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The Emperor's New Loans: A Cautionary Tale from the Subprime Era

David Reiss¹

A body of folk tales from the subprime mortgage era is now being written. Some are in [PowerPoint](#).² Some are in [video format](#).³ Some appear in the guise of a non-fiction account—after all, isn't [The Big Short](#)⁴ just [Jack the Giant Slayer](#)⁵—with the little guys not only ending up with the gold, but also with the big guys dead on the ground? And some stories, like the one below, are just plain old fairy tales.

You might ask why a complex financial crisis needs such folk tales. And I would tell you that they are necessary because they help us to identify the essence of the crisis. They can also make the significance of the crisis clear to non-experts. And they can help shape government responses to the last crisis in order to avert potential future crises. Luckily, noted storyteller Philip Pullman offers us some guidance on finding the essence of a story.

The introduction to Pullman's new edition of [Fairy Tales from the Brothers Grimm](#)⁶ explains that he seeks to find what is essential to the tales, among all of the translations and variants, and then let the tales tell themselves.

“Swiftness is a great virtue in the fairy tale. A good tale moves with a dreamlike speed from event to event, pausing only to say as much as is needed and no more. The best tales are perfect examples of what you need and what you don't ...”⁷ On the other hand, [sophisticated academic work](#) is abstract, based on models, and chock full of caveats, even when it is just trying to demonstrate that *lenders lied* to investors about the quality of the loans that they were selling.⁸ Similarly, regulators needed [804 pages](#) to define and explain “Qualified

¹ David Reiss is a professor at Brooklyn Law School. He told a version of this tale at the *Ongoing Implementation of the Dodd-Frank Act: Consumer Protection and Other Goals from a Rulemaking and Litigation Perspective* symposium at the University of Pennsylvania Law School on November 18, 2011.

² Jonathan J. Miller, *The Subprime Primer*, MATRIX: INTERPRETING THE REAL ESTATE ECONOMY (FEB. 15, 2008), <http://matrix.millersamuel.com/?p=1438>.

³ *The Crisis of Credit Visualized—HD*, https://www.youtube.com/watch?v=bx_LWm6_6tA (last visited Mar. 20, 2013).

⁴ MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010).

⁵ *JACK THE GIANT SLAYER* (Warner Brothers Entertainment 2013).

⁶ *FAIRY TALES FROM THE BROTHERS GRIMM: A NEW ENGLISH VERSION* (Philip Pullman ed., 2012).

⁷ *Id.* at xiv–xv.

⁸ See David Reiss, *Asset Quality Misrepresentation in RMBS Market*, REFINBLOG (Feb. 20, 2013) <http://refinblog.com/asset-quality-misrepresentation-in-rmbs-market> (discussing Tomasz Piskorski et al., *Asset Quality Misrepresentation by Financial Intermediaries: Evidence from RMBS Market* (February 12, 2013) (Columbia Business School Research Paper No. 13-7), available at SSRN: <http://ssrn.com/abstract=2215422>).

Mortgages.” That regulation is intended to protect consumers from predatory lenders.⁹ And because simple rules like “originate fair mortgages only” do not work, regulators *do* need those 804 pages to do their work.

Pullman also tells us “[t]here is no psychology in a fairy tale. The characters have little interior life; their motives are clear and obvious. If people are good, they are good, and if bad, they’re bad.”¹⁰ Policy analysts are too sophisticated to use words like “good” and “bad,” but we do have parallel concepts. For instance, some entities respond to financial incentives and make misrepresentations to others if the risk of criminal and civil penalties is outweighed by the potential financial reward. And other entities that follow the rules “lose market share,” and are driven out of business. Thus, a fairy tale for the subprime crisis is at its best when it makes underlying motives clear and obvious.

Pullman ends with some words of wisdom for those of us drawn to the power of the fairy tale: “There have been many, and there will be many more, versions of these tales that are brimful of their author’s own dark obsessions, or brilliant personality, or political passions. The tales can stand it.”¹¹ He thus gives us permission to tell our own tales for our own times.

The [Emperor’s New Clothes](#)¹² is one of Hans Christian Andersen’s best-known tales. In the spirit of Pullman’s book, I have adapted it below for our times. Whether my version of the tale reflects dark obsessions or brilliance, however, should reflect only on me and on me alone.

* * *

Once upon a time there lived an Emperor Populus whose only worry in life was to live in an elegant palace. He refinanced mortgages often and loved to show off low monthly payments. Word of the Emperor's habits spread over his kingdom and beyond. Two scoundrels who had heard of the Emperor's vanity decided to take advantage of it. They introduced themselves at the gates of the Emperor’s palace with a scheme in mind.

"We are two very good lenders and after many years of research we have invented an extraordinary method to originate mortgages so slight and appropriate that it feels insubstantial to the pocketbook. As a matter of fact, it only looks burdensome to anyone who is too stupid and incompetent to appreciate its quality." The chief of the guards heard the scoundrels’ strange story and sent for the court advisor. The advisor ran to the Emperor and disclosed the incredible news. The Emperor's curiosity got the better of him and he decided to see the two scoundrels.

⁹ Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6407 (Jan. 30, 2013).

¹⁰ FAIRY TALES, *supra* note 5, at xiii.

¹¹ FAIRY TALES, *supra* note 5, at xix.

¹² HANS CHRISTIAN ANDERSEN, THE ANNOTATED HANS CHRISTIAN ANDERSEN 3 (2007) (Maria Tatar ed. and trans.).

"Besides feeling insubstantial, Your Highness, your first mortgage will have teaser rates woven into it and adjustable rates created especially for you. Your second mortgage will literally float a few points above prime." The Emperor gave the two men a bag of gold in exchange for their promise to begin working on the mortgages immediately. A few days later, he called the old and wise advisor who was considered by everyone as a man with common sense.

"Go and see how the work is proceeding," the Emperor told him, "and come back to let me know." The advisor was welcomed by the two scoundrels. "We're almost finished, but we need a lot more gold. Admire its lightness!" The old man bent over and held the mortgages; he felt cold sweat on his forehead.

"It doesn't feel insubstantial to me, but I know that in principle a mortgage can be made to be as light as a small [LIBOR](#)¹³ spread over a low real interest rate on a summer morn," he thought. "These feel inappropriate to me, but that must mean I am stupid! Or worse, incompetent!" If the advisor admitted this, he feared he would be discharged from his office.

"How marvelous," he said to the two scoundrels. "I'll certainly tell Populus." The two scoundrels rubbed their hands gleefully. They had almost made it. More gold was requested to close out the work, with some of it distributed to the scoundrels' guild brothers in exchange for laudatory appraisals of their work. Finally, the Emperor received the announcement that the two lenders had come to take all the details needed to originate his new mortgage.

"Come in," the Emperor ordered. Even as they bowed, the two scoundrels held a large stack of documents. "Here it is Your Highness, the result of our underwriting," they said. "We have worked night and day but, at last, the least burdensome mortgages in the world are ready for you. Feel how light they feel on your shoulders."

Of course the mortgages were not light on the Emperor's shoulders. He panicked and felt like fainting. Luckily the throne was right behind him and he sat down. But when he realized that no one knew that he did not see that the mortgages were insubstantial, he felt better. Nobody could find out he was stupid and incompetent. However, what the Emperor did not know was that everybody else around him was thinking and doing the very same thing.

The farce continued as the two scoundrels had foreseen. The two began signing and notarizing the documents. "Your Highness, you'll have to release your old mortgage to take on your new one." The two scoundrels handed the documents to him. The Emperor was embarrassed, but since none of his courtiers said anything, he felt relieved. "Yes, this is a fine mortgage and it looks very good for me," the Emperor said trying to look comfortable. "You've done an amazing job."

¹³ *Libor*, FINANCIAL TIMES LEXICON, <http://lexicon.ft.com/Term?term=LIBOR> (last visited Mar. 20, 2013) ("[LIBOR] stands for London interbank offered rate. The interest rate at which banks offer to lend funds (wholesale money) to one another in the international interbank market.").

"Your Majesty," the scoundrels said, "we have a request for you. The citizenry have found out about these extraordinary mortgages and they are anxious to see them for themselves." The Emperor was doubtful about showing his mortgage to the people, but then he abandoned his fears. "All right," he said. "I will grant the people this privilege." The ceremonial parade was formed. A crowd had gathered, pushing and shoving to get a better look. Realizing how burdensome the mortgages were, everyone wanted to see how stupid or incompetent his or her neighbors would reveal themselves to be in praising them. But as the Emperor passed, a strange murmur rose from among them.

Everyone said, loud enough for the others to hear: "Look at the Emperor's new mortgages. They are so insubstantial!"

"Marvelous!"

"Wonderful! I have never seen anything like it in my life!" They all tried to conceal their disappointment at not being able to see exactly how light the terms of the mortgage were, and since nobody was willing to admit his own stupidity and incompetence, they all behaved as the two scoundrels had predicted.

A small child, who had no important job and could only see things as his eyes showed them to him, went up to the Emperor. "The Emperor's new loans are burdensome," he said. "He should shed them and get his old one back."

"Fool!" the court advisor reprimanded, running after him. "The Emperor has freely chosen this mortgage—it must be the right one for him."

"Don't talk nonsense!" said one of the scoundrels' guild brothers. "Your nonsense will undercut everyone's faith in the mortgage market and we will be forced to constrict credit as a result of your fear mongering."

"Troublemaker!" said a member of the Emperor's privy council. "Your solution is worse than the problem. His old mortgage may have been lighter on his shoulders, but it was not nearly as bespoke as it should have been. No man, let alone our Emperor, should be seen with an off-the-rack mortgage."

But the boy's remark, which had been heard by the bystanders, was repeated over and over again until everyone cried: "The boy is right! The Emperor's mortgage is burdensome! It's true!"

The Emperor realized that the crowd was right, but could not admit it. He thought it better to continue the procession under the illusion that anyone who could not see that the mortgages were light on his shoulders was either stupid or incompetent.

At first the crowd took up the little boy's cry: "I too see that the Emperor's new loans are burdensome!" But the advisor, the guild, and the council worked the crowd and soon the crowd was doubting its own eyes and its own experience once again—and the Emperor shuffled home wearing his heavy burden with as much nobility as he could muster under the circumstances.

The scoundrels, on the other hand, returned to their guildhall and made plans to be ready to strip Emperor Populus' remaining equity when the opportunity next presented itself.

* * *

We take pleasure from the traditional tale because we are in on a joke that everyone else (except the little boy) has fallen for. This darker telling is more heartrending though, because in the standard version we are laughing at the foibles of the powerful. In this telling, however, we have only ourselves to laugh at.