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Subprime Loans: Turning the American Dream into a Nightmare

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SUBPRIME LOANS: TURNING THE AMERICAN DREAM INTO A NIGHTMARE

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"EVERYBODY wants it. Nobody understands it. Money is the great taboo. People just won't talk about it. And that is what leads you to subprime. Take the greed and the financial misrepresentation out of it, and the root of this crisis is massive levels of financial illiteracy."[2]

Delia Villegas' story is one of many examples illustrating how homeowners have lost their homes as a result of unscrupulous and predatory home lenders capitalizing on financial illiteracy.[3] Ms. Villegas

1. Juris Doctor Candidate, May 2010, St. Thomas University School of Law. B.B.A., Finance, Dec. 2006, Florida International University. I would like to thank my family, especially my Mom, for her endless support and encouragement during the writing of this Comment and during my entire law school career. Special thanks to Professor Gary Kravitz and Jesmany Jomarron for overseeing this project and for their guidance and support.

2. *Getting It Right on the Money*, THE ECONOMIST.COM, Apr. 3, 2008, http://www.economist.com/displaystory.cfm?story_id=10958702.

3. Interview with Delia Villegas, homeowner who lost her home to foreclosure (Nov. 14,

arrived in this country seven years ago with little money, but with the dream of buying her own home.[4] After five years of hard work and endless sacrifices, she was able to buy a beautiful townhome in 2005.[5] Although Ms. Villegas was providing a ten percent down payment, she was not able to qualify for a traditional loan because she could not document her income.[6] As a result, Ms. Villegas had to resort to a high interest subprime loan to finance her purchase.[7] After two years of timely payments, Ms. Villegas received a letter from her lender indicating that her monthly mortgage payment had increased by over $400.[8] Unbeknownst to Ms. Villegas, her loan was an adjustable rate mortgage.[9] Unfortunately, she was unable to afford the new monthly payment and lost her home to foreclosure in early 2008.[10]

The subprime loan's share of the mortgage industry is approximately one quarter of the overall industry, increasing from $150 billion in 2000 to $650 billion in 2007.[11] Subprime loans, however, are six times more likely to default than prime loans.[12] In addition, home foreclosure and the rate of homes entering foreclosure have risen to a record high during 2008.[13]

Cathy Lesser Mansfield explained:

> The challenge in the coming years will be to find a balance between the need to make reasonable amounts of credit available to borrowers with varying credit backgrounds and the need to protect borrowers from credit that is unjustifiably expensive, inappropriate for certain borrowers, or tainted by fraud and other misconduct. One of the most difficult questions that must be answered is whether and what kind of government regulation might be required to assure progress in addressing these issues.[14]

This Comment will first illustrate how the prime and subprime

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2008).

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. Interview with Delia Villegas, *supra* note 3.

10. *Id.*

11. Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 407 (2007).

12. *Id.* at 411.

13. *See* Julie Haviv, *Home Foreclosures Reach Record High*, REUTERS, Sept. 5, 2008, http://www.reuters.com/article/newsOne/idUSNAT00434820080905.

14. Cathy Lesser Mansfield, *The Road to Subprime "HEL" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 475 (2000) (discussing how to protect the consumer in subprime lending by regulation).

industry works by addressing various subtopics such as: (1) the characteristics of subprime borrowers; (2) the qualification process; (3) the different loan products available; and (4) how consumers are trapped by subprime loans. Second, it will discuss the current federal and state legislation governing the lending industry, and inquire into proposed lending regulations. Third, it will analyze the current financial crisis, along with its causes and consequences. Fourth, it will provide both a short-term and long-term solution to the current financial crisis.

I. THE MORTGAGE INDUSTRY, DIFFERENT CHANNELS TO OBTAIN A LOAN: PRIME V. SUBPRIME

The lending industry in the United States is divided into two markets or tiers: the prime and the subprime market.[15] The term *subprime* generally refers to borrowers with blemished credit histories, although the term *prime* refers to borrowers with a solid credit record.[16] These terms can also be used to refer to different types of loans.[17]

The recent development of the subprime industry was fueled in part by Congress's enactment of four acts or laws that benefited lenders by removing interest rate caps imposed by state usury statutes.[18] First, Congress passed the Community Reinvestment Act of 1977 ("CRA"), which has three main goals: (1) to motivate financial institutions to make loans in low and moderate income areas; (2) to guarantee "that the loans meet the credit needs" of the community; and (3) to achieve those "needs with safe . . . banking practices."[19] Second, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980

15. Dayana Yochim, *Need a Loan? No Problem*, Fool.com: Credit Center, http://www.fool.com/ccc/secrets/secrets02.htm (last visited Nov. 12, 2008).

16. *See* DEP'TS OF HOUSING AND URBAN DEVELOPMENT AND THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING, HUDUSER.ORG 1, 104 (2000), http://www.huduser.org/publications/pdf/treasrpt.pdf [hereinafter HUD-Treasury Report]. While the subprime market generally lends to borrowers with blemished credit history, it also serves as a source of finance for borrowers with good credit that are unable to verify their income or assets such as Ms. Villegas. *See id.* at 27. These borrowers have to resort to subprime lenders that offer limited or no documentation loans. *Id.* at 34.

17. *See generally* Jo Carrillo, *Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages*, 5 BERKELEY BUS. L.J. 1, 20 (2008).

18. *Cf.* Mansfield, *supra* note 14, at 484, 495 (stating that in the past, the rise or elimination of usury ceilings were prompted by congressional concerns about the solvency of the savings and loan industry). State usury statutes were the first attempt at consumer protection legislation. *Cf. id.* at 494. These statutes used a broad stroke approach, limiting the interest rate that could be charged on consumer credit. *Cf. id.* Usury is defined as the "charging of an illegal rate of interest" or "[a]n illegally high rate of interest." BLACK'S LAW DICTIONARY 1290 (8th ed. 2004).

19. Richard D. Marsico, *Subprime Lending, Predatory Lending, and the Community Reinvestment Act Obligations of Banks*, 46 N.Y.L. SCH. L. REV. 735, 735 (2003).

("DIDMCA"), which preempted the majority of states' usury statues dealing with residential mortgage loans.[20] While DIDMCA removed the states' usury caps, it did not create nationwide usury ceilings or any other mechanism to deal with predatory lending issues that the states' usury laws had prevented.[21] Third, in 1983, Congress passed the Alternative Mortgage Transaction Parity Act (AMPTA).[22] AMPTA preempted state statutes, prohibiting certain provisions in residential loan mortgages such as variable interest rate riders, balloon payments, and negative amortization.[23] Fourth, the Tax Reform Act of 1986 (TRA) allowed a deduction for mortgage interest paid on a primary residence and one second home, increasing the demand for residential mortgage loans.[24]

By the 1980s, mortgage brokers and lenders started to play an important role in the mortgage industry, offering new financing alternatives with requirements that were more flexible than those of traditional local banks.[25] Over time, these institutions became the largest group of subprime lenders, lending to borrowers with less than perfect credit who were unable to obtain conventional mortgage loans.[26] By the 1990s, lenders started to securitize the subprime loans in order to raise capital to satisfy the growing demand for subprime loans.[27] Consequently, there was a considerable influx of capital into the subprime market from investors willing to buy those securities.[28] Securitization was already a standard practice in the

20. *See generally* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980).

21. *See* Mansfield, *supra* note 14, at 507 (addressing Congress's failure to deal with potential problems resulting from the preemption of state usury limits). During the Senate debate, "there was virtually no discussion of what might prevent a covered lender from charging predatory rates once state limits were preempted." *Id.*

22. *See* Alternative Mortgage Transaction Parity Act, 12 U.S.C. §§ 3801–3806 (1982). AMPTA was passed as a portion of the Garn-St. Germain Depository Institutions Act of 1982. § 3803.

23. Mansfield, *supra* note 14, at 510.

24. Tashman, *supra* note 11, at 411.

25. *See* Mansfield, *supra* note 14, at 526 (explaining the change in type of lenders interacting in home-secured lending market).

26. *Id.* (recognizing a major influence of finance companies in the subprime mortgage market).

27. *See* HUD-Treasury Report, *supra* note 16, at 30 (pointing to securitization of subprime loans as a factor in the growth of the subprime market); *see also* Mansfield, *supra* note 14, at 531 (observing the growth of the subprime market as a result of the securitization of loan pools). Securitization is the packaging of loans to create securities, which are later broken into pieces and sold in the secondary market. *Id.* at 532.

28. *See* Tashman, *supra* note 11, at 410. "The federal government first created a secondary market for mortgages in the 1930s to combat the Depression-era shortage of residential loan funds." *Id.* "In the 1970s, government sponsored entities Fannie Mae and Freddie Mac created and sold securities backed by federally insured home loans to further increase the aggregate

prime market—Fannie Mae and Freddie Mac would buy prime loans from banks, package them, and then sell the pieces in the secondary market.[29] As private agencies started to rate the mortgage-backed securities, creating more confidence, investors followed the prime market example, purchasing more of these assets as subprime lenders increased their securitization.[30]

A. SUBPRIME BORROWER CHARACTERISTICS

There are certain characteristics that distinguish prime from subprime borrowers. The main difference is that subprime borrowers usually have a blemished credit history, which typically includes late payments, charge-offs or collections, bankruptcy, and even prior foreclosures.[31] In addition to low credit scores, subprime borrowers frequently have high debt-to-income ratios and high loan-to-value ratios, factors directly correlated with a high risk of default.[32] A loan is considered to have a high loan-to-value ratio when the borrower is making a down payment of less than 20%.[33] As a

available residential lending capital." *Id.*

29. *See* HUD-Treasury Report, *supra* note 16, at 41 (highlighting increase in securitization of various types of loans, including subprime loans).

30. *Id.* at 41–42.

31. Memorandum for the Chief Executive Officers of the Dep't of Treasury Office of Thrift Supervision on Interagency Guidelines on Subprime Lending 1–2, http://files.ots.treas.gov//25104.pdf (Mar. 3, 1999) (providing factors relevant for assessing subprime borrowers). While there is no established definition in the mortgage industry for subprime loans, federal banking regulators have established guidelines to delineate and classify subprime loans in order to securitize and sell the loan portfolio in the secondary market. *Id.* Furthermore, traditional lending institutions usually deny prime loans to borrowers with late bill payments, collections, bankruptcies, or foreclosure since a bad credit record is considered a good indicator of the borrower's high probability of default. *Id.* at 1; *see also* HUD-Treasury Report, *supra* note 16, at 34 (describing the characteristics for subprime borrowers). Additionally, subprime borrowers do not necessarily have bad credit. *Id.* at 27. In fact, some borrowers with good credit histories have to resort to subprime loans in order finance their home because they are unable to verify their income or assets, or have variable income. *Id.*

32. *See* HUD-Treasury Report, *supra* note 16, at 34; *see also* Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FED. RES. BANK OF ST. LOUIS REV. 31, 36 (2006),http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf; Alina Tugend, *What You Need to Know to Get a Mortgage*, N.Y. TIMES, June 1, 2008, at RE. 1. The debt-to-income ratio (often abbreviated DTI) is the percentage of a consumer's monthly gross income that goes toward paying debts. *Id.* There are two main kinds of DTIs. The first DTI, known as the *front ratio*, indicates the percentage of income that goes toward housing costs, which for homeowners is PITI (mortgage principal and interest, taxes and insurance). *Id.* The second DTI, known as the *back ratio*, indicates the percentage of income that goes toward paying all recurring debt payments, including those covered by the first DTI, and other debts such as credit card payments, car loan payments, student loan payments, child support payments, and alimony payments. *Id.*

33. *See, e.g.*, FRANK J. FABOZZI, THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 210

consequence, subprime borrowers are generally charged a higher interest rate in order to offset the higher risk of default associated with these loans.[34]

B. QUALIFICATION PROCESS

Traditional minimum lending standards for loan qualification include the borrower's income, payment history, and down payment amount.[35] The subprime industry, however, deviates from these standards, using a risk-based analysis of the borrower's credit scores and other factors to determine the interest rate the borrower will be charged.[36] Therefore, subprime lenders generally ignore the borrower's income or assets, and are left with only a credit score to determine the borrower's ability to repay the loan.[37] Although a credit score may be representative of the borrower's past payment history, it does not mean the borrower will be able to afford a future obligation.[38] Many scholars refer to subprime loans as equity stripping loans because lenders charge borrowers high fees and interest rates knowing the individual borrower will likely be unable to repay the loan.[39] Sometimes, it takes only a few months before the borrower falls behind on the payments and it is foreclosed upon.[40]

Subprime loan guidelines frequently required little or no

(Frank J. Fabozzi ed., 2006).

34. *See* HUD-Treasury Report, *supra* note 16, at 27–28; Carrillo, *supra* note 17, at 18. It is harder for the lender to recover the loan balance from a foreclosure sale since the borrowers usually owe 95–100% of the purchase price. *See* DARRYL E. GETTER, UNDERSTANDING MORTGAGE FORECLOSURE: RECENT EVENTS, THE PROCESS, AND COSTS 6–7 (2007).

35. *See* Tashman, *supra* note 11, at 409.

36. *Id.* at 409. *Risk-based pricing* is a method to determine the interest rate on a loan based not only on time value of money, but also considering other factors to determine the probability that the borrower will default. *Id.* The lender may consider different factors such as the borrower's credit score or employment status. *Id.* These factors might also be characteristics of the loan, for example, whether the collateral is a single-family house or a condominium. Wells Fargo, Loan Pricing Disclosure,https://www.wellsfargo.com/mortgage/rates/pricingdisclosure (last visited Mar. 16, 2009). This means different borrowers will pay different rates. *See id.*

37. *See* Tania Davenport, *An American Nightmare: Predatory Lending in the Subprime Mortgage Industry*, 36 SUFFOLK L. REV. 531, 534 (2003).

38. *See* Posting of Bob Sullivan to REDTAPE, http://redtape.msnbc.com/2008/03/credit-scores-1.html (Mar. 14, 2008, 05:00 CT); *see also* Carrillo, *supra* note 17, at 15–16.

39. Davenport, *supra* note 37, at 543 (describing a typical equity stripping situation). "A lender engaging in equity stripping, also known as asset-based lending, essentially grants loans that are doomed to fail because the borrower does not have the income nor assets, other than the equity in the home, to repay the loan." *Id.* Subprime loans are also referred to as *equity stripping* since lenders sometimes charge excessive fees thereby stripping the equity out of the home. *Id.*

40. *See* Davenport, *supra* note 37, at 543 (describing how homeowners lose their homes a few months after closing).

documentation. Such guidelines include: (1) SISA: "applicant's income is stated, but only employment and assets are verified"; (2) SIVA: "applicant's income is stated, but only employment and assets are verified"; (3) NIVA: "applicant's income is not disclosed, but the borrower's employment and assets are verified"; (4) NINA: "no income and assets are disclosed, but employment is verified"; (5) No Ratio; and (6) No Doc: "no income and assets are disclosed."[41] Subprime borrowers were attracted to these products because, with little or no documentation of their ability to repay the debt, these loans opened up the doors to homeownership.[42]

C. PRODUCT DESCRIPTION

There are two main types of mortgages across the United States credit sector. On the one hand, there are traditional fixed-rate mortgages ("FRM") consisting of periodic payments based on a fixed rate note.[43] On the other hand, there are adjustable-rate mortgages ("ARM") consisting of variable periodic payments as determined by an index plus a fixed margin.[44] Both of these loan types usually have a thirty-year amortization.[45] Although prime and subprime loans are on opposite sides of the spectrum, from the borrower's point of view there are only two differences: higher upfront costs and continuing costs for subprime loans.[46]

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41. LoanKrunch Documentation Types, http://www.loankrunch.com/Education/DocumentationTypes.pdf (last visited Oct. 9, 2008) (explaining the different documentation requirements for each type of loan). For No Doc, "you only need to disclose name, Social Security number, the down payment amount and the address of the property being financed." *Id.*

42. *See* Arthur G. Boylan, *The Subprime Mortgage Market: Its Broad Impact and the Initial Hurdle for Securities Class Actions*, 55-AUG FED. LAW. 20 (2008).

43. RALPH R. ROBERTS & CHIP CUMMINGS, MORTGAGE MYTHS: 77 SECRETS THAT WILL SAVE YOU THOUSANDS ON HOME FINANCING 38 (2008).

44. *Id.* at 213. An index is a market indicator rate used to calculate the interest rate on adjustable rate mortgages. *See id.* The interest rate on an ARM is calculated by adding to the index the margin or lender's profit, generally a couple of percentage points. *Id.* The index is variable and reflects the conditions of the financial markets while the margin is fixed for the life of the loan and represents the lender's profits. *See id.* Lenders can choose from among the several market indicators or indexes available to calculate the borrowers' interest rates. *Id.*

45. *See* Dan Melson, *What Types of Mortgages Are Available?*, SEARCHLIGHT CRUSADE, Oct. 25, 2008, http://www.searchlightcrusade.net/2008/10/what_types_of_mortgages_are_av.html. Subprime loans could also have forty and fifty year amortization. *Id.* Amortization is defined as "[t]he act or result of gradually extinguishing a debt, such as a mortgage, by contributing payments of principal each time a periodic interest payment is due." BLACK'S LAW DICTIONARY 71 (8th ed. 2004).

46. Tashman, *supra* note 11, at 409.

Upfront costs are those related to the loan origination, such as lender fees, title insurance, and taxes; while continuing costs are those the homeowner incurs during the life of the loan, such as principal, interest, taxes, and insurance.[47] Although subprime loans are usually damaging to the household economy, they can provide a vehicle by which homeowners can access funds based on home equity during difficult financial circumstances.[48] Thus, subprime mortgage loans are a double-edged sword: potentially beneficial during difficult times, but likely to be detrimental in the long run.

Although subprime mortgages can be either fixed or adjustable, most are adjustable and contain finance provisions or clauses that are difficult for the average consumer to understand.[49] Additionally, low teaser rates on subprime ARMs are used in order to attract borrowers. Teaser rates generally expire within two to three years.[50] Subprime loans are also characterized by prepayment penalties, which require borrowers to pay a fee upon paying their loans ahead of schedule.[51] Almost three-quarters of loans in a large dataset of securitized subprime loan pools originating from 2003 through the first half of 2007 had a prepayment penalty provision.[52]

The majority of borrowers do not voluntarily choose to have a prepayment penalty, but there are several reasons why prepayment penalties are so popular with subprime lenders. First, originators have an incentive to induce borrowers to accept a prepayment penalty because originators usually get paid a large commission for selling a loan with this provision.[53] Second, prepayment penalties also guarantee the lender a

47. *Id.* Subprime loans usually carry a higher continuing cost than prime loans since lenders charge a higher interest rate, which results in a higher monthly payment. *Id.* at 408.

48. *See* HUD-Treasury Report, *supra* note 16, at 31.

49. *See* Laurie A. Burlingame, *A Pro-Consumer Approach to Predatory Lending: Enhanced Protection Through Federal Legislation and New Approaches to Education*, 60 CONSUMER FIN. L. Q. REP. 460, 462 (2006).

50. *See* Carrillo, *supra* note 17, at 21.

51. *See id.* at 17. A prepayment penalty can amount to several thousand dollars. For example, a consumer who obtains a 3-27 ARM with a thirty-year term for a loan in the amount of $200,000 with an initial rate of 6% would have a principal balance of $194,936 at the end of the second year following consummation. If the consumer pays off the loan, a penalty of six months' interest on the remaining balance—close to six monthly payments—will cost the consumer about $5,850. A penalty of this magnitude reduces a borrower's likelihood of prepaying and assures a return for the investor if the borrower does prepay.

52. Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation, Address Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Jan. 31, 2008), *available at* www.fdic.gov/news/news/speeches/archives/2008/chairman/spjan3108.html.

53. *See* DEBBIE GOLDSTEIN & STACY STROHAUER SON, WHY PREPAYMENT PENALTIES ARE ABUSIVE IN SUBPRIME HOME LOANS, CTR. FOR RESPONSIBLE LENDING 5 (CRL Policy Paper

larger return.[54] Third, borrowers do not have access to information on rates and the amount of the prepayment penalties because these are usually determined after the loan is submitted to underwriting for lender revision.[55] Among the most common subprime products are Option ARMs, 100% Financing Loans, Interest-Only Loans, and Forty- and Fifty-Year Amortization Loans.[56]

The concept of how the Option ARM works can be complicated and confusing for the standard consumer. In simple terms, the Option ARM could be described as a regular ARM, but with an extra feature: a minimum payment.[57] It is important to understand how a regular ARM works in order to realize the dangers inherent in an Option ARM. In a regular ARM, the interest rate is calculated by adding the margin (lender's profit) to the index (market indicator), and based on this rate the lender calculates the borrower's monthly payment.[58] In an Option ARM loan, however, the lender gives the borrower the opportunity to make a minimum payment (less than what is due under the fully indexed rate).[59] The minimum payment is calculated based on the teaser or introductory interest rate the borrower and the lender contracted for at closing, usually between 1% and 1.99% of the principal borrowed.[60] If the borrower elects to make the minimum payment, the lender will add the difference between the minimum payment and the interest due under the fully indexed rate to the loan principal.[61] This is known as negative amortization, which means the loan balance will increase instead of decrease.[62] Further, negative amortization also involves negative compounding because the borrower would pay interest on the interest deferred every month, which is added to the loan principal when the borrower elected to make the minimum payment.[63] In essence, the borrower is financing not only the loan balance,

No. 4, 2003), http://www.responsiblelending.org/pdfs/PPP_Policy_Paper2.pdf.

54. *See id.*

55. *See id.* at 7.

56. Carrillo, *supra* note 17, at 16.

57. *See id.* at 20. A regular ARM is a traditional adjustable rate mortgage. *Id.* An adjustable rate mortgage is one "in which the lender can periodically adjust the mortgage's interest rate in accordance with the fluctuations in some external market index." BLACK'S LAW DICTIONARY 849 (8th ed. 2004).

58. *See* Carillo, *supra* note 17, at 21.

59. *See id.* at 20.

60. *Id.* at 21.

61. Dustin Fisher, *Selling the Payments: Predatory Lending Goes Primetime*, 41 J. MARSHALL L. REV. 587, 603 (2008).

62. *See id.*

63. *See* Carrillo, *supra* note 17, at 21; *see also* Truth in Lending (Regulation Z), 12 C.F.R. § 226.22(a)(1) (1996) (explaining the method to calculate negative amortization). There are two

but also part of the monthly payment.

In theory, an Option ARM gives a borrower multiple payment options such as fixed (minimum payment), interest only, fifteen-year amortization, and thirty-year amortization.[64] The minimum payment, however, rather than an option, becomes an *economic necessity* for many borrowers who cannot afford to make the full payment.[65] Therefore, these loans are very dangerous because if the borrower elects to make only the minimum monthly payment, she will eventually owe more than the original loan balance.[66]

D. How Are Consumers Trapped by Subprime Loans?

As a result of the harsh terms and practices in the subprime sector, many borrowers were locked in a cycle of subprime refinances while losing equity with each transaction.[67] Unwitting consumers were often unaware of the price information because subprime rates are not generally advertised and can vary considerably depending on the borrower's risk profile.[68]

The terms and provisions of a subprime adjustable rate mortgage tend to be confusing for the average consumer because they require the borrower's understanding of the financial markets in order to determine the possible fluctuations in interest rates, which later can translate into payment shock.[69] A borrower usually lacks the information to compare the products

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types of interest: simple interest and compound interest. Simple interest is "[i]nterest paid on the principal only and not on accumulated interest," regardless of how often interest is paid. BLACK'S LAW DICTIONARY 672 (8th ed. 2004). Compound interest, on the other hand, is "[i]nterest paid on both the principal and the previously accumulated interest." *Id.* at 673.

64. *See* Fisher, *supra* note 61, at 602–03.

65. *Cf.* Carrillo, *supra* note 17, at 20–21 (resulting in negative amortization).

66. *See id.* at 21 (explaining the negative amortization calculation method). The differed interest is the difference between the interest due under the regular terms of the loan, and the minimum payment option; this difference is added back into the loan balance. *See Deferred Interest*, INVESTOPEDIA, http://www.investopedia.com/terms/d/deferredinterest.asp (last visited Mar. 16, 2009). For example, in a $100,000 loan, the interest due under the terms of the loan is $600.00; however, the loan allows the borrower to make a $400 minimum payment. *Id.* The $200 difference is added to the loan balance. *Id.* Therefore, the new loan balance is $100,200. *Id.*

67. *See* GOLDSTEIN & STROHAUER SON, *supra* note 53, at 3.

68. Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 734 (2005).

69. *See* HUD-Treasury Report, *supra* note 16, at 17–18 (detailing how confusing the terms and provisions in subprime loans are in comparison to prime loans). The terms and conditions in the prime loans are more standardized; in part because of the competition between banks and because these loans need to conform with Fannie Mae standards in order to be sold in the secondary market. *Id.* at 17.

offered by different lenders; thus, it is very difficult for him or her to determine whether to continue shopping for a loan or to simply accept the first proposal.[70] Evidence shows subprime borrowers have often been turned down for credit at least once before accepting a subprime loan.[71] As result, once the lender extends an approval to a subprime borrower, the consumer does not usually look for other offers, settling for predatory terms rather than being rejected by another lender.[72]

II. THE MORTGAGE INDUSTRY REGULATIONS

Federal and state governments have enacted laws to regulate the lending industry; however, these laws have failed to avoid predatory lending and the current financial crisis.[73] There are three main federal laws that regulate the industry: Truth in Lending Act (TILA), Real Estate Settlement Procedure Act (RESPA), and Home Ownership and Equity Protection Act (HOESPA).[74] TILA was originally enacted in 1968 and has been amended several times since its enactment.[75] TILA is a fairly complex disclosure statute, which applies to open-end and closed-end transactions with the objective of "[assuring] a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the

70. *See* Practising Law Institute, *Proposed Amendment to Regulation Z, Truth in Lending, Federal Register, Vol. 73, No. 6/Wednesday January 9, 2008, in* SUBPRIME CREDIT CRISIS: EVERYTHING YOU NEED TO KNOW NOW 493, 501 (PLI Corp. L. & Practice, Course Handbook Series No. B-1668, 2008).

71. JAMES M. LACKO & JANIS K. PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS, F.T.C. BUREAU OF ECONOMICS STAFF REPORT ES-12 (June 2007), http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.

72. *See* Practising Law Institute, *supra* note 70, at 501.

73. *See* C. Lincoln Combs, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L. J. 617, 621–22 (2006). Although the federal government has enacted a series of laws to prevent predatory lending, this has proven to be ineffective. *Id.* at 621. A prime example of a failed regulation is the Home Ownership and Equity Protection Act, also known as HOEPA. *Id.* HOEPA is an attempt to regulate predatory lending and high cost loans; however, lenders have learned how to circumvent this restriction. *Id.* For instance, HOEPA regulates the amount of finance fees, such as origination or discount fees, the lender can charge at closing. *Id.* In order to circumvent this provision, lenders include a prepayment penalty or exit fee, which is payable when the borrower pays off the loan, but is not taken into account when classifying the loan as predatory or not. *Id.* "Thus, almost no predatory loans are subject to its regulations." *Id.* At the federal level, regulation has been mostly ineffective because of the lack of a "bright-line definition of 'predatory lending'"" and the lobbying efforts of the mortgage industry. *Id.* at 617.

74. *See* MEGAN DORSEY & DAVID L. ROCKWELL, FINANCING RESIDENTIAL REAL ESTATE 55, 71 (1992); Combs, *supra* note 73, at 621.

75. DORSEY & ROCKWELL, *supra* note 74, at 55; *see also* Truth in Lending Act, Pub. L. No. 104-29, 15 U.S.C. § 1649 (amended 1995).

various credit terms available to him and avoid the uniform use of credit . . . ."[76]

The implementation of TILA becomes more complex given the fact that it has to be read in conjunction with Regulation Z,[77] which is "issued by the Board of Governors of the Federal Reserve System to implement the Federal Truth in Lending Act."[78] Regulation Z provides for *clear and conspicuous* disclosure of all the terms included in a finance agreement.[79] Pursuant to TILA's standards, the disclosure of the finance charges must include "the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit."[80] For closed-end transactions dealing with the borrower's primary residence, TILA mandates the disclosure of certain terms such as the annual percentage rate, finance charges, the amount financed, and the total number of payments.[81]

The annual percentage rate (APR) prescribed by Regulation Z is a way of providing the borrower with the real cost of borrowing by factoring the loan's upfront cost into the loan interest rate.[82] The APR, however, does not reflect the true cost of borrowing because lenders do not have to take into account third party costs such as appraisal fees or title insurance in computing the APR.[83]

76. Truth in Lending Act, 15 U.S.C. § 1601(a) (2007) (stating the functions of Truth in Lending Act).

77. *See* Truth in Lending Act, 12 C.F.R. § 226.

78. 12 C.F.R. § 226.1(a) (allowing the Federal Reserve Board to apply TILA and promulgate Regulation Z).

79. *See* 15 U.S.C. § 1632(a) (2007) (stating the "Information required by this subchapter shall be disclosed clearly and conspicuously, in accordance with regulations of the Board.").

80. 15 U.S.C. § 1605(a) (2009); *see also* 15 U.S.C. § 1632 (stating that "[t]he terms 'annual percentage rate' and 'finance charge' shall be disclosed more conspicuously than other terms, data, or information provided in connection with a transaction, except information relating to the identity of the creditor.").

81. 12 C.F.R. § 226.1(b), (c) (stating all the disclosures the borrower must receive in residential mortgage transactions). TILA also streamlined the disclosure process in the finance industry by outlining mandatory disclosures that must be given to consumers in every transaction and providing a uniform method to calculate the annual percentage rate. *See* 12 C.F.R. § 226.22(a) (2009).

82. *See* 12 C.F.R. § 226.22 (2009) (defining APR per Regulation Z as "[the] measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of value received by the consumer to the amount and timing of payments made."). To determine the APR, the lender considers the upfront costs such as origination charges, discount points, and lender fees as prepaid interest. 15 U.S.C. § 1606(a) (2007). These fees are then added to the total interest payment during the life of the loan in order to determine the effective cost of borrowing. *Id.*

83. *See* HUD-Treasury Report, *supra* note 16, at 66 (explaining how the APR does not accurately reflect the cost of the credit since it fails to include certain expenses which are required in order to get a mortgage loan).

In addition to the disclosure requirements, TILA provides homeowners with a right of rescission which allows the borrower three days after closing to cancel the transaction without an excuse under certain circumstances.[84] If the lender fails to fully disclose all of the terms according to the regulations, the rescission period could be extended to three years.[85]

Although TILA's clear and conspicuous requirements are certainly helpful, it neither prevent lenders from charging exorbitant fees and rates, nor preclude the use of predatory provisions, such as, negative amortization in residential home loans.[86] In addition, TILA fails to provide an adequate punishment for lenders who violate the statute in comparison to the prospective damages homeowners could suffer.[87] Therefore, the penalties within TILA are not enough to deter the lender's wrongful conduct.

In response to TILA's shortfalls in combating unfair lending, Congress amended TILA in 1994 by creating the Home Ownership and Equity Protection Act (HOEPA).[88] HOEPA offers more effective remedies for borrowers, yet it only addresses certain disclosure requirements for *high cost*: closed-end loans on the borrower's primary residence.[89] Although HOEPA does not address all types of loans, it does bar certain provisions from high cost loans such as: (1) balloon payments in loans with terms of less than five years; (2) negative amortization that allows the loan balance to increase instead of decrease; (3) higher interest rates in the event of default; (4) certain prepayment penalties; and (5) a requirement of payment bundles paid in advance.[90] Regulation Z provides for two parameters to

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84. 12 C.F.R. § 226.23 (2007) (explaining the consumer's right of rescission). Regulation Z provides for a three-day right of rescission for borrowers who take a second mortgage or lien of credit on their homes. *Id.* This right, however, does not apply to a loan used in a purchase transaction in which the loan is the first lien on the borrower's primary residence. *Id.* Furthermore, this right does apply "to the extent the new amount financed exceeds the unpaid principal balance, any earned unpaid finance charge on the existing debt, and amounts attributed solely to the costs of the refinancing or consolidation." *Id.*

85. 15 U.S.C. § 1635(f) (2007) (stating the borrower's right of rescission ceases to exist either within three years or upon the sale of the property, whichever occurs first).

86. *See generally* 12 C.F.R. § 226.32(c) (2007) (outlining TILA's disclosure requirements).

87. HUD-Treasury Report, *supra* note 16, at 69–70 (comparing how low TILA's penalties are in comparison to the damage it causes to consumers who usually lose their homes to foreclosure).

88. *Id.* at 53.

89. *Id.* (describing the different provisions of HOEPA but failing to address open-ended loans); *see also* 12 C.F.R. § 226.32(a)(i)-(ii) (2007) (defining high cost loans under HOEPA).

90. *See* 12 C.F.R. § 226.32(d) (outlining prohibited loan terms). HOEPA also prohibits mandatory arbitration clauses, which force the borrower to go to arbitration to resolve issues arising with the lender from the loan transaction, depriving the borrower of her day in court and seeking judicial recourse. Anna Beth Ferguson, Note, *Predatory Lending: Practices, Remedies*

determine whether a loan is *high cost* or not: a rate trigger or a fee trigger.[91] Based on the rate trigger, a loan is considered *high cost* when the APR of the loan is more than 8% greater than the yield on a Treasury security with a maturity date comparable to the loan.[92] Based on the fee trigger, a loan is considered *high cost* when the total of all of the loan's points and fees payable at or before closing exceeds the greater of $400 or 8% of the total loan amount.[93]

If one of these triggers is satisfied, the lender is required, three days before the closing date, to provide the borrower with a set of disclosures regarding the APR, the amount of regular payments, and a warning that the borrower may lose the home through foreclosure if the borrower goes through with the transaction.[94]

Another important lending regulation is the Real Estate Settlement Act (RESPA), which was enacted in 1974 with the aim of implementing more effective disclosures of settlement costs to home buyers and prohibiting unnecessary kickbacks or referral fees.[95] RESPA's prohibition of kickbacks or referral fees blocks all individuals from receiving or giving

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and Lack of Adequate Protection for Ohio Consumers, 48 CLEV. ST. L. REV. 607, 609 (2000). A balloon payment is a lump sum payment of the loan balance due sometime during the life of the loan, as prescribed in the note. *See id.* at 611. If the borrower just made interest payments during the life of the loan, a balloon payment could be for the entire principal balance. *Id.* On many occasions, borrowers do not have the money to make the payment and have to resort to the same lender for more of the same, another balloon payment. *Id.* Amortization is defined as the "[a]ct or result of gradually extinguishing a debt, such as a mortgage, by contributing payments of principal each time a periodic interest payment is due." BLACK'S LAW DICTIONARY 71 (8th ed. 2004). A loan with negative amortization allows the borrower to make a minimum payment below the interest due under the loan terms. *Id.* The difference between the minimum payment and the interest due on the loan is added to the principal; therefore, the principal balance increases every month the borrower elects to make the minimum payment. *Id.* Prepayment penalties are loan provisions that force the borrower to pay a penalty for repaying the loan earlier than a prescribed period of time, usually between two and three years. HUD-Treasury Report, *supra* note 16, at 8. Furthermore, HOEPA also bars lenders from making loans classified as high cost loans without regard to the borrower's ability to pay. Richard C. Jordan, *Will the Bubble Burst? Some Subprime Lessons for Mexico, Latin America's Leader in Asset Securitization*, 42 INT'L LAW. 1181, 1190 (2008).

91. David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Market*, 33 FLA. ST. U. L. REV. 985, 1026 (2006).

92. 12 C.F.R. § 226.32(a)(1); *see also* Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption*, 56 CONSUMER FIN. L. Q. REP. 78, 80 (2002)_("[L]owering the APR 'trigger' from ten percent above the U.S. Treasury rate to eight percent above the Treasury rate for first lien loans.").

93. 12 C.F.R. § 226.32(a)(2); *see also* Reiss, *supra* note 91, at 1026.

94. *See* 15 U.S.C. § 1639(a)–(b) (2007).

95. *See* Real Estate Settlement Procedures Act (RESPA) of 1974, 12 U.S.C. § 2601(b) (2007) (providing for consumers to receive timely and detailed information concerning the settlement process and cost).

anything of value in connection with a real estate transaction that involves a federally related mortgage loan.[96]

A. DIFFERENT STATE STATUTES AGAINST PREDATORY LENDING

Due to inefficient federal regulations, several states have enacted laws restricting predatory lending.[97] The state statutes focus on the many loopholes or gaps that the federal regulations do not cover and that result in predatory lending practices. These statutes usually bar lenders from lending without regard to the borrower's ability to repay the loan, charging exorbitant fees and interest rates, imposing unreasonable prepayment penalties, and partially disclosing loan terms.

In 1999, North Carolina was the first state to pass predatory lending legislation.[98] Under the North Carolina statute, a loan is considered high-cost if any of the following occurs: (1) the APR is ten percentage points above the rate of the U.S. treasury security of equal term; (2) the loan origination points and fees exceed 5% of the loan amount; or (3) the prepayment penalty amount exceeds 2% of the unpaid loan balance.[99] If the loan is classified as a high cost loan, the lender cannot proceed with the transaction until the borrower has received homeownership counseling and the lender verifies that the borrower is able to repay the loan.[100] Furthermore, the statute prohibits balloon payments, acceleration clauses allowing the lender to recall the loan at any time, and the financing of points or insurance premiums.[101]

Subsequently, North Carolina enacted the Mortgage Lending Act (MLA) in 2001.[102] The MLA requires individuals involved in the mortgage

96. 12 U.S.C. § 2601(a)–(b) (2007).

97. *See* Jessica Fogel, *State Consumer Protection Statutes: An Alternative Approach to Solving the Problem of Predatory Mortgage Lending*, 28 SEATTLE U. L. REV. 435, 451 (2005) (explaining how the current federal statutes are not efficient in preventing predatory lending because they are not enforced by the government).

98. KEITH ERNST, JOHN FARRIS & ERIC STEIN, NORTH CAROLINA'S SUBPRIME HOME LOAN MARKET AFTER PREDATORY LENDING REFORM: A REPORT FROM THE CTR. FOR RESPONSIBLE LENDING iii (2002), http://www.responsiblelending.org/pdfs/HMDA_Study_on_NC_Market.pdf.

99. N.C. GEN. STAT § 24-1.1E(a)(6).

100. C. Bailey King, Jr., *Preemption and the North Carolina Predatory Lending Law*, 8 N.C. BANKING INST. 377, 381 (2004) (explaining how lenders are prohibited from including negative amortization and balloon payment clauses in North Carolina high-cost loans).

101. *See* N.C. GEN. STAT. § 24-1.1E (outlining specific provisions in the North Carolina predatory lender statute). A call provision or acceleration clause authorizes the lender to demand the full payment of the loan balance upon a certain event or condition. BLACK'S LAW DICTIONARY 780 (8th ed. 2004).

102. *See* Susan E. Hauser, *Predatory Lending, Passive Judicial Activism, and the Duty to*

finance industry, such as brokers and loan officers, to comply with certain licensing requirements, which require examinations and practical experience.[103] Based on this statute, the state can deny applicants licensing based on past criminal records or for providing misleading information on their applications.[104]

B. PROPOSED REGULATIONS

Several solutions have been proposed to help alleviate the current financial crisis. One of these regulations is the Mortgage Reform and Anti-Predatory Lending Act of 2007.[105] The act imposes a duty of care upon lenders and financial institutions, requiring them to register the employees involved in the origination of residential loans with a nationwide mortgage licensing registry.[106] To be able to register, applicants will have to complete a twenty-hour training program, pass an examination, and pass a background check.[107] Furthermore, an applicant will not be able to get a license if, in the last seven years, he or she has been convicted of a felony or if, in the last five years, has had a similar license revoked.[108] Loan terms such as the interest rate, total monthly payment, and any other provisions, such as negative amortization and prepayment penalties, must be disclosed promptly in a Good Faith Estimate for the borrower to be able to make an informed decision.[109]

The Homeownership Preservation and Protection Act (HPPA), which amends the Truth in Lending Act, was introduced in December of 2007.[110] This law requires lenders to determine whether a borrower can afford a mortgage payment after the teaser interest rate elapses and the interest rate starts to adjust.[111] Furthermore, for refinanced transactions, lenders will

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Decide, 86 N.C. L. REV. 1501, 1524 (2008).

103. *Id.*

104. *Id.*

105. H.R. 3915, 110th Cong. (2007), *available at* http://www.govtrack.us/congress/bill.xpd?bill=h110-3915 (last visited Feb. 27, 2009).

106. *See id.* § 104.

107. *Id.*

108. *Id.*

109. *See id.* § 201 (amending Chapter 2 of the Truth in Lending Act, 15 U.S.C. § 1631, by adding § 129B after § 129A).

110. Home Ownership Preservation and Protection Act of 2007, S. 2452, 110th Cong. (2007), *available at* http://www.govtrack.us/congress/bill.xpd?bill=s110-2452.

111. *Id.* § 301 (amending the Truth in Lending Act, 15 U.S.C. §§ 1601–1615, by adding § 129B(c)(1) after § 129A) (re-establishing new protections for all consumers; it stops brokers from steering prime borrowers into more expensive subprime loans, creating a duty for mortgage brokers to consider the best interests of their clients, and providing for a duty of good faith and fair dealing toward borrowers from all lenders).

have to determine whether the transaction will confer a net benefit to the borrower, instead of stripping the homeowner's equity.[112]

HPPA also mandates a loan suitability analysis that requires the lender to determine in good faith whether the borrower can truly repay the loan.[113] In the analysis, the lender will have to take into account a series of factors including, but not limited to, the borrower's income, credit record, employment history, assets, and debt-to-income ratio.[114] Under this bill, if the borrower's debt-to-income ratio exceeds 45%, the loan is presumed to be unaffordable unless the borrower is able to provide some compensating factors such as a large down payment.[115] Additionally, lenders will be barred from attaching a prepayment penalty to all loans if the borrower's debt-to-income ratio is 50% or higher.[116] The length of the prepayment penalty period will be capped at five years, and it must expire at least sixty days before the mortgage payment starts to adjust.[117]

III. THE CURRENT SUBPRIME CRISIS: CAUSES AND CONSEQUENCES

The current financial crisis has been considered the worst since the Great Depression, and it began with the rampant increase of subprime loan foreclosures.[118] As the number of foreclosures increased, property values fell in a downward spiral with no preset destination, leaving homeowners owing more on their mortgages than the value of their homes.[119] The number of foreclosure filings gradually increased during 2007, hitting an all time record of 1.2 million homes in foreclosure during the second quarter of 2008.[120] Although subprime ARMs represent only 6% of the

112. *Id.* § 102(r).

113. *Id.* § 201 (amending the Truth in Lending Act, 15 U.S.C. §§ 1601–1615, by adding § 129A(a)(2)(E) after § 129).

114. *Id.* §201 (amending the Truth in Lending Act, 15 U.S.C. §§ 1601–1615, by adding § 129A(a)(1)(B)(i)–(vi) after § 129).

115. *Id.* §201 (amending the Truth in Lending Act, 15 U.S.C. §§ 1601–1615, by adding § 129A(a)(3)(A)–(B) after § 129).

116. Home Ownership Preservation and Protection Act of 2007, S. 2452, 110th Cong. § 201 (2007) (amending the Truth in Lending Act, 15 U.S.C. §§ 1601–1615, by adding § 129A(a)(3)(A)–(B) after § 129).

117. *Id.*

118. James R. Hagerty, *Foreclosures, Overdue Mortgages Increase Again*, WALL ST. J., Sept. 6, 2008, at A3, *available at* http://online.wsj.com/article/SB122065813054205679.html?mod=residential_real_estate.

119. *Id.*

120. Les Christie, *Record 1.2 Million Homes Hit by Foreclosure*, CNNMONEY.COM, Sept. 5, 2008, http://money.cnn.com/2008/09/05/real_estate/foreclosures_rise_again/index.htm (explaining how the 1.2 million homes represent 2.8% of the outstanding home loans, compared to 1.4% during

outstanding loans, they account for 36% of the loans in foreclosure during the second quarter of 2008.[121]

California and Florida are currently the nation's leaders in loan foreclosures; accounting for 39% of the homes in foreclosures.[122] Despite the current national effort to fight foreclosures, it is expected that 47% of the loans originating in 2006 will ultimately be foreclosed. [123]

A. CAUSES

According to statistics, payment increases on *subprime* loans has not been the major cause of delinquencies and foreclosures, as most delinquencies occurred before the payments were adjusted.[124] Rather, a major contributor to these delinquencies was lenders' extension of credit on the basis of income stated on an application without verification.[125] Because lenders simply relied on the borrowers' stated incomes to qualify the consumers, they were unable to assess whether an individual consumer could really afford a loan.[126] Loan originators also contributed to the current financial crisis. Because they were paid based on volume, originators had an incentive to push consumers into *stated loans*, which required less documentation and could be closed more quickly than conforming loans.[127] It was the *perfect* arrangement: subprime loans allowed consumers to overstate their income in order to qualify for loans they could not really afford, and, at the same time, originators helped them

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the same period in 2007).

121. *Id.* Subprime loans' default rate is twenty times higher than fixed rate loans' default rate. *Id.*

122. Hagerty, *supra* note 118. In both states, builders and developers overbuilt, overestimating the housing demand. *Id.* The housing oversupply has pushed property values down. *Id.* Even if the homeowner has good credit, the lower prices make it impossible for her to refinance into a lower cost loan once the adjustable rate mortgage starts adjusting. *Id.* As a result, a homeowner does not have an option but to let her monthly payments lapse or to refinance into a lower cost home. *Id.*

123. Keith S. Ernst & Deborah N. Goldstein, *The Foreclosure Crisis and its Challenge to Community Economic Development Practitioners*, 17-SPG J. AFFORDABLE HOUS. & CMTY. DEV. L. 273, 273 (2008).

124. Posting of AGO Blog Moderator to Report Finds Delinquent Borrowers Not Receiving Help to Prevent Foreclosure,
http://www.atg.wa.gov/BlogPost.aspx?id=19020 (Feb. 7, 2008, 16:56 EST).

125. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, INFORMATION ON RECENT DEFAULT AND FORECLOSURE TRENDS FOR HOME MORTGAGES AND ASSOCIATED ECONOMIC AND MARKET DEVELOPMENTS 48 (2007),
http://www.gao.gov/new.items/d0878r.pdf.

126. *Id.* at 35.

127. *See generally id.* at 41, 53.

do it because a larger loan translated into a bigger commission.[128] As a result, the share of *low doc* or *no doc* loans in the subprime market started to gradually increase from 20% in 2000 to 40% in 2006.[129]

In addition, lenders not only disregarded borrowers' income, but also, at the time of assessing whether a particular borrower qualified for a loan, also failed to consider certain housing expenses such as taxes, insurance, or the payment on second mortgages.[130] Lenders were, in essence, lending based on the value of the property as collateral.[131] Furthermore, when a borrower was financing 100% of the purchase price, she had limited or no equity in the property; therefore, the loans were based on the expectation that the property would go up in value.[132]

As property values started to decline in 2007, many homeowners were trapped in their expensive adjustable rate mortgages, unable to refinance to lower their monthly payments becuase their individual properties were now worth less than the amount owed.[133] Property owners were unable to sell because they did not have the money to cover the difference between the property value and the mortgage balance, and no prospective buyer would be willing to pay more than the respective properties were worth.[134] The decline in prices led to an abrupt increase in delinquencies. Even homeowners who were able to afford their payments lost the incentive to continue paying in light of the fact that they owed considerably more than their houses were worth.[135]

Additionally, many subprime lenders failed to include the escrows in the borrowers' monthly payments. Consequently, when it came time to pay for those expenses, many homeowners were unable to do so.[136] The lack of

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128. *See generally* MORTGAGE ASSET RESEARCH INST., INC., NINTH PERIODIC MORTGAGE FRAUD CASE REPORT TO THE MORTGAGE BANKERS ASSOCIATION 4 (2007), http://www.marisolutions.com/pdfs/mba/MBA9thCaseRpt.pdf (reporting that ninety of one hundred stated income loans sampled used inflated income when compared to tax return data).

129. *See* Practising Law Institute, *supra* note 70, at 515.

130. *Id.* at 514–15.

131. *Id.* at 497. Sometimes even the value of the collateral was not accurate since brokers would pressure appraisers to inflate the property value. *Id.* at 503.

132. *Id.* at 512.

133. *See* Associated Press, *Foreclosures Hurt Neighbors' Refinance Efforts: Even if Homeowner's Credit is Good, Property Values are Affected*, MSNBC.COM, Mar. 12, 2008, http://www.msnbc.msn.com/id/23599085/.

134. *See generally id.* The decline in prices also affected neighbors at the time of putting their own properties for sale, since value is based on the sale of comparable properties in the area. *Id.* Therefore, every time a house goes into foreclosure, the value of the houses around it declines. *Id.*

135. *Cf. id.*

136. *See* Ken Harney, *Subprime Fallout Focuses on Escrow Accounts*, REAL DEAL, May 1, 2007, *available at* http://ny.therealdeal.com/articles/ken-harney-subprime-fallout-focuses-on-

escrows on subprime loans led many consumers to believe they could afford a loan, when in reality they could not because the payment did not actually represent the borrowers' total obligation.[137] As a result, many of these loans entered into default when the taxes or the insurance became due as many borrowers did not have the extra money to pay the unforeseen expenses.[138] First-time homebuyers are the most vulnerable to the waiver of escrows from their monthly payment because they tend to have limited knowledge about the responsibilities of a homeowner.[139]

Subprime borrowers generally have had trouble meeting their financial obligations and making timely payments.[140] Therefore, they are more likely to miss their taxes and insurance payments as they become due.[141] This is a key issue because if a borrower fails to pay the escrows, the local government could foreclose on her property for failure to pay property taxes or the lender could place costly insurance on the property.[142] Refinancing is one of the few solutions available to homeowners with outstanding taxes and insurance expenses, a transaction which could make them victims of predatory lending because of the desperate need for money.[143] A common practice by lenders toward homeowners in this circumstance is *loan flipping*, a practice in which the lender takes advantage of the consumer by making a series of refinances, charging exorbitant fees without conferring any real benefit to the borrower, but paying the delinquent taxes and insurance from the proceeds of the new loan.[144] Ultimately, if the borrower is unable to refinance, or to obtain the money from any other source, the lender will foreclose on the property.[145]

The result of all of these factors is a sharp increase in foreclosures due

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escrow-accounts.

137. *See id.* Escrow accounts are set up by lenders to guarantee the payment of taxes and insurance when they become due. *Id.* Every month the lender collects, along with the principal and interest, a pro-rata share of the annual taxes and insurance. *Id.* Escrow accounts are very convenient for borrowers who are unable to save enough money during the year to pay the taxes and insurance since it assures the borrower will be able to pay these costs. *Id.*

138. *See id.*

139. *See id.*

140. *See* Justin Pritchard, *Subprime–Definition of Subprime Borrowers and Lending*, ABOUT.COM, http://banking.about.com/od/loans/g/subprime.htm?p=1 (last visited Feb. 27, 2009).

141. *See* Jack Guttentag, *Escrow Could Help Subprime Borrowers*, WASH. POST, July 21, 2007, at G04, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/07/20/AR2007072000964.html.

142. *See id.*

143. *See* Practising Law Institute, *supra* note 70, at 522.

144. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a-Blind-Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2051 (2007).

145. *Id.*

to irresponsible lending practices and consumers' financial illiteracy.[146] The increase in foreclosures has created a vicious cycle in which property values continue to decrease; resulting in more homeowners losing interest in keeping their homes, which are now worth much less than what is owed on them.[147]

B. CONSEQUENCES

There has been a selling of almost all mortgage-backed securities in the secondary market due to both the increasing number of delinquent home loans and bank losses due to foreclosures.[148] Bank losses resulting from foreclosure proceedings have ascended to the hundreds of billions of dollars.[149] So far the list of failed, or nearly failed, financial institutions includes Bear Stearns, Fannie Mae, Freddie Mac, IndyMac, Lehman Brothers, Merrill Lynch, Wachovia, and Washington Mutual.[150] Consequently, the number of foreclosed homes continues to increase and cause devastating instability in the financial market; taking a severe toll on the American economy. More than 7.5 million Americans owe more than what their homes are worth, while another 2.1 million people are about to be in that position in the near future.[151]

C. SOLUTION FROM THE GOVERNMENT

The most recent economic measure adopted by the United States government is the Emergency Economic Stabilization Act of 2008, also known as the *bailout* of the American Financial System.[152] Congress

146. *See generally* RECOMMENDATION OF "BEST PRACTICES" FOR AND RESPECT TO THE FUTURE OF RESPONSIBLE SUB-PRIME MORTGAGE LENDING, COMMITTEE ON THE UNDERSERVED PRESIDENT'S ADVISORY COUNCIL ON FINANCIAL LITERACY 3 (2008).

147. *Id.*

148. *See* Evelyn M. Rusli, *In Wall Street We Don't Trust*, FORBES.COM, Aug. 21, 2007, *available at* http://www.forbes.com/2007/08/21/treasury-bills-yield-markets-bonds-cx_er_0812markets18.html?partner=links.

149. *See* Yalman Onaran, *Banks' Suprime Losses Top $500 Billion on Writedowns*, BLOOMBERG.COM, Aug. 12, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aSKLfqh2qd9o&refer=worldwide.

150. *See* James Bullard, *Three Funerals and a Wedding* 5–7, Nov. 20, 2008, http://www.stlouisfed.org/news/speeches/2008/11_20_08.html.

151. Les Christie, *7.5 Million Homeowners 'Underwater,'* CNNMONEY.COM, Oct. 31, 2008, http://money.cnn.com/2008/10/30/real_estate/underwater_borrowers/?postversion=2008103107.

152. *See* Posting of Luke Mullins to The Home Front, *The $700 Billion Bailout Plan (Take Two)*, http://www.usnews.com/blogs/the-home-front/2008/10/14/the-700-billion-bailout-plan-take-two.html (Oct. 14, 2008, 11:23 EST).

recently passed the measure, authorizing the Secretary of the Treasury to purchase mortgage-backed securities from the nation's largest financial institutions over the next two years.[153] This law authorizes the creation of the Trouble Asset Relief Program (TARP), which will allow the government to buy distressed assets.[154] The program will be administered by the newly created Office of Financial Stability, a division of the Office of Domestic Finance.[155] This plan will help banks lend money to consumers and businesses by buying nonperforming assets from financial institutions, which would have the effect of freeing funds currently tied up by non-performing loans.[156] Another goal of this program is to restore confidence in the United States financial system by increasing the Federal Deposit Insurance Corporation (FDIC) insurance on consumer deposits to $250,000 from the $100,000 level.[157]

In July 2008, the Housing and Economic Recovery Act of 2008, was signed into law.[158] This act will aid approximately 400,000 homeowners, in danger of losing their homes, to refinance their subprime loans into fixed rate, low cost, Federal Housing Administration (FHA) insured loans.[159] These new loans will be for 90% of the current value of the home, allowing lenders a tax write-off for the difference between the old loan balance and the new loan balance.[160] The law requires that the owners must use the house as their principal residence, have a high debt-to-income ratio, and

153. *See id.*

154. *See id.*

155. *See* Alice Gomstyn, *Bailout Bill Basics: From TARP to Tax Breaks*, ABC NEWS, Oct. 2, 2008, http://abcnews.go.com/Business/Economy/story?id=5932586. According to the bailout plan, the Treasury Department will receive up to $700 billion dollars. *Id.* The money will be disbursed progressively as needed and the Treasury will receive an initial $250 billion to start the program. *Id.* Thereafter, disbursements will be in the amount of $100 billion as the President deems necessary. *Id.* The program also allows the government to insure certain assets instead of buying them. *Id.* The bill also provides for the creation of a board to supervise the Treasury's use of the funds. *Id.* Furthermore, the bill imposes restrictions on financial institutions that participate in the program, such as paying excessive bonuses to top executives. *Id.* Participating institutions will also lose certain tax benefits. *Id.*

156. *Id.*

157. Christine Hughes, *Commentary: Fear Not . . . About Money in the Bank*, DAILY REC. AND KAN. CITY DAILY NEWS-PRESS, Oct. 16, 2008, *available at* http://findarticles.com/p/articles/mi_qn4181/is_20081016/ai_n30924824?tag=content;col1. The same insurance increase applies to the National Credit Union Share Insurance Fund, which backs accounts at most of the country's credit unions. *Id.*

158. *See* Housing and Economic Recovery Act of 2008, H.R. 3221, 110th Cong. (2008), http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActof2008.pdf.

159. Summary of the "Housing and Economic Recovery Act of 2008," http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf.

160. *Id.*

share any profits from a future sale with the government.[161] The law, however, does not force the lender to participate in the program; instead, it is at the discretion of the lender to allow a reduction on the mortgage balance and issue a new loan to the borrower.[162] If the prior lender agrees to the refinance, the new FHA lender will carefully review the proposed loan to ensure compliance with the different lending guidelines and upon closing, the borrower will start making payments on the new loan.[163] Under this arrangement, the government will retain an interest in the property in order to bar the homeowner from getting a second mortgage for five years and to assure that the borrower shares any profits from a future sale.[164]

The Housing and Economic Recovery Act also amends the Internal Revenue Code, providing first-time homebuyers with a tax credit equal to the lesser of 10% of the property's purchase price or $7,500.[165] This tax credit, however, does not apply to single and married taxpayers with an adjusted gross income greater than $75,000 and $150,000, respectively.[166] According to statistics from the National Association of Realtors, up to three million homebuyers could benefit from this law.[167]

In addition, the law will allow taxpayers to deduct local real estate taxes, even if they claim their standard deductions, and choose not to itemize.[168] There is a *catch*, however, to this tax credit, the borrower must repay the tax credit to the Internal Revenue Service over fifteen years.[169] Even though the borrower repays the credit, it could still be considered an interest free loan, which the borrower could use to remodel or repair the

161. *Id.* (requiring homeowners to share 50% of the profits from the sales of their home).

162. *Id.*

163. Posting of Marlyn Wiener to the Housing and Economic Recovery Act of 2008, *New Housing Bill—Refinance Help for Some, But Not for All*, http://www.myfloridarealestatelawblog.com/tp-080806185846.shtml (Aug. 6, 2008).

164. *See* Housing and Economic Recovery Act of 2008, H.R. 3221, 110th Cong. § 1402 (2008).

165. Mortgage News Daily, *$7,500 Tax Credit Now Available to First-Time Home Buyers*, Sept. 4, 2008, http://www.mortgagenewsdaily.com/942008_First_Time_Homebuyer_Tax_Credit.asp (last visited Feb. 19, 2009).

166. *Id.*

167. Anna Bahney, *Housing Rescue Bill May Fall Short; Who Benefits?*, USA TODAY, July 26, 2008, *available at* http://www.usatoday.com/money/economy/housing/2008-07-26-housing-bailout-bill_N.htm.

168. William Perez, *Additional Standard Deduction for Property Taxes*, About.com, http://taxes.about.com/od/deductionscredits/qt/propertytax2008.htm (last visited Mar. 7, 2009).

169. *See* Housing and Economic Recovery Act of 2008, H.R. 3221, 110th Cong. §§ 3011–3012 (2008).

property.[170]

IV. SOLUTIONS TO THE SUBPRIME CRISIS

The solution to the current subprime and financial crises requires a two step approach. First, action must be taken to address the current crisis. Second, legislation must be enacted to avoid similar crises in the future.

A. CURRENT SOLUTION

Today, foreclosure is the awful reality facing many American families who have put sweat, sacrifice, and hard-earned savings into making their *American Dream* a reality—a reality now lost to unfair lending practices. The consequences of foreclosure go far beyond affecting individual families. Foreclosure causes surrounding neighbors to lose equity in their properties as property values drop and it causes municipalities to lose tax revenue when called upon to deal with vacant homes.[171] There is no doubt that the current financial crisis has developed as a consequence of the increasing number of foreclosures.[172] Therefore, the short term solution must address how to stop this rampant phenomenon. Thus far, voluntary loan modifications have failed to stop the flood.[173] A viable alternative would be the implementation of a judicial loan modification program.

1. Judicial Loan Modifications

Judicial review and modification of subprime loans could allow homeowners to stay in their homes while saving taxpayers billions of dollars in bailout plans.[174] Judicial loan modification is not a new concept.

170. Summary of Key Provisions of H.R. 3221–The Housing Stimulus Bill (as of 8/22/2008), http://www.realtor.org/government_affairs/gapublic/hr_3221_key_provisions (last visited Mar. 7, 2009).

171. Luke Mullins, *The Run-down Foreclosure Next Door: What You Can Do*, U.S. NEWS, Oct. 23, 2008, http://www.usnews.com/articles/business/real-estate/2008/10/23/the-run-down-foreclosure-next-door-what-you-can-do.html; *see also* Alan Zibel, *Foreclosures Can Decrease Neighboring Home Values*, DESERET NEWS, Mar. 13, 2008, http://deseretnews.com/article/1,5143,695261157,00.html.

172. *See generally* Pritchard, *supra* note 140.

173. VOLUNTARY LOAN MODIFICATIONS FALL FAR SHORT: FORECLOSURE CRISIS WILL CONTINUE UNABATED WITHOUT COURT-SUPERVISED MODIFICATIONS, CTR. FOR RESPONSIBLE LENDING (CRL Issue Brief, Jan. 30, 2008), http://www.responsiblelending.org/pdfs/paulson-brief-final.pdf.

174. Steven LeBlanc, *Delahunt Calls for Changes in Bankruptcy Court*, BOSTON GLOBE, Oct. 22, 2008, http://www.boston.com/news/local/massachusetts/articles/2008/10/22/delahunt_calls_for_change

In fact, it is currently available to large companies such as Lehman Brothers and subprime lenders like New Century.[175] Under current bankruptcy law, however, a borrower's primary residence mortgage loan is the only debt a judge is barred from revising or changing.[176]

It is estimated that under this alternative, judges would be able to modify loan terms and avoid foreclosures of approximately 600,000 homes belonging to families currently victimized by unaffordable and usurious subprime loans.[177] This mechanism should only be available to homeowners on the verge of losing their homes because their adjustable rate mortgage has started to adjust and the payment has skyrocketed, resulting in payment shock. This judicial authority should be limited, encompassing only certain loan term modifications such as interest rate reduction, loan balance adjustment to fair market value, or an extension of the amortization period from thirty to forty years. This program would not only help many homeowners stay in their homes, but would also be an incentive for banks to get involved in voluntary loan modifications. Such modifications would likely be cheaper than going through the court system for a judicial loan foreclosure.[178]

B. LONG TERM SOLUTION

Although Congress has enacted several laws to help ease the current financial crisis, these measures have failed to address how to avoid a similar crisis in the future.[179] One key step in avoiding such a crisis is to increase the financial literacy of borrowers. Financial knowledge will give the American people the power to make responsible monetary decisions in order to build stronger financial futures.[180] Therefore, the long term solution to the current financial crisis must incorporate two essential points: financial literacy and a national anti-predatory statute.

s_in_bankruptcy_court/ (last visited Mar. 7, 2009).

175. Eric Stein & Ellen Harnick, PERMITTING JUDICIAL MODIFICATION OF HOME LOANS WOULD SAVE 600,000 HOMES—PURCHASE OF SECURITIES WILL NOT SAVE ANY, CTR. FOR RESPONSIBLE LENDING (CRL Issue Brief, Sept. 19, 2008),http://www.responsiblelending.org/pdfs/crl-judicial-mod-of-home-mortgages-brf.pdf.

176. Eric Stein & Ellen Harnick, *HR 3609*—COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES, CTR. FOR RESPONSIBLE LENDING (CRL Issue Brief, Jan. 18, 2008),http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf.

177. *Id.*

178. *Id.*

179. *See generally* Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong. (2007).

180. The Quotation Page, http://www.quotationspage.com/quote/2060.html.

1. Financial Literacy: A Key Issue

Undoubtedly, "a substantial proportion of the general public in the English-speaking world is ignorant of finance" and, as a consequence, borrowers do not understand how credit works, why it is important, or the terms of a loan.[181] It is imperative to improve the nation's financial literary because without a clear understanding of either finances or the terms of the loans they are signing, Americans are unable to make informed decisions, which increases the likelihood of default.[182] Although the federal government has recently implemented various programs dedicated to teaching Americans the basics of financial education,[183] these programs are insufficient.

One way to accomplish financial literacy is to create a mandatory class or seminar in the school system that will teach students about personal finances, just as they are taught algebra or history.[184] The curriculum should cover essential components such as: (1) the basics of banking and financial services; (2) checking and savings accounts; (3) the power of credit; and (4) basic investments.[185] This type of learning will give individuals the tools needed to survive in a society where credit is the foundation for the major events in peoples' lives, such as purchasing their first homes or cars.

In addition to the class component, consumers should be required to attend mandatory counseling programs if they are going to get a subprime loan to either purchase or refinance a property. The curriculum should be designed to comply with the principles provided by the National Industry

181. *See Getting It Right on the Money*, *supra* note 2.

182. *See* Paul Bannister, *25 Fascinating Facts About Personal Debt*, BANKRATE.COM, Sept. 20, 2004, http://www.bankrate.com/brm/news/debt/debtguide2004/debt-trivia1.asp.

183. U.S. Fin. Literacy and Educ. Comm'n, http:// www.mymoney.gov (last visited Feb. 19, 2009). For example, a government funded website, mymoney.gov, has a free tool kit. *Id.* Additionally, the United States Treasury established the Office of Financial Education in 2002. U.S. Dep't of Treasury, Office of Financial Education, Mission, http://www.treas.gov/offices/domestic-finance/financial-institution/fin-education/ (last visited Feb. 25, 2009). Congress established the Financial and Literacy Education Commission in 2003. Comptroller of Currency, Community Affairs: Financial Literacy Resource Directory, http://www.occ.treas.gov/cdd/finlitresdir.htm (last visited Feb. 25, 2009). In 2006, the Commission published the National Strategy for Financial Literacy. *Id.* The government websites and free kits are insufficient because there is a need for financial literacy education in the school system. EducationWorld.com, Financial Literacy Begins at School, http:// www.education-world.com/a_lesson/lesson232.shtml (last visited Feb. 19, 2009).

184. *Cf. Getting It Right on the Money*, *supra* note 2 (educating children on finances at a young age has worked in other countries so it should also be implemented here in the U.S.).

185. Banking on Our Future, http://www.operationhope.org/smdev/clst4.php?id=172 (last visited Feb. 25, 2009).

Standards for Homeownership Education and Counseling.[186] This program must explore certain areas such as: (1) assessing readiness to buy a home; (2) budgeting and credit; (3) financing a home; (4) selecting a home; (5) maintaining a home and finances; (6) budgeting for homeownership; (7) sustaining homeownership and avoiding delinquency.[187] The program should also explain the basics of how the credit scoring system works and why it is important to have good credit.

The program could be administered through the local offices of the Department of Housing and Urban Development (HUD)[188] or other national organizations that provide homeownership counseling.[189] The homeownership counseling program should be provided by a party or person not involved in the transaction, either directly or indirectly. Mortgage realtors, originators, processors, or underwriters must be barred from conducting the program. In addition, the program could provide post-lending counseling.[190] Unquestionably, lending counseling will bring borrowers closer to financial literacy by giving them a better understanding of the rights and obligations of a homeowner.[191] Once financially literate, Americans will be less likely to obtain loans they are unable to afford.[192]

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186. National Industry Standards for Homeownership Education and Counseling, http://www.homeownershipstandards.com (last visited Feb. 25, 2009). The National Industry Standards for Homeownership Education and Counseling (NISHEC) provides the basis for standards required in homeownership counseling. *Id.*

187. Freddie Mac, http://www.freddiemac.com/singlefamily/news/newsletter/2008/04/edu_requirement.html. (last visited Feb. 25, 2009) (outlining the minimum requirements mandated by the National Standards for Homeownership Education & Counseling).

188. U.S. Dep't of Housing and Urban Development, www.hud.gov (last visited Feb. 25, 2009).

189. Find a Counselor Search, http://www.fanniemae.com/findCounselorApplication/fanniemae/findCounselor.jsp (last visited Feb. 25, 2009). Some of the most widely known counseling agencies include ACORN Housing Corporation (ACN) and Neighborhood Housing Services (NHS). *See* ACORN Housing, http://www.acornhousing.org/index.php (last visited Feb. 25, 2009); *see also* Google.com, search terms: Neighborhood Housing Services, http://www.google.com/ (last visited Feb. 25, 2009).

190. Under the post-lending counseling program, the lender is required to notify the counselor as soon as the borrower is late or falls behind on payments. *See* Protecting Your Investment, https://www.inhp.org/Resources/Post%20Purchase%20General%20Brochure.pdf (last visited Feb. 25, 2009).

191. *See* Nat'l Ass'n of Mortgage Brokers, Abusive Lending Practices (2006), http://www.namb.org/Images/namb/GovernmentAffairs/Position_Papers/Abusive%20Lending%20-%20General%20(8-15-2006).pdf.

192. *See* Bannister, *supra* note 182.

2. National Anti-Predatory Standards

As proposed by the FDIC and Congress, the United States needs a National Anti-Predatory Standard Act that establishes a nationwide standard to monitor predatory lending.[193] This law should preempt the different state' laws governing predatory lending and create nationwide uniformity. According to a study performed by the University of North Carolina, the creation of a national anti-predatory law will be beneficial.[194] Such a national standard should be palatable because thirty-six states have already enacted anti-predatory lending laws dealing with issues such as balloon payments, prepayment penalties, and the verification of a borrower's ability to repay the loan.[195] The requirements vary across different states and some states do not have such a law.[196] Therefore, this national standard would ensure the existence of uniform protection.

This law should require improved underwriting standards to protect both the borrower and the lender.[197] Consequently, lenders will have fewer defaults because the law will require the lender to examine the borrower's ability to repay the loan as a whole before funding any loans. The borrowers will also be protected from lenders who allow borrowers to misstate income. Moreover, the law must grant regulatory power to an agency to supervise and ensure compliance with the law. By allowing an agency to regulate predatory practices, lenders and borrowers will still have the flexibility to choose techniques that are helpful while regulations prevent lenders from taking advantage of uneducated borrowers.

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193. *See* Mat Carter, *Top FDIC Official Calls for National Anti-Predatory-Lending Standard*, INMAN, Mar. 28, 2007, http://www.inman.com/news/2007/03/3/top-fdic-official-calls-national-anti-predatory-lending-standard.

194. *See* ROBERTO G. QUERCIA ET AL., CTR. FOR CMTY. CAPITALISM, THE IMPACT OF NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT 16–18 (2003), http://www.planning.unc.edu/pdf/CC_NC_Anti_Predatory_Law_ Impact.pdf.

195. Raphael W. Bostic et al., *The Impact of State Anti-Predatory Lending Laws: Policy Implications and Insights*, Jan. 25, 2008, http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-9_bostic_et_al.pdf.

196. *Id.*

197. The statute must mandate that the lender verify the borrower's ability to repay any mortgage related loan. Furthermore, it must require the borrower to include the escrows in the monthly payment if the borrower is giving less than 20% as a down payment. *See* Harney, *supra* note 136–39. In addition, the borrower's debt-to-income ratio should not exceed 40% in order to ensure that the borrower has enough residual income. *See* HUD-Treasury Report, *supra* note 16, at 77. The statute should also bar lenders from charging a prepayment penalty or allowing negative amortization in residential mortgage loans. *See* Carrillo, *supra* note 17, at 17–21.

V. CONCLUSION

The subprime mortgage market crisis continues to have a devastating effect on both the American economy and the American family. As a result of predatory lending practices and borrowers' financial illiteracy, more families lose their homes everyday. Like Ms. Delia Villegas, victims have been left to realize that their lifetime dreams have become their worst nightmares. Although the subprime crisis will not be fixed overnight, the government can take immediate action by streamlining the loan modification programs and trying to minimize future losses. Furthermore, the United States should work toward protecting homeowners by enacting national anti-predatory statutes to protect consumers and establishing an effective program to provide prospective homeowners with basic financial education in order to avert future crises. The adoption of these measures will not only help America get out of the current financial crisis, but will also set the foundation for a stronger financial future, where every citizen can afford and enjoy the *American Dream* of owning a home.