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Navigating the Subprime Lending Industry

Leading Lawyers on Understanding the Subprime Collapse, the Causes of the Current Lending Climate, and the Industry's Pending Future

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Fallout and Survival in the Subprime Crisis

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The Subprime Mortgage Industry and the Crisis

The subprime mortgage industry was created to serve that portion of the population that otherwise could not enjoy the dream of home ownership due to income constraints and poor credit. Generally, consumers of subprime mortgages had low FICO or credit scores combined with a history of financial difficulty. Accounting for nearly one-fifth of all home loans, the subprime mortgage business was estimated at $600 billion in 2006.

Consumer behavior behind subprime mortgages is best exhibited by the average life of a subprime loan. The majority of subprime borrowers remained in their loans for a very short period of time—on average, less than eighteen months. Those borrowers who obtained these loans often refinanced within a very short time after the loan was originated. These loans were used as a way for borrowers to access the equity in their homes, which was then used to finance other consumer purchases. While specific consumer behavior by region is unknown, it is clear that consumers of subprime mortgage products used them as a way to finance their lifestyle. By refinancing, borrowers were able to pull out the equity in their homes and used that equity to finance retail purchases.

Owning a home has always been the American dream. For those fortunate enough to own a home, property values over the years have appreciated at modest and, in some cases, double-digit gains. For those first-time buyers looking to enter the market, most are unable to qualify for a traditional loan as they do not have the savings necessary to put 20 percent down. Escalating home values have made the cost of affording a home a larger percentage of individual income. To continue to sustain the growth in the housing market, lenders began to offer non-traditional loans. These loans were geared to the borrower who was a greater credit risk (i.e., the likelihood of default was greater). In most cases, these borrowers had low credit scores, little or no funds to make a down payment, and likely had experienced financial difficulty in the past.

To qualify, interest-only loans and adjustable rate loan products with very low teaser rates were created. Adjustable rate mortgages were offered to already financially challenged borrowers who were put into loan products such as “2/28” and “3/27” adjustable rate mortgages that offered very low fixed interest rates for the initial two to three years of the loan followed by periodic interest rate adjustments over the remaining life of the loan. These loans made it possible for borrowers to qualify as their income-to-debt ratios were lower. To compound the problem, lax underwriting standards allowed otherwise unqualified borrowers to qualify for a loan. Appraisal inflation and the failure to document income constituted two of the most abused underwriting failures. Once interest rates began to adjust upwards, most of these borrowers were unable to continue making their mortgage payments. Sale of the property was not an option as most borrowers discovered they were “upside down” in their homes (i.e., the debt was greater than the value of the property). Unable to pay and unable to sell, most borrowers had no choice but to walk away and lose their homes to foreclosure.

As a result, foreclosure rates across the country have soared. And in turn, financial institutions that invested in collateralized debt obligations began to experience erosion in the value of their investment. The meltdown in the subprime lender market has caused a tightening of lending guidelines that will likely continue to tighten over the course of time. The resulting implication is that subprime borrowers will be unable to qualify for new loans or will be unable to refinance their current loans. When combined with rate increases, the corresponding default and foreclosure rates will continue to escalate.

Subprime borrowers are now unable to refinance or qualify for new loans because of heightened lending standards. Collectively, the large institutional investors that purchased collateralized debt obligations have had to write off billions of dollars of investments as default rates on the underlying real estate loans backing those investments have skyrocketed. Warehouse lenders and others that provided credit to nearly all of the subprime lenders have stopped funding. Without funding, subprime lenders have no capital to originate new loans. Additionally, with foreclosures escalating, the federal government is now seeking to intervene.

Warehouse lenders, repurchase participants, and investment banks are the groups most involved with the subprime mortgage industry. As a result of the meltdown in the subprime market, warehouse lenders and repurchase participants have stopped loaning money to/buying loans from subprime lenders (also referred to as the "originators"). Similarly, financial institutions and investment banks that invested heavily in securities that were backed by collateralized debt obligations have written down a substantial amount of their investments.

These parties are now focused on recovering their losses. In the case of warehouse lenders and repurchase participants, the originators were unable to respond to margin calls and repurchase requests. In the case of investment banks, they have been forced to write off billions of dollars of investments that were made in real estate-backed securities known as collateralized debt obligations. These write-offs have forced several chief executive officers of investment banking firms to resign their positions. Estimates put the combined loss to investment banks because of their investment in collateralized debt obligations as high as $250 billion.

Participants in the subprime mortgage market are motivated to preserve their financial investment or exposure. Subprime lenders are motivated to remain in business to preserve value for shareholders and, to the extent that remaining in business is not an option, maximizing value for the benefit of creditors. Those who provided credit to the originators are motivated to reduce further financial exposure and minimize the size of their loss.

Objectives are determined by the current status of the subprime lender. The objective for a subprime lender that is continuing to operate is much different from the objective for a lender that has lost funding. With the exception of the very large financial institutions that may have devoted a small percentage of their business to originating subprime loans, the majority of subprime lenders are hanging on by a thread, or have already collapsed. Once collapsed, maximizing value for creditors requires a determination of what value, if any, can be realized from the sale of existing assets. To the extent that there are residuals, a servicing platform, and/or loans that can be sold, unsecured creditors may see a nominal return. Otherwise, the likelihood of a return is bleak. In these cases, creditors may seek to tap a directors and officers insurance policy and pursue claims against directors and officers of the originator as a means to create value.

Attorneys handling subprime mortgage issues must be well versed in those provisions of the Bankruptcy Code that render useless many of the code's enforcement provisions. Since the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the Bankruptcy Code has expanded the protections available to counterparties to certain qualifying derivative transactions. For instance, pursuant to Section 362(a) of the Bankruptcy Code, the filing of a bankruptcy immediately creates a stay that enjoins persons from taking certain acts against the debtor. However, under the Bankruptcy Code's safe harbor provisions, a counterparty that is a qualifying party to a qualifying transaction may terminate the transaction and foreclose on its collateral after the commencement of the bankruptcy. Qualifying parties include, among others, repossession participants, financial institutions, financial participants, swap counterparties, and master netting agreement participants. Qualifying transactions include, among others, repossessions, securities contracts, swap agreements, and master netting agreements.

Unlike other parties to a contract, a qualifying party to a qualifying transaction may set off if the setoff relates to a margin payment or a settlement payment arising out of the qualifying contract. Specifically, according to Section 362(b)(6) of the Bankruptcy Code, the filing of a bankruptcy does not stay:

> The offset by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any mutual debt and claim under or in connection with…securities contracts, as defined in Section 741 of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in Section 101, 741, or 761 of this title, or settlement payment, as defined in Section 101 or 741 of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by, pledged to, under the control of, or due from such participant.

Likewise, pursuant to Section 362(b)(7), the filing of a bankruptcy does not stay:

> The setoff by a repo participant or financial participant, of any mutual debt and claim under or in connection with repurchase agreements that constitutes setoff of a claim against the debtor for a margin payment, as defined in Section 741 or 761 of this title, or settlement payment, as defined in Section 741 of this title, arising out of repurchase agreements against cash, securities, or other property held by, pledged to, under the control of, or due from such repo participant or financial participant to margin, guarantee, secure, or settle repurchase agreements.

Additionally, a qualifying transaction is also immune from the avoidance powers that may be utilized by a debtor-in-possession or a trustee in bankruptcy to set aside and recover transfers made prior to the bankruptcy. Specifically, Section 546(e) of the Bankruptcy Code provides that "a transfer that is a margin payment, as defined in Section 101, 741, or 746 of this title, or settlement payment, as defined in Section 101 or 741 of this title, made by or to a commodity broker, forward merchant contract, stockbroker, financial institution, financial participant, or securities clearing agency, that is made before the commencement of the case, except under Section 548(a)(1)(A) of this title," is exempt from avoidance.

Sections 555, 556, 559, and 560 of the Bankruptcy Code allow a qualifying party to a qualifying transaction the ability to liquidate, terminate, and accelerate qualifying derivative transactions.

With regard to securities contracts, Section 555 of the Bankruptcy Code provides that a contractual right to liquidate, terminate, or accelerate shall not be stayed, voided, or limited:

> The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract as defined in Section 741 of this title because of a condition of the kind

> specified in Section 365(3)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title.

Section 556 of the Bankruptcy Code provides similar protection to qualifying parties to qualifying commodities and forward contract transactions:

> The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract, as defined in Section 761 of this title, or forward contract because of a condition of the kind specified in Section 365(e)(1) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title.

Qualifying parties to a qualifying repurchase transaction are entitled to protection under Section 559 of the Bankruptcy Code, which provides, in part, as follows:

> The exercise of a contractual right of a repo participant or financial participate to cause the liquidation, termination, or acceleration of a repurchase agreement because of a condition of the kind specified in Section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title.

Swap agreements are covered by Section 560 of the Bankruptcy Code, which provides, in part, as follows:

> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in

> Section 365(e)(1) of this title or to offset or new out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more sway agreement shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

The foregoing safe harbor provisions apply to "securities contracts," which are defined under Section 741(7) of the Bankruptcy Code as:

(A) means

I. a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan or any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option;
II. any option entered into on a national securities exchange relating to foreign currencies;
III. the guarantee by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option;
IV. any margin loan;

V. any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

VI. any combination of the agreements or transactions referred to in this subparagraph;

VII. any option to enter into any agreement or transaction referred to in this subparagraph;

VIII. a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), (iv), (v), (vi), or (vii), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under the subparagraph, except that such master agreement shall be considered to be a securities contract under the subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), or (vii); or

IX. any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562; and

(B) does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan.

The 2005 amendments to the Bankruptcy Code included for the first time the term "financial participant," which is defined under Section 101(22A) as:

> An entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of Section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding on any day during the previous fifteen-month period, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) on any day during the previous fifteen-month period.

Faced with the ever-increasing problems in the subprime market, attorneys must be versed in those provisions of the Bankruptcy Code that deal with derivative transactions as well as those that provide safe harbor protections for certain derivative transactions.

The subprime mortgage industry fueled not only a surge in the residential housing market, but also transcended and crossed over into other segments of the economy. As a result, the meltdown in the subprime mortgage industry has affected the construction industry, and will also trickle down to retailers, manufacturing, and other segments. Unable to refinance, and unable to finance their lifestyle by using the equity in their homes, consumers are struggling to hold onto their homes. As a result, they no longer have the disposable income to make home improvements and pay off existing credit card balances. Similarly, they no longer have the financial resources to make retail purchases. This will affect every segment of the retail economy from home improvement stores to department stores.

What can be learned from this is that the residential housing market plays an important role in the success of the U.S. economy. Investor and consumer confidences are shaken to the core when troubles in the housing market continue to get worse, not better, over the course of time.

The major financial elements of the subprime mortgage issue can be traced to rising default/foreclosure rates, decreasing property values, and the lack of capital to originate new loans. Borrower wealth has decreased as the largest single asset for most borrowers is their home. Liquidity for subprime borrowers is nearly nonexistent as they are usually unable to refinance to gain access to the equity in their homes and, more likely, any equity they did have has evaporated due to the decrease in property values. As for the capital markets, liquidity is scarce as most investors are staying away from risky, capital-intensive investments tied to subprime lending.

Rate increases combined with the inability of borrowers to refinance into new loans are driving the default trend for subprime mortgages. Residential defaults throughout the country are up with states such as Nevada, Florida, Ohio, Colorado, and California experiencing some of the highest foreclosure rates in the country. There would appear to be a correlation between areas that have seen significant property appreciation (often the result of inflated appraisal valuations) and the default rate. Those areas that saw significant property appreciation are now experiencing a decline in property values. A home that a year ago was valued at $500,000 may only be valued at $450,000. Assuming the homeowner put little or no money down, they now find themselves in a position where the loan amount is greater than the value of the property. In most instances, the homeowner is unable to refinance because of the negative loan-to-value ratio, and is unable to keep up with the increasing rate adjustments. As a result, most homeowners have walked away and mailed the keys back to the bank. Much of the blame falls on the shoulders of subprime lenders who lured many borrowers into risky loans. Many of these lenders failed to adhere to their own underwriting guidelines, and relied on inflated property valuations.

The ability of subprime lenders to originate loans is based upon the ability to access capital so they can continue making loans. Warehouse lenders and repurchase participants supplied capital to subprime lenders. Institutional investors acquired pools of loans that were held in special purpose entities and then sold interests in these pools as securities to investors across the world. When providers of credit exercised margin calls, requiring originators to post additional collateral or requiring originators to repurchase loans because of early payment defaults, originators simply did not have the financial resources to cover these cash calls. The inability to cover margin calls and repurchase obligations resulted in defaults under warehouse lines of credit and repurchase agreements.

Once a default occurred, the lenders stopped funding. Without the ability to fund new loans originators were also unable to raise capital through the sale or securitization of loans. For those loans that could be sold or securitized, the profit margins originators could expect to realize grew increasingly smaller as higher-than-average default rates on these loans directly impacted the value of the loans being sold. Investment banks saw the value of real estate-backed securities plummet. Unable to originate new loans, subprime lenders were forced to cease business and attempt to liquidate their remaining assets to maximize value for creditors.

Unlike other economic bubbles that have burst, the meltdown in the subprime market will cause widespread economic turmoil in multiple segments of the U.S. economy. The subprime crisis will result in problems for most, if not all, sections of the retail, manufacturing, and construction industry. Retailers will experience continued contraction from shoppers who are limiting the amount of money they spend as more of their disposable income is consumed by higher mortgage payments. Manufacturers will decrease orders for goods. Developers that target first-time homebuyers will find an ever-dwindling population of qualified buyers. This will affect the construction industry as the number of new home permits will continue to fall in 2008 and 2009. Similarly, those retailers that service the home remodeling industry will see a decline in sales as consumers are unable to obtain home equity loans or refinance existing homes to pull equity out of the house to pay for improvements.

As defaults and foreclosures skyrocket, the President is now asking lenders to forego resetting interest rate adjustments. It is estimated that nearly $361 billion in subprime loans are set to adjust upwards in 2008. This demonstrates not only the severity of the problem facing borrowers who are on the verge of losing their homes to foreclosure, but it also highlights the impact this crisis has caused on other parts of the economy. On December 20, 2007, the President signed into law the Mortgage Forgiveness Act of 2007. This new law amends the Internal Revenue Code to exclude from the calculation of taxable income that portion of a home mortgage loan that is ultimately forgiven by a lender.

We have not seen the bottom of the trough. The economy will experience continued downturn, because of the fallout from the subprime crisis, through all of 2008 and 2009, and likely into 2010. The economic downturn will permeate across multiple sectors of the economy. From retail to construction, small and large business that rely upon consumer spending will face continued economic pressure as consumers reduce their spending.

It is unclear whether there will ever be a rebound in the subprime mortgage market. Certainly, it can be expected that both underwriting guidelines as well as regulation of mortgage originators will be increased. In the end, the dream of home ownership may not be within the reach of many Americans. The real impact this may have on the economy will likely not be known for years.

Concerns

The biggest issue for subprime mortgage lenders today is the inability to access capital markets and obtain the capital necessary to originate loans. The subprime mortgage business is a capital-intensive operation. To generate the capital necessary to continue to fund new loans, most subprime mortgage lenders operate three separate but related businesses: loan origination, loan sales, and loan servicing. While operating separately, each business unit provides the capital required for the subprime lender to operate. For instance, regardless of whether the subprime lender originated loans through wholesale or retail channels, it obtained capital from financial institutions that provided warehouse lines of credit (e.g., a lender that advances monies secured by an interest in the underlying mortgage loans that were made with the monies advanced by the lender) or through the use of repurchase agreements (e.g., the originator sells the underlying loan to the financial institution (a.k.a. the repurchase participant) in consideration for the transfer of funds with the understanding that the originator will buy back the loan from the repurchase participant at a later date.

In addition to borrowed funds, an originator can also raise capital through securitizations and loan sales. In a securitization, loans are packaged with other loans and placed in a special-purpose entity whose equity is then sold to investors on Wall Street. For those loans pledged as security for a warehouse line, the originator sells the loan to the warehouse lender to satisfy the warehouse line of credit or, in the case of a repurchase agreement, the originator might buy back the loan from the repurchase participant and then resell it. Lastly, the subprime lender can raise additional capital through loan servicing. In this instance, the originator handles the collection and remittance of monthly principal, interest, and impound payments for each loan, whether on its own behalf or for the benefit of the warehouse lender, repurchase participant, or those third parties who purchased loans.

As home values dropped and interest rates on subprime loans adjusted upward, the number of delinquencies and, correspondingly, the number of defaults and foreclosures on subprime mortgages increased. This directly affected the ability to raise new capital. Warehouse lenders and repurchase participants enforced their right to make margin calls that required originators to post additional cash security. In the end, most originators were unable to answer the margin call and were declared to be in default and, by virtue of the default, either had their warehouse lines frozen or found that the repurchase participants refused to acquire new loans. The originator's capital requirements were further stretched when repurchase participants exercised their right to require the originator to buy back those mortgage loans that experienced an early payment default. In connection with selling loans, originators typically provide representations and warranties that borrowers will make their initial mortgage payments. An early payment default by a borrower constitutes a default of the representation and warranty, requiring the originator to buy back the loan from the repurchase participant. Finally, as default rates on subprime mortgages escalated, subprime lenders found it increasingly difficult to sell loans on the secondary market, which directly affected the ability to raise additional capital.

That delinquency and foreclosure rates will continue to accelerate and, in turn, that real estate-based securities will continue to decline in value is of major concern for lenders and the banking industry. Despite action taken by the Federal Reserve, which cut interest rates three times in 2007 to stabilize the credit markets and, when that did not work, slashed the federal funds rate by an additional three-quarters of a percent on January 22, 2008, (representing the single largest reduction in twenty years), the real estate market continues to deteriorate as foreclosure rates contain to rise and residential homebuilders are either liquidating or mothballing projects. *The Wall Street Journal*, relying on information provided by economists at Moody's, reported that there are $2.45 trillion in outstanding risky mortgages, which includes subprime, interest-only loans, mortgages that exceed Fannie Mae lending limits, and others, and that as many as a quarter of these risky mortgages could suffer defaults. Increased defaults will further continue to erode the investments made by banks in real estate-based securities. While the value of the most risky securities plummeted early in 2007, investors are now starting to see declines in the more highly rated real estate-backed securities. The erosion of the subprime market also affects new home purchases as borrowers who may have been able to qualify for a home loan one year ago are now unable to qualify. This directly affects residential builders that focus on consumers who are looking to enter the market as well as those consumers who are looking to trade up to larger, more expensive homes. Given the current state of the economy, it is likely that the housing market will continue to deteriorate well into 2008, and some economists are predicting that the housing slump will last into 2009 and 2010.

As losses continue to grow, the amount of money available to lend will be reduced. With the exception of home loans made to qualified buyers, lenders will likely redirect their funds away from the consumer housing market and focus their attention on lending to companies. Investment banks are addressing the concern by taking enormous write-downs on their investments in collateralized debt obligations.

The largest concern for existing borrowers is the ability to make their monthly payment as interest rates adjust higher and, for prospective borrowers, the ability to qualify for a home loan. As interest rates adjust upward, monthly payments will adjust upward as well. In some cases, a fully adjusted interest rate on a subprime loan could reach as high as 11 percent, which may represent a several-hundred-dollar increase in a borrower's monthly mortgage payment. As the finances of most borrowers are already stretched thin, an increased monthly payment will likely result in the inability to make a monthly mortgage payment. Estimates are that nearly three million loans will experience a payment default in 2007 and 2008, and of this number, nearly two-thirds of the borrowers will lose their homes to foreclosure. Because of the meltdown, lending guidelines have gotten tougher. Prospective borrowers, who a year ago would have easily qualified for a mortgage, are now unable to qualify.

It was not just Wall Street investment banks that made large investments in real estate-backed securities. Many foreign financial institutions acquired large investments in collateralized debt obligations and subsequently have been forced to write down billions of dollars on the value of their investments. The extent of the impact these write-downs will have on global economics has not yet been felt. Repercussions could include decreased global lending activity. Since the United States has been impacted most severely, there has been very little mention as to what the global impact, if any, may be from the subprime mortgage crisis.

Impact, Changes, and the Future

Very little can be done with respect to those subprime loans that have already been made. Going forward, the ability of borrowers with subprime credit to qualify for a home loan will be much more difficult. There will be an adjustment in the nature of loans made to risky borrowers, and there will be a corresponding adjustment (or lowering) of property values. Lenders will likely be required to comply with more stringent underwriting guidelines. Borrowers will need to better manage their finances and lower their expectations relating to their buying power.

Investor confidence continues to be a problem. The stock market has fluctuated up and down over the past six months. The stock of nearly all publicly traded investment banks has fallen based on reported write-downs in the billions of dollars taken on investment in securities backed by collateralized debt obligations. The write-downs have been so dramatic that several chief executive officers, including Charles Prince of Citigroup and Stan O'Neal of Merrill Lynch, have resigned. Despite attempts by the Federal Reserve to prop up the stock market with multiple interest rate cuts, investors still appear concerned over the seemingly ever-growing meltdown of the housing market. Additionally, certain segments of the market, namely junk corporate debt, asset-backed commercial paper, and municipal bond markets, have slowed.

Default and foreclosures rates continue to rise across the country. The fact that interest rates on adjustable rate loans will reset to higher levels in 2008 will further raise default and foreclosure rates. In turn, many regional homebuilders have sought bankruptcy, and the larger national homebuilders have been forced to take significant write-downs on their real estate portfolios due to the decrease in land values. Those national homebuilders that have considerable cash reserves have mothballed their existing projects rather than continuing to offer steep discounts and incentives to potential buyers.

Many changes in the laws and rules for subprime mortgage practices have been proposed. These proposals are aimed at assisting prospective borrowers and current homeowners as well as regulating mortgage brokers.

Congress and the Federal Reserve Bank are behind these changes. Both the Senate and the House are working on bills that would make Federal Housing Administration loans available to subprime borrowers facing foreclosure. They are also proposing lowering the down payment requirement for those borrowers who qualify for federally insured loans. The House of Representatives is also advocating stricter standards for those who originate loans. A bill proposed by the House seeks to prevent loan originators from offering loans in states when they are under investigation by authorities in another state. The Federal Reserve has suggested new lending standards that would require borrowers to establish the financial ability to handle mortgage payments at the fully indexed rate, as opposed to the teaser rate payments. The Federal Reserve is also advocating new rules that would require lenders to clearly disclose mortgage information to borrowers.

The legal practice areas that will see the most impact from these trends in subprime mortgages include structured finance and bankruptcy. Lawyers practicing in structured finance helped create the mortgage-backed investment vehicles that were sold by Wall Street to investors around the globe. In addition, the bankruptcy/restructuring practice will be impacted.

Bankruptcy lawyers will be required to provide counsel and guidance on the sale and liquidation of many subprime lenders, as well as the liquidation of mortgage-backed investment vehicles.

Structured finance lawyers assisted parties in creating special-purpose investment entities through securitizing an income stream from a pool of assets that included real estate-backed loans that could then be sold as a security on Wall Street. Because of the collapse of the subprime market, structured finance deals have slowed considerably, and law firms that once maintained a large structured finance practice are scrambling to find other work for those lawyers and, in some cases, are releasing lawyers. In turn, there will be an up-tick in work for bankruptcy/restructuring professionals who will assist subprime lenders, warehouse lenders, and repurchase participants, as well as those investors who hold investments in collateralized debt obligations that may need to be liquidated. Like any market that is subject to cyclical changes, these practice areas require cautious growth and strategic planning.

The risk for all parties involved, resulting from the recent changes in the subprime mortgage market, is that the economy may not rebound for several years. Identifying other risks should not be difficult. If your business is reliant upon consumer spending, you are at risk of seeing decreased revenues. For instance, businesses most at risk include those that manufacture and provide services to the home improvement industry. Homeowners who are struggling to pay their mortgage will not be spending money on home remodeling or the installation of new windows or siding. Completing the risk assessment will allow a business owner to determine what adjustments are necessary to survive the economic downturn.

Completing the risk assessment is only one part of the process. Once the assessment has been completed, steps must be determined and implemented to weather the storm. Employee downsizing, holding off on capital improvements, and reduced compensation are some of the steps a business may need to institute.

Of those lenders still in business, some have completely stopped originating subprime loans, and those who are still originating have tightened their lending and underwriting criteria. Guideline changes may include requiring higher FICO scores, more rigorous income documentation, tougher appraisal standards, and, if proposed new laws are adopted, requiring borrowers to qualify for home loans at the fully adjusted interest rate, as opposed to the teaser rates.

Five Steps to Determine Impact

The five basic steps for interpreting the real impact of the subprime mortgage crisis on clients, businesses, and corporations are assessing exposure, working with professionals to develop a plan, implementation, monitoring, and flexibility.

The first step is assessing your business's exposure. The collapse of the subprime mortgage market has and will continue to spread across many areas of the economy. Housing, retail, and manufacturing businesses will all be impacted. The earlier in the curve that a business can identify its susceptibility to the problems associated with the subprime market, the quicker it can develop a plan to weather the likely downturn in business.

Once a business has assessed its exposure, it must develop a plan that will allow it to remain alive despite the drop in revenue. Where feasible, the business should work with a professional such as a financial adviser, who can pinpoint areas where costs can be reduced or contained, and focus on maximizing revenues. For instance, the plan may require downsizing the number of employees, spending less money on advertising, or focusing on a core business while discontinuing other business lines. Even if a financial adviser cannot be retained, the business must engage in this exercise.

The third, and perhaps most difficult step, is implementing the plan. This is where the rubber meets the road. A business can do all the planning and identify all the crucial steps necessary to preservation, but unless you have someone at the helm of the business who can make difficult decisions, the plan is worthless. Most often, the plan will require workforce reductions. It is never pleasant having to let go of valuable and trusted employees. Sometimes the plan requires that a particular line of business be abandoned. If the business line is one the owner of the company is passionate about, the decision to forego further investment becomes personal to the business owner, who may not be willing to let go of their "special project." The single biggest shortcoming facing most business owners is the inability to make difficult business decisions.

Once the plan is implemented, it must be constantly monitored, and its success or failure must be measured. In the case of a manufacturing facility, this may require a daily or weekly review. Monitoring performance is essential to ensuring the business does not stray from the plan. Because no plan is perfect, the business must remain flexible and able to accommodate change when required. By monitoring plan performance, the need for change can be identified and implemented as necessary.

Clients and businesses that are tied to or rely upon the residential housing market needed to have anticipated in late 2006 and early 2007 that there would be a significant slowdown in the economy to have prepared for the impact of the recent subprime crisis. Clearly, no one, including the most savvy investors, could have anticipated that the meltdown would have extended for this long and would have the impact it has had on Wall Street.

The most important issue now may be acknowledging that the economy may continue to remain sluggish and may not rebound until 2010. There are very few segments of the market that will not be touched by the meltdown of the subprime mortgage market. Chances are that if you have not already made adjustments to your business model in 2006, in anticipation of decreased revenues for 2007 and 2008, you have found or will find your business struggling to stay alive. Determining how to ride out the wave until 2010 will be the key to success for many businesses.

Cases, Statutes, Regulations

In closing, the following is a list of cases, statutes, and regulations relevant to this discussion of the subprime crisis:

- Claims by borrowers against subprime originators, lawyers, appraisers, and broker: *Barkley v. Olympia Mortgage Co. et al.*, 2007 U.S. Dis. LEXIS 61940 (E.D.N.Y August 22, 2007)
- Claims by shareholders against mortgage insurer and their officers: *Koesterer v. Washington Mutual et al.*, Case No. 07 Civ. 9801 (S.D.N.Y. November 5, 2007)

- Claims by shareholders against purchasers of residential mortgage-backed securities, investors of subprime-related securities, and their officers: *Harris v. Prince et al.*, Case No. 07 Civ. 9841 (S.D.N.Y. Nov. 7, 2007); *Cohen v. Bear Stearns Companies Inc.*, Case No. 07 Civ. 10453 (S.D.N.Y. November 19, 2007)
- Claims by participant of Employee Retirement Income Security Act plans against purchasers of commercial paper, subprime originator, and their officers: *Gray v. Citigroup, Inc.*, Case No. 07 Civ. 9790 (S.D.N.Y. November 6, 2007)
- Claims by borrowers against provider of credit to subprime lender: *In re First Alliance Mortgage Co.*, 471 F.3d 977 (Ninth Circuit 2006)

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