an incorrect decision. Such reliance must cease once one accepts the fact that markets are not self-correcting. Indeed, if we move away from the conception of "market" as a desirable end in itself—the negative effects falling on all those in the wake of another's pursuit of profit—toward something that enables the arrangement of exchange networks to achieve cost-effective goals and objectives, then the need for regulation and oversight to confirm a market's ability to effectuate these ends is imperative. Judgment and accountability must be reintroduced into market transactions.

Professor Prentiss Cox[6] believes that the greatest regulatory failure in this crisis was the shift in regulatory focus toward the fiscal soundness of banking entities, and away from consumer protection. In fact, federal regulatory agencies enacted

4. Navid Vazire, *Smoke and Mirrors: Predatory Lending and the Subprime Mortgage Loan Securitization Pyramid Scheme*, 30 PACE L. REV. 41 (2009).

5. Robin Paul Malloy, *Mortgage Market Reform and the Fallacy of Self-Correcting Markets*, 30 PACE L. REV. 79 (2009).

6. Prentiss Cox, *The Importance of Deceptive Practice Enforcement in Financial Institution Regulation*, 30 PACE L. REV. 279 (2009).

regulations that preempted many effective state consumer protection laws. Consumer protection at the federal level should include more than mere disclosure, but limits on lending practices should be prescribed and aggressive enforcement of consumer protection laws must be undertaken. Allen H. Scheiner,[7] while recognizing the need for greater regulatory oversight, believes that the best approach would be to develop uniform, national standards, rather than to rely upon individual state laws. He believes that state laws, while addressing predatory lending—particularly those laws that have recently been enacted—purport to impose liability upon assignees of mortgages, not because of any objective culpability, but solely as a consequence of having purchased a loan. These laws are thus based upon newly-crafted definitions of unfair trade practices, and as such, risk market uncertainty and threaten to upset the carefully crafted national policies, as reflected in recent amendments to banking laws. Mr. Scheiner argues that a securitized transaction is a national affair.

Banks and homeowners were not the only ones to be sent reeling by the financial crisis. In fact, as Suzanne M. Garcia[8] describes, reckless and improvident lending practices have wreaked havoc in the title insurance industry as well, leading to revenue shortages and reductions in staff. Not only do title examinations now take longer to complete, but they have become more complicated as many states have enacted procedural requirements for making loans in the first place and for pursuing foreclosures. The failure to comply may mean that a loan will be avoided or that title will fail, thus giving rise to claims under the title policy. The specter of such claims is rather large, particularly because an examination of the cold land records cannot reveal the circumstances of a failure to comply with borrower protection requirements. Marvin N. Bagwell[9] describes how the whole process of securitization and the lack of regulatory oversight provided an environment for more and more schemes designed to fleece the next person down the line.

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7. Allen H. Scheiner, *State Subprime Lending Litigation and Federal Preemption: Toward a National Standard*, 30 PACE L. REV. 253 (2009).

8. Suzanne M. Garcia, *A Glance at the Impact of the Subprime Mortgage Crisis on the Title Insurance Industry*, 30 PACE L. REV. 233 (2009).

9. Marvin N. Bagwell, *Can't Live Without Air: Title Insurance and the Bursting of the Real Estate Bubble*, 30 PACE L. REV. 180 (2009).

These circumstances enabled the denials or finger-pointing by those who kept silent when they should have declared that the transactions "stink to high heaven."

So far, the Federal Government's response to this grave crisis has been a massive infusion of capital—including loans to ailing banks, purchases of bank stock, reduction of the Federal Reserve's discount rate, loan modification programs, and rescues of failing banks. These responses, though, seem to be *ad hoc*, developed on the fly, as if responding to a sudden casualty—an act of God. But who should pay for these efforts? How should actors be put on notice of their liability for future disasters? Professor Mehmet K. Konar-Steenberg[10] identified parallels to another national disaster that required massive and sustained government involvement to remedy. This earlier response, CERCLA,[11] involved a comprehensive scheme to hold all potentially responsible parties liable for active conduct as well as for the failure to address conduct that could produce harm. In the current disaster, the range of potentially responsible parties would quite fairly begin with the loan originators, extend to credit ratings agencies, and also include investment bankers. Professor Konar-Steenberg notes that this class might be even broader.

The theme that seems to pervade the articles in this issue of the PACE LAW REVIEW is the need to reign in the baser human instincts—those that manifest themselves in greed, undue risk-taking, and folly—and to introduce higher norms of honesty, prudence, and judgment. These themes will surely inform legislators and regulators as they seek to adopt measures to make the mortgage and financial worlds safe again.

10. Mehmet K. Konar-Steenberg, *A Superfund Solution for an Economic Love Canal*, 30 PACE L. REV. 310 (2009).

11. The Comprehensive Environmental Response, Compensation, and Liability Act of 1980, § 101, 42 U.S.C. § 1901 (2006).