

## Abstract

### *Wealth and Inequality, Thinking About Communities and Individualism: Economic Connection in the Subprime Mortgage Crisis*

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*The collapse of a series of major financial institutions in the fall of 2008 precipitated a massive public rescue. The Troubled Assets Relief Fund (TARP) was established to provide a fund to buy non-performing subprime loans and mortgage-backed securities based on subprime loans from banks and investment firms that were on the edge of insolvency. Taxpayers were outraged that public funds would be committed without major conditions on how they were spent.*

*As the crisis proceeded, the public criticism increased for taxpayer support for the same financial institutions that caused the financial crisis that created the loss of jobs, home equity, retirement savings, and a general contraction of consumer and small business credit for millions of citizens. The public discourse about the palpable sense of outrage was strangely unstructured. Elected representatives were pressed to vote against the authorization of the TARP fund. Taxpayers whose modest fortunes were now hostages to the crisis were asked to ransom their future by providing unrestricted taxpayer support for the very actors who were responsible for their loss. The rhetoric of contract and private obligation converted the government into a conduit of public injustice, in which the needs of a small number of very large financial entities redistributed the wealth of the nation from the bottom and middle of the income scale to the very top.*

*This paper shows how the subprime crisis is an artifact of preexisting economic inequalities in which low income families were routinely locked out of the market for homeownership. The introduction of risk-based loan pricing that allowed bankers to design loan products and origination systems that purported to neutralize the risk of default. The new loan systems were based on aggressive distribution of loans in formerly credit-starved communities. The loan originators and every unit of the*

*investment and loan funding system collected commissions for each transaction. The loan originators did not have any legal liability for loans that failed. In fact, they were compensated for repeatedly refinancing loans to the same borrowers, each time for a new fee. To compensate for the risk created by reckless lending practices that matched loans that were not suitable for borrowers, investors were promised high yields.*

*The heart of the new subprime lending system was the financial “innovation” of the loan securitization. Loans were placed into pools, divided into separate interests and given high credit ratings that suggested that there was little risk of default. As the securities were sold with the newly attached credit rating, the managers of the pools of investment capital that purchased these funds received extreme bonuses and the CEOs of the investment banks and commercial banks that purchased the mortgage-backed securities were rewarded for failure.*

*I make three arguments here. First, the combination of the commission and compensation structure for subprime loans, the pooling of loans into vast, complex pools of securities constituted an inequality machine. The bottom quintile of the income scale was the first targets for subprime loans. The top 1 percent of income earners was disproportionately members of the new financial engineering sector. The inequality machine operated in an arena facilitated by the legal theories of law and economics.*

*Second, once the crisis began state law enforcement efforts to obtain economic restoration to the victims of the securitization inequality machine were placed in direct opposition to the private contract claims of recipients of bonuses and securitization agreements. Greenwich v. Countrywide Mortgage is the first case to apply a traditional model of contract theory to resolve the conflict in favor of the contracts of investors. Greenwich does not address the public law claims of homeowners holding subprime loans with predatory features. In the narrow, private contract model, a contract is a contract, is a contract. The public claims for restoration could not abrogate, nor mitigate the mortgage originators obligation to pay inflated contractual returns to investors.*

*Third, I provide a model for how to resolve this conflict. My model of economic justice relies on three ideas. First, I draw on common law doctrines that mitigate the conventional contract claims of investors in pools of securitized mortgages. Second, I consider the deficient procedural posture in which cases like Greenwich will be resolved. The action pits a private investor against the private loan originator and securitizer. Without a direct representative of public concerns there is no way to consider the full range of affected parties to the decision. This presents the classic case for mandatory intervention of right. Finally, I turn to Rawls who offers an opportunity to consider how the extreme interconnectedness of the securitized loan creates a “veil of ignorance” in which the conflict between the narrow private contract theory and the public claims for restoration and justice to seek relief from predatory loans can be resolved by assuming that everyone has an equal chance of becoming the party who is on the disadvantaged side of any legal rule.*

