

COLLAPSE OF THE SUBPRIME MARKET

CAUSES OF THE ECONOMIC CRISIS

Studies and reports on subprime loans reveal problems in almost every aspect of the subprime lending process. In fact, nearly a decade ago, the North Carolina Legislature passed a law to prohibit predatory lending, inappropriate loan products, inadequate underwriting, bloated appraisals, abusive prepayment penalties, excessive broker fees, the steering of borrowers into high-cost products, and servicing abuses have been widely reported. The funding of subprime loans has also played a major role in the crisis. The rating of securities as investment-grade products that were backed by loans that might be aptly described as subprime mortgage junk bonds fueled the funding pipeline that enabled the exponential growth of the subprime market. Without the extraordinary access to financing provided by securitization, the growth of the subprime market would have been greatly limited and the financial damage to homeowners and the economy significantly reduced.

Prior to securitization, banks were meticulous about making sure that borrowers could repay their loans. That was because banks held loans in their portfolio. In short, their own money and that of their customers was at risk. But with securitization, this self-regulatory incentive mechanism was lost. And, despite this transformation of the markets, federal regulation of the mortgage lending industry grew increasingly inadequate. The result was increasingly risky behavior of mortgage lenders, particularly in the subprime market. In recent years, a majority of subprime mortgages peddled to consumers have not been structured or underwritten to sustain homeownership; rather they were intended to lock borrowers into a financial relationship with mortgage brokers and mortgage finance companies in which loans had to be refinanced, usually within two to three years, in order for mortgage payments to remain affordable. With each refinancing came another set of upfront broker and mortgage finance fees and servicing and securitization revenue. Securitization of the underlying assets allowed the risks of these products to be spread widely, literally to investors around the world. The result was that billions of dollars in profits were made while millions of families were put at high risk for foreclosure.

The magnitude of the crisis today has generated enormous debate on who is at fault. Two arguments put forward in the popular press are that 1) The crisis was a result of the *Community Reinvestment Act*, which forced banks to make loans to low-income households that cannot afford homeownership; and 2) The crisis is the result of banks feeling pressured to increase homeownership for minority households. Both of these arguments are without merit. Regarding the latter assertion, research by the Center for Responsible Lending has confirmed that between 1998 and 2006, the majority of subprime loans originated were refinance products. In fact, less than ten percent were for first-time homeownership.

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Regarding the *Community Reinvestment Act*, this law was enacted in 1977, and research illustrates that the most reckless subprime lending occurred between 2004 and 2007. Moreover, the Federal Reserve Bank released a report yesterday that shows that only 13 percent of high-cost loans were covered by CRA. Only six percent of high-cost loans were CRA loans to low-income families. Approximately 90 percent of the high-cost toxic loans were made by financial institutions without regard to the *Community Reinvestment Act*.

Subprime lending increasingly became an unstable house of cards; i.e., a market that gave the appearance of performing well, but in reality, required unrealistically high and unsustainable rising home prices. In fact, irresponsible lending practices contributed greatly to the artificial ballooning of house prices by offering homebuyers financing terms that created the illusion of affordability, thereby encouraging them to purchase properties that were far beyond their financial reach. When house prices began to soften in 2005, the foundation began to collapse under the subprime market's house of cards. But it was not until subprime market losses led to the implosion of a billion-dollar Wall Street hedge fund that the subprime market's woes rose to public prominence and nearly daily press coverage. Today, the subprime market is in shambles, and with it, many of the nation's blue chip financial institutions that supported the subprime market.