A SUBPRIME PRIMER

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Introduction

Financial crises are not new and financial systems are prone to instability and abuses. Until the implementation of modern financial regulation in the early 1930's and 1940's, financial panics were a regular feature of American life. As early as 1792, the nation suffered a severe panic that froze credit and nearly brought the economy to its knees. Over the next 140 years financial crisis struck almost every 15-20 years – 1797, 1819, 1837, 1857, 1873, 1893-96, 1907, and 1929-1931.

After the Great Depression and the introduction of federal deposit insurance and federal banking and securities regulation, the next significant financial crisis did not occur for more than 40 years. The mid-1980's ended this period of relative stability with the savings and loan crisis which cost the American taxpayers approximately $132 billion. The country suffered a number of bank failures that (1) produced the need to recapitalize the Federal Deposit Insurance Corporation's initial Bank Insurance Fund in the early 1990's; (2) resulted in a stock market crash in 1987; (3) witnessed a wave of foreign currency crises and instability in 1994-1995 and 1997-1998; (4) contributed to the collapse of Long Term Capital Management hedge fund in 1998; and (5) assisted in the collapse of the high tech bubble in 2001. A financial crisis has now struck again, the worst since the Great Depression, with the subprime-induced financial turmoil of 2007-2009.[2]

The bursting of the housing bubble produced the first true stress of modern capital markets, their investments, and their participants. The first cracks were evident in the subprime mortgage markets and in the secondary markets from mortgage-related securities. From there, the crisis spread worldwide, taking down the most venerable names in the investment, banking, and insurance businesses and crippling others, wreaking havoc in the credit markets, and crippling the equity markets worldwide.[3]

This primer will seek to chronologically describe the reasons for the subprime crisis and will discuss some of the proposed and implemented solutions, as they are understood as of February 6, 2009.

This subject is somewhat complicated by the overuse of acronyms, which are cataloged in this primer in the Glossary of Acronyms, which is appended hereto. Also see the Chronology of Events which is appended hereto.

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[2] CONGRESSIONAL OVERSIGHT PANEL, *Special Report on Regulatory Reform of the Congressional Oversight Panel: Modernizing the American Financial Regulatory System: Recommendation for Improving Oversight, Protecting Consumers, and Ensuring Stability* (January 2009), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

[3] *Id.*

What Are Subprime Loans?

General Structure

A subprime mortgage loan is, by definition, a mortgage loan to a borrower with sub-standard or undocumented credit. A subprime loan is not automatically considered a bad or deceptive loan. A subprime loan is merely one made to a borrower who has one or more risk factors that suggest the loan has a higher risk of default. These borrowers often have poor credit histories, unstable income levels, insufficient documentation of income, the capacity to make only a low (or no) down payment, and would not generally qualify for traditional, prime rate loans. A subprime credit score is generally considered to be a FICO score below 620. The U.S. median score is 720. To compensate the lender for the increased risk of making subprime loans, the upfront and continuing costs of a subprime loan are higher than that of a traditional loan. This compensation could include higher interest rates, upfront fees, and/or prepayment penalties.

In many cases, homeowners with subprime loans were not given a choice of products, but were instead automatically steered to these loans, and were given little or no explanation of the loan's terms. Approximately 50% of persons with subprime loans could have received prime loans.[4] The reason for this steering is likely due to the compensation incentives given to industry professionals to make these subprime loans. Yield premiums were often offered to mortgage brokers by lenders in exchange for convincing borrowers to take a loan with a higher interest rate than the rate for which they were qualified. The real estate industry itself has acknowledged that many borrowers placed in subprime loans could have received fixed-rate loans.[5] Often a fixed rate loan can have a lower interest rate (by 50 to 80 basis points) and lower monthly payments than a subprime loan.

This paper will focus on subprime loans that were made due to predatory lending practices. In 2001, the financial institution regulatory agencies identified the characteristics most often associated with predatory lending as: 1) making unaffordable loans based on the collateral of the borrower rather than on the borrower's ability to repay an obligation; 2) inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced; and 3) engaging in fraud or deception to conceal the true nature of the loan obligation.[6]

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[4] *Subprime Mortgage Crisis and America's Veterans*, Hearing Before the Subcomm. on Econ. Opportunity of the Comm. on Veterans' Affairs, 110th Congress, Second Session, Serial No. 110-74 (Feb. 28, 2008) (statement of Ellen Harnick) (study was performed by Wall Street Journal regarding loans originated in 2005 and 2006).

[5] *Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions*, Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit, 110th Congress, First Session, Serial No. 110-18 (March 27, 2007) (hereinafter referred to as "Subprime and Predatory Lending Congressional Hearing - March 2007") (statement of Michael D. Calhoun, Center for Responsible Lending).

[6] *Id*. (statement of Sheila C. Bair, Chairman, FDIC).