Government Solutions: An Answer to the Subprime Market Problems

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Though homeownership has grown phenomenally in the United States over the past decade, recent developments with subprime mortgages threaten to undo that growth and hurt the economy in the process. With record rates of foreclosures and defaults on subprime mortgages, there has been a public outcry for the government to take charge and fix the problem before it does significant damage to the United States economy. Many different government agencies and branches have answered the call with four differing approaches to this issue. Each group's approach is analyzed and the four approaches are then compared to see which provides the most success in the current situation. In the end, each has had mixed results that seem to answer most of the problems effectively but each has its drawbacks, as well. The final conclusion is that the federal regulatory agencies approach has the most effective solution with the least drawbacks.

Homeownership is an integral part of the American dream. To own one's own home is not only liberating, but often goes together with financial stability and success. The housing market, though, has taken a downturn and the subprime market has been at the forefront of that downturn due to the rise in delinquency rates on variable rate loans (Dougherty & Reddy, 2007). Subprime mortgages have become controversial and have led to bigger troubles throughout the market. In order to fix this problem, several different groups within the government have proclaimed that they hold the key to solving this strenuous economic issue; but the plan set out by federal regulatory agencies[1] is the only one that will likely have an impact on the current subprime mortgage crisis.

The subprime mortgage industry has been hit with higher-than-expected foreclosures that seem to have rocked the real estate industry and the economy on the whole. The problem is not with the whole subprime market, but with those lending institutions that have had poor underwriting or predatory lending practices. Recently, poorly underwritten and predatory subprime mortgages have become problematic due to the lack of education for borrowers, poor regulation of the industry, and poor underwriting standards that allowed those in the industry to loan money to borrowers that could not afford their payments.

[1]The Agencies consist of the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

Many different government agencies and branches have come up with four differing approaches to this issue and in the end, although each of the approaches has had mixed results, each of them seem to at least partially answer some of the problems effectively and decisively.

Homeownership Background

Homeownership has risen from 65% to 69% over the past decade with subprime mortgages making up nearly 50% of this rise according to some estimates (Whitehouse, 2007).

Ben S. Bernanke, Chairman of the Federal Reserve, explained that subprime mortgages are usually offered to borrowers who have high credit risk because they lack a strong credit history or other issues that raise the probability of defaulting on the loan (2007). A lender mitigates risks by increasing their interest rate as a penalty in order to satisfy the investor and encourage investment. Even though these mortgages pose higher risk, they also provide a great opportunity for return to borrowers.

A subprime mortgage creates the opportunity for those with a bad credit history to purchase their own home, improve their circumstances and obtain a part of the American dream, but subprime borrowers face higher costs of borrowing than prime borrowers and therefore run a higher risk of default and foreclosure (Bernanke, 2007).

Two-thirds of subprime mortgages are mortgages with adjustable APRs (Bernanke, 2007). Most of those mortgages were created as 2/28 mortgages which means they have an introductory fixed interest rate for 2 years and then an adjustable rate for the next 28 years. The lending institution introduces a low fixed "teaser" rate which can cause "payment shock" when the loan moves to an adjustable APR (Salvant, 2007). The low introductory rate entices people to sign mortgages that seem affordable, but have the potential to increase their monthly mortgage payments when the teaser rate ends and the mortgage payment adjusts to becomes higher. If the mortgage is underwritten properly, the borrower should have the ability to handle the increase in the interest rate or to refinance the loan at a fixed rate.

There are three main types of mortgages in the subprime market: regular bank backed subprime mortgages, poorly underwritten mortgages and mortgages made by predatory lending institutions. The first type of mortgages are the most stable because the lending institution was forward and fair to the borrower and confirmed that the borrowers are financially able to afford the loans.

Poorly underwritten mortgages result when the borrower's financial information was not processed or else processed improperly in order for them to receive the loan (Ernst et. al., 2006). These low- or no-document loans are not underwritten according to regulatory standards and it is unknown whether the borrower can make payments on the mortgage or not. These types of loans generally are provided for individuals and families who have no credit history or who are self-employed and do not have regular documentation of their work.

Predatory lending companies deceive and defraud borrowers by selling subprime mortgages that the borrower is not likely able to afford after the introductory rate ends. These lending institutions "push market ARM's (adjustable rate mortgages) with temporarily low interest rates, even if these ultimately will become unaffordable" for those who borrow (Ernst et. al., 2006). There are gray areas in between each type of subprime lending and it is not always easy to identify whether a company was sloppy in its underwriting standards or if it engaged in outright predatory lending.

Subprime Mortgage Characteristics

According to the Mortgage Bankers Association, subprime adjustable rate mortgages have one or more of the following characteristics: low initial fixed rate payment period that expires after a short time period and then adjusts to a variable index rate with a margin, very high or no limits on the payment or rate caps when the mortgage reaches its reset date, limited or no documentation of borrower's income, product features that encourage frequent refinancing in order to keep monthly payment reasonable, and/or substantial penalties for prepayment of the loan or prepayment penalties that extend beyond the introductory rate offering (2007).

Each subprime characteristic is an example of how risky a mortgage of this type is for the borrower and the investor. Banks and lending institutions have allowed borrowers to use their homes equity as "glorified ATM's, pulling out money for all sorts of reasons" because the market was increasing in price and home prices were on the rise (Henderson, 2007). When the market stopped growing and actually decreased, suddenly borrowers were unable to afford their payments and they started defaulting on their loans.

Subprime Mortgages and Predatory Lending

Predatory lenders have found ways of exploiting the subprime market to their advantage. These unscrupulous lenders lure borrowers with terms that are likely to result in default on such loans. The lender forecloses on the house and then begins the process over by selling the house to another inexperienced borrower. Predatory lending has three key characteristics according to the federal regulatory agencies involved.[2] First, predatory lenders make loans based on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to terms of the loan. (Federal Register, 2007) Predatory lending institutions will lend money to the borrower according to price at which that institution may be able to resell the property after foreclosure, rather than the income and assets necessary for the borrower to fulfill the contract.

Second, loan flipping is the process in which predatory lenders entice borrowers to repeatedly refinance a loan in order to charge higher fees each time the loan is refinanced (Federal Register, 2007). Each time someone refinances their home brings opportunities for an unscrupulous lender to include clauses that force borrowers to pay heavy prepayment penalties. This means that the next time they try to refinance, they must pay large fees on top of the mortgage amount.

The final characteristic of predatory lending is when lending institutions engage "in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower" (Federal Register, 2007). Many lending institutions depend on the complexity of risky mortgage contracts to hide predatory lending. By confusing the borrower, predatory lending institutions can prey on uninformed and uneducated borrowers that are not aware of the long-term implications when signing for the mortgage. Many are promised that they will be allowed to refinance without a problem, only to find out two years later when they must refinance that they will incur prepayment penalties and extra fees which most borrowers cannot afford.

While it seems that this trend should be a problem primarily for low-income individuals and families, subprime lending reaches many borrowers that qualify for prime mortgages. Subprime mortgages can be a sound mortgage option for some people, but in many cases predatory lenders use these products for their advantage at detriment to borrowers. Subprime lending is focused at first-time homebuyers because they normally do not have strong credit ratings. First-time

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homebuyers lack experience in homeownership and often lack the financial education necessary to purchase a home without being taken advantage of, or to manage their mortgage debt loads, choose the appropriate mortgage, etc. They often do not even understand the terms of their mortgage. Poor underwriting of their loans puts these borrowers at risk because they may not be financially capable of making payments when the mortgage switches to the higher interest rate. In such cases, the lending institution may not engage in predatory lending, but simply allow a bad loan due to poor financial background checking procedures.

MARKET EFFECT

Why is the whole market affected? Loans do not usually remain between the original lender and the borrower. Most subprime loans are sold or "securitized" to investors around the world that invested into collateralized debt obligations (CDO's) in hopes of higher dividends (Samualson, 2007). Most of these investors are concerned about the "broader qualities of the securities . . . than exactly where and to whom the loans were made" (Whitehouse, 2007). So with defaults up now, these investors are losing money and many of the firms holding bonds that are secured by the subprime market are already experiencing or "bracing for heavy losses" (Paletta, 2007).

As stated, several companies have already folded due to the subprime mortgage market failure. American Home Mortgage Investment Corp, the 10th largest U.S. retail mortgage lender, "filed for Chapter 11 bankruptcy protection after rising customer defaults and unfriendly credit markets" forced it to close (Giannone, 2007).

Additionally, as more and more borrowers enter foreclosure, the property values in those areas decrease. This domino effect has become evident in Detroit, where property values have immensely fallen due to an increase in foreclosures in one area. In the 48235 zip code "one in three subprime loans made from 2002 through 2006 . . . were more than 60 days in arrears, meaning they were either already in foreclosure or well on their way there" (Whitehouse, 2007). In other words, as property values drop, people do not buy into those areas, and neighboring subprime borrowers have even more difficulty refinancing their loans.

GOVERNMENT SOLUTIONS

With subprime lending problems, several institutions have taken steps to stop predatory lending and calm the storm of the subprime market to minimize the impact on the economy. There are four groups approaching this problem from different angles. The first group comprises Senator Christopher J. Dodd (D-CT) and leaders in the lending industry who have collaborated to introduce principles for responsible subprime lending. The next group is composed of federal regulatory agencies that have regulatory power over lenders. Congressional lawmakers are the third group that will come together in an effort to solve this complex issue. The forth group is the Bush administration which is also working with the mortgage industry. Each group has designed or plans to design policies, regulations, or laws to fix the subprime problems.

SENATOR DODD AND THE LENDING INDUSTRY

Senator Dodd met with the banking leaders in the subprime market and created a comprehensive set of seven principles to fix Adjustable Rate Mortgages (ARM's) and the subprime markets. These principles are primarily focused on the issue of poor underwriting of mortgages. The first principle is early contact and evaluation of the situation. Lenders should contact borrowers and see if they can afford the new higher mortgage payments when the resets to an adjustable rate (Dodd, 2007). The lender should then reevaluate whether intervention is needed to ensure that the borrower does not default on the loan. Intervention may include modifying the loan to make it affordable.

The second principle is to modify the mortgage to create long-term affordability. Servicers should seek to provide affordable solutions to help borrowers avoid defaulting on the loan (Dodd, 2007). Lending institutions should create permanent solutions that will last the life of the loan. There are many aspects of the mortgage that could be modified including changing the terms, reducing the interest rate, reducing the principal, reamortizing the loan, or creating escrow for the taxes and insurance on the loan (2007).

The third Dodd principle is to dedicate teams and resources to ensuring that modifications to loans happen "on the scale required in the time required" (2007). In other words, Lending institutions should employ sufficient resources to follow up with borrowers and make sure that they are capable of handling a reset of their mortgage to an adjustable rate. Where feasible, lenders should work with non-profits and third party counselors (Dodd, 2007).

The fourth principle that Senator Dodd and the industry agreed upon is low cost refinancing. For borrowers that are eligible, "refinancing to prime loans should be made in as streamlined and low-cost fashion as possible" (2007). Prepayment penalties and other costly fees keep many borrowers from seeking to refinance. If lending institutions adopted these principles, they would need to modify these at-risk loans to allow borrowers to refinance to a prime mortgage without charging them prepayment penalties or fees to do so.

Credit Availability is the fifth principle Senator Dodd proposed. Government Sponsored Enterprises (GSEs), such as Fannie Mae and Freddie Mac, "should work with lenders to make credit available to borrowers through new products and services" that help protect borrowers from resetting ARM's (2007). The idea is to make affordable, long-term solutions that are still profitable for lenders, servicers, investors, and borrowers. FHA should provide insurance for these loans and GSEs should look into purchasing subprime portfolios and making these changes as needed (Dodd, 2007).

The sixth principle is to maximize success and minimize the damages. All the participants "understand that not every foreclosure can be prevented nor every home saved" (Dodd, 2007). The mortgage industry should work to minimize damages to borrowers, communities, and the mortgage markets if there is no other option but foreclosure. In foreclosure, everyone involved looses money as well as the community because it drives down property values throughout the area (Ernst et. al., 2006). As multiple houses in an area come under foreclosure, the whole area becomes devalued which can lead to more foreclosures. This principle strives to minimize the number of foreclosures in order to prevent this domino effect.

The final principle proposed is accountability. "A system needs to be developed in order to measure and track progress on achieving the principles outlined" so that the process can be transparent (Dodd, 2007). This brings those lending institutions that have engaged in predatory lending to task and helps weed out bad practices. Accountability is necessary to stabilize subprime market.

Regulatory Agencies

The regulatory agencies[3] have incorporated the Dodd principles and created new regulations for the mortgage industry. These new regulations address the following areas of concern: risk management practices for lenders, new arrangements for borrowers to work out loans that are in default, consumer protection principles that help ensure safe underwriting practices, control systems to monitor how everything is implemented and supervisory reviews to verify all these practices continue to work. With these new regulations come better protections for consumers that have subprime loans and also tighter underwriting rules that will make it more difficult for borrowers to receive subprime loans.

Risk management practices would hold subprime loans to the same standards as any "prudently underwritten real estate loans" and they should "reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt" (Federal Register, 2007). This will limit the amount of low-document or no-document loans as well as ensure that borrowers who choose subprime loans will be able to afford the payments over the life of the loan. These new standards will limit the availability of credit.

In order to arrange for borrowers that are currently in default on their subprime loans, the agencies need to convince lending institutions to "pursue reasonable workout arrangements with borrowers" (Federal Register, 2007). Each borrower has different needs so each arrangement will differ. Lending institutions will need to work with borrowers to determine what the need is and how to best tailor the loan to meet their needs and still be beneficial to the lender.

There are two key consumer protection principles outlined by the regulatory agencies. First, "approving loans based on the borrower's ability to repay the loan according to its terms" (Federal Register, 2007). Second, lending institutions should provide "information that enables consumers to understand material terms, costs, and risks of loan products" at the time when borrowers are looking for products (Federal Register, 2007). This places the burden on lending institutions to educate their customers on the loan products that they offer. Borrowers will also have more information on a wider variety of products, enabling them to pick the best products for their situation.

For lending institutions to follow through with these regulations, these institutions will need to "develop strong control systems to monitor whether actual practices are consistent with their policies and procedures" (Federal Register, 2007). Institutions will need to establish programs to ensure that they are adhering to these new regulations and providing services to borrowers that are in the best interest of both parties. Lending institutions' relationships with mortgage brokers will be key.

Before the subprime mortgage meltdown "fly-by-night brokers were peddling low-interest mortgages to bad credit risks with no documentation and no money down" (Pearlstein, 2007). As lending institutions scrutinize the mortgage brokers before funding their loans, these institutions should have the power to influence and stop mortgage brokers from making bad loans.

The regulatory agencies will take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws or engage in other types of "unsound lending practices" (Federal Register, 2007). Banks are "raising rates and tightening terms for their best borrowers" in order to hedge off any problems from the subprime market (Pearlstein, 2007). The regulatory agencies want to ensure that lending institutions meet these new regulations and that the subprime market can be restored to the levels before the foreclosure problems of late 2006 and early 2007.

Congressional Action

Recently, Congressmen and Senators have become concerned with the nature of the subprime market, and they too have weighed in on the issue. Lawmakers are also looking at North Carolina's recently passed mortgage reform bill that tightens standards for subprime mortgage and includes "a ban on no- and low-document loans" as well as eliminating prepayment penalties (Kaper, 2007). Representatives Mel Watt (D-NC), Barney Frank (D-MA), and Brad Miller (D-NC) introduced legislation that would incorporate the major provision of North Carolina's bill, in order to introduce similar steps nationally (Kaper, 2007). They also began the process of

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implementing many of the regulatory agencies reforms and the Dodd principles into federal law in the same bill.

With H.R. 3815, The Mortgage Reform and Anti-Predatory Lending Act of 2007, Congressional lawmakers are hoping to limit subprime mortgages and curb the mounting foreclosures (Frank, 2007). The reforms include "registering mortgage originators to prevent abuses," ensuring responsible lending, preventing discriminatory and abusive leading, and establishing a nationwide liability standard as well as many other reforms to help ensure subprime mortgage market stability and slow the increasing rate of foreclosures (Frank, 2007). The current bill has been sitting in the Senate with no action taken for months (Cho, 2007). The Senate has recently promised to consider this piece of legislation soon and vote on the bill.

THE BUSH ADMINISTRATION'S CONUNDRUM

The Bush Administration, frustrated with the lack of movement in the Senate since the subprime market crisis started, met with mortgage industry leaders and was able to reach an agreement with the mortgage industry to freeze interest rates on subprime mortgages (Cho & Irwin, 2007). This would allow those with credit scores below 660 to get a freeze on their loans at the introductory rate for up to 5 years. This measure is to help those who cannot refinance out of their current mortgage, which would allow them time to escape out of their subprime mortgages.

The idea is that the housing market will correct itself in 5 years and that housing prices will increase again. At some point, the value of the subprime borrower's home will be greater than the loan. Also, this would allow the borrower enough time to improve their credit rating. With better property values and higher credit ratings, borrowers should be able to refinance their subprime mortgage into something better. All of this is contingent on the housing market moving upward within that 5 year time period. If real estate recession continues, then all that is accomplished is to delay the problem for five more years.

Some, like Senator Dodd, have criticized the Bush Administration for being late and not providing enough help to everyone suffering with a subprime mortgage (Cho & Irwin, 2007). Some borrowers were also disappointed because the agreement started on January 1st 2008 and their loans adjusted before then (Andrews & Bajaj, 2007). Over all, it should help those families have the highest risk of foreclosure but does not help those that are already in foreclosure or those whose credit score is higher than 660.

The next step of the Bush administration was to help bolster a stimulus package that would stimulate growth in the economy by putting more money back into the hands of the consumers. With house prices falling and the economy in terrible shape, the Bush Administration built a stimulus package that was passed in Congress with some alteration (The Economist, 2008). The idea behind the stimulus package is that Americans will buy their way out of a recession if given the money to spend. Households will receive a $300 to $1200 tax rebate on their 2007 taxes depending on how many children they have (The Economist, 2008). Congress "moved with uncommon speed" to pass the $168 billion stimulus package (Herszenhorn, 2008).

This will not solve the current plummet of house prices but may actually aggravate the problem by increasing the national debt (Herszenhorn, 2008). By increasing the national debt, this stimulus package would then weaken the national economy and force housing prices down even further which would force more homes into foreclosure.

CONCLUSION

Subprime Mortgages that are poorly underwritten or predatory in nature are dangerous and are detrimental. Not all subprime mortgages are dangerous; many borrowers are able to purchase a home and afford their mortgage. As the market tries to correct itself from the difficult downturn due to large numbers of borrowers defaulting on their loans, those left in the market are caught in the middle with home prices devaluing and forcing more of them into foreclosure. Fear rises as the economy slips into a recession.

The government has tried to step in to protect citizens and help to stabilize the market. With new laws and rules of conduct, lending institutions have reformed their practices. While the market has started flushing out companies that have engaged in predatory lending, the process has only started, which means that the end of the issue is still not in sight.

The federal regulatory agencies are the only ones that have positive momentum behind them. They are working on long term solutions that should help to build confidence back up in the housing market. It addresses the root of the issue with predatory lending and puts stiff penalties for institutions that engage in such practices.

The new regulations seem to be helping, but for many borrowers they have come too little, too late. The rising foreclosures and spiraling property values have set the stock market on the slide because of investors losing money on the securitized loans. The hope is that the problem was caught in time to stop huge losses and to create long-term stability in the market. The new principles for lending institutions will hopefully protect borrowers and provide them a way out of the subprime mortgage nightmare.

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The Tri-Border Area's Link To The War On Terror

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Just how global is the Global War on Terror? For both IR theorists and US foreign policy makers, this question is a major concern. Never before in history has the United States taken such extensive action against a non-state enemy. Most of the current focus lies on the war in Iraq, as well as Afghanistan, but recent activities of Islamic terrorists in the Tri-Border Area of South America shows just how far-reaching the War on Terror needs to be. This paper attempts to examine the implications of the War on Terror for international relations theory and US foreign policy while doing a case study of terrorist activities and counter-terrorist measures in the Tri-Border Area.

INTRODUCTION: THEORIES AND POLICIES ON TERRORISM

The War on Terror presents a unique challenge for both IR theorists and policy makers alike. Though terrorism has been around for a long time, the terrorist threat we see today on such a massive, global scale is a relatively new phenomenon. The events of 9/11 and President Bush's subsequent declaration of a War on Terror present a shift in thinking in the area of international relations theory. Little work had previously been done on examining terrorism as such a massive threat to national and global security. Therefore, it is important to understand the implications of terrorism in IR and how each theory addresses the issue. US policy on this matter is evolving, and one can see clear differences in foreign policy before and after 9/11. Even today, the debate continues among IR scholars and theorists about how to approach such a unique challenge.

Scholar William Tow wrote, "At first glance, the terrorist attacks [of 9/11] represent the most recent and perhaps the most glaring failure yet in international relations analysts' quest to 'get it right' in terms of anticipating and responding to sudden and cathartic events in world politics" (Tow, 2003). Before September 11, the Bush administration was operating within a realist framework. However, they failed to understand the scope of the terrorist threat as "realism…is a worldview ill-equipped to deal with the challenges to security in the 21st century, as it greatly underestimates the critical role played by non-state actors" (Klarevas, 2004), such as al-Qaeda. Secretary of State Condoleezza Rice believed that, "state sponsors of terrorism had to be the primary targets of any counterterrorism policy" (Klarevas, 2004). This reflects the realist view that some blame for the failure of the US government to prevent the attacks of 9/11 and an increasingly unpopular war in Iraq.

By contrast, liberalism gives great value to the impact of non-state actors. Liberalism places emphasis on international cooperation, economic prosperity through globalization, and the importance of international institutions. For liberals, the course to victory in the war on terror looks very different. Former New York mayor, Rudy Giuliani said in *Foreign Affairs*, "The most effective means for achieving these goals [of victory] are building a stronger defense, developing a determined diplomacy, and expanding our economic and cultural influence," and making sure the international system works (Giuliani, 2007). It is this combination of tools that will, according to liberals, provide the means for victory in the War on Terror.

On the other hand, realism remains a very relevant theory despite the threat of non-state actor terrorists. Stephen Walt argues that realists like himself, Morgenthau and Kennan correctly predicted that the Vietnam War was a