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# Capital in Chaos: the Subprime Mortgage Crisis and the Social Capital Response

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# ARTICLES

## CAPITAL IN CHAOS: THE SUBPRIME MORTGAGE CRISIS AND THE SOCIAL CAPITAL RESPONSE

RAYMOND H. BRESCIA\*

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Can law create trust? Can law make people more trustworthy? These are some of the questions posed by scholars across the political spectrum interested in the impact of law on society. There is no shortage of arguments on both sides of these questions: that law can be a tool for promoting trust, or destroying it. This Article is an attempt to address these questions through an analysis of a single market, to explore the interplay between law and trust in a situation of abject market failure: the subprime mortgage crisis in the United States. It is possible that as many as three million American homeowners will lose their homes to foreclosure over the coming years, and the subprime mortgage crisis has spilled over into many other areas of the market, resulting in a global credit crunch and likely spurring a deep recession.

This analysis will look to the roots of this crisis to determine the extent to which aspects of trust, cooperation and mutual interdependence were lacking. As the following discussion shows, asymmetry of information and inadequate legal protections created market incentives that led to the collapse of this sector. The worst abuses of the subprime market came about because of a breakdown of economic relationships that were, in the past, bound by trust and mutual interdependence. In addition, deregulation, the lasting impact of mortgage lending discrimination and the fact that much subprime lending took place outside the scope of some of the laws designed to combat discrimination in mortgage lending, all resulted in a dramatic increase in subprime lending in previously underserved communities, and this increase disproportionately impacted communities of color.

This Article makes the case for the need for legal protections in markets that change: those that transform from a situation where trust is high and informal mechanisms of enforcing trust are effective, to one where such informal mechanisms are no longer useful. Furthermore, this analysis also concludes that the legal framework in place to prevent discrimination in the mortgage market was ill-equipped to deal with reverse redlining—the concentration of subprime mortgage products in, and the targeting by subprime lenders of, previously underserved African-American and Latino communities. Thus, the legal regime in place—or, more accurately, the *absence* of legal protections—created a legal vacuum where abuse of trust could thrive.

The home mortgage market in its traditional form, and when it worked well, was one in which personal relationships between parties involved in the transaction could trust one another and were constrained by laws created to combat discriminatory denials of credit. When this market experienced a radical transformation, and these personal relationships gave way to more impersonal transactions, the law has proven slow to respond. I submit that responses to the changes to the market should attempt to take into account the extent to which the market might have functioned well in its high trust incarnation and try to recreate and build trust on a larger scale. With the advance of globalization, and the transition of many economic markets, such insights might help in guiding markets to adopt legal protections that might incorporate the ways that laws can foster trust and promote economic growth.

Through this analysis, I will utilize the concept of social capital—defined as “social networks and the associated norms of reciprocity and trustworthiness”<sup>1</sup>—and analyze the subprime mortgage crisis in an effort to explore the ways that laws and

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<sup>1</sup>Robert D. Putnam, *E Pluribus Unum: Diversity and Community in the Twenty-first Century*, 30 SCANDINAVIAN POL. STUD. 137, 137 (2007).

legal institutions can foster, promote, discourage and decrease trust, trusting behavior and trustworthiness.

Initially, I will introduce the concept of social capital, as it has been defined by sociologists, historians, legal scholars and economists, and provide an overview of the arguments concerning the effects of law on trust and social capital. I will then provide a history of the subprime mortgage crisis and examine some of the key facets of the market that created the conditions necessary for its collapse, looking specifically at the following: (1) the relationship between the borrower, mortgage broker and lender and the incentives created by the mortgage securities market; (2) the asymmetries of information that pervade these relationships; (3) the terms of the mortgage and subsequent security agreements and the likelihood that borrowers in default might enjoy relief from foreclosure. After this analysis, I will review the extent to which changes in the legal and regulatory framework failed to take into account the role that social capital plays in the mortgage market and whether legal institutions in place are adequate to respond to the collapse of the market and the lasting impact of discrimination in that market. I will then propose responses to the causes for the subprime mortgage crisis that take into account the role that social capital can play in mortgage finance transactions and analyze the extent to which these proposals might strengthen this market at present and into the future.

#### I. LAWS, NORMS OF TRUST AND SOCIAL CAPITAL

It is now well recognized that the norms and networks that develop as a result of interactions within civil society—i.e., that sphere of human interaction that is separate from the state—can have a distinct value for creating trust and trustworthiness. For the purposes of this Article, I will join others in describing these norms and networks, collectively, as “social capital.” Driven by norms of trust, shared interests and generalized reciprocity, social capital plays a critical role in ensuring that neighborhoods, markets, communities and nations function well and efficiently.<sup>2</sup>

The relative presence or strength of social capital can mean the difference between a well-functioning society and one that is riddled by corruption, crime, low levels of civic participation and high levels of mistrust of neighbors, civic institutions, and elected officials. Research shows that in communities where social capital is high, the residents of those communities are healthier, wealthier, happier, and feel stronger bonds to their neighbors in particular and their communities in general.<sup>3</sup>

For the purposes of this Article, I will borrow the definition articulated earlier, and will use the term social capital to refer to “social networks and the associated norms of reciprocity and trustworthiness.”<sup>4</sup> Such networks and norms help to

<sup>2</sup>See, e.g., ROBERT D. PUTNAM, *BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY* 19 (2000); ROBERT C. SOLOMON & FERNANDO FLORES, *BUILDING TRUST: IN BUSINESS, POLITICS, RELATIONSHIPS, AND LIFE* 20 (2001).

<sup>3</sup>See, e.g., Michael Woolcock, *The Place of Social Capital in Understanding Social and Economic Outcomes*, 2 *CANADIAN J. OF POL’Y RESEARCH* 1, 5 (2001), available at <http://www.oecd.org/dataoecd/5/13/1824913.pdf> (compiling studies of the developing world).

<sup>4</sup>See Putnam, *supra* note 1. See also Deepa Narayan, *Bonds and Bridges: Social Capital and Poverty* 6 (World Bank Poverty Group, Working Paper, 1999) (“[S]ocial capital is defined as the norms and social relations embedded in the social structures of society that enable

overcome collective action problems in several ways. First, they facilitate feelings of obligation to other members of a network and lead to expectations of certain conduct between such members. Second, they help to promote the flow of information, to overcome information asymmetries, including answering the question “who can be trusted.” Third, they convey a set of norms that carry sanctions for violation of such norms.<sup>5</sup>

In these ways, social capital facilitates communication and exchange between individuals. When individuals are able to engage in conduct that furthers their mutually beneficial ends they are able to build a trusting relationship that facilitates mutually beneficial conduct in the future, with fewer costs associated with monitoring the behavior of those participating in the activity and searching for adequate partners for collective action. These relationships are constrained by the threat of many different types of sanctions that might discourage predatory conduct and encourage a receptivity and penchant for future collective activity. Such sanctions can result in harm to reputation and shunning, to more formal punishment, administered by the state.

As a number of commentators have noted, “life is easier” when the presence of social capital is high in a community.<sup>6</sup> As Robert Putnam explains:

In the first place, networks of civic engagement foster sturdy norms of generalized reciprocity and encourage the emergence of social trust. Such networks facilitate coordination and communication, amplify reputations, and thus allow dilemmas of collective action to be resolved. When economic and political negotiation is embedded in dense networks of social interaction, incentives for opportunism are reduced. At the same time, networks of civic engagement embody past success at collaboration, which can serve as a cultural template for future collaboration. Finally, dense networks of interaction probably broaden the participants' sense of self, developing the “I” into the “we,” or . . . enhancing the participants' “taste” for collective benefits.<sup>7</sup>

Social capital can be found in the relations between two neighbors; in the collective activity of a neighborhood association; in business transactions; in the communications between the constituents of a national, membership organization. It can even be virtual, found in an internet chat room or affinity group. In sum, social

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people to co-ordinate action and to achieve desired goals.”). *See also* Woolcock, *supra* note 3, at 9 (“[S]ocial capital refers to the norms and networks that facilitate collective action.”).

<sup>5</sup>James S. Coleman, *Social Capital in the Creation of Human Capital*, 94 AM. J. OF SOC. (SUPP.) S95, S119 (1988).

<sup>6</sup>Robert D. Putnam, *Bowling Alone, Revisited*, 5 THE RESPONSIVE CMTY. 18, 20 (1995); Jason Mazzone, *Towards A Social Capital Theory of Law: Lessons from Collaborative Reproduction*, 39 SANTA CLARA L. REV. 1, 8 (1998).

<sup>7</sup>Putnam, *supra* note 6, at 20. *See also* Denise M. Rousseau et al., *Not So Different After All: A Cross-Discipline View of Trust*, 23 ACAD. MGMT REV. 393, 394 (1998) (“There is agreement that trust is important in a number of ways: it enables cooperative behavior; promotes adaptive organizational forms, such as network relations; reduces harmful conflict; decreases transaction costs; facilitates rapid formulation of ad hoc work groups; and promotes effective responses to crisis.”) (citations omitted).

capital “commonly refers to the stocks of social trust, norms, and networks that people can draw upon in order to solve common problems.”<sup>8</sup> Indeed, some level of social capital and trust is necessary for many forms of human interactions, collective action and the promotion of collective interests, especially economic endeavors.<sup>9</sup>

Norms of trust flourish, and are typically present, in the relations between individuals in, and the activities of, voluntary networks and associations:

Whereas physical capital refers to physical objects and human capital refers to properties of individuals, social capital refers to connections among individuals – social networks and the norms of reciprocity and trustworthiness that arise from them. In that sense social capital is closely related to what some have called “civic virtue.” The difference is that ‘social capital’ calls attention to the fact that civic virtue is most powerful when embedded in a dense network of reciprocal social relations. A society of many virtuous but isolated individuals is not necessarily rich in social capital.<sup>10</sup>

There are two types of social capital. The first, “bonding” social capital, refers to the norms of reciprocity and trust that develop within a closely knit group that help facilitate information sharing, mutual support and collective action. The second, “bridging” social capital, helps facilitate connections between individuals in different networks, and facilitates information sharing and economic exchange across different closely knit associations.<sup>11</sup> The two types of social capital have also been

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<sup>8</sup>Robert E. Lang & Steven P. Hornburg, *What is Social Capital and Why Is It Important to Public Policy?*, 9 HOUS. POL’Y DEBATE 1, 4 (1998).

<sup>9</sup>See, e.g., Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. AND PUB. AFF. 343, 357 (1972) (“Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence.”) (citation omitted). It seems hard to imagine walking out one’s door without engaging in a great deal of trust just to get through the morning. The train or subway operator, the bus driver, the car manufacturer, the coffee vender and muffin purveyor all are actors in whose hands we place our lives every day in the belief they will not drive off the rails or road, not assemble defectively, and not poison us. See also FRANCIS FUKUYAMA, *TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY* 151-152 (1995) (arguing that a basic level of trust that permits day-to-day activities is likely “a matter of habit” that is “fairly widespread” throughout society).

<sup>10</sup>PUTNAM, *supra* note 2, at 19. As one early proponent of the concept of social capital asserts: “Unlike other forms of capital, social capital inheres in the structure of relations between actors and among actors. It is not lodged either in the actors themselves or in physical implements of production.” Coleman, *supra* note 5, at S98.

<sup>11</sup>PUTNAM, *supra* note 2, at 22. Putnam goes on to explain that bonding social capital is “inward looking and tend[s] to reinforce exclusive identities and homogeneous groups.” *Id.* at 22. Bridging social capital tends to be “outward looking and encompass[es] people across diverse social cleavages.” *Id.* “Dense networks in ethnic enclaves, for example, provide crucial social and psychological support for less fortunate members of the community, while furnishing start-up financing, markets, and reliable labor for local entrepreneurs. Bridging networks, by contrast, are better for linkages to external assets and for information diffusion.” *Id.* See also Christiaan Grootaert & Thierry van Bastelaer, *Understanding and Measuring Social Capital: A Synthesis of Findings and Recommendations from the Social Capital*

described, by Xavier de Souza Briggs, respectively, as, first, “social support”, which “helps one ‘get by’ or cope,” the forms of which “might include being able to get a ride, confide in someone, or obtain a small cash loan in an emergency”; and, second, as “social leverage,” which “helps one ‘get ahead’ or change one’s opportunity set through access to job information, say, or a recommendation for a scholarship or loan.”<sup>12</sup> A critical component of bridging social capital is the ability of individuals and networks to move beyond closer bonds, and share information and ideas across otherwise insular networks.<sup>13</sup> A failure on the part of an insular group to recognize the need for bridging beyond its members’ particular characteristics to create broader networks of trust represents the “dark side” of social capital: when bonding social capital produces negative consequences for the larger community, which is present in such groups as the Ku Klux Klan or an organized crime “family.”<sup>14</sup>

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*Initiative 16* (World Bank Soc. Cap. Initiative, Working Paper No. 24, 2001); ROSS GITTELL & AVIS VIDAL, *COMMUNITY ORGANIZING: BUILDING SOCIAL CAPITAL AS A DEVELOPMENT STRATEGY 10* (1998) (describing forms of social capital).

<sup>12</sup>Xavier de Souza Briggs, *Brown Kids in White Suburbs: Housing Mobility and the Many Faces of Social Capital*, 9 HOUS. POL’Y DEBATE 177, 178 (1998) (citations omitted). *See also* Woolcock, *supra* note 3, at 10 (“[Bonding social capital] refers to relations between family members, close friends, and neighbors, . . . [bridging social capital refers to] more distant friends, associates, and colleagues.”).

<sup>13</sup>*See, e.g.*, WORLD BANK, *WORLD DEVELOPMENT REPORT 2000/2001: ATTACKING POVERTY 117-28* (2001). The differences between these two forms of social capital can be subtle, but both forms can be mutually reinforcing. In one study of U.S.-based microenterprise programs that focused on building both bonding and bridging capital, borrowers were able to form relationships with other borrowers that increased networking opportunities and helped build self-esteem and increased marketing and information-sharing among the borrowers (an example of bonding social capital at work). At the same time, these strong networks were also able to make connections with other organizations, lenders and government entities, to improve economic opportunities for their members (an example of bridging social capital). Lisa J. Servon, *Credit and Social Capital: The Community Development Potential of U.S. Microenterprise Programs*, 9 HOUS. POL’Y DEBATE 115, 119-45 (1998).

<sup>14</sup>*See, e.g.*, Putnam, *supra* note 2, at 340 (describing negative consequences of some forms of social capital); Nat J. Colletta & Michelle L. Cullen, *The Nexus Between Violent Conflict, Social Capital and Social Cohesion: Case Studies from Cambodia and Rwanda*, (World Bank Soc. Cap. Initiative, Working Paper No. 23, 2000) (describing negative effects of bonding social capital in Rwandan genocide). Given the potential negative externalities associated with associational activity, some scholarship has focused less on associational activity and more on the role of trust and trusting behavior for improving economic conditions. *See, e.g.*, Stephen Knack & Philip Keefer, *Does Social Capital Have an Economic Payoff? A Cross-Country Investigation*, 112 Q. J. ECON. 1251, 1271-1274 (1997) (arguing that associational activity that involves homogenous actors engaged in self-interested, rent-seeking activities can reduce levels of trust in a society); MANCUR OLSON, *THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES* (1982); Stephen Knack, Address at the HRDC-OECD International Symposium on the Contribution of Investment in Human and Social Capital to Sustained Economic Growth and Well Being: Trust, Associational Life and Economic Performance 1, 31-32 (Mar. 19, 2000), *available at* <http://www.oecd.org/dataoecd/6/31/1825662.pdf> (arguing that “high radius trust” is more closely linked to economic growth than associational activity) [hereinafter Knack, *Trust*]; Michael P. Claibourn & Paul S. Martin, *Trusting and Joining? An Empirical Test of the Reciprocal Nature of Social*

Communities with a history of civic activism that are high in social capital have been shown to have highly effective governments.<sup>15</sup> To the extent that social capital thrives in the activity of civic associations, social capital can be enhanced by laws that promote civic participation, like a legal tradition that promotes free speech, freedom of association and freedom of religion. In these ways, the concept of social capital takes into account “the most formalized institutional relationships and structures, such as government, the political regime, the rule of law, the court system, and civil and political liberties.”<sup>16</sup> When social capital takes this form—when it “facilitates mutually beneficial collective action through established roles and social networks supplemented by rules, procedures, and precedents”—it is often referred to as “structural” social capital, which is to be distinguished from “cognitive” social capital, “which includes shared norms, values, attitudes, and beliefs, [which] predisposes people toward mutually beneficial collective action.”<sup>17</sup>

There is an obvious interplay between the cognitive aspects of social capital and its structural elements, particularly with respect to the extent to which a given individual will engage in trusting behavior of another. An individual’s willingness to trust, that is, to engage in an “optimistic acceptance of a vulnerable situation in which the trustor believes the trustee will care for the trustor’s interests,”<sup>18</sup> will depend on a range of factors, including the extent to which one’s trust will not be abused, that one will not be in a worse off position because of such trust. This calculation will be a function of many factors, including the trustor’s experience with trusting generally, the knowledge the trustor has about the foreseeable conduct of the trusted, and whether the trusted feels sufficiently protected from the downside risk of trusting, i.e., the nature and effectiveness of the sanctions for breach of trust that are available. While a mountain of research exists concerning individual’s likelihood to trust, often tested in classic “prisoner’s dilemma” games,<sup>19</sup> an exploration of this

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*Capital*, 22 POL. BEHAV. 267 (2000) (finding little correlation between associational activity and trust); PIPPA NORRIS, *DEMOCRATIC PHOENIX: REINVENTING POLITICAL ACTIVISM* 153-156 (2002) (conducting cross-country analysis and linking economic growth to trust and not associational behavior).

<sup>15</sup>See, e.g., ROBERT D. PUTNAM ET AL., *MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY* (1993); Coleman, *supra* note 5, at S105-S108. Cross-country studies have established a high correlation between levels of trust in society and effective government. See, e.g., Rafael LaPorta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. PAPERS & PROC. 333 (1997) (conducting cross-country analysis and finding higher levels of trust consistent with better functioning governments); Knack & Keefer, *supra* note 14, at 1275-1277; Stephen Knack, *Social Capital and the Quality of Government: Evidence from the States*, 46 AM. J. OF POL. SCI. 772 (2002) (finding opinions of government performance higher in states within the United States where social capital was higher).

<sup>16</sup>Thierry van Bastelaer, *Imperfect Information, Social Capital and the Poor’s Access to Credit* 6 (World Bank Soc. Cap. Initiative, Working Paper No. 234, 2000).

<sup>17</sup>Anirudh Krishna & Norma Uphoff, *Mapping and Measuring Social Capital Through Assessment of Collective Action to Conserve and Develop Watersheds in Rajasthan, India*, in *THE ROLE OF SOCIAL CAPITAL IN DEVELOPMENT* 85, 87 (Christiaan Grootaert & Thierry van Bastelaer eds., 2002).

<sup>18</sup>Mark A. Hall, *Law, Medicine and Trust*, 55 STAN. L. REV. 463, 474 (2002).

<sup>19</sup>In a survey of research concerning prisoner’s dilemma games, Professors Blair and Stout identify common themes from these studies, including that individuals are not always strictly



literature is beyond the scope of this Article. Instead, I will focus on the so-called structural aspects of this calculation, which brings us back to the questions first posed in this piece: can the law create trust and can it make people more trustworthy?

There is a growing body of literature that is now looking at the extent to which social capital theory can inform our understanding of how laws and the legal system can promote trust,<sup>20</sup> how laws can weaken or strengthen social capital,<sup>21</sup> and how social capital theory can even serve as an aid in constitutional interpretation.<sup>22</sup>

Some argue that laws remove the incentives for individuals and communities to work together to overcome collective action problems.<sup>23</sup> A community that is self-

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individualistic and self interested, that individuals vary in their willingness to trust, and that economic incentives can influence an individual's willingness to trust. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1741-1742 (2001) (summarizing research) (citations omitted). See also ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984) (describing prisoner's dilemma theory and outcomes of prisoner's dilemma games); David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958-1992*, 7 RATIONALITY & SOC'Y 58 (1995) (summarizing findings from prisoner's dilemma studies).

<sup>20</sup>Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996) (assessing impact of law on development of social norms); Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457 (2005) (assessing legal system's ability to foster trust and increase positive social capital); Jason Mazzone, *When Courts Speak: Social Capital and Law's Expressive Function*, 49 SYRACUSE L. REV. 1039, 1041 (1999) ("An expressive function may, in fact, be the most significant one that courts perform"); Richard H. McAdams, *The Origin, Development and Regulation of Norms*, 96 MICH. L. REV. 338 (1997) (analyzing extent to which law can strengthen or erode societal norms). Cf. Russell Hardin, *Distrust*, 81 B.U. L. REV. 495 (2001) (arguing trust is not a resource that can serve as a form of social capital).

<sup>21</sup>Richard H. Pildes, *The Destruction of Social Capital Through Law*, 144 U. PA. L. REV. 2055 (1996) (analyzing extent to which laws can erode conditions necessary for social capital to flourish); Jason Mazzone, *Towards a Social Capital Theory of Law: Lessons from Collaborative Reproduction*, 39 SANTA CLARA L. REV. 1 (1998) (arguing for analysis of family law from the perspective of promoting social capital); Asmara Tekle Johnson, *Correcting for Kelo: Social Capital Impact Assessments and the Re-Balancing of Power Between "Desperate" Cities, Corporate Interests and the Average Joe*, 16 CORNELL J.L. & PUB. POL'Y 187 (2006) (arguing for social capital impact assessment of eminent domain actions); Sheila R. Foster, *The City as an Ecological Space: Social Capital and Urban Land Use*, 82 NOTRE DAME L. REV. 529 (2006) (analyzing impact of land use law on social capital formation).

<sup>22</sup>Jason Mazzone, *The Social Capital Argument for Federalism*, 11 S. CAL. INTERDIS. L.J. 27 (2001) (analyzing extent to which federalism in the constitutional structure of the United States promotes social capital).

<sup>23</sup>For analysis that sees the rise of the law and lawyers as eroding trust, see, e.g., FUKUYAMA, *supra* note 9, at 309-311 (arguing that trust has been displaced by legalistic approaches to societal disputes that are less effective and efficient); MARY ANN GLENDON, *RIGHTS TALK: THE IMPOVERISHMENT OF POLITICAL DISCOURSE* (1991) (arguing that adherence to the absolute protection of individual rights undermines creation of community of shared interests); MICHAEL TAYLOR, *THE POSSIBILITY OF COOPERATION* (1987). Some scholars point to the phenomenon that excessive control through regulation and oversight can lead to a reduction in trust and trusting behavior, as the trusting become pre-occupied with controls and regulating the acts of the trusted, and the trusted (or not so trusted) feel they are not trusted

regulating, with swift punishment for offenders of the common interest, enjoys more efficient activities and outcomes, with infrequent resort to the courts and legal system, which would otherwise carry with them high transactions costs.<sup>24</sup> Others posit that laws and regulations, when focused on protecting individual rights over communitarian sensibilities, create a fractured society that emphasizes difference over shared histories and interests.<sup>25</sup> Theorists who believe law weakens trust argue that countries with higher rates of trust in the aggregate have greater economic growth and better functioning democracies.<sup>26</sup>

Defenders of the role of law in promoting trust point to the role that law and regulations can have in creating a legal “backstop” that permits trust to flourish in a given setting, facilitating collective and beneficial action. Research shows that functioning markets require the rule of law and an effective legal regime that honors and enforces contracts and protects property rights.<sup>27</sup> Similarly, formal legal institutions can enhance trust because parties can believe that others will adhere to their contracts and cooperation can be encouraged when agents agree to follow professional licensing requirements and ethical codes.<sup>28</sup> Litigation can also serve to

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due to the fact that those supposedly trusting them are engaged and pre-occupied with oversight. *See, e.g.*, Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 580-584 (2001) (arguing regulation promotes opportunistic behavior that undermines trust); Sumantra Ghoshal & Peter Moran, *Bad for Practice: A Critique of the Transaction Cost Theory*, 21 ACAD. MGMT REV. 13, 24 (1996) (arguing oversight reduces trusting and trustworthy behavior).

<sup>24</sup>*See, e.g.*, ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991) (arguing that in high trust communities, transactions costs are reduced because of recourse to informal mechanisms for resolving disputes); *See* Knack, *Trust*, *supra* note 14, at 5 (arguing that costs of contract enforcement and agency monitoring is reduced in high trust communities).

<sup>25</sup>For the communitarian analysis of law and trust, *see, e.g.*, AMITAI ETZIONI, *THE SPIRIT OF COMMUNITY, RIGHTS, RESPONSIBILITIES, AND THE COMMUNITARIAN AGENDA* (1993).

<sup>26</sup>*See, e.g.*, FUKUYAMA, *supra* note 9, at 7; Paul F. Whitley, *Economic Growth and Social Capital*, 48 POL. STUD. 443, 455-459 (2000) (conducting a thirty-four country study to show that economic performance is closely related to social capital); Knack & Keefer, *supra* note 14, at 1258-1274 (showing positive relationship between levels of trust in society and economic growth).

<sup>27</sup>*See, e.g.*, Rafael LaPorta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1147-49 (1997) (conducting a forty-nine country study and finding that nations with stronger investor protections and enforcement had larger and more robust capital markets); Paul J. Zak & Stephen Knack, *Trust and Growth*, 111 ECON. J. 295, 307-16 (2001) (conducting a cross-country analysis of forty-one nations and finding that the relative strength of formal institutions that promote trust—like investor protections and enforceability of contracts—relate “positively and significantly” with higher growth).

<sup>28</sup>Knack, *Trust*, *supra* note 14, at 8. *See also*, Douglas G. Baird, *Self-Interest and Cooperation in Long-Term Contracts*, 19 J. LEGAL STUD. 583-84 (1990) (arguing that contract law fosters cooperation by permitting parties to overcome suspicion); Simon Deakin et al., *Contract Law, Trust Relations, and Incentives for Co-Operation: A Comparative Study in CONTRACTS, CO-OPERATION AND COMPETITION: STUDIES IN ECONOMICS, MANAGEMENT AND LAW* 105, 133 (Simon Deakin & Jonathan Michie eds., 1997) (conducting cross-country analysis of firm behavior in three European countries and finding that contract law facilitates economic activity by reducing uncertainty and complexity in business relationships).

remedy breaches of trust, make those guilty of such breaches accountable to those whose trust they violated, and try to restore confidence in the trusted.<sup>29</sup>

As in most things in life, however, the answers to these questions are not always simple, one sided or definitive. There is no easy formula for determining cause and effect. Trust can improve interactions between actors, can make government run more efficiently, and can reduce the need for legal interventions, but effective government and non-arbitrary enforcement of the law can also foster trust and trusting behavior.

The relationship between trust and civic cooperation, on the one hand, and property rights and government performance on the other, is likely to be complex, with each influencing the other. Formal institutions can be substitutes for—as well as causes of—trust and civic cooperation. Societies with low trust require more robust formal institutions if they are to undertake the exchanges that are crucial to growth.<sup>30</sup>

Research shows that trust is higher in homogenous communities where the likelihood of repeat interactions is higher; the presence of such attributes of a society increases the effectiveness of sanctions such as reputational harm and shunning.<sup>31</sup> In more heterogeneous communities, social capital is harder to develop; there the power of trust sanctions is significantly weaker.<sup>32</sup> In such settings, the need for greater monitoring and stronger legal controls is apparent.<sup>33</sup>

The fall of the Soviet Union and the spread of globalization have opened up societies and markets throughout the world to new ideas, commerce, and investment. Communities in emerging economies recovering from state control or integrating their economies into the world economy for the first time have proven a rich field of study to stress the importance of social capital in economic development in such settings.<sup>34</sup> This research has allowed us to see the importance of social capital in overcoming collective action problems in areas where civil society has been non-existent (due to restraints on civil liberties), or where social capital has been strictly insular and of the “bonding” variety.

But so-called “emerging markets” are not the only markets that are in a state of transformation. Globalization has impacted markets even in post-industrial Western

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<sup>29</sup>For an analysis of the role of tort litigation in remedying the breaches of trust evident in the recent sexual abuse scandals in the Roman Catholic Church in the United States, see Timothy D. Lytton, *Clergy Sexual Abuse Litigation: The Policymaking Role of Tort Law*, 39 CONN. L. REV. 809 (2007).

<sup>30</sup>See, Knack & Keefer, *supra* note 14, at 1279, n. 34.

<sup>31</sup>Edward L. Glaeser et al., *Measuring Trust*, 115 Q. J. ECON. 811, 814 (2000) (finding the degree of social connection between individuals correlated to trusting and trustworthy behavior).

<sup>32</sup>Putnam, *supra* note 1, at 141-151, (finding the level of social capital reduced in communities with increased heterogeneity).

<sup>33</sup>Zak & Knack, *supra* note 27, at 296-98.

<sup>34</sup>Two excellent collections of important research in this area are: *ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMIES* (Peter Murrell ed., 2001), and *ROLE OF SOCIAL CAPITAL IN DEVELOPMENT: AN EMPIRICAL ASSESSMENT* (Christiaan Grootaert & Thierry van Bastelaer eds., 2002).

countries, and relationships of trust and mutual interdependence have broken down in many areas, creating impersonal interactions where the norms and sanctions that might facilitate more trusting behavior are ineffective.<sup>35</sup> Jane Jacobs's Hudson Street, with its collection of shopkeepers, neighbors and friends, all engaged in a dance of commerce and communication,<sup>36</sup> have given way to gated communities, drive-through stores and internet commerce. While emerging markets have been the target of a great deal of research on the importance of social capital, less focus has been placed on markets transitioning from ones dominated by local, longer term interactions, to ones on a global stage where networks of trust are less effective in curbing predatory conduct.

As a way to join this rich debate, it is helpful to test the different theories about trust and social capital in previously unexplored areas. Such research can serve to address some of the lingering questions about the role of law in promoting or destabilizing trust and social capital. I submit that an area that is appropriate for such an analysis is the home mortgage market in the United States generally, and the subprime market in particular.

The current system of home mortgage finance is rife with instances where social capital plays a critical role in the proper functioning of this market. The mortgage borrower-lender relationship is one that traditionally has been defined by mutual interdependence and elements of trust. Furthermore, informal information networks have proven helpful in identifying potential borrowers and linking them to prospective lenders. Given the deep interplay between social capital and the mortgage market, it is thus helpful to attempt to analyze the subprime mortgage meltdown to understand the role that social capital might have played in this collapse and determine if the presence or absence of law and functioning legal institutions had any impact on this demise.<sup>37</sup>

As the analysis in Part II, *infra*, shows, in many ways the crisis in the subprime mortgage market can trace some of its root causes to the rupture of the traditional borrower-lender relationship. At the heart of this relationship are elements of trust, shared interests and shared risks: all essential features of an environment where

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<sup>35</sup>See, e.g., Joseph E. Stiglitz, *Formal and Informal Institutions*, in SOCIAL CAPITAL: A MULTI-FACETED PERSPECTIVE 59, 64-67 (Partha Dasgupta & Ismail Serageldin eds., 2000) (describing transition of developed economies with respect to nature of social capital at work within them).

<sup>36</sup>JANE JACOBS, THE DEATH AND LIFE OF GREAT AMERICAN CITIES (1961).

<sup>37</sup>Interestingly, too, and for a variety of reasons, homeownership is closely tied to social capital in that communities with higher homeownership rates enjoy higher rates of social capital. See, e.g., PUTNAM, *supra* note 2, at 204 ("Because of their greater rootedness, homeowners are substantially more likely to be involved in community affairs than renters.") (citations omitted). According to one study that used the National Opinion Research Center's General Social Survey to compare the civic involvement of homeowners and renters, with respect to several relevant indicators, homeowners were more active in their communities than renters, controlling for many variables, including race, income and gender. The study showed that homeowners were more likely to vote in local elections, more likely to know the names of their local elected representatives, more likely to participate in non-professional associations, more likely to get involved in civic causes and more likely to garden. See Denise DiPasquale & Edward L. Glaeser, *Incentives in Social Capital: Are Homeowners Better Citizens*, 45 J. URB. ECON. 354, 356 (1999).

social capital can flourish. The legal system's failure to remedy the breakdown of social capital in the new world of subprime mortgage finance has led to the depth and breadth of the crisis we currently face. Taking this into account, what follows is an attempt to (1) gauge the extent to which the existing legal environment—one that included few checks on the conduct of actors central to the functioning of the market—fostered the market's collapse and (2) propose solutions that can strengthen social capital and, in the end, stabilize that market. As a central component of this assessment, I analyze the impact of the subprime mortgage market on African-American and Latino communities and assess, in light of this crisis and its disproportionate impact on these communities, the effectiveness of the legal protections in place that were originally designed to discourage mortgage lending discrimination.

## II. THE SUBPRIME MORTGAGE CRISIS

### A. *Overview of the Subprime Mortgage Market and Its Impact on Certain Communities*

The expansion of the subprime market generally was a result of several factors, all of which are reviewed in detail below, e.g., the strength of the housing market; relatively low interest rates; and deregulation that led to innovations in mortgage products making loans available with less money down, and fewer documentation requirements. The growth of securitization of subprime mortgage products contributed to this expansion of subprime loans by converting future income streams into immediate and liquid funds.<sup>38</sup> In turn, the funds made available by securitization were used to serve as capital to fund more home finance. In this way, through securitization, the more loans originated meant more money was available for future home finance. The presence of subprime loans as a percentage of all mortgages originated in a given year increased from nearly 8% in 2003 to 20% in 2006. And much of this expansion was funded by securitization; approximately 75% of the \$600 billion of all mortgages originated in a given year are now securitized.<sup>39</sup>

The increase in subprime lending has unquestionably made the dream of homeownership available to people who, because of many factors—including outright discrimination, community-based redlining and greater lender scrutiny of perceived risk—might not have obtained a mortgage just a decade ago. Expanding access to mortgage credit has resulted in significant gains in homeownership rates in low- and moderate-income communities in general, with a disproportionate increase in African-American and Latino communities. According to the U.S. Census Bureau, in 2006, the homeownership rate hit an all-time high of nearly 69% and

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<sup>38</sup>*Possible Responses to Rising Mortgage Foreclosures: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007) (statement of Sheila C. Bair, Chairman Fed. Deposit Ins. Corp.)[hereinafter *Bair Testimony*]; *Mortgage Market Turmoil: Causes and Consequences: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007) (testimony of Roger T. Cole, Dir., Div. of Banking Supervision and Regulation)[hereinafter *Cole Testimony*]; Allan N. Krinsman, *Subprime Mortgage Meltdown: How did it Happen and How will it End*, 13 J. STRUCTURED FIN. 13 (2007); Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 546 (2002).

<sup>39</sup>*Bair Testimony*, *supra* note 38, at 2 (citations omitted).

much of this expansion has been in poorer communities and communities of color.<sup>40</sup> Borrowers who were seen as risky investments several years ago might have had greater options available in the mortgage market due to the spread of subprime mortgage products. Subprime lending thus opened the possibility of homeownership to communities that long have had problems with access to credit for myriad reasons.<sup>41</sup>

At the outset, it is important to note that this Article will focus on the effect of the subprime mortgage market on communities with only a relatively weak historical connection to the mortgage market, primarily communities of color that still carry

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<sup>40</sup>See John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets* 4, n.4 (Int'l Monetary Fund Working Paper, No. 188, 2007) (citations omitted).

<sup>41</sup>Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK OF ST. LOUIS REV. 31 (2006). See, Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 534-540 (2005) (providing overview of economic reasons for failure of the mortgage market to serve certain communities). One of the prime reasons for the historical discrepancies in the homeownership rates in communities of color is, no doubt, outright discrimination. This history began with the explicit discriminatory preferences apparent in the distribution of federal mortgage insurance in the post-WWII era, and was followed by “redlining”, the decisions by many banks to exclude certain communities from mortgage lending. See, DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 87-108 (2004); Adam Gordon, *The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and out of Reach for Blacks*, 115 YALE L. J. 186 (2005). Civil rights agitation and exposure of these practices led to a wave of statutes designed to combat discriminatory practices with respect to mortgage lending, with a particular focus on combating discriminatory rejection of lending by protected classes and communities. See Fair Housing Act, 42 U.S.C. §§3601-19 (2006) (FHA), Equal Credit Opportunity Act, 15 U.S.C. §§1691(a)-(f) (2006) (ECOA); Home Mortgage Disclosure Act of 1975, 12 U.S.C. §§ 2801-11 (2006) (HMDA), and the Community Reinvestment Act, 12 U.S.C. §§ 2901-08 (2006) (CRA). While the FHA and ECOA do prohibit discrimination in lending, proving discriminatory terms in the *extension* of a particular mortgage, as opposed to the denial of a mortgage (which has its own problems of proof), can prove difficult. At the same time, HMDA is a disclosure statute that requires certain banks to disclose their lending patterns; it does not prohibit any particular conduct. Similarly, the CRA requires certain banks to meet the needs of the communities they serve, consistent with safe and sound lending practices, and requires federal bank regulators to take into account such banks’ records of meeting these needs when those banks seek approval of certain transactions. It does not prohibit any particular discriminatory conduct. See Barr, *supra* note 41, at 534. For an overview of the CRA and the legislative history that led to its passage, see, RICHARD D. MARSICO, DEMOCRATIZING CAPITAL: THE HISTORY, LAW, AND REFORM OF THE COMMUNITY REINVESTMENT ACT, 11-28 (2005). The Home Ownership and Equity Protection Act (HOEPA), 15 U.S.C. §§1639, 1648, is also intended to provide some protections against predatory lending by requiring certain loan term disclosures. Because its protections are only triggered when a mortgage’s interest rates are extremely high – higher than even most of the worst subprime loans – HOEPA’s disclosure requirements only apply to approximately one percent of subprime loans. EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA’S LATEST BOOM AND BUST 28 (2007). Because HOEPA’s coverage is so limited, I will not discuss it at any length here.

vestigages of a long legacy of mortgage discrimination. Throughout, I will refer to the impact of the crisis on African-American and Latino communities as a lens through which to assess the most pernicious conduct of certain mortgage brokers and loan originators: precisely the conduct, I would submit, that is greatly responsible for the breadth and depth of this crisis. While there may be many well-intentioned brokers and lenders that have worked responsibly in this sector, and there may be just as many if not more borrowers who were utterly reckless, for the sake of the discussion of the impact of law and trust on the subprime market, I will focus on those features of the subprime crisis that are most relevant to communities previously underserved by the mortgage industry. It is through such an analysis that a reflection on the impact of law on trust is most fruitful. A review of the development of the subprime market in general, and its impact on African-American and Latino communities helps to make this connection clear.

While much of the growth in the mortgage market can be attributed to the expansion of the subprime market generally, the distribution of subprime mortgages falls more heavily in communities of color; more than half of the mortgages taken out by African-American families in 2005 were of the subprime variety (as compared to the industry average of 20%), and 40% of Latino families taking out mortgages in 2005 were also subprime borrowers.<sup>42</sup> Research on this phenomenon indicates that this was no accident.<sup>43</sup> And since a disproportionate share of foreclosures can be traced to subprime mortgages, it is likely that, over the next few years, a disproportionate share of foreclosure actions will involve borrowers of color.

Furthermore, the concentration of predatory subprime borrowing in African-American and Latino communities cannot be disputed, and is the result of many different factors.<sup>44</sup> As stated in a report issued by several federal agencies:

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<sup>42</sup>Robert B. Avery et al., *Higher-Priced Home Lending and the 2005 HMDA Data*, FED. RES. BULL. A123, A160-161 (2006), available at <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>.

<sup>43</sup>CALIFORNIA REINVESTMENT COALITION ET AL., PAYING MORE FOR THE AMERICAN DREAM: THE SUBPRIME SHAKEOUT AND ITS IMPACT ON LOWER-INCOME AND MINORITY COMMUNITIES, 4-5 (2008), available at <http://nedap.org/documents/MultistateHMDAReport-Final21.pdf> (analyzing activity of “high-risk” lenders – entities that had failed and had generated more than 50% of their loans as subprime loans – in seven metropolitan areas and finding that over 40% of the loans by these entities were in predominantly minority neighborhoods while only 10% of their loans were in predominantly white neighborhoods, “suggest[ing] that these neighborhoods were targeted by high risk lenders”). These findings are consistent with earlier patterns in the subprime market. A federal report from 2000 that focused primarily on HMDA data from mortgage refinance loans in 1998 found as follows: 39% of residents from upper income African-American neighborhoods refinanced their mortgages using subprime products as opposed to only 6% of residents of upper income white neighborhoods utilizing such products. Moreover, residents of low-income white neighborhoods only utilized subprime products to refinance their mortgage 18% of the time, so that upper-income residents of African-American neighborhoods were twice as likely to utilize subprime refinance products as residents of low-income white neighborhoods. U.S. DEP’T OF HOUS. & URBAN DEV. & U.S. DEP’T OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 48 (2000), available at <http://www.hud.gov/library/bookshelf12/pressrel/treasrpt.pdf> [hereinafter HUD-TREASURY REPORT].

<sup>44</sup>For a discussion of the definitions of predatory and subprime borrowing, see *infra* Part II.B.

While predatory lending can occur in the prime market, such practices are for the most part effectively deterred by competition among lenders, greater homogeneity in loan terms and the prime borrowers' greater familiarity with complex financial transactions. In combination, these factors make prime borrowers more likely to shop for the best loan terms and less likely to fall victim to predatory loans. In addition, many prime lenders are banks, thrifts, and credit unions that are subject to extensive oversight and regulation by federal and state governments.<sup>45</sup>

The subprime market, on the other hand, "provides much more fertile ground for predatory lending practices"<sup>46</sup> for the following reasons: because of their difficulty in obtaining financing in the past prospective subprime borrowers may underestimate their own creditworthiness and accept the first offer of credit made without shopping for better loan terms; because they frequently come from low-income and minority communities that have been traditionally underserved by financial institutions they may have fewer options available to them, lending alternatives might be harder to find, or a person may be unaware of his or her options.<sup>47</sup>

In addition, subprime lenders active in many low-income and minority communities are not subject to the same federal oversight as prime lenders, which "may create an environment where predatory practices flourish because they are unlikely to be detected."<sup>48</sup> Most importantly, the Community Reinvestment Act does not cover most subprime lending; Fed Chairman Bernanke has asserted that fully two-thirds of subprime mortgages are beyond the scope of the CRA.<sup>49</sup> Since this does not take into account other reasons why subprime mortgage lending might be

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<sup>45</sup>HUD-TREASURY REPORT, *supra* note 43, at 17.

<sup>46</sup>*Id.*, at 18.

<sup>47</sup>*See, e.g.*, Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L. J. 1571, 1583-84 (2002) (noting the absence of legitimate lending activity in communities of color allows predatory lending to target such communities); ALVARO CORTES ET AL., EFFORTS TO IMPROVE HOMEOWNERSHIP OPPORTUNITIES FOR HISPANICS: CASE STUDIES OF THREE MARKET AREAS (2006), *available at* [http://www.huduser.org/Publications/PDF/hisp\\_homeown2.pdf](http://www.huduser.org/Publications/PDF/hisp_homeown2.pdf) (studying practices of Latino communities in three urban settings and finding lack of information about the mortgage process was the most significant barrier to homeownership and access to home mortgage financing).

<sup>48</sup>HUD-TREASURY REPORT, *supra* note 43, at 18.

<sup>49</sup>Ben S. Bernanke, *The Community Reinvestment Act: Its Evolution and New Challenges*, Speech at the Community Affairs Research Conference, Washington, DC, 5 (March 30, 2007) (citation omitted), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20070330a.htm>. *See also*, ROBERT E. LITAN ET AL., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT, 70-72 & chart 14 (2000), *available at* [http://www.novoco.com/low\\_income\\_housing/resource\\_files/research\\_center/crareport.pdf](http://www.novoco.com/low_income_housing/resource_files/research_center/crareport.pdf) (analyzing HMDA data from 1993 through 1998 and finding that two thirds of the increase in subprime lending to low- and moderate-income communities during this period was from subprime lenders not covered by the CRA whereas only 15% of these loans were originated by CRA-covered institutions).



beyond the scope of the CRA, the percentage is actually much higher.<sup>50</sup> Indeed, there are several reasons for this gap in the CRA's coverage. First, most subprime borrowers are not covered by the CRA.<sup>51</sup> Second, even banks that are covered by the CRA engage in subprime lending outside their CRA "assessment area", thus excluding such activity from review by federal regulators enforcing the CRA.<sup>52</sup> Third, some banks might engage in subprime lending through affiliates and subsidiaries, which they can elect to exclude from CRA review as well.<sup>53</sup>

All of these forces have led to the dramatic increase in subprime lending in communities of color. As the trajectory of the subprime market crisis has proven, however, this greater access to credit has, undoubtedly, come with a price. First and foremost, subprime borrowers—because of their status and the nature of the mortgages they purchased—are saddled with far less favorable terms (e.g., higher interest rates than "prime" borrowers, greater closing costs and fees, and penalties for early satisfaction of the loan). The problem, however, is much deeper, and goes to the very structure of the market. As the following discussion shows, the intervention of brokers and subprime mortgage originators in the mortgage process has led to an increase in subprime lending in communities where pent up demand and a lack of information about the mortgage process led to abuse. Furthermore, the incentive structure in place, due, for the most part, to the securitization process, means the actors seeking to originate these loans placed a higher premium on the quantity of mortgage loans made, and not their quality. They worked hard to make as many deals as possible, as quickly as possible, regardless of the borrower's ability to meet the demands of the mortgage. Once the mortgage was sold and packaged as part of a securitization deal, it became harder for the borrower to renegotiate terms of the agreement should hardship occur. For some borrowers at least, should they default on their mortgage agreement and lose their homes to foreclosure, they will be worse off than if they had never purchased the home in the first place. They stand to lose whatever equity they may have had in the home, cannot reclaim any closing costs or fees they might have paid, and will suffer displacement. What follows in

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<sup>50</sup>William C. Apgar & Mark Duda, *The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges*, 9 FED. RES. BANK OF N.Y. ECON. POL'Y REV., June 2003, at 169, 180 (noting that in 2000, only 3% of subprime loans were made by CRA covered institutions in their assessment areas, and 96% of subprime refinance loans were made by independent mortgage companies and covered institutions lending out of their CRA assessment areas).

<sup>51</sup>Many subprime lenders are "non-depository institutions," and thus are exempt from the CRA. See 12 U.S.C. §§ 2902, 1813 (2006). For an overview of the different regulatory structures for depository and non-depository institutions, see Patricia A. McCoy and Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Home Mortgages*, HARV. U., JOINT CENTER FOR HOUSING STUDIES, Policy Paper # UCC08-5, February 2008, at 20-23, available at [http://www.jchs.harvard.edu/whatsnew/new\\_pubs.html](http://www.jchs.harvard.edu/whatsnew/new_pubs.html).

<sup>52</sup>See, e.g., 12 CFR § 25.41(a) (2005) (describing how a regulated entity's "assessment area" is established for the purpose of CRA review). For a critique of the limitations of using an assessment area approach to CRA review, see MARSICO, *supra* note 41, at 177-178.

<sup>53</sup>See Engel & McCoy, *supra* note 48, at 1588-1589; Richard D. Marsico, *Subprime Lending, Predatory Lending, and the Community Reinvestment Act*, 46 N.Y. L. SCH. L. REV. 735 (noting that banks have the option of including the lending of their affiliates in the regulators' CRA review of the parent bank) (citation omitted).

this section is an analysis of the subprime mortgage crisis: how we got here and the causes of the crisis.

### B. Definitions

In the first instance, it is important to define the meaning of the term “subprime mortgage.” In testimony before the Senate Committee on Banking, Housing and Urban Affairs, Roger T. Cole, Director of the Federal Reserve’s Division of Banking Supervision and Regulation described the use of the term “subprime borrower” as to refer to those “who do not qualify for prime interest rates because they exhibit one or more of the following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios.”<sup>54</sup>

In addition to these characteristics of subprime borrowers, the loans generally considered as subprime also typically have higher upfront costs, in terms of fees associated with closing the loan (such as appraisal and application fees), and continuing costs stemming from higher interest rates.<sup>55</sup> They are often identifiable by such other “hybrid” characteristics as an initial, low introductory interest rate (sometimes called a “teaser” rate, for obvious reasons) that is in effect for two or three years (or sometimes even for just a few months), that then changes to an adjustable rate for the remainder of the life of the loan. In some ways, then, we define subprime mortgages by the characteristics of the borrowers as well as by the terms of the loans that are made to them.

For the purposes of this discussion, the term “subprime borrower” will be used when discussing a borrower who possesses the characteristics that make him or her ineligible for a prime or “Alt-A” loans (described below). The term “subprime mortgage” will be used when discussing a mortgage product that has terms that are less favorable to the borrower than a typical prime mortgage.<sup>56</sup>

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<sup>54</sup>*Cole Testimony, supra* note 38, at 2 (citations omitted).

<sup>55</sup>Chomsisengphet & Pennington-Cross, *supra* note 41, at 32.

<sup>56</sup>Another term that is often used to define some subprime lending is “predatory lending”. Yet defining this term is itself problematic. One attempt to “distill” such a definition from a variety of other attempts considers predatory lending as lending that “occurs when a lender extends to a consumer a loan with unfavorable terms that are structured to strip the equity from the home, possibly resulting in foreclosure on the home used to secure the loan and personal bankruptcy for the consumer.” Jonathan L. Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 *FORDHAM URB. L. J.* 757, 761 (2007). Others have attempted to collect a series of predatory features, the presence of “one or more” of them in a mortgage transaction would render that transaction predatory in nature: e.g., “asset-based” lending, which occurs when a loan is made based on the value of the collateral, and not on the ability of the borrower to repay the loan. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 *TEX. L. REV.* 1255, 1259-1270 (2002). See also, Patricia Sturdevant & William Brennan, Jr., *A Catalogue of Predatory Lending Practices*, 5 *CONSUMER ADVOC.* 4 (1999) (cataloguing list of predatory lending practices). While many predatory loans are subprime loans, not all subprime loans are necessarily predatory in nature. Since many of the practices described herein would fall under the various definitions of predatory lending contained in the literature on this issue, there is no doubt that many of these abuses could be described as predatory and would fit within any

In terms of the overall mortgage market, more than 75% of the 43 million first-lien mortgage loans outstanding in the United States are for prime borrowers, while subprime borrowers represent about 13 or 14% of the total. What remains are borrowers sometimes referred to as “Alt-A”, or “near prime”; these are borrowers who might have good credit, but have other deficiencies on their record, like high debt-to-income ratios or have less of an ability to document their income than the typical prime borrower.<sup>57</sup>

### C. *The Path to the Crisis*

Subprime lending is a relatively recent phenomenon, and has been made more prevalent by statutory changes to banking legislation in the 1980s, and innovations in the way that mortgages are financed.<sup>58</sup> First, state interest rate caps on mortgages were preempted by federal legislation in 1980 through the Depository Institutions Deregulation and Monetary Control Act (DIDMCA).<sup>59</sup> In 1982, lenders were permitted to offer adjustable rate mortgages through the Alternative Mortgage Transaction Parity Act of 1982 (AMTPA).<sup>60</sup> The Tax Reform Act of 1986<sup>61</sup> encouraged more home lending as the interest paid on residential mortgages remained as the only consumer loans where the interest paid was tax deductible.<sup>62</sup> In the end, deregulation was critical to getting subprime lending off the ground.

Federal deregulation permitted lenders to charge a risk premium to less creditworthy borrowers in the form of higher interest rates and fees. Equally importantly, deregulation allowed lenders to market new and more complex types of mortgage products, including adjustable rate mortgages and loans with balloon payments and negative amortization, which expanded the pool of eligible borrowers and helped lenders control for interest-rate risk.<sup>63</sup>

While the growth of subprime lending generally and securitization in particular first began in the mid-1990s, questions about the risk involved in investing in

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definition of predatory lending. For the sake of simplicity, I will utilize the term “subprime lending”.

<sup>57</sup>*Cole Testimony*, *supra* note 38, at 2 (citations omitted).

<sup>58</sup>While the first mortgage-backed security was issued over 100 years ago, the modern era of securitization began in 1970 with government-issued securities from the Government National Mortgage Association (“Ginnie Mae”). These securities carried little risk because the underlying loans that were the collateral for the securities met the federal government’s underwriting criteria. *See, e.g.*, Eggert, *supra* note 38, at 537.

<sup>59</sup>Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 226 (2006) (DIDMCA).

<sup>60</sup>Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. §§ 3801-06 (2006) (AMTPA).

<sup>61</sup>Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

<sup>62</sup>Kiff & Mills, *supra* note 40, at 3; Chomsisengphet & Pennington-Cross, *supra* note 41, at 38.

<sup>63</sup>McCoy & Renuart, *supra* note 51, at 7 (citation omitted).

subprime lending, coupled with the Asian fiscal crisis on 1998, slowed the growth of subprime lending and securitization towards the end of the 1990s. With the steady and growing strength of the housing market after 2000, with its brief interruption after the events of September 11, 2001, interest and investment in subprime lending started to grow again, and went through substantial growth from 2003 through 2006.<sup>64</sup> According to Inside Mortgage Finance, in 2006 approximately 20% of total originations were subprime loans, and 25% of the total mortgage securitizations were backed by subprime mortgages.<sup>65</sup>

#### D. Overview of the Mortgage and Securitization Process

In the modern mortgage transaction, a prospective borrower communicates with a mortgage broker and expresses an interest in pursuing a mortgage to purchase a home, or seeks to refinance a current mortgage. This relationship may have been pre-existing (in the case of a refinance, the broker might have handled the underlying mortgage), or, may have begun as a response to marketing by the broker directly, through in-person marketing, targeted mailing, or generally, through print or other media advertising. Importantly, in many jurisdictions, the broker owes no independent duty, fiduciary or otherwise, to seek out the best mortgage product for the borrower, and the borrower, who likely has incomplete (at best) knowledge about the market, relies heavily on the broker to obtain the most favorable terms.<sup>66</sup>

The broker will typically gather information about the borrower's creditworthiness: i.e., an assessment is made about the borrower's likely ability to pay back a loan. Information that is gathered will include the prospective borrower's work and credit history; any history of prior liens, judgments and/or bankruptcies; the nature and size of any assets he or she might possess; and his or her income amount and sources. Far more often than not, this information is gathered by a credit rating agency, and a score is calculated by that independent agency based on these and other factors. An estimated loan amount is taken into account, and an estimated monthly payment is calculated based on the terms of that loan. The credit score is intended to serve as an indicator of the borrower's ability to pay back a loan based on the expected terms (one important factor that is taken into account is the anticipated monthly payments when viewed against the household's monthly income).<sup>67</sup>

Based on this analysis, the products that might be available to the prospective borrower are identified. If the prospective borrower has a high credit rating, high and stable income, significant savings, and little debt, "prime" mortgage products will be available to her. If the prospective borrower has a poor credit rating, unstable

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<sup>64</sup>Chomsisengphet & Pennington-Cross., *supra* note 41, at 41-43.

<sup>65</sup>*The Role of Secondary Market in Subprime Mortgage Lending: Hearing Before the H. Subcomm. on Fin. Insts. and Consumer Credit*, 110th Cong. (2007) (testimony of Warren Kornfeld, Managing Dir. of Moody's Inv. Serv.)[hereinafter *Kornfeld Testimony*].

<sup>66</sup>*See infra* Part III.

<sup>67</sup>*Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, Subcomm. on Sec., Ins., and Inv.*, 110th Cong. (2007) (testimony of Christopher L. Peterson, Assoc. Professor of Law, Univ. of Fla.)[hereinafter *Peterson Testimony*].

income and/or high credit card or other debt, she might be classified as eligible only for a subprime mortgage, which would generally have terms that are less favorable to the borrower.

After undertaking a review of the prospective borrower's creditworthiness, the mortgage broker then tries to identify potential products that a loan originator might offer to the borrower. The originator can be a bank in the classic sense, one that is also in the business of home lending, or simply a mortgage bank that specializes in originating home loans. Once a match is made by the broker, an originator offers a mortgage product to the borrower and that product is accepted by the borrower, the mortgage agreement is then consummated.

As is typical today, soon after the mortgage agreement is recorded with the proper government authorities, typically a county clerk, the originator often starts the process of transferring the lender's interest. Sometimes the single mortgage is sold on what is called the secondary mortgage market, where financial institutions purchase the originator's interest in the loan: the right to collect the payments and the right to foreclose should the borrower default on her obligations. When the originator plans to "securitize" the mortgage it will transfer its interest in the mortgage to a Special Purpose Vehicle (SPV), typically a trust, which holds multiple mortgages in its portfolio, creating a pool of loans.<sup>68</sup>

Once the SPV is created, the process of securitization begins. The assets of the SPV (for the most part, the income streams that flow from the mortgagors' obligations under the mortgages held by the SPV)—whether it is the right of payment of interest on the loans in the pool, or the payment of principal, or some other right—are classified into "tranches" (French for "strips"), and those tranches are then packaged as securities to be sold to investors. The terms of these securities will generally require some payment to the investors from the income streams generated by payment of interest and/or principal on the loans.<sup>69</sup>

Working with an underwriter and rating agency, the different tranches are examined for the risk related to the assets (the income streams) that back them. Typically, the bond rating agency relies on information provided by the lender, especially the representations and warranties made that guarantee that the loans in the pool all complied with applicable law when they were originated.<sup>70</sup> It also looks at information in the aggregate concerning the loans in a particular pool, analyzing information such as credit scores, the equity borrowers have in their homes, and documentation of income and assets. An assessment is also made of the lender itself, reviewing its underwriting standards as well as its lending and performance history.<sup>71</sup>

With larger pools, involving many mortgages, the underwriter and rating agency review a sample of the loans backing a particular security for the relative risk of default of the borrowers under those loans, and often rely on the representations of the originator that the sample is typical of the types of loans in the pool. High risk

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<sup>68</sup>Eggert, *supra* note 38, at 539; *Peterson Testimony*, *supra* note 67, at 5.

<sup>69</sup>*Kornfeld Testimony*, *supra* note 65, at 9.

<sup>70</sup>*Id.*, at 13.

<sup>71</sup>*Id.*, at 13-14.

will translate into a lower rating for the security, or will result in the removal of the riskier assets from the pool of loans backing the security.<sup>72</sup>

Sometimes the originator is asked to insure the purchasers of the securities (the investors) against the risk, thereby improving the risk rating. “Credit enhancements” are also employed by the originator to make investing in the securities more attractive by lowering the risk associated with the investment. Such enhancements can include loan guarantees from an insurance company or similar guarantor, the creation of the security with the value of the collateral backing the security greater than the aggregate amount of the securities issued (“overcollateralization”), and/or the creation of a hierarchy of tranches whereby certain tranches are more exposed to risk than others.<sup>73</sup> In addition, many security agreements require that the originator make certain representations with respect to the types of interests included in a particular tranche. If the representations prove unfounded with respect to particular assets included in that tranche, the originator might be forced to take back those assets.

Investors—mutual funds, pensions, hedge funds, brokerage houses, and individuals—then purchase the securities created and backed by the assets in the SPV. An independent agent, known as the servicer, handles the day-to-day management of the individual mortgages backing the securities. That servicer is responsible for collecting the monthly payments of interest and principal, monitoring loans in default, and typically is responsible for pursuing foreclosures where necessary.<sup>74</sup>

#### *E. The Current Crisis: Loosening Standards and Perverse Incentives*

With the weakening of the home mortgage market, the drive to continue to issue mortgage-backed securities led many lenders to loosen their underwriting criteria and write riskier loans. As the following discussion shows, the incentive structure in the market, combined with a lack of accountability in the system, has led to the present state of the subprime mortgage market: rising defaults, bankrupt lenders, devalued securities, and skittish markets.

##### 1. Information Asymmetry and Conflicting Loyalty

Subprime brokers and loan originators had a substantial advantage over their prospective customers: possessing a wealth of information about the mortgage market, the products available and the terms for which those prospective borrowers might qualify. This asymmetry of information meant that prospective mortgagors had insufficient information about a range of issues related to the mortgages they were seeking.<sup>75</sup>

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<sup>72</sup>*Subprime Mortgage Market Turmoil: Examining the Role of Securitization*, Before the S. Comm. on Banking, Hous. and Urban Affairs Comm.’s Subcomm. on Secs., Ins., and Invs., 110th Cong. (2007) (testimony of Kurt Eggert, Professor of Law, Chapman Univ. School of Law)[hereinafter *Eggert Testimony*].

<sup>73</sup>*Kornfeld Testimony*, *supra* note 65, at 10.

<sup>74</sup>*Eggert Testimony*, *supra* note 72, at 7; *Peterson Testimony*, *supra* note 67, at 6.

<sup>75</sup>An argument certainly can be made, and has, that lenders also suffer from asymmetry of information because they do not know, for certain, the credit risk of a potential borrower. In a now classic article, it was assumed that a lender’s lack of information about the risks

For example, prospective borrowers may not have had a full understanding of the origination fees and mortgage insurance costs that would be assessed against them. They may not have understood the impact of rate changes with an adjustable rate mortgage. Borrowers may not have understood complicated terms of hybrid subprime loans, and not even the Chairman of the Federal Reserve can predict what interest rates will be in two years, yet borrowers were supposed to understand the consequences of having an adjustable rate mortgage and what their monthly payments would be once their interest rate re-set.

Because many might have been less sophisticated borrowers, from communities with less of a history of homeownership, they might not have had ready access to a neighbor or family member with knowledge and experience with a home mortgage to assist them in understanding what holding a mortgage meant, or to explain to them the products and features for which they should have bargained and those of which they should have steered clear.

Borrowers might have had an irrationally optimistic view of the housing market, and felt they could refinance their way out of future trouble. Brokers and lenders interested in prospective refinance clients might not have disabused prospective buyers of either of these beliefs. Borrowers may also have had an incomplete picture of the mortgage options available to them given their credit risk, or may have been steered into a less favorable mortgage product out of incentives their broker or originator may have had to sell them a particular product.

Simply put, in many instances, brokers and loan originators exploited this information asymmetry, leading many unsophisticated borrowers into loan agreements they did not understand and could not afford.

## 2. Severing the Borrower-Lender Relationship

A second development that has led to the current crisis is the fact that the traditional relationship between borrower and lender has broken down and a new, “atomized” relationship exists where the incentive structure for mortgage brokers and originators leads to faulty loans and little accountability.<sup>76</sup> In the traditional relationship, the borrower and lender had mutual interests: the borrower in maintaining current in his or her loan, and the lender in the borrower’s performance and a reliable stream of income. This relationship was long-term, and might have even been pre-existing (i.e., the borrower might have used loan products from the lender in the past, or had maintained depository accounts with that lender).

As the Chairperson of the FDIC recently explained:

Prior to widespread use of securitization, home finance typically involved a bank or savings institution granting a loan to a borrower. The lending

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associated with lending would lead to credit rationing. See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981). Due to the expansion of the subprime market through deregulation, and with standardized underwriting criteria and the increased availability of credit funds through securitization, credit rationing was not a primary concern during the explosion in the subprime market.

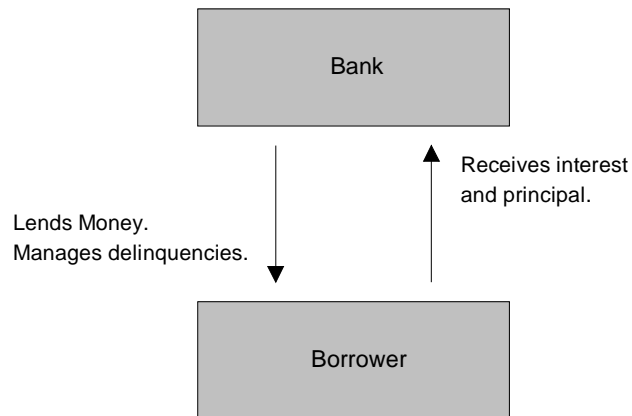
<sup>76</sup>Eggert, *supra* note 38, at 552. See also Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUD. 161, 188 (2005) (explaining that asset securitization insulates the loan originator from fluctuations in the value of underlying collateral).

institution would make the decision to grant credit, fund the loan, and collect payments. In the event of borrower default, the same institution could choose to restructure the loan or foreclose on the property. The lender also might have an established relationship with the borrower, and, thus, be able to evaluate the relative long-term benefits of various alternatives.<sup>77</sup>

Innovations in underwriting and liquidity from securitization have also “weakened the traditional long-term relationship between the borrower and the company that originated and serviced his mortgage loan.”<sup>78</sup>

A graphic portrayal of this shift in the structure of the mortgage market is helpful to recognize this change.

Figure 1.<sup>79</sup>



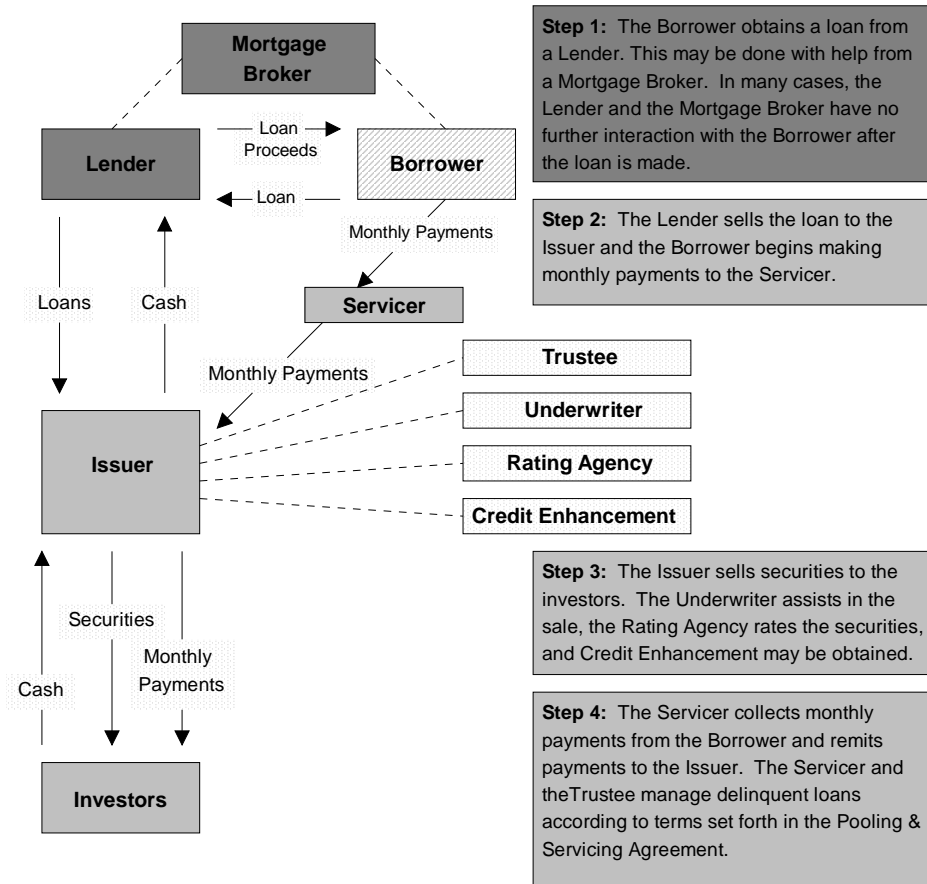
The first figure represents the traditional borrower-lender relationship, with its shared responsibilities, where mutual interdependence is critical to its functioning. The second, more complex figure below represents the current web of diffuse relationships, where accountability for bad loans is hard to trace.

<sup>77</sup>*Bair Testimony*, *supra* note 38, at 2.

<sup>78</sup>Krinsman, *supra* note 38, at 14.

<sup>79</sup>*Bair Testimony*, *supra* note 38, at 2.



Figure 2.<sup>80</sup>

In addition, federally regulated financial institutions are more closely regulated for safety and soundness concerns as compared to non-bank lenders<sup>81</sup> and many subprime lenders are beyond the reach of such laws as the Community Reinvestment Act.<sup>82</sup> Furthermore, bank lenders are not shielded by the holder in due course doctrine for any fraud or illegality in the loans they originate and hold. For these reasons, lending by traditional banks that hold their mortgages tends to be less risky and such lenders are less dominant in the subprime mortgage market. Indeed, non-bank lenders made 50% of the subprime loans in 2006.<sup>83</sup>

<sup>80</sup>*Id.*

<sup>81</sup>Engel & McCoy, *supra* note 56, at 1291-1292.

<sup>82</sup>*See supra* Part II.A.

<sup>83</sup>Eggert Testimony, *supra* note 72, at 8-9.

Instead of the traditional relationship, which involved a borrower and a federally regulated lending institution, the new borrower and lender relationship is often mediated by a mortgage broker with unclear loyalties.<sup>84</sup> The connection between subprime lending and the role of the mortgage broker could not be clearer. One study that looked at the role of the mortgage broker in lending showed that nearly half of all subprime loans reviewed went through a broker, while only 28% of prime loans involved such a broker.<sup>85</sup> The role of the broker also has racial aspects: one study showed that 64% of African-American borrowers used a broker, while only 38% of White borrowers did so.<sup>86</sup>

### 3. Weakening Underwriting Criteria

The problems embedded in the subprime mortgage market—rising risk of unaffordability due to higher fees and interest rates and adjustable rate mortgages waiting to reset at a higher rate—lay dormant during a time of “froth” in the housing market.<sup>87</sup> As home prices continued to rise and even after initial “teaser” rates expired and adjustable rate mortgage terms kicked in, existing borrowers were able to refinance mortgages with unfavorable terms due to the increased equity they enjoyed with rising home prices. Because of the strength of the housing market, subprime borrowers were able to stave off default in many subprime mortgages simply by refinancing their home mortgages. These refinances made more money available to borrowers, and borrowers dipped into their growing equity to pay their mortgage brokers and originators for the ability to refinance, even when these actors may have been the same individuals and companies the borrowers had paid when they assumed the initial underlying mortgage. In this way, the strong market delayed any questions about affordability of the underlying mortgage, or the inequitable nature of its terms, to a day when rising home values could no longer make up for the borrower’s inability to meet the terms of his or her mortgage. Furthermore, underwriting standards were loosened in the drive to write more mortgages and to continue the mill of mortgages and refinances, the steady stream of fees they generated for brokers and originators, and the income they could produce by sale in the securities market. Another common phenomenon was “risk layering”:

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<sup>84</sup>Real Estate Settlement Procedures Act (RESPA): Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49,134, 49,140 (July 29, 2002) (to be codified at 24 C.F.R. pt. 3500). According to the U.S. Department of Housing and Urban Development (HUD): “During the 1980’s and 1990’s, the rise of secondary mortgage market financing resulted in the emergence of new retail entities, notably mortgage brokers, to compete with traditional mortgage originators, lending institutions, and mortgage bankers. Today, mortgage brokers are estimated to originate more than 60% of the nation’s mortgages.” *Id.*

<sup>85</sup>INSIDE MORTGAGE FINANCE, THE 2004 MORTGAGE MARKET STATISTICAL ANNUAL (2004).

<sup>86</sup>Kellie Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender- Originated Loans*. 83 AARP PPI DATA DIGEST 1 (2003), available at [http://0-assets.aarp.org.mill1.sjlibrary.org/rgcenter/post-import/dd83\\_loans.pdf](http://0-assets.aarp.org.mill1.sjlibrary.org/rgcenter/post-import/dd83_loans.pdf).

<sup>87</sup>Edmund L. Andrews, *Greenspan is Concerned about “Froth” in Housing*, N.Y. TIMES, May 21, 2005, at C1.

originators taking chances on borrowers who met more than one of the criteria for a subprime loan.<sup>88</sup>

In 2006, when home prices flattened, interest rates rose, and more onerous loan terms started to kick in for many subprime mortgagors, the subprime crisis began to take its toll on the market, and the numbers of loan defaults began to rise.<sup>89</sup> Furthermore, the downturn in the market may have also driven up demand for more originations, to maintain the flow of fees they generate for the originator and to satisfy the investors who were still seeking opportunities in the mortgage-backed securities market. These forces may have resulted in loosening of underwriting criteria even further, meaning new loans were made to borrowers who, in the end, were greater risks.<sup>90</sup> Indeed, according to an analysis conducted by Moody's, the rate of subprime mortgages delinquent more than sixty days included in securitization pools rated by Moody's increased dramatically—nearly doubling—with respect to mortgages originated in 2006 when compared with performance of subprime mortgages originated in 2002 to 2005 also included in securitization pools. This strongly suggests that mortgages consummated later in time, after underwriting criteria were loosened, were more likely unsuitable for those borrowers.<sup>91</sup>

This cycle was no aberration, and is simple to understand: when borrowing demand slows, originators lower their criteria and make riskier loans to maintain the origination rate and continue the steady flow of fees that are generated by and accompany each origination.<sup>92</sup> And this seems to be exactly what happened here; lenders used lax underwriting standards to originate more subprime loans. They lowered their documentation requirements, did not verify borrowers stated income and permitted 100% financing of loans (i.e., originated “no money down” mortgages).<sup>93</sup> Indeed, the rise in early defaults (loans that went into default just months after origination) in the final quarter of 2006 and the first quarter of 2007 were likely the result of lax underwriting criteria.<sup>94</sup>

#### 4. Perverse Incentives

At the heart of this loosening of underwriting criteria lies a simple fact about the incentives inherent in the current mortgage market. Amid growing concerns about risk in the market and the rising specter of default the riskier the loan and the more onerous its terms, mortgage brokers and originators benefited from a relentless drive to securitize more mortgages, despite these risks. Indeed, the cycles of finance and re-finance taking place throughout the years 2002 through 2005 meant even more income for the brokers and originators; they would collect their fees with each consummated mortgage or refinance agreement. In this way, the interest of the

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<sup>88</sup>Krinsman, *supra* note 38, at 14.

<sup>89</sup>*Cole Testimony*, *supra* note 38, at 4; Kiff & Mills, *supra* note 40, at 7; Krinsman, *supra* note 38, at 13; *Kornfeld Testimony*, *supra* note 65, at 6-7.

<sup>90</sup>Krinsman, *supra* note 38, at 14.

<sup>91</sup>*Kornfeld Testimony*, *supra* note 65, at 4.

<sup>92</sup>*Id.* at 5-6.

<sup>93</sup>Krinsman, *supra* note 38, at 15.

<sup>94</sup>*Id.* at 5.

mortgage brokers and originators is to enter into as many mortgages as possible and get them into the market as securities as quickly as possible. The brokers want their fees, and to make more with each transaction, and the originator wants to get as many mortgages as possible into the securities market, because they make money for selling these securities.<sup>95</sup> As described by several analysts looking at the problem:

Safeguards ensuring prudent lending were weakened by a combination of fee-driven remuneration at each stage of the securitization process and the dispersion of credit risk which weakened monitoring incentives. Hence, intermediaries were remunerated primarily by generating loan volume rather than quality, even as the credit spreads on the resulting securities shrank.<sup>96</sup>

In recent experience, with the rise of the securitization market, the incentive structure has changed, rewarding quantity over quality.<sup>97</sup> The broker seeks to identify a mortgage product for which the borrower might qualify, but might not think of the long-term viability of the borrower to meet his or her obligations. With the incentive of a quick payday once the mortgage is transferred to another entity for sale as a security, the broker and originator, who are both now interested in generating the fees associated with the mortgage closing, are driven by a desire to package as many loans as possible, and are not concerned with the borrower's likelihood of default under the mortgage. The lender no longer has an incentive that is tied to the borrower's interest in long-term sustainability of the mortgage, and the broker is no longer interested in his or her reputation of bringing viable borrowers to the lenders. The subprime market thus created a classic "moral hazard" similar to that created during the Savings & Loan crisis where banks could lend regardless of the risk,<sup>98</sup> with an advantage in information, no accountability and little risk, brokers and originators in the subprime market were able to engage in aggressive rent seeking, leaving borrowers and the holders of securities with no recourse and devalued assets.

When few lenders service the loans they originate, there is less of an incentive to monitor the relative risks associated with lending to a borrower for whom a particular loan is unaffordable, in utter disregard for the danger of default. When the whole incentive structure favors quantity over quality, however, it was to be expected that we would find ourselves in exactly the situation we are in: growing default rates, especially so-called "early defaults"—where the borrower falls behind on payments in the first few months of the loan.

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<sup>95</sup>Kiff & Mills, *supra* note 40, at 11; Krinsman, *supra* note 38, at 14.

<sup>96</sup>Kiff & Mills, *supra* note 40, at 7.

<sup>97</sup>Eggert *Testimony*, *supra* note 72, at 10; Peterson *Testimony*, *supra* note 67, at 10.

<sup>98</sup>See John C. Coffee, Jr., WHAT CAUSED ENRON? A CAPSULE SOCIAL AND ECONOMIC HISTORY OF THE 1990S, 89 CORNELL L. REV. 269, 278 (2004) (describing savings and loan crisis as moral hazard problem).

### 5. Undercapitalized Lenders

Recently, securitization agreements have begun to include clauses which require the originator to take back loans in early default.<sup>99</sup> But even where such securitization agreements do require originators to take back loans in early default, these originators suffer significant losses on these loans. Due to the fact that the loan is in default, it must be purchased back by the originator at a discounted rate. Since many of these loan origination companies have few liquid assets themselves, they might not be able to finance these forced re-purchases and there is little recourse against the originator should it simply file for bankruptcy when the volume of the defaulted loans it must take back becomes too burdensome.<sup>100</sup> As a result of these forces, mass defections from the market have ensued: “[s]ince the end of 2006, over 30 subprime originators have filed for bankruptcy or gone out of business. In almost every case, the subprime originators that went out of business were specialty finance lenders and were not institutions with federally insured deposits.”<sup>101</sup>

### 6. Limits on Forbearance

Where early default has not occurred, and the investors hold a loan in default and cannot force the originator to buy it back, securitization often makes it more difficult to handle default and avoid foreclosure, which leads to the identification of a second problem: lack of an ability on the part of the servicer to permit deviation from the strict terms of the loan to avoid default. Such measures can offer a borrower the chance to comply with his or her long-term obligations under the loan, and can include reductions in the interest rate owed on the loan, extension of the loan term to bring down monthly charges, deferral of payment obligations and outright forgiveness of certain payments and penalties.<sup>102</sup>

The barriers securitization agreements may hold for renegotiating borrower obligations come in several forms. First, the terms of many securities limit the extent to which a servicer can negotiate with an individual borrower in default, and there is likely no pre-existing relationship between the borrower and lender that can help facilitate these negotiations.<sup>103</sup> “When difficulty arises in making payments on a securitized loan, the borrower generally will not be dealing with the local banker with whom there might be an established relationship. Instead, the borrower will be dealing with the servicer.”<sup>104</sup>

Second, the servicer must act in the perceived best interest of the investors. If a workout would meet those interests, the interests of the borrower and investors are aligned. If, however, foreclosure on the collateral is in the best interest of the investors, the terms of the securitization agreement covering that asset will require that the service take action to carry out the foreclosure.<sup>105</sup>

<sup>99</sup>Krinsman, *supra* note 38, at 15-16.

<sup>100</sup>*Id.* at 16; *Cole Testimony*, *supra* note 38, at 3.

<sup>101</sup>Krinsman, *supra* note 38, at 16.

<sup>102</sup>*Kornfeld Testimony*, *supra* note 65, at 17.

<sup>103</sup>*Bair Testimony*, *supra* note 38, at 4; *Kiff & Mills*, *supra* note 40, at 13.

<sup>104</sup>*Bair Testimony*, *supra* note 38, at 4.

<sup>105</sup>*Id.*; *see also* *Kiff & Mills*, *supra* note 40, at 13.

Third, some securitization agreements might limit the percentage of loans modified to five to ten percent of the original value of the outstanding loans.<sup>106</sup> Most securitization conduits are established as Real Estate Mortgage Investment Conduits (REMICs). The REMIC structure excludes the entity from taxation, although the investors' income is taxable. However, using such a structure has implications for the ability of the servicer to modify the terms of the loans in the event of default by a particular borrower. In order to qualify for the tax benefits of the REMIC structure, the loan pool must be static, and modifications of the loans contained in the pool can only take place if default under the loan is reasonably foreseeable.<sup>107</sup> Such a limitation means that loans cannot be restructured in anticipation of default, e.g., in the event a borrower loses a job and has some assets to liquidate to satisfy the mortgage for a period of time. Under the terms of the REMIC, the borrower probably cannot restructure payments until after he or she goes into default. Even with a borrower in default, some deals require a legal opinion prior to any restructuring of that borrower's loan that would assure the investors that such a restructuring would not impact the tax benefits of the REMIC status.<sup>108</sup> Sometimes, the servicer must obtain the consent of the ratings agency, the bond insurer and/or guarantors or entities providing credit enhancement to support a particular pool of loans before restructuring any debt in those pools.<sup>109</sup>

These barriers are proving difficult to overcome. Indeed, a recent survey of loan servicers conducted by Moody's found that just 1% of adjustable rate mortgages where the rates had recently been adjusted had been modified by those servicers.<sup>110</sup>

#### Conclusion:

As the previous discussion shows, there are several reasons for the current crisis in the subprime mortgage market. One of the chief causes of the crisis is the fact that subprime mortgage loans were made under market forces that encouraged brokers and originators to promote mortgages with little regard for the viability of the

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<sup>106</sup>Kiff & Mills, *supra* note 40, at 13. See also, Krinsman, *supra* note 38, at 18 ("The terms of pooling and service agreements for subprime [asset backed securities] often restrict the percentage of loans that can be modified if the loans aren't defaulted or reasonably likely to default."); Kornfeld Testimony, *supra* note 65, at 17 ("Some residential mortgage securitizations have limits on the percentage of loans in any pool that the servicer may modify.").

<sup>107</sup>*Bair Testimony*, *supra* note 38, at 5; Michael S. Gambro & Scott Leichtner, *Selected Legal Issues Affecting Securitization*, 1 N.C. BANKING INST. 131, 157 (1997).

<sup>108</sup>See, Joint Statement, Federal Deposit Insurance Corporation, *et al*, "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," Sept. 4, 2007, (confirming that the Department of the Treasury has indicated that REMIC rules permit modification of loan terms when default is reasonable foreseeable), at pp. 2-3 and n. 3, (citing 26 CFR 1.860G-2(b)(3)(i)), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070904a1.pdf>.

<sup>109</sup>*Bair Testimony*, *supra* note 38, at 5-6.

<sup>110</sup>Michael P. Drucker and William Fricke, "Moody's Subprime Mortgage Servicer Survey on Loan Modifications," Moody's Investors Service (2007), available at [http://www.americansecuritization.com/uploadedFiles/Moodys\\_subprime\\_loanmod.pdf](http://www.americansecuritization.com/uploadedFiles/Moodys_subprime_loanmod.pdf).

borrower, driven by a short-term desire for the profits generated by mortgage origination and securitization, as opposed to the long-term concerns that surround safe and sound lending practices. Borrowers suffer from asymmetries of information, and must rely on mortgage brokers—who might have conflicting loyalties, or, at worst, have interests in direct opposition to those of the borrower—for information about the mortgage products available to them, the nature of their obligations under different mortgage products, and the extent to which their obligations might change over time (for example, with adjustable rate mortgages). If a borrower falls behind on his or her obligations, and a loan enters into default, a securitization agreement that impacts that loan may limit the extent to which the borrower can seek accommodations to assist in avoiding foreclosure. With these phenomena in mind, what follows is an application of social capital theory to the subprime mortgage crisis, emphasizing innovative approaches that might help to resolve some of these problems inherent in the current system.

### III. SOCIAL CAPITAL TO THE RESCUE: RE-INFUSING THE MORTGAGE PROCESS WITH TRUST, MUTUAL INTERDEPENDENCE, AND INTERNALIZED RISK

From a social capital perspective, many of the features and sources of the subprime mortgage crisis set forth above stem from deficiencies in structural social capital. Social capital is absent when prospective borrowers do not have contacts on whom they can rely for legitimate information about the risks and rewards of pursuing a home mortgage, whether this is an informal source of information, like a neighbor or community-based organization, or something more formal, like a mortgage broker looking out for the borrower's best interest. As a result of these forces, there are failures of both bonding and bridging social capital.

In low-income communities, and other communities with low homeownership rates, the informal information network—the “horizontal” bonds between individuals—is often not of a quality that can provide critical information to the prospective borrower because other members of the network are similarly situated; they have no more information on the mortgage market than the prospective borrower. In this way, “pooling” of information about honest brokers and fair deals is not possible in communities with little information at the outset.<sup>111</sup>

As HUD notes, apart from other barriers to homeownership that face communities of color, like discrimination and inadequate access to capital for a down payment, low-income, minority and immigrant communities also face a lack of access to traditional mortgage lenders and adequate information about the mortgage process.<sup>112</sup> Similarly, families with little connection to the financial system, who

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<sup>111</sup>See generally George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961) (discussing the impact of information networks on markets).

<sup>112</sup>See HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac, 69 Fed. Reg. 63,585 (Nov. 2, 2004) (to be codified at 24 C.F.R. pt. 81). See also, William Apgar & Allegra Calder, *The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending*, in *THE GEOGRAPHY OF OPPORTUNITY: RACE AND HOUSING CHOICE IN METROPOLITAN AMERICA* 101, 101 (Xavier de Souza Briggs ed., 2005) (noting low-income and minority borrowers less likely to comparison shop for mortgage products and less likely to have information about the mortgage market).

often do not have banking accounts or credit cards, will have a difficult time meeting stringent underwriting criteria.<sup>113</sup>

When new subprime mortgage products came onto the scene, the history of mortgage discrimination in communities of color meant there were more prospective homebuyers available in such communities, such prospective homebuyers had less information about the mortgage market and subprime lenders faced little competition for such consumers from more traditional banks.<sup>114</sup> It is no accident that much of the increase in the homeownership rate in communities of color noted above has been fueled by subprime products, and that, controlling for disparities in income and potential disparities in credit risk, African-American borrowers are more likely than White borrowers to have subprime mortgages.<sup>115</sup>

With respect to bridging social capital, the formal forces of the market and the legal structures in place weakened the traditional relationships where bridging social capital could flourish: the “vertical” relationships between borrowers, brokers and mortgage lenders and the incentive structures embedded in the market, which increased the quantity and not the quality of home mortgages. Furthermore, there was an utter lack of accountability in the mortgage process, where brokers often acted with impunity and may have had conflicting loyalties between the borrower and the lender. Similarly, undercapitalized originators were able to sell risky mortgages on the securities market with little recourse for those purchases should the borrowers default on their obligations.<sup>116</sup>

Another phenomenon that flows out of the lack of a strong bond between the borrower and lender is the significant barriers to loss mediation when a borrower is in distress and in danger of defaulting on his or her mortgage. In the traditional model, a lender will have screened a potential borrower carefully given the shared interest in the viability of the loan. That lender might have specialized knowledge about the micro-economic climate in a neighborhood or town, and be able to make an educated assessment about the prospective borrower’s long-term prospects.<sup>117</sup>

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<sup>113</sup>See, e.g., Engel & McCoy, *supra* note 56, at 1258-1259 (noting predatory lenders’ efforts to target prospective borrowers who are “disconnected” from the credit market due to “historical credit rationing, discrimination, the exodus of banks from inner-city neighborhoods, and other social and economic forces”); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 133 (2004) (describing barriers to access to credit for those without bank accounts).

<sup>114</sup>See BD. OF GOVERNORS OF THE FED. RESERVE AND THE DEP’T OF HOUS. AND URBAN DEV., JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT 13 (1998), available at <http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf> [hereinafter JOINT REPORT].

<sup>115</sup>DANIEL IMMERGLUCK & MARTI WILES, TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT (1999) (noting lending disparities in Chicago were the result of the failure of mainstream lenders to market to communities of color); Anthony Pennington-Cross et al., *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* 14 (Research Inst. for Hous. Am., Working Paper No. 00-03, 2000) (noting difference in subprime lending patterns a function of race and ethnicity of borrowers).

<sup>116</sup>Eggert Testimony, *supra* note 72, at 14; Engel & McCoy, *supra* note 56, at 1288-1289.

<sup>117</sup>Of course, this assumes no discrimination or other kinds of steering on the part of the lender.



Furthermore, should those assessments prove incorrect—should there be an economic downturn, a closing of a business or the flight of a company from the area—the lender will know about it with some advance warning and will be able to communicate with the borrower about prospects for maintaining that borrower's obligations under the loan. Short-term modifications of the loan could be made to accommodate a temporary setback and long-term restructuring could be put in place, or a planned sale of the property could occur, with enough lead time to preserve the asset and the credit history of the borrower.

In the modern relationship, not only is there little communication between the borrower and the servicer of the debt—other than the monthly mailing with a return envelope for payment—the borrower might not even know the person to call when he or she fears an economic setback will make delinquency a real possibility. Furthermore, based on this lack of a relationship with or knowledge of the servicer, and out of ignorance of the full consequences of default, a borrower might ignore calls from the servicer or a collection agency inquiring about the borrower's ability to meet his or her obligations.<sup>118</sup>

There are also structural barriers to forbearance; as stated earlier, many securitization agreements contain limits on the extent to which a servicer can negotiate terms with a borrower in default, or might limit the percentage of loans in a tranche that can be modified, and a servicer might receive compensation from the holders of the securities based on the amount that is collected from the borrower.

In order to address the asymmetries of information, the weak relationships among the parties, the absence of accountability levers in the market, and the limits on negotiability, which are all failures of social capital, among other things, the following is a discussion of the ways that the subprime mortgage market could be re-infused with social capital so that information sharing, trust and accountability can be restored to a system that is all too often lacking in all three.

#### A. *Mortgage Broker Accountability*

In many instances, particularly with subprime borrowers who might not have a pre-existing relationship with a lender, a prospective mortgagor's first foray into the mortgage market is guided by a mortgage broker. For the typical unsophisticated borrower, the mortgage broker may hold the economic fate of the prospective borrower in his or her hand. The prospective borrower relies on the mortgage broker as an advisor, confidante, "fixer" and matchmaker. The borrower will often have the mortgage process explained to him or her by the mortgage broker and that broker will assess the creditworthiness and viability of the prospective borrower, will help identify mortgage products and generally shepherd the borrower through the process, from assisting him or her in gathering documentation of income and assets straight through to the mortgage closing.

The mortgage broker therefore sits at a critical juncture in the process and becomes not only a source of information about the process for the prospective borrower, but also ultimately counsels the borrower on what he or she can afford and identifies the mortgage product that, in the broker's and lender's opinion, is

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<sup>118</sup>John Leland, *Swift Steps Help Avert Foreclosures in Baltimore*, N.Y. TIMES, March 26, 2008, at A1 (noting a tendency of borrowers in default to ignore efforts of servicers to contact those borrowers).

appropriate for the borrower. Particularly when dealing with an unsophisticated borrower, that borrower relies heavily on a broker's counsel and will often assume that the product identified for the borrower is the most advantageous for him or her.

As more fully described above, a mortgage broker in the subprime/securitization market has incentives that do not always function to promote the best interests of the borrower. A mortgage broker who is compensated each time a mortgage is consummated, and is rarely held accountable—short of being held responsible for outright acts of fraud, particularly for failing to follow disclosure requirements imposed upon brokers—when those borrowers are delinquent, will obviously pursue quantity over quality. Furthermore, they might not take the time to explore different mortgage products to ensure that the borrower is entering into a loan that is in his or her best interests, especially when taking such time to do so would take away from that broker's generating more loans, in pursuit of more compensation.<sup>119</sup>

Unfortunately, there are few legal limitations on the mortgage broker's conduct, apart from basic strictures outlawing outright fraud, and in only a few jurisdictions is the broker considered a fiduciary of the borrower, despite the extent to which the borrower might believe he or she can trust that broker. Indeed, in very few jurisdictions are there statutes that explicitly impose a fiduciary relationship between the broker and borrower,<sup>120</sup> and only a few states have recognized a common law duty, generally basing such duty on principles of agency law.<sup>121</sup> In these ways,

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<sup>119</sup>A perfect example of the conflicting loyalties facing the broker is the so-called "yield spread premium": a payment made to the broker by the originator, for, in effect, convincing the borrower to accept a loan that is more expensive than a loan that originator might otherwise offer the borrower. If the broker is able to convince the borrower to accept the more expensive loan (without telling that borrower that he or she could obtain the less expensive loan), the originator will pay the broker the difference between the interest rate ultimately paid by the borrower and that which the originator would have accepted. *See*, Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J. L. BUS. & FIN. 289, 291-292 (2007).

<sup>120</sup>*See* Wyatt v. Union Mortgage Co., 598 P.2d 45, 50 (Cal. 1979) (finding, under California Real Estate law and principles of agency law, that mortgage brokers owe fiduciary duties to borrowers); *see also* Rede v. Great Am. First Sav. Bank, No. 95-55616, 1997 U.S. App. LEXIS 747, at \*2 (9th Cir. Jan. 15, 1997). *Cf.* MINN. STAT. §58.16(1), § 58.02(3), .02(14), .02(19), .02(23) (2007) (setting forth duties owed between borrower and mortgage originator, but including mortgage broker within definition of mortgage originator); MINN. STAT. §58.16(2)(a)(2)-(a)(3) (2007) (imposing duty on broker to enter into a contract with the borrower and describe whether the broker is to receive compensation from another source). *See also* Grambart v. Fremont Inv. & Loan, Inc., Civ. No. 05-2416, 2006 U.S. Dist. LEXIS 22565, at \*4 (D. Minn. April 21, 2006) (referencing Minnesota statutory scheme). *But cf.* Brancheau v. Residential Mortgage & Mercantile Bank of St. Louis, 182 F.R.D. 579, 588 (D. Minn. 1998) (finding question of fiduciary relationship hinges on acts of parties reviewed under principles of agency law); Shafer v. GSF Mortgage Corp., C1-02-1165, 2003 Minn. App. LEXIS 550, at \*8 (Minn. Ct. App. May 6, 2003) (finding no fiduciary relationship exists under state law between mortgage broker and borrower).

<sup>121</sup>*See* Jones v. USMoney Source, Inc., No. 1:99-CV-1522A-JEC, 2000 U.S. Dist. LEXIS 20400, at \*52 (N.D. Ga. Aug. 9, 2000) (finding fiduciary relationship between borrower and broker under principles of agency law); McWhorter v. Ford Consumer Fin. Co., 33 F. Supp. 2d 1059, 1071 (N.D. Ga. 1997) (same); Vargas v. Universal Mortgage Corp., No. 01 C 0087, 2001 U.S. Dist. LEXIS 6696, at \*9 (N.D. Ill. May 18, 2001) (construing Illinois law to find that fiduciary relationship may exist based on agency law; construing principals of agency law

structural social capital—the legal backdrop to human relations—typically does not reinforce the expectations that the borrower may have that the broker will be acting in his or her best interests.

What I propose here is that mortgage brokers assume this duty voluntarily, and, consistent with other disclosure requirements,<sup>122</sup> they must disclose to their prospective clients whether they are agreeing to assume the role of fiduciary in defense of the borrowers' interests. A borrower can then have the choice of enlisting the assistance of a broker who agrees to assume a fiduciary relationship to that borrower. In this way we can ensure that borrowers have the choice of hiring mortgage brokers that have agreed to place the interests of the borrower ahead of their own interests.

The fiduciary obligation has elements that are deeply tied to trust, but also includes proper sanctions and legal ramifications for breach of that trust. As Professor Mitchell points out:

Ideally, and in its original design, [the] fiduciary obligation is self-enforcing. It is one of the few instances in our law where we levy a moral injunction against an actor as such, holding the trustee legally accountable to an otherwise aspirational standard of conduct that depends for its efficacy on the good faith of the actor.<sup>123</sup>

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to determine whether fiduciary relationship may exist between mortgage broker and borrower); *Epps v. The Money Store, Inc.*, No. 96 C 2703, 1997 U.S. Dist. LEXIS 17964, at \*20 (N.D. Ill. Sept. 30, 1997) (permitting “inference” of fiduciary relationship between broker and borrower based on principles of agency law); *Tomlin v. Dylan Mortgage Inc.*, No. 99 CVS 3551, 2000 NCBC LEXIS 11, at \*16 (N.C. Super. Ct. June 12, 2000) (finding question of fact existed whether mortgage broker owed fiduciary duty to borrower under principles of fiduciary law). *See also* *Barker v. Altegra Credit Co.*, 251 B.R. 250, 259 (Bankr. E.D. Pa. 2000) (finding fiduciary relationship existed between mortgage broker and borrower under principles of agency law); *McGlawn v. Pa. Human Relations Comm’n*, 891 A.2d 757, 769 (Pa. Commw. Ct. 2006) (same). *But cf.* *Brazier v. Sec. Pac. Mortgage, Inc.*, 245 F. Supp. 2d 1136, 1143 (W.D. Wash. 2003) (finding no fiduciary relationship between broker and borrower under Washington law).

<sup>122</sup>The most important federal statutes that cover disclosure requirements concerning the mortgage transaction, are the Truth in Lending Act, 15 U.S.C. §§ 1601-1693r (2006) (TILA), and Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601-17 (2006) (RESPA). While RESPA deals mostly with disclosure of closing costs, TILA deals primarily with disclosures about the cost associated with the deal itself, i.e., the interest rate and finance charge. So-called Regulation Z, which implements the requirements of TILA, sets forth a series of disclosure requirements imposed upon the creditor, see, e.g., 12 C.F.R. § 226.18 (2006), but imposes no disclosure requirements on brokers. The Home Ownership and Equity Protection Act of 1994, 15 U.S.C. §§ 1601, 1602(aa), 1639(a)-(b) (2006) (HOEPA), which amended TILA, and the regulations of which are also found in Regulation Z, require additional disclosures for “high cost”, closed-end mortgages (with interest rates that exceed a certain amount). At the time of publication, the Federal Reserve has proposed changes to Regulation Z in response to the subprime mortgage crisis, one of which will lower the “trigger” of HOEPA with respect to the interest rate to which it applies, but still has not sought to impose any fiduciary duties on brokers. *See* Truth in Lending, 73 Fed. Reg. 1672 (Jan. 9, 2008) (to be codified at 12 C.F.R. pt. 226).

<sup>123</sup>Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 614-615 (2001).

By assuming a fiduciary duty to the borrower, the broker will act solely in the best interests of the borrower, and with the “utmost good faith.”<sup>124</sup> Such a duty will prohibit self-dealing, conflicts-of-interest, and shoddy and incomplete research into the market.<sup>125</sup> The very act of assuming this duty voluntarily will signal to the borrower that this broker can be trusted, and can be held accountable for violations of that trust.<sup>126</sup> Given the inability of the borrower to monitor all of the actions of the broker, fiduciary law offers an appropriate response in this situation: one that will protect the borrower while not imposing restrictions that would result in honest brokers leaving the market.<sup>127</sup>

What flows from such an enhanced relationship, admittedly, is that there might be loans that will not be made, because the mortgage broker will have a frank discussion with the prospective borrower about that borrower’s obligations, and prospects for compliance with such obligations. And there are some loans that simply should not be made because the borrower will be worse off should he or she default on them. In the end, by inviting brokers to assume a fiduciary responsibility towards borrowers, and to tell them when they will not, we will restore some effective checks and balances into the system, altering the incentive structure that has put short-term profits well ahead of long-term economic viability. In this way, “bridging” social capital can assist in overcoming asymmetries of information present in many mortgage transactions,<sup>128</sup> and permit the broker—voluntarily—to

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<sup>124</sup>For an overview of fiduciary obligations, see Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard Zeckhauser eds., 1985); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

<sup>125</sup>For an analysis that suggests that a “duty of best execution” should be imposed on loan originators that would require that the originator offer the most suitable loan to the borrower, see, Howell E. Jackson, *Enlisting Market Mechanisms to Police the Origination of Home Mortgages*, HARV. U., JOINT CENTER ON HOUSING STUDIES, Policy Paper UCC08-7, February 2008, at 12, available at [http://www.jchs.harvard.edu/whatsnew/new\\_pubs.html](http://www.jchs.harvard.edu/whatsnew/new_pubs.html).

<sup>126</sup>See, e.g., Blair & Stout, *supra* note 19, at 1796 (arguing fiduciary law “frames” relationships to encourage the internalization of behavior worthy of trust). For an argument for why brokers should not be fiduciaries of their client-borrowers, see David Unseth, Note, *What Level of Fiduciary Duty Should Mortgage Brokers Owe Their Borrowers?* 75 WASH. U. L. Q. 1737 (1997).

<sup>127</sup>Blair & Stout, *supra* note 19, at 1788 (noting wide-spread recognition that situations where the principal cannot monitor the agent are appropriate for the imposition of fiduciary duties) (citations omitted).

<sup>128</sup>In studies that have looked at the impact of social capital on the success of lending programs, research shows that a high level of trust between borrower and lender is positively related to the success of such programs, and high levels of social capital help overcome asymmetries of information, especially in the micro-lending context where building vertical social capital between the borrower and lender is seen as a priority. See, e.g., Asif Dowla, *In Credit We Trust: Building Social Capital by Grameen Bank in Bangladesh*, 35 J. OF SOCIO-ECON. 102 (2006); Grootaert & Bastelaer, *supra* note 11, at 20; Narayan, *supra* note 4, at 38; Lan Cao, *Looking at Communities and Markets*, 74 NOTRE DAME L. REV. 841 (1999); Alexander Goldmark, *Fewer Loans for the Lonely: Can Social Capital Improve Access to Credit for the Poor?*, 9 GEO. PUB. POL’Y REV. 49, 53 (2003). In addition, the length and quality of the relationship between borrower and lender also matter; one recent report analyzing information from domestic credit unions showed that the longer-term members of

assume a fiduciary relationship to the borrower. This voluntary act alone will help to restore confidence in the broker and the process.

*B. Community Education and Neighborhood-Based Good Will*

Prospective borrowers and borrowers in distress might have similar social capital profiles, i.e., they have nowhere to turn for information and counseling that might help them navigate the mortgage process. Prospective borrowers, particularly those with little knowledge about the mortgage process, need a wide range of information in order to determine whether homeownership is right for them. Prospective borrowers whose horizontal contacts might have little information themselves about the mortgage process need a source for critical information about that process, so that they can determine if they are viable candidates for a mortgage. They need to be able to make an objective assessment of their income, assets, long-term economic prospects, credit history and what size and type of mortgage they can afford. This lack of knowledge—this structural social capital failure—helped lead many borrowers to subprime loans they could not ultimately afford.

Pre-purchase counseling that provides basic education on the mortgage process, which might also include counseling on budgeting and financial planning, is critical for these prospective borrowers. Homeownership counselors can provide low cost information to non-traditional markets, cross cultural and linguistic barriers, bridge the knowledge gap in non-traditional markets, assist lenders in meeting their requirements under the Community Reinvestment Act, and identify worthy borrowers.<sup>129</sup> A growing body of evidence shows that community-based organizations that have entered this area are having a beneficial effect on default rates.<sup>130</sup>

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these credit unions had better repayment rates of micro-loans than did new members. See Marva Williams, *Cooperative Credit: How Community Development Credit Unions are Meeting the Need for Affordable, Short-Term Credit*, WOODSTOCK INSTITUTE (2007), available at [http://www.economicintegrity.org/pdf/cooperativecredit\\_may2007\\_williams-1.pdf](http://www.economicintegrity.org/pdf/cooperativecredit_may2007_williams-1.pdf).

<sup>129</sup>Steven P. Hornburg, *Strengthening the Case for Homeownership Counseling: Moving Beyond "A Little Bit of Knowledge"* 9 HARV. U., JOINT CENTER FOR HOUSING STUDIES, Working Paper No. W04-12, 2004), available at <http://www.nw.org/network/training/homeownership/documents/StrengtheningCaseforHomeownershipCounseling.pdf>; see also George W. McCarthy & Roberto G. Quercia, *Bridging the Gap between Supply and Demand: The Evolution of Homeownership, Education and Counseling Industry*, RES. INST. FOR HOUS. AM., REP. NO. 00-01 (2000), available at [http://www.housingamerica.org/Publications/48506\\_BridgingtheGapBetweenSupplyandDemand.pdf](http://www.housingamerica.org/Publications/48506_BridgingtheGapBetweenSupplyandDemand.pdf).

<sup>130</sup>See, e.g., Roberto G. Quercia & Susan M. Wachter, *Homeownership Counseling Performance: How Can It Be Measured?*, 7 HOUSING POL'Y DEBATE 175 (1996), available at [http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd\\_0701\\_quercia.pdf](http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_0701_quercia.pdf) (showing that pre-purchase counseling can help identify viable borrowers, assist in budgeting and managing debt repayment, and help navigate potential crises); Abdighani Hirad & Peter M. Zorn, *A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling*, HARV. U., JOINT CENTER FOR HOUSING STUDIES, Working Paper No. LIHO-01.4, 2001, available at [http://www.jchs.harvard.edu/publications/homeownership/liho\\_01-4.pdf](http://www.jchs.harvard.edu/publications/homeownership/liho_01-4.pdf) (studying 40,000 mortgages to individuals at 100% of the median income in an area where pre-purchase home counseling was undertaken and showing that individual home mortgage counseling had the effect of reducing 90-day delinquencies by 34 percent); Roberto G. Quercia et al., *The Cost-Effectiveness of Community-Based Foreclosure Prevention*, HARV. U., JOINT CENTER FOR HOUSING STUDIES, Working Paper No. BABC 04-

When community-based organizations enter into this area, they will generally already enjoy the trust of the communities they serve. They can leverage the social capital they have developed—the bonds of trust and the good will and respect they have garnered over the years—to improve their constituents’ knowledge about the mortgage process and market so that they can find the product that is right for the borrower. They can also help to winnow out individuals who, because of poor credit history or insufficient or irregular income, might be bad candidates for a mortgage.

In addition, community-based organizations can assist servicers in identifying and communicating with borrowers in distress, and the good will they have developed can generate a better response than a dunning phone call or threatening letter from a servicer or collection agency. There is a growing recognition that an aggressive approach to mortgage collection is less likely to lead to positive outcomes. As a recent survey of mortgage lenders from the Office of the Comptroller of the Currency (OCC) found, banks agree that a “friendlier approach” to borrowers in distress, through which the contact rate with these borrowers is increased, is “the key to success of their foreclosure prevention initiatives,” contrary to the “old method” of “flood[ing] borrowers” with harassing letters and phone calls.<sup>131</sup> Furthermore, as the OCC explains:

Some servicers have realized that counseling agencies are more trusted by borrowers and that borrowers may be more likely to respond to a call or letter from a counseling agency. These servicers have found that by partnering with a counseling agency, their contact rates with delinquent borrowers have increased. These partnerships capitalize on the desire of both the banks and counseling agencies to have borrowers stay in their homes if they can afford their mortgage payments.<sup>132</sup>

Community-based organizations recognize the impact the positive effect homeownership can have on the communities they serve, and the negative externalities of foreclosure. More and more, banks are realizing that “keeping homeowners in their homes is the best way to mitigate credit loss, preserve customer relations, maintain stable neighborhoods, and minimize the detrimental effects vacant properties can have on crime and property values.”<sup>133</sup>

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18, 2004, available at [http://www.jchs.harvard.edu/publications/finance/babc/babc\\_04-18.pdf](http://www.jchs.harvard.edu/publications/finance/babc/babc_04-18.pdf) (finding lower mortgage delinquency rates for recipients of post-purchase credit counseling).

<sup>131</sup>U.S. DEPT. OF THE TREASURE, COMPTROLLER OF THE CURRENCY, FORECLOSURE PREVENTION: IMPROVING CONTACT WITH BORROWERS, INSIGHTS 3-4, 9 (June 2007), [http://www.occ.treas.gov/cdd/Foreclosure\\_Prevention\\_Insights.pdf](http://www.occ.treas.gov/cdd/Foreclosure_Prevention_Insights.pdf) [hereinafter OCC: IMPROVING CONTACT].

<sup>132</sup>*Id.*, at 6.

<sup>133</sup>*Id.*, at 2. Lenders should be interested in avoiding foreclosure because of the reputation risk, the cost to lender-owned portfolios, the costs of servicing a foreclosed property, diminished property values, and the impact of rampant foreclosures on Community Reinvestment Act ratings. *Id.* at 2-3. A representative of Moody’s bond rating agency recently testified concerning the value of negotiating to preserve homeownership arrangements and avoid foreclosure as follows:

Moody’s believes that restrictions in securitizations which limit a servicer’s flexibility to modify distressed loans are generally not beneficial to the holders of the bonds. Loan modifications, when used judiciously, can mitigate losses on mortgage loans and

Because pre-purchase counseling works and post-purchase counseling can help stave off foreclosure, greater resources should be directed at strengthening the home counseling network and community-based organizations should be given opportunities to enter into this arena if they are not in it already.<sup>134</sup> Lenders and servicers should be encouraged to partner with community-based organizations to conduct outreach to borrowers, and should not just be required to give notice of their availability to a borrower in default.<sup>135</sup> For first-time homebuyers and borrowers that might otherwise be seen as risky investments, pre- and post-purchase counseling should be integrated into the lending process, and lenders should coordinate their efforts with community-based organizations to build on and leverage the social capital in the communities these organizations serve.<sup>136</sup>

One structural barrier to enhancing the role of community-based organizations in the pre- and post-purchase lending process is the effect of privacy laws that might otherwise prevent the lender from communicating the status of a debt to a third party. This communication could be facilitated by offering borrowers, at closing, the opportunity to give advance consent to the lender/servicer to enlist a local community-based organization of the borrower's choice should that borrower enter into delinquency or face distress.<sup>137</sup>

### C. Foreclosure, Problem-Solving Courts and Community Mediation

In approximately half of the states, the parties to a mortgage transaction may agree that a judicial act is not required for a mortgagee to foreclose on a property when the mortgagor is in default.<sup>138</sup> Virtually all states provide a formal judicial mechanism of foreclosure when a mortgagor is in default, and that mortgagor must receive formal notice of the pendency of the action and be afforded an opportunity to respond. Judicial foreclosure is the exclusive remedy in approximately forty percent

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increase the likelihood that bonds will be paid. Consequently, while loan modifications can not eliminate losses or generate more credit enhancement for a given transaction, we believe that they can typically have positive credit implications for securities backed by subprime mortgage loans.

*Kornfeld Testimony*, *supra* note 65, at 17-18.

<sup>134</sup>See, e.g., REN S. ESSENE & WILLIAM APGAR, UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS, HARV. U., JOINT CENTER, FOR HOUSING STUDIES (2007), available at [http://www.jchs.harvard.edu/publications/finance/mm07-1\\_mortgage\\_market\\_behavior.pdf](http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf) (suggesting the creation of a network of "trusted advisors" that would build on the trust and good will community-based organizations have established in the communities they serve).

<sup>135</sup>See 15 U.S.C. § 1692(a)-(p) (2006).

<sup>136</sup>See MARK WIRANOWSKI, SUSTAINING HOME OWNERSHIP THROUGH EDUCATION AND COUNSELING, HARV. U., JOINT CENTER, FOR HOUSING STUDIES (2003), available at [http://www.jchs.harvard.edu/publications/homeownership/w03-7\\_wiranowski.pdf](http://www.jchs.harvard.edu/publications/homeownership/w03-7_wiranowski.pdf) (arguing for a comprehensive approach to counseling, that assists borrowers from the pre-purchase stage through post-purchase and any threatened delinquency, that is also integrated into the lending process).

<sup>137</sup>OCC: IMPROVING CONTACT, *supra* note 137, at 8-9, 11.

<sup>138</sup>Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 492 (1991) (citations omitted).

of the states.<sup>139</sup> Unfortunately for many subprime borrowers, they cannot afford an attorney to defend them in such an action, and the complicated defenses that might be available are often too difficult to raise without an attorney. In addition, defenses such as fraud in the inducement, or that the loan might violate predatory lending laws, might be impossible to interpose against servicers or holders of the note after securitization due to the “holder in due course” doctrine.<sup>140</sup>

Furthermore, when courts are engaged in the foreclosure process, the actions are usually filed wherever venue is appropriate, and matters are scattered throughout the court system, without concentrating them before a single judge or a group of judges with expertise in the law or knowledge about a particular lender, borrower or community. Unlike specialized courts that often handle landlord-tenant matters, where the laws are often just as arcane as in the mortgage transaction area, judges handling foreclosure actions are usually generalists and rarely have an expertise in this area of the law. Moreover, when foreclosure actions affecting a community are spread throughout a court system, little attention can be paid to the community consequences of foreclosures in a particular neighborhood.

Given the structural deficiencies of such an approach to foreclosure actions, in jurisdictions where judicial intervention is required to complete a mortgage foreclosure, consideration should be given to channeling foreclosure actions before a specialized court that would be equipped to take into account (1) the complexities of foreclosure litigation and the defenses that might be available to mortgagors; (2) the availability of counseling, loss mitigation services and mediation in the community; and (3) the impacts of foreclosures on specific neighborhoods and communities.<sup>141</sup> Courts would also build their own social capital by developing an ethic of accountability among the litigants by playing a monitoring function, ensuring that parties that have entered into an agreement to permit forbearance abide by the terms of the agreement.

In addition, and viewing matters from a social capital perspective, judges handling these matters would get to know the parties and their lawyers, who will likely appear before the court regularly. As a result, they can develop a dense social network of mutual cooperation and obligation: what one commentator calls “thick

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<sup>139</sup>GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 558 (4th ed., West Group 2001) (noting judicial foreclosure is available in every jurisdiction but the “exclusive or generally used method” in forty percent of states); *see also* FORECLOSURE LAW & RELATED REMEDIES: A STATE-BY-STATE DIGEST (Sidney A. Keyles ed., 1995) (cataloguing state procedures); Debra Pogrud Stark, *Foreclosing on the American Dream: An Evaluation of State and Federal Foreclosure Laws*, 51 OKLA. L. REV. 229 (1998) (describing foreclosure remedies).

<sup>140</sup>*See* Eggert, *supra* note 38. Further complicating matters, because investors are shielded from liability from any predatory terms that might arise in the underlying mortgage, there is little ability to police such terms where the originator may no longer exist due to bankruptcy or other dissolution. *See, e.g.*, Kiff & Mills, *supra* note 40, at 11-12.

<sup>141</sup>For a discussion of a community court’s experience with taking into account the neighborhood context of court sanctions, see Victoria Malkin, *Community Courts and the Process of Accountability: Consensus and Conflict at the Red Hook Community Justice Center*, 40 AM. CRIM. L. REV. 1573, 1581-82 (2003).



trust.”<sup>142</sup> In this way, the lawyers regularly appearing before this court will “have reputations at stake that are almost surely worth more than gains from momentary treachery.”<sup>143</sup>

In this way, the judicial system could build on the work of other “problem-solving courts.” This phenomenon has expanded in recent years with a number of approaches, handling for example, low-level and first offense drug crimes, domestic violence and misdemeanor and/or criminal level offenses committed in a particular community.<sup>144</sup> These courts approach the problems they are designed to face by utilizing principles of “therapeutic justice,”<sup>145</sup> as court personnel become aware of both the community impacts of the issues they are designed to address as well as the community supports available to the litigants to reduce those harmful impacts.<sup>146</sup> At

<sup>142</sup>Bernard Williams, *Formal Structures and Social Reality*, in TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 3-13 (Diego Gambetta ed., 1998). For a description of efforts of judges to develop the trust of prosecutors, defense counsel, criminal defendants, mental health professionals and community-based social services providers in a criminal setting, see Carol Fidler, *Building Trust and Managing Risk: A Look at a Felony Mental Health Court*, 11 PSYCHOL. PUB. POL’Y & L. 587 (2005); see also Judith S. Kaye, *Delivering Justice Today: A Problem-Solving Approach*, 22 YALE L. & POL’Y REV. 125, 142 (2004) (arguing problem-solving courts are restoring litigants’ trust in the legal system).

<sup>143</sup>PUTNAM, *supra* note 2, at 136. The connection between law, trust and problem-solving courts has been well-recognized in at least one arena: problem-solving courts are often seen as restoring the public’s faith in the legal system itself. See, e.g., Judith S. Kaye, Chief Judge of the State of N. Y., Keynote Address at the Eleventh Annual Symposium on Contemporary Urban Challenges: Problem-Solving Courts (Feb. 28, 2002), in 29 FORDHAM URB. L.J. 1925, 1928 (2002) (arguing that problem-solving justice “is an opportunity to restore trust and confidence that the courts are indeed concerned with producing meaningful results, not simply proliferating legal process”); Roger K. Warren, *Public Trust and Procedural Justice*, 37 CT. REV. 12, 15 (2000) (arguing improved perceived procedural fairness of problem-solving courts can improve public trust in the legal system).

<sup>144</sup>For a description of such problem-solving courts, see GREG BERMAN & JOHN FEINBLATT, GOOD COURTS: THE CASE FOR PROBLEM-SOLVING COURTS 31 (2005); Michael C. Dorf & Jeffrey A. Fagan, *Problem-Solving Courts: From Innovation to Institutionalization*, 40 AM. CRIM. L. REV. 1501 (2003).

<sup>145</sup>“Therapeutic jurisprudence,” or “judging with an ethic of care,” has typically been seen as a worthwhile approach to utilize in settings where courts might work to address psychological forces that might prove resistant to change through punitive measures, as in drug prosecutions involving someone who is mentally ill and chemically addicted. See, e.g., JUDGING IN A THERAPEUTIC KEY: THERAPEUTIC JURISPRUDENCE AND THE COURTS 9 (Bruce J. Winick & David B. Wexler eds., 2003). There is no reason why an “ethic of care” could not be utilized to minimize the impact of foreclosures on the courts, the litigants and the community. For a description of the therapeutic role of courts of general jurisdiction, see William G. Schma, *Judging for the New Millenium*, 37 CT. REV. 4, 6 (2000) (“A trial court that moves deliberately in response to emergent issues is a stabilizing force in society and acts consistently with its role of maintaining the rule of law.”).

<sup>146</sup>The ability to connect litigants to needed social services, which might be appropriate for some subprime borrowers, is often a feature of problem-solving courts. Bruce J. Winick, *Therapeutic Jurisprudence and Problem Solving Courts*, 30 FORDHAM URB. L.J. 1055, 1061 (2003) (describing role of social services in problem-solving courts); Greg Berman & John Feinblatt, *Problem Solving Courts: A Brief Primer*, 23 LAW & POL’Y 125, 131-132 (2001) (same).

present there are over approximately 2000 such problem-solving courts throughout the country, though none in the area of mortgage foreclosure.<sup>147</sup>

Even in jurisdictions that permit foreclosures to occur without judicial intervention, more resources could be directed—perhaps even subsidized by lending institutions—towards making community mediation more available to lenders saddled with borrowers in default. These mediators could enjoy the respect of the community in general and the borrowers in particular, and might bring borrowers in default to the negotiating table more readily than servicers pursuing their debts.

#### IV. LAW, SOCIAL CAPITAL AND TRUST

As the previous discussion shows, the subprime mortgage crisis is, in many ways, the product of a market in transition. Deregulation,<sup>148</sup> the spread of mortgage products to previously untapped markets, the increase in available mortgage products and lenders, and the influx of capital through securitization that resulted in the globalization of the home mortgage market: these all came together in a “perfect storm.” With the severance of the traditional borrower-lender relationship, which undermined the value that social capital brought to that relationship, potential borrowers who might not have had sufficient contacts or networks on which to rely for information about the mortgage process were victimized by brokers and lenders looking for a quick payday through the securitization process.

Some have instituted litigation to try to weed out and punish brokers and lenders who discriminated against subprime borrowers.<sup>149</sup> Congress, the Bush Administration and some banks have explored potential responses to the subprime mortgage crisis, though much of them have the air of palliative care: making the inevitable less painful, if not less swift. Furthermore, the Bush Administration’s recently announced proposed changes to the manner in which the federal government regulates financial markets indicate that, while expanding the scope of covered entities and practices is one goal of those changes, further deregulation and federal pre-emption are still driving forces behind the proposal.<sup>150</sup> As this volume goes to print, however, because of the political fallout from the Fed’s intervention in the collapse of financial giant Bear Stearns, bi-partisan support seems to be mounting on Capital Hill for more serious interventions in the subprime market, notably increasing funding support for housing counseling: a development that is certainly welcome and might indicate more comprehensive reforms are possible.<sup>151</sup>

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<sup>147</sup>BERMAN & FEINBLATT, *supra* note 147, at 32. Recently, a working group has formed of trial court judges in Brooklyn, NY, through which these judges are able to share information about trends in their foreclosure dockets. Mark Fass, *Judges Take the Reins in Brooklyn Foreclosures*, NEW YORK LAW JOURNAL, Feb. 25, 2008.

<sup>148</sup>*See supra* Part II.C.

<sup>149</sup>*See, e.g.*, Gretchen Morgenson, *Baltimore is Suing Bank Over Foreclosure Crisis*, N.Y. TIMES, January 8, 2008, at A12; Christopher Maag, *Cleveland Sues 21 Lenders Over Subprime Mortgages*, N.Y. TIMES, January 12, 2008, at A9.

<sup>150</sup>Edmund L. Andrews, *Treasury’s Plan Would Give Fed Wide New Power*, N.Y. TIMES, March 29, 2008, at A1.

<sup>151</sup>David Herzenhorn, *In Senate, Agreement on Housing*, N.Y. TIMES, Apr. 3, 2008, at D1.

What can the absence of legal protections tell us about the effect of law on this market? Prior to this market's collapse, many might have hailed the triumph of deregulation and economic markets over attempts to legislate against discrimination. The loosening of restrictions on certain types of lending through deregulation, federal pre-emption of some state efforts to combat predatory lending,<sup>152</sup> and a web of laws designed to discourage "old fashioned" discrimination in mortgage lending, encouraged subprime lending in previously "redlined" communities. Subprime lenders filled that void and exploited that market. And thus, discrimination in mortgage lending was no longer a problem. A strong housing market was the solution to housing discrimination. Lending disparities in communities of color were a result of lenders concerned about their bottom line, not motivated by bias against borrowers or certain communities. Let the market do its job and discrimination will turn out to be inefficient. At least that was the theory.<sup>153</sup>

It is true that the relentless drive to securitize pushed lenders into previously underserved communities in an effort to maximize profits. Tragically, the brokers and lenders who brought these products to these communities found themselves with both an informational advantage over their customers and with no accountability to their investors. Ultimately, this mix has proven toxic. And the laws designed to root out discriminatory practices have proven dull weapons against "reverse redlining": the infusion of mortgage products in previously underserved markets.<sup>154</sup> Indeed, laws like HMDA and the Community Reinvestment Act are designed, respectively, to monitor, through disclosure, mortgage rejection and approval patterns and the failure of covered banks to meet the credit needs of the communities they serve. In these ways, they primarily target the failure of banks to extend loan products to communities of color. The Fair Housing Act, on the other hand, although its primary purpose is to prohibit the rejection of loan applications based on race, also prohibits the imposition of different and less favorable loan terms based on the race of the borrower. In litigation under the FHA, however, as with many other anti-

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<sup>152</sup>See Nicholas Bagley, Note, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 N.Y.U. L. REV. 2274, 2274 (2004) (describing efforts by the Office of the Comptroller of the Currency to pre-empt some state anti-predatory lending laws).

<sup>153</sup>See, e.g., GARY BECKER, *THE ECONOMICS OF DISCRIMINATION* (1957) (arguing that discrimination is inefficient and free markets, not regulation, will eliminate it); Jeffrey W. Gunther, *Should CRA Stand for "Community Redundancy Act"?*, 23 REG. 56 (2000) (arguing market forces, and not the CRA, can best promote lending in previously underserved communities). For a critique of the argument that free markets will eliminate discrimination, see CASS R. SUNSTEIN, *FREE MARKETS AND SOCIAL JUSTICE* 155-57 (1997). See also IAN AYRES, *THE ELUSIVE NATURE OF DISCRIMINATION: PERVASIVE PREJUDICE? UNCONVENTIONAL EVIDENCE OF RACE AND GENDER DISCRIMINATION* (2003) (identifying discriminatory conduct in many economic settings).

<sup>154</sup>Although identified for over a decade, there are few reported cases where courts have found, on the merits, that a broker or lender was engaged in so-called "reverse redlining". See, e.g., *Barkle v. Olympia Mortgage*, 2007 U.S. Dist. LEXIS 61940 (E.D.N.Y., Aug. 22, 2007) (finding allegations of targeting of minority borrowers for less favorable loan terms sufficient to withstand motion to dismiss); *Matthews v. New Century Mortgage Corp.*, 185 F. Supp.2d 874, 887 (S.D. Ohio 2002) (same); *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7, 20-22 (D.D.C. 2000) (finding allegations of targeting of minority borrowers for less favorable loan terms sufficient to withstand motion for summary judgment).

discrimination laws in the area of mortgage discrimination, causation is often difficult to prove.<sup>155</sup>

Deregulation and a legacy of mortgage discrimination meant that there were certain communities that were likely targets for new mortgage products and aggressive lenders. Given the nature of anti-discrimination laws that were designed primarily to prevent mortgage rejections, a Community Reinvestment Act that was easily circumvented, and a cadre of mortgage purveyors that were largely unconstrained, unsophisticated borrowers from previously untapped markets fell prey to the promise of homeownership through subprime products. When the subprime lenders did come to town, borrowers could not rely on networks of information from other borrowers to help them steer clear of harmful loan terms. Trust was present in all of these transactions: too much trust, and trust that was not backed up by law. In these ways, the legal institutions in place were not designed for the changes that occurred, leaving a legal vacuum.

Perhaps tightly knit communities with deeply embedded norms of trust and cooperation can function well without much recourse to the law.<sup>156</sup> But in markets in transition, where traditional relationships of trust have broken down and been replaced by more impersonal communications and where the laws in place do not respond to the changes in these relationships, norms of trust and the sanctions that might otherwise enforce them prove illusory. Information asymmetries and the prospect of moral hazard abound. Without a legal response to such market transformations, where law can help to shore up these relationships in transition and insulate them from the harsh consequences of the departure of social capital, trust is replaced by predation.

Law can restore trust, and with it, social capital, however: in one example, by the creation of fiduciary duties that may help to offset information asymmetries. Market responses like better consumer education can also help to offset such market distortions. Judicial responses that attempt to rebuild social capital in dispute resolution—like the problem-solving courts described here—can also help rectify structural impediments to negotiations to reach mutually beneficial ends.

Are there other markets to which this analysis may be helpful? One close cousin to the subprime mortgage market is the consumer credit market. In a small town or tightly knit community, a local merchant might be willing to extend credit to customers he or she knows or trusts. Such a merchant will only permit such credit to grow so high, and will rein in customers seeking to take advantage of good will. At the same time, low-income communities and communities of color have long suffered from the high price of consumer credit, through rent-to-own schemes and contracts of adhesion. With deregulation, consumers are overwhelmed by credit card offers, and the working poor are all too often saddled with high cost consumer debt.

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<sup>155</sup>See, e.g., Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 SYRACUSE L. REV. 233, 241, n.44 (2006) (describing challenges to bringing litigation to raise claims of discrimination brought about by predatory lending practices); Barr, *supra* note 41, at 626-627 (identifying difficulties in proving discriminatory treatment in extension of mortgage credit).

<sup>156</sup>For example, order can be maintained without law in the cattle-raising communities of Shasta County, California, as described by Professor Ellickson. See ELLICKSON, *supra* note 24.

While deregulation might have made consumer credit readily available, the consequences of such debt, and the long-term impacts of the profligate consumer spending of the first half of the 2000s, are now becoming apparent. Could the consumer credit market turn into the next market in crisis?<sup>157</sup> Are there steps that could be taken today to attempt to ameliorate the high cost of credit before the rapid increase of consumer debt has an adverse effect on the economy, like a rapid and vast contraction of consumer spending, the beginnings of which we are probably already seeing? Does social capital have an answer to this looming crisis? A look at one area of consumer credit that seems to have benefited from the creation of social capital certainly suggests that it is possible.

Grameen Bank is generally acknowledged as the pioneer in micro-finance, and has brought about lasting change for millions of people throughout the world who have benefited from loans from Grameen Bank (Grameen) itself and its many imitators. This recognition met its climax, perhaps, when Grameen's founder, Muhammad Yunus, was awarded the Nobel Peace prize for his groundbreaking work in poverty alleviation. The Grameen model, replicated the world over with varying degrees of success, finds at its core a fundamental reliance on the creation, nurturing and maintenance of social capital among its participants. The term "participants" is critical here, as opposed to borrowers, because those individuals who seek loans through a lender following the Grameen model must become a part of a small network of prospective borrowers. These individuals form a "lending circle" and decide on who shall join the circle, determine who should get the benefit of a loan first, what the terms of that loan should be, and how the income stream from that loan should be transformed into a loan for another member of the circle.<sup>158</sup>

The whole system is one built on trust, mutual interdependence and shared goals. All members of the circle are collectively responsible for repayment of each loan, creating peer pressure and mutual dependence. These aspects of the process are reinforced through highly structured rituals that tend to strengthen bonds among individuals who, but for their participation in such an endeavor, are often highly marginalized and isolated, with few opportunities for building relationships beyond their own families. These rituals include regular and formal meetings, attendance at which is mandatory; a reliance on rotating leadership roles; and even the simple act of requiring that participants call each other by their first name, a practice uncommon in some patrilineal societies where women are typically addressed by their married name only. Grameen staff bend over backwards to develop trust with participants, including striving to express genuine concern for their well being, especially in times of crisis and natural disaster.<sup>159</sup> In the end, the more these

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<sup>157</sup>Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A1 (noting increased delinquencies in other areas of consumer credit, like credit card debt and auto loans).

<sup>158</sup>For a general description of the Grameen approach, see MUHAMMAD YUNUS, GRAMEEN BANK: EXPERIENCES AND REFLECTIONS (1998).

<sup>159</sup>For an analysis of the social capital features of the Grameen model, see Dowla, *supra* note 128, at 102; Lisa Young Larence, *Fostering Social Capital through NGO Design: Grameen Bank Membership in Bangladesh*, 44 INT'L SOC. WORK 7 (2001); Thierry van Bastelaer, *Does Social Capital Facilitate the Poor's Access to Credit? A Review of the Microeconomic Literature* (World Bank Soc. Cap. Initiative, Working Paper No. 9, 2000),

organizations following the Grameen model are able to utilize its social capital features, the more successful they have been and the stronger the relationship between bank staff and participants, the better the loan repayment rate.<sup>160</sup>

Would increased consumer counseling in the area of consumer debt improve borrowers' chances for repayment and lower the ultimate cost of their credit? Studies in the mortgage counseling area would seem to suggest that. Could community-based lenders, i.e., Community Development Financial Institutions like credit unions and other community-based financial institutions, make micro-loans to consumers in debt to help them pay off their consumer debt?<sup>161</sup> Could such lenders institute social capital building features into their programs that might make repayment more likely? Pilot programs seeking to institute the Grameen model in the United States have met with limited success, but more research into what type or types of micro-credit programs might work in the U.S. market is certainly needed.<sup>162</sup>

Another area that has seen explosive growth and a legal system ill-equipped to handle it is the issue of immigration reform in the United States. For the last twenty years, an influx of undocumented workers has created an underground economy in the United States where low-wage, immigrant workers work in the shadows, often

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available at <http://siteresources.worldbank.org/INTSOCIALCAPITAL/Resources/Social-Capital-Initiative-Working-Paper-Series/SCI-WPS-08.pdf>.

<sup>160</sup>The importance of trust and social capital in the micro-finance area, as exemplified by the Grameen Bank model, cannot be underestimated. As noted in Dowla, *supra* note 128, at 108:

Grameen Bank proved that the poor can be trusted and, with proper incentives and institutional structures they will take advantage of the assistance. The Bank's trust in its members has created a realization among them that they have to reciprocate by repaying the loans on time. The mere fact that the bank has placed its trust in the poor makes them feel obligated, and this makes it harder for them to betray that trust.

<sup>161</sup>The Community Development Financial Institutions (CDFI) movement in the United States seeks, among other things, to improve the functioning of financial markets in previously underserved communities. The CDFI Act, by increasing the availability of federal funds to support such institutions, greatly enhanced the ability of this movement to address the financial needs of low- and moderate-income communities. See Community Development Financial Institutions Act of 1994, Pub. L. No. 103-325, 101-121, 108 Stat. 2160 (codified at 12 U.S.C. 4701-4718 (2001)). For an overview of the history of the CDFI movement in the United States, see Nellie R. Santiago, Thomas T. Holyoke & Ross D. Levi, *Turning David and Goliath Into the Odd Couple: How the New Community Reinvestment Act Promotes Community Development Financial Institutions*, 6 J.L. & Pol'y 571, 595-609 (1998); Rochelle Lento, *Community Development Banking Strategy for Revitalizing Our Communities*, 27 U. MICH. J. L. REFORM 773 (1994). For an analysis of the CDFI Act, see Christopher Jordan Heisin, *Community Development Lite: An Economic Analysis of the Community Development Financial Institutions Act*, 39 How. L.J. 337 (1995).

<sup>162</sup>For a review of the micro-finance movement generally, see Jonathan Morduch, *The Microfinance Promise*, 37 J. OF ECON. LIT. 1569 (1999). Some question the viability of the Grameen Bank model generally and its application in the United States. See, e.g., Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L L. 217 (2005); Louise A. Howells, *The Dimensions of Microenterprise: A Critical Look at Microenterprise as a Tool to Alleviate Poverty*, 9 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 161, 161 (2000) (critiquing application of micro-credit model to poverty alleviation in the United States).

afraid to raise issues about mistreatment, unsafe work conditions and illegal wages for fear that their undocumented status will be revealed.<sup>163</sup> Similarly, undocumented immigrants are often afraid to report crime, to seek medical assistance and to participate in the mainstream economy by doing things like open bank accounts for want of proper identification and fear of prosecution.<sup>164</sup> It is unquestionable that formal legal protections that may shield immigrants in many situations<sup>165</sup> are often unenforceable because immigrants are afraid to vindicate what rights they may have for fear that the legal system cannot truly protect them. Structural social capital—formal legal institutions and laws that might promote civic participation and collective action—has failed to provide adequate protections to undocumented immigrant workers to permit them to integrate into the community as full participants and has created a lawless sector, where employers can act with virtual impunity and immigrants cannot partake of the full benefits of society. There are examples of progressive reform in this area, however, where legal institutions are being designed to promote trust and integrate immigrant communities into society. In New York City, Executive Order 41 allows undocumented immigrants access to social services by making immigration status confidential information.<sup>166</sup> In New Haven, a municipal identification system has been put in place that, among other things, will encourage integration of undocumented immigrants into the life of the city.<sup>167</sup> While countered by anti-immigrant legislation and policies across the country, these efforts provide an example of effective formal mechanisms that can help promote trust and integration, and thereby foster the creation of social capital.

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<sup>163</sup>See, e.g., INTERNATIONAL ASSOCIATION OF CHIEFS OF POLICE, POLICE CHIEFS GUIDE TO IMMIGRATION ISSUES (2007), available at <http://www.theiacp.org/documents/pdfs/Publications/PoliceChiefsGuidetoImmigration.pdf> (noting importance of building trust between local law enforcement agencies and immigrant communities to combat crime in those communities effectively); HANNAH GLADSTEIN, ET AL., BLURRING THE LINES: A PROFILE OF STATE AND LOCAL POLICE ENFORCEMENT OF IMMIGRATION LAW USING THE NATIONAL CRIME INFORMATION CENTER DATA BASE 2002-2004, 11 (2005), available at [http://www.migrationpolicy.org/pubs/MPI\\_report\\_Blurring\\_the\\_Lines\\_120805.pdf](http://www.migrationpolicy.org/pubs/MPI_report_Blurring_the_Lines_120805.pdf) (describing criticism of enforcement of immigration laws by local law enforcement officials because it leads to diminished trust and greater fear of the police). For an overview of current immigrant labor issues, see JENNIFER GORDON, SUBURBAN SWEATSHOPS: THE FIGHT FOR IMMIGRANT RIGHTS (2005).

<sup>164</sup>See, e.g., Francine J. Lipman, *Taxing Undocumented Immigrants: Separate, Unequal, and Without Representation*, 59 TAX L. 813, 857 (2006) (arguing that undocumented workers pay more into the government than the services they receive).

<sup>165</sup>See, e.g., Michael J. Wishnie, *Emerging Issues for Undocumented Workers*, 6 U. PA. J. LAB. & EMP. L. 497, 509-511 (2004) (reviewing labor law protections that are available to workers regardless of immigration status). To protect workers from having to reveal their immigration status when they seek claims where their immigration status is irrelevant, courts have granted protective orders to prevent discovery of immigration status. See, e.g., *Zeng Liu v. Donna Karan Int'l, Inc.*, 207 F. Supp. 2d 191, 192-93 (S.D.N.Y. 2002); *Flores v. Amigon*, 233 F. Supp. 2d 462, 464 (E.D.N.Y. 2002).

<sup>166</sup>Exec. Order No. 41, The City of New York Office of the Mayor, (Sept. 17, 2003), available at [http://www.nyc.gov/html/imm/downloads/pdf/exe\\_order\\_41.pdf](http://www.nyc.gov/html/imm/downloads/pdf/exe_order_41.pdf).

<sup>167</sup>Cara Rubinsky, *City OKs ID Card for Illegal Migrants*, CHI TRIB., June 5, 2007, at 6.

## V. CONCLUSION

An analysis of the subprime mortgage market shows that the manner in which it developed in the early part of this decade invited abuse. It permitted mortgage brokers and lenders to promote their own interests with little regard for the ramifications, whether it was packaging a mortgage for a borrower who could not afford it, or selling such doomed-to-fail mortgages on the securitization market, with little recourse. Once those mortgages entered the securitization market, they were harder to re-negotiate, and borrowers and those holding the interest in the mortgage have had a harder time accommodating the needs of the borrower in default. Given this structure, it is easy to see that the subprime mortgage market created its own crisis, with borrowers and investors left holding the bag.

From a social capital perspective, this structure, so ripe for abuse, dashed any hope for trust, mutual dependence and accountability to play a meaningful role in monitoring the problems embedded in the system. It is respectfully submitted that the reforms suggested here—mortgage broker accountability, greater homeowner education, and the introduction of specialized courts to handle foreclosures—offer ways to re-introduce norms of trust and accountability to the system. As such, they offer solutions grounded in social capital theory that can begin to address these defects and help strengthen the market, improve the current state of affairs and avoid the next crisis.

The modest proposals suggested here are not meant to offer a broad-based solution to the subprime mortgage crisis. This study of the role that trust and the absence of trust played in the subprime market's collapse offers an opportunity to test social capital theory, and review ways that social capital theory can restore trust to a market where it is sorely needed. More sweeping responses to the crisis have been proposed,<sup>168</sup> and are most certainly needed. On the global, macro-economic stage, trust in our financial institutions—as mediated by effective government oversight and legitimate constraints on predatory and reckless behavior—is also needed to restore confidence in the financial system and convince investment capital that it is safe to enter the water once again. If the subprime market's collapse tells us anything, it is that trust, backed up by law, is an essential component of a functioning, efficient and robust system of finance and investment.

The mortgage market, when it functioned well, operated on personal contacts and relationships of trust and mutual interdependence. These bonds helped to identify unreasonable risks and untenable contracts. The transition of the mortgage market from local in nature to one with global reach, with international investors purchasing bundles of mortgages for properties in every corner of the United States, severed these bonds, inviting the abuses detailed in this piece. The failure of the law and legal institutions to prevent such abuses is, some would argue, consistent with a view of the law that it is unnecessary, and cannot build trust. I submit that the opposite is the case. The law's failure to prevent the subprime mortgage crisis is a reflection of the fact that it is in precisely such situations that the law is most needed: where the

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<sup>168</sup>See, e.g., Michael S. Barr, Sendhil Mullainathan & Elda Shafir, *A One-Size-Fits-All Solution*, N.Y. TIMES, December 26, 2007, at A31 (suggesting standardized, "opt out" mortgage product as a default mortgage offering to avoid pitfalls of non-conventional and confusing loan terms).



ability of trust and trusting relationships to combat predatory behavior has been weakened.

Can law create trust? Sometimes. Can law make people trustworthy? It depends.