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Subprime Lending, Foreclosure and Race

An Introduction to the Role of Securitization in Residential Mortgage Finance

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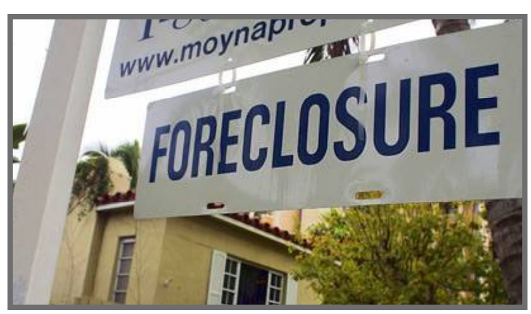

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SUBPRIME LENDING, FORECLOSURE AND RACE: AN INTRODUCTION TO THE ROLE OF SECURITIZATION IN RESIDENTIAL MORTGAGE FINANCE

Christopher L. Peterson*

In recent years, Wall Street financiers opened up a new frontier of home mortgage lending to Americans of relatively modest means with minimal down payments and through exotic, untested financial products.[1] Capital markets largely funded this new breed of aggressive subprime mortgage finance through "securitization"—the process of bundling assets, such as mortgage loans, into large pools and then reselling those assets as securities to investors.[2] Financiers justified this new private "subprime" home mortgage market to leaders and to the American people with a promise of new opportunities for home ownership.[3] Today, the course of events has proven this promise to be, at least for the time being, empty.[4] Millions of Americans borrowed money against their homes and now cannot afford to repay. Current estimates suggest that over six million mortgages—nearly 13% of all American residential loans—will end in foreclosure by 2012.[5] After years of frenzied investment in risky home mortgages sold to investors outside the traditional public secondary market channels, the American financial markets are now facing financial upheaval and the prospect of structural change of a magnitude not seen since the Great Depression.

This essay attempts to provide a short, accessible introduction to the evolution and structure of the American home mortgage lending industry with particular emphasis on how securitization of subprime home mortgages led to the current foreclosure crisis. Initially, Part I of this summary briefly describes the early American mortgage lending market before and after Franklin Roosevelt's "new deal." Next, Part II

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* Professor of Law, University of Utah, S.J. Quinney College of Law. This introduction to securitization, prepared for the Ohio State University Kirwan Institute for the Study of Race and Ethnicity's conference on Subprime Lending, Foreclosure, and Race, is based largely on background material written for an earlier publication. For a complete discussion please *see*: Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929118.

[1] DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 40 (2004).

[2] The finance industry does not have a universally agreed upon definition of the terms "securitization" or "structured finance." *See* Henry A. Davis, *The Definition of Structured Finance: Results from a Survey*, 11 J. OF STRUCTURED FIN., Fall 2005, at 5. However, for purposes of this Article "securitization" will refer to the process of pooling assets, such as mortgage loans, and then reselling them to investors. ANDREW DAVIDSON ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 3 (2003). "Structured finance," in turn, refers to the process by which securitized assets are made more desirable to investors, such as by dividing the income into securities with different credit risks and maturation dates, or by isolating the assets from the risk that the originator of the assets will declare bankruptcy. *Id.* In practice, the notions of securitizing and structuring are often used interchangeably. *See, e.g.*, STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (Adam D. Ford ed., 3d. ed. 2002 & Supp 2005); JAMES A ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3-5 (1988) ("Credit securitization is the carefully structured process whereby loans and other receivables are packaged, underwritten, and sold in the form of securities (instruments called asset-backed securities).").

[3] Richard A. Oppel, Jr. & Patrick McGeehan, *Lenders Try to Fend Off Laws on Subprime Loans*, N.Y. TIMES, April 4, 2001, C1.

[4] CENTER FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON Homeownership 2 (2007), *available at* http://www.responsiblelending.org/issues/mortgage/research/subprime-lending-is-a-drain-on-home-ownership.html.

[5] *Foreclosures to Affect 6.5 Mln by 2012*, REUTERS, Apr. 22, 2008, *available at* http://www.reuters.com/article/bondsNews/idUSN2233380820080422.

of this essay summarizes the evolution and operation of subprime mortgage securitization. Part III concludes with observations on how securitization encouraged poor underwriting practices and predatory loan terms.

I. THE EARLY SECONDARY RESIDENTIAL MORTGAGE MARKET

A. Simple Origins: Two Party Mortgage Finance

The earliest American home mortgage lending institutions were small cooperative groups of neighbors and friends called building societies. Modeled after similar British institutions formed in the late eighteenth century, American building societies first appeared in 1831.[6] In the first building societies, members of the group agreed to make a weekly contribution to a common building fund.[7] In return, the society paid for the construction of a home for each member of the group, one family at a time.[8] All members were obliged to continue making contributions until every member obtained a home, at which time the society terminated.[9] Throughout the nineteenth century, building societies became more popular, eventually shedding their terminal nature, employing professional management, and taking savings deposits instead of mutual contributions.[10] By the late nineteenth century, U.S. building societies were more commonly referred to as "building and loans," a label which later morphed into "savings and loans," and eventually into today's term "thrifts."[11] Commercial banks generally refused to make mortgages, eschewing the liquidity and risk problems of this type of credit.[12] However, in the mid-to-late-1800s, mutual savings banks,[13] private mortgage lending firms, and some insurance companies joined building and loans in making home mortgages.[14]

Despite these sources of credit, by the beginning of the twentieth century, consumers hoping to own a home had quite limited financing options. Most mortgages required a large down payment of around 40 percent of the home purchase price.[15] Moreover, early twentieth century mortgage loans had terms typically averaging between three and six years.[16] These short repayment durations necessitated high monthly payments, often followed by a large balloon payment of the remaining balance, due at the end of

[6] M. MANFRED FABRITIUS & WILLIAM BORGES, SAVING THE SAVINGS & LOAN: THE U.S. THRIFT INDUSTRY AND THE TEXAS EXPERIENCE 1950-1988, at 12 (1989); Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL'Y DEBATE 147, 154 (1996).
[7] MARK BOLEAT, THE BUILDING SOCIETY INDUSTRY 3 (1982).
[8] Rhoda James, Cosmo Graham & Mary Seneviratne, *Building Societies, Customer Complaints, and the Ombudsman*, 23 ANGLO-AM. L. REV. 214, 214-15 (1994).
[9] BOLEAT, *supra* note 232, at 3; *Benefit Building Societies*, 29 L. MAG & L. REV. Q.J. JURIS. 3D SEV 323, 324-25 (1870). *See also* Benefit Building Societies, 14 L. REV. & Q.J. BRIT. & FOREIGN JURIS. 1 (1851) (discussing legal foundations of mid-nineteenth century building societies).
[10] Lea, *supra* note 6, at 155.
[11] *Id.* at 156. Of course today's thrifts bear little resemblance to their nineteenth century forebears. Contemporary thrifts are often indistinguishable from banks and engage in a virtually unlimited range of business and consumer financial services. For more thorough treatment of this commercial evolution, see generally BOLEAT, *supra* note 7; FABRITIUS & BORGES, *supra* note 6.
[12] IMMERGLUCK, *supra* note 2, at 33.
[13] Some state legislatures chartered mutual savings banks which had some characteristics of building and loans and some characteristics of traditional commercial banks. THOMAS B. MARVELL, THE FEDERAL HOME LOAN BANK BOARD 4 (1969). The primary focus of the first savings banks was to take small deposits to encourage thrift in working class communities. Immergluck, *supra* note 2, at 34-35. By the late 1800s, they had also become an important source of mortgage finance. Lea, *supra* note 6, at 156.
[14] Lea, *supra* note 6, at 156.
[15] Kenneth A. Snowden, *Mortgage Rates and American Capital Market Development in the Late Nineteenth Century*, 47 J. ECON. HIST. 671, 675 (1987).
[16] *See* D. M. Frederiksen, *Mortgage Banking in America*, 2 J. POL. ECON 203, 206 (1894); Snowden, *supra* note 15, at 675.

the loan term.[17] Relatively few families could overcome these financial hurdles. Moreover, lenders had both formal and informal policies discriminating against minorities and women. As a result, none but the most affluent men of European ancestry had reliable and widespread access to home finance.[18]

Early home mortgage lenders themselves had limited options in acquiring the capital to make home mortgage loans. By far, the most common mortgage lenders were individual non-professional landowners who usually accepted a mortgage along with partial payment in connection with the sale of property.[19] Building societies only had the funds they could gather in deposits from their local community and had little opportunity to assign their loans.[20] Insurance companies made mortgage loans out of the funds gathered from insurance premiums and then held those loans in their portfolio.[21] The earliest efforts to form a secondary market came out of private mortgage companies which, by the 1880s, were making mortgage loans around the country through local agents.[22] Some of these companies raised funds by issuing bonds to East Coast and European investors.[23] Called "mortgage-backed bonds," these loans included not only a promise to pay a fixed amount, but also security agreements where the mortgage company pledged its loans as collateral for the bond.[24] Foreshadowing some of the problems in today's market, this system proved extremely unstable. Because distant and uninformed investors bore the ultimate risk on individual home mortgages, lenders and their local agents had an incentive to use inflated appraisals and fraudulent origination practices to generate up-front profits.[25] When recessions in the 1890s produced widespread consumer defaults, all of these mortgage companies folded and their investors took horrendous losses.[26] Thus, with the exception of a few fitful experiments, early American mortgage loans were two party transactions with lenders holding their own notes, collecting payments, and foreclosing on defaulting borrowers when necessary.

B. The Government as Assignee: Three Party Mortgage Finance After the Great Depression

The defining event shaping the secondary mortgage market in the twentieth century was the Great Depression. When millions of people lost their jobs in the early 1930s, prices for goods, services, and

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[17] OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, REPORT TO CONGRESS: CELEBRATING 10 YEARS OF EXCELLENCE 1993-2003, at 11 (June 2003), http://www.ofheo.gov/media/pdf/websiteofheoreptoCongress03.pdf [hereinafter OFHEO REPORT TO CONGRESS].
[18] CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET 81 (2004) (discussing origins of American credit discrimination).
[19] Frederiksen, *supra* note 16, at 209 (mortgages taken by local and non-local individuals constituted 73 percent of American residential mortgages recorded between 1879 and 1890).
[20] Building society loans constituted about seven percent of recorded mortgages. *Id.* We should expect that few businesses would be willing to take building society loan assignments since these potential assignees would have a debilitating comparative disadvantage in evaluating the likelihood of default.
[21] Insurance company loans constituted about 5 percent of recorded mortgages. *Id*
[22] *Id.* at 210-13; Lea, *supra* note 6, at 156. Some of these companies specialized in lending to settlers taking advantage of the homestead laws. Fredericksen, *supra* note 25, at 213.
[23] Frederiksen, *supra* note 16, at 207; Lea, *supra* note 6, at 156-58.
[24] *See* WM. COLEBROOKE, A TREATISE ON THE LAW OF COLLATERAL SECURITIES AS APPLIED TO NEGOTIABLE, QUASI-NEGOTIABLE AND NON-NEGOTIABLE IN ACTION 250-57 (1883); Fredericksen, *supra* note 25, at 210; Lea, *supra* note 6, at 156-58. Often ownership of the mortgages was held in a trust, not dissimilar to today's special purpose vehicles. Fredericksen, *supra* note 16, at 210.
[25] Lea, *supra* note 6, at 158. Much like today's mortgage brokers, some mortgage loan company agents in the 1880s received up-front commissions which amounted to around as much as an interest rate point over the life of the loan. Frederiksen, *supra* note 16, at 206. Loan agents cashed in on land speculation as settlers in the Dakotas, Nebraska, Kansas and other territories made claims to land, borrowed money, and defaulted without making any improvements or establishing successful homesteads. *Id.* at 213.
[26] Fredericksen, *supra* note 16, at 213; CHRISTINE A. PAVEL, SECURITIZATION: THE ANALYSIS AND DEVELOPMENT OF THE LOAN-BASED/ASSET- BACKED SECURITIES MARKET 56 n.2 (1989).

land all dramatically declined.[27] Agricultural prices were so low, family farmers could not profit from selling their crops.[28] Demand for goods and the investment capital from the stock market both dried up, forcing manufacturers to lay off workers.[29] In the mortgage lending market, lenders were forced to call in their loans as *half* of all single-family mortgages fell into default.[30] In foreclosure, real estate prices were so low, lenders could not recoup their investment by selling seized homes.[31] Because lenders were understandably reluctant to continue making uncollectible loans, the mortgage finance and housing construction industries ground to a halt.[32]

Throughout the 1930s, the federal government took a series of steps to restart and expand these industries. This Depression-era legislation established an infrastructure for mortgage lending which, in addition to helping establish the American middle class, is crucial for understanding the playing field within which today's predatory lenders operate. First, during the Hoover administration, Congress created the twelve regional Federal Home Loan Banks (FHLBs).[33] Analogous to the federal reserve banks, the FHLBs loaned money to thrifts, who in turn lent these funds to consumers.[34] Although started with government capital, the FHLBs gradually accumulated private funds and eventually became wholly owned by their member thrifts. The FHLBs gave thrifts a reliable and inexpensive source of funds to supplement consumer deposits, which allowed thrifts to develop into the most significant source of home mortgage credit in the mid-twentieth century.

Nevertheless, at the beginning of the Roosevelt administration, lenders were still reluctant to re-enter the market. FDR backed three important legislative initiatives, all of which pushed the federal government further into residential mortgage lending.[35] First, in 1933, Congress created the Home Owners Loan Corporation (HOLC). HOLC used taxpayer funds to buy mortgages owed by financially distressed families.[36] HOLC then refinanced these borrowers into more affordable government loans with longer terms.[37] Second, in 1934, Congress created the Federal Housing Administration (FHA), tasking it with offering government guaranteed insurance to home mortgage lenders.[38] For loans that met FHA's

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[27] Edwin F. Gay, *The Great Depression*, 10 FOREIGN AFFAIRS 529, 530 (1932); Ben S. Bernake, *Macroeconomics of the Great Depression: A Comparative* Approach, in ESSAYS ON THE GREAT DEPRESSION 5, 6 (Ben S. Bernake, ed., 2000).
[28] Ben S. Bernake, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression,* 73 AM. ECON. REV. 257, 260 (1983); HOWARD ZINN, A PEOPLE'S HISTORY OF THE UNITED STATES: 1492-PRESENT 378-80 (1995).
[29] Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant role in the U.S. Economy's Boom-and-Bust Cycle of 1921-33? A Preliminary Assessment*, 4 CURRENT DEV. IN MONETARY & FIN. L. 559, 582 (2006).
[30] OFHEO REPORT TO CONGRESS, *supra* note 17, at 11.
[31] MARVELL, *supra* note 13, at 19.
[32] Gay, *supra* note 27, at 533.
[33] IMMERGLUCK, *supra* note 2, at 36.
[34] MARVELL, *supra* note 13, at 20-21.
[35] *See* Franklin D. Roosevelt, A Message Asking for Legislation to Save Small Home Mortgages from Foreclosure (Apr. 13, 1933), *in* 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, at 135 (1938) (illustrating FDR's vision for government leadership in mortgage lending markets).
[36] Although HOLC's refinanced mortgages were initially funded by taxpayers, homeowners eventually paid back all the money used by the agency. MARVELL, *supra* note 13, at 24. HOLC was created as a temporary agency to help the country out of the depression. It stopped refinancing loans in 1936 and was altogether out of business by the early 1950s. *Id.* at 25.
[37] Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 560 (2003). In about two years HOLC refinanced over a million loans amounting to approximately ten percent of the country's outstanding residential non-farm mortgages. Kenneth T. Jackson, *Race, Ethnicity, and Real Estate Appraisal: The Home Owners Loan Corporation and the Federal Housing Administration*, 6 J. URB. HIST. 419, 421 (1980). Conversely, HOLC also used overtly racist underwriting and appraisal practices, such as rating minority neighborhoods much more unfavorably than white neighborhoods. Michael H. Schill & Susan M. Wachter, *The Spatial Bias of Federal Housing Law and Policy: Concentrated Poverty in Urban America*, 143 U. PA. L. REV. 1285, 1309 (1995). This federal leadership set a dangerous discriminatory precedent which far outlived the agency itself. Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economic Analysis*, 73 TEX. L. REV. 787, 799-802 (1995).
[38] Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991, 992 (1986); IMMERGLUCK, *supra* note 2, at 38.

underwriting criteria, the government agreed to pay mortgage lenders the difference between the price fetched by a repossessed home and its outstanding loan balance.[39] In effect, this insurance protected the lender from the borrower's credit risk and from downward movement in realty prices. FHA's insurance facilitated mortgage loans with much longer durations, down payments of only 20 percent of the home value, and more affordable monthly installments.[40] With loan terms of up to thirty years, families could now purchase a home over the duration of an adult's working life. FHA's underwriting guidelines also created industry standards which encouraged cautious and professional behavior in loan origination.[41] Finally, in 1938, Congress created the Federal National Mortgage Association (FNMA), now more popularly known as "Fannie Mae."[42] Fannie Mae's function was to act as an assignee by purchasing FHA's "nonconventional" insured loans.[43] Not only was a qualifying mortgage guaranteed, but the lender, if it chose, could assign the loan to Fannie Mae for cash, quickly recouping its investment plus a premium.[44] This secondary market outlet alleviated fears of illiquidity, inducing many mortgage loan companies, insurance companies, and even commercial banks back into the consumer home loan business.

Collectively, these government initiatives (along with millions of cheap automobiles cranked out by the post-World War II industrial base) facilitated migration of the nesting white middle class to rapidly expanding suburbs surrounding American cities.[45] In effect, the Depression-era legislation created what Diamond and Lea have described as two housing finance "circuits."[46] Thrifts and the twelve regional Federal Home Loan Banks constituted the first circuit. The second circuit included mortgage loan companies, insurance companies, and banks—all of whom relied on FHA insurance (as well as analogous Veterans Administration insurance offered after World War II)[47] and assigned their loans to Fannie Mae. While the thrift circuit was the larger of the two until the 1980s, the Fannie Mae circuit proved more influential in determining today's secondary market structure.[48]

What both circuits shared, and continue to share, is a unifying theme of federal government sponsorship.[49] In the thrift circuit, even after member thrifts became the sole owners of the regional

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[39] Malloy, *supra* note 38, at 992. *See also* Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783, 785-87, 823-825 (2004) (describing operation of mortgage insurance).
[40] Immergulck, *supra* note 21, at 38.
[41] FHA did not, however, encourage equal treatment of all groups. Like HOLC, FHA not only tolerated but encouraged exclusion of ethnic minorities. IMMERGLUCK, *supra* note 2, at 93-95.
[42] Malloy, *supra* note 38, at 993.
[43] *Id.* at 993. Residential mortgages are still usually divided into two categories: "conventional" and "non-conventional" loans. Anand K. Bhattacharya, Frank J. Fabozzi & S. Esther Chang, *Overview of the Mortgage Market*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 3, 3 (Frank J. Fabozzi ed., 5th ed. 2001). In a conventional loan, if the borrower defaults and the loan becomes uncollectible, then the lender or the lender's assignee suffers the loss. *Id.* In contrast, nonconventional loans are insured by the federal government. *Id.* Such insurance is still provided by the FHA, the VA or the Rural Development Administration (RDA). *Id.* The Reconstruction Finance Corporation (RFC) actually preceded Fannie Mae in purchasing FHA insured loans. However, like HOLC, it was another temporary agency which disbanded in 1948. Malloy, *supra* note 38, at 993.
[44] Malloy, *supra* note 38, at 992-93.
[45] KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 195, 200 (1985). Excluded yet again were many white working class families, families headed by single women, and families of color, all of whom tended to lack the credit profile Fannie Mae and the thrifts required to participate in this new "prime" home mortgage lending market. Swire, *supra* note 37, at 798-99.
[46] Douglas B. Diamond, Jr. & Michael J. Lea, *The Decline of Special Circuits in Developed Country Housing Finance*, 3 HOUSING POL'Y DEBATE 747, 756-57 (1992).
[47] Malloy, *supra* note 38, at 992.
[48] Diamond & Lea, *supra* note 46, at 56-61.
[49] *See* Federal National Mortgage Association, *Federal National Association Background*, *in* 1 REAL ESTATE SECURITIES REGULATION SOURCEBOOK 1087, 1087-88 (1975) (providing a characterization of different levels of government sponsorship in quasi-governmental agencies). Dan Immergluck has explained that:

> In both circuits, the public sector has seeded, nurtured, and been largely responsible for the size and functioning of mortgage markets now and in the foreseeable future. Without federal involvement, we would today have far fewer

Federal Home Loan Banks, the federal government still "backstopped" them with authorization to borrow from the U.S. Treasury.[50] In the second home finance circuit, the government purchased and held consumer borrowers' promissory notes.[51] Both circuits are best conceptualized as a three party model: borrower, lender, and the government as a guarantor or assignee. Moreover, as discussed further in Part IV, the fact that a federal agency was the most important assignee of home mortgages exerted significant influence on the mortgage loan assignment laws that now govern trafficking in predatory loans.

C. The Government as Issuer: The Innovation of Public Residential Mortgage Securities

In the post-war years, the two circuits provided historically unprecedented levels of secured credit to Americans. The larger thrift circuit focused primarily on conventional mortgages that were either uninsured or underwritten with private mortgage insurance.[52] The second circuit became increasingly reliant on mortgage companies that focused on nonconventional FHA and VA insured loans which were then assigned to Fannie Mae. By the 1960s, growth in the Fannie Mae circuit was limited by the policy objectives of government insurance programs. The federal government directed its mortgage insurance programs with policy objectives in mind, such as "increasing military housing, national defense housing, urban renewal housing, nursing homes, mobile home parks, and housing for the elderly, among others."[53] Many mortgage bankers wanted to penetrate into the conventional market dominated by the thrifts, but lacked the reliable and inexpensive capital necessary to do so.[54] The result was pressure on the federal government to provide a source of liquidity for conventional loans made by non-depository mortgage lenders.

Once again, the federal government responded by facilitating the development of new home mortgage finance infrastructure. In 1968, Congress partitioned Fannie Mae into two separate organizations. The first organization retained the original function, but operated under a new name: The Government National Mortgage Association.[55] "Ginnie Mae," as it became known, continued to purchase nonconventional FHA and VA insured mortgages.[56] The second organization kept the old name, but received a new mission. Fannie Mae became a private federally chartered corporation whose primary function would be to purchase conventional home mortgages from private lenders.[57] At this point, Fannie Mae still held home mortgages in its own portfolio, and in turn borrowed money in its own name to finance its operations. The hope was that this new private incarnation of Fannie Mae would provide a reliable low-cost source of funds for lenders wishing to offer conventional, non-government insured

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> home owners or potential home owners. Thus, the size of the home lending market today and for the foreseeable future rests on a federally initiated, supported, and sponsored infrastructure.

Immergluck, *supra* note 2, at 40.
[50] *Id.*
[51] Sivesind explains, "Since low-risk FHA-VA loans could be sold to investors across the country, the programs facilitated the early development of an integrated, national mortgage market at little direct cost to the government." Charles M. Sivesind, *Mortgage-Backed Securities: The Revolution in Real Estate Finance, in* HOUSING AND THE NEW FINANCIAL MARKETS 311, 312-13 (Richard L. Florida ed., 1986).
[52] Diamond & Lea, *supra* note 46, at 56-61. *See also supra* note 43 (explaining origin of the term "conventional" in mortgage lending).
[53] Immergluck, *supra* note 2, at 39 (citing Kerry Vandell, *FHA Restructuring Proposals: Alternatives and Implications*, 6 HOUSING POL'Y DEBATE 299, 311 (1995)).
[54] Richard S. Landau, *The Evolution of Mortgage Backed Securities*, *in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 135, 135-36 (Jess Lederman ed., 1987).
[55] Sivesind, *supra* note 51, at 317.
[56] *Id.*
[57] *Id.* at 315-16.

mortgages. In 1970, Congress created "Freddie Mac" to serve a similar role as Fannie Mae.[58]

A short time later, a fundamentally new method of obtaining funds for mortgage loans developed: securitization. Rather than holding mortgages themselves, both Ginnie Mae and then Freddie Mac began issuing mortgage-backed securities that "passed through" interest income to investors.[59] The agencies would purchase home mortgages, deposit large numbers of them in "pools," and sell participations in the pools to investors on Wall Street. With these new pass-through investment vehicles, investors could hold a share of large (and diversified) numbers of mortgages insured by the government in the case of Ginnie Mae, or guaranteed by the large stable government sponsored enterprises (GSEs) in the case of Freddie Mac and Fannie Mae (who also began securitizing shortly thereafter).[60] Because the agencies now guaranteed the principal and interest income of their securities even when mortgagors defaulted, investors saw the securities as a low risk investment even without the assurances of a rating organization, such as Standard and Poor's or Moody's.[61] Investors could buy and easily resell their investments in order to best suit their portfolios and investment strategies.[62] These mortgage-backed securities had stability and liquidity which generated greater spreads over comparable term treasury obligations than securities of similar risk.[63] Securitization of mortgage loans by the GSEs allowed the larger capital markets to directly invest in American home ownership at a lower cost than the older depository lending model of business.[64]

II. PRIVATE LABEL SECURITIZATION

A. The Evolution of Private Securitization

Like the GSEs, purely private institutions saw the potential benefits of pooling home mortgages into mortgage-backed securities and soon began attempting to channel capital into home mortgage lending in similar ways.[65] In the early 1970s, the baby boom generation was just reaching the age and means necessary to buy homes.[66] Private financiers wanted to mobilize capital to serve this enormous potential demand for credit.[67] Moreover, because the GSEs invested in mortgages with specific middle class oriented policy objectives in mind, they would not purchase unusually large ("jumbo") mortgages,

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[58] *Id.* at 318-19.
[59] Schwarcz, *Structured Finance*, *supra* note 105, at 609. *See also* Linda Lowell, *Mortgage Pass-Through Securities*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 25, 26 (Frank J. Fabozzi ed., 5th ed. 2001) ("Pass-through securities are created when mortgages are pooled together and undivided interests or participations in the pool are sold.").
[60] Richard S. Landau, *The Evolution of Mortgage-Backed Securities, in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 135, 135 (Jess Lederman ed., 1987).
[61] Although Ginnie Mae securities are guaranteed by the full faith and credit of the U.S. government, Fannie Mae and Freddie Mac securities are not. Nevertheless, many investors have traditionally regarded the two GSEs as "too big to fail,"—the view that there is an implicit government guarantee of agency securities, if not an actual one. Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 630-31 (2005). Whether investors are correct in this view is a matter of growing debate. *See id.* at 596; Benton E. Gup, *Are Fannie Mae and Freddie Mac Too Big to Fail?, in,* POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 285, 310 (Benton E. Gup, ed., 2003).
[62] Sivesind, *supra* note 51, at 313.
[63] Loan pools insured by Fannie Mae and Freddie Mac must meet relatively strict underwriting guidelines and must be originated on standardized forms designated by the agencies. Anand K. Bhattacharya et al., *Overview of the Mortgage Market, in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 3, 22 (Frank J. Fabozzi ed., 5th ed. 2001). These procedures help homogenize the risk from different loans with agency loan pools, in turn alleviating the concerns of all but the most risk averse investors.
[64] Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 (1991) at 1383.
[65] Sivesind, *supra* note 51, at 320.
[66] Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, *in* A PRIMER ON SECURITIZATION 31, 31 (Leon T. Kendall & Michael J. Fishman, eds., 1996)).
[67] *Id.*, at 31-32.

mortgages with variable interest rates (ARMs), home equity loans, or—most importantly for our purposes—subprime mortgages.[68] Unmet demand in these market segments left enticing (and large) niches for private investors.[69]

In 1977, Bank of America and Salomon Brothers (with some limited cooperation from Freddie Mac) moved to take advantage of these potential markets by issuing a security where outstanding loans were held in trust, with investors as beneficiaries.[70] The trust itself was entirely passive—it had no employees or assets aside from the home mortgages themselves.[71] Participations in these trusts are generally recognized as the first mortgage-backed securities issued by the private sector—now called "private label" mortgage-backed securities.[72]

Initially, investment in these "securitized" mortgages suffered from legal and pricing problems stemming in part from the novelty of the new method of finance.[73] For instance, some large public investment funds were effectively precluded from investing in mortgage-backed securities by laws meant to prevent purchases of undiversified or risky investments.[74] The New York State Retirement System, for example, could not invest in mortgages of less than a million dollars on the theory that the risks from smaller individual consumer home mortgages were too great.[75] Also, investors and brokers alike had difficulty comparing the present value of bundles of thirty-year home mortgages. Since few investors were willing to keep their money tied up for thirty years, they needed a relatively reliable method for predicting what actual yields would be, so investors could compare those yields to yields of other potential investments. Without such a method, mortgage-backed securities suffered from liquidity problems and were accordingly artificially undervalued.[76] Eventually, the market, along with some help from Congress in the mid-1980s,[77] succeeded in developing financial tools to overcome these hurdles.

[68] MEIR KOHN, FINANCIAL INSTITUTIONS AND MARKETS 623-24 (1994).
[69] Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WA. U. L.Q. 1061, 1121 (1996). One result of these trends was that thrifts began to more aggressively use their home mortgage portfolios as security for long term bond issues. Ranieri, *supra* note 66, at 32. These bonds, sometimes called mortgage-backed bonds, are different from mortgage-backed securities. Shenker & Colletta, *supra* note 64, at 1380-81. Income from the underlying mortgages in mortgage-backed bonds is not passed through to bond investors. *Id.* Rather the mortgages simply serve as collateral subject to foreclosure in the event of default on the bond. *Id.* The principal disadvantage of this financing structure is that the bond must be overcollateralized to cover the costs of foreclosure in the event of default on the bond. Ranieri, *supra* note 66, at 32. This creates a pocket of swamped resources in comparison to pass-through mortgage-backed securities. Much older than mortgage-backed securities, mortgage-backed bonds date at least as far back as the late nineteenth century mortgage companies that were wiped out in the recessions of the 1890s. Shenker & Colletta, *supra* note 64, at 1380-81; Lea, *supra* note 6, at 158..
[70] Ranieri, *supra* note 66, at 33-34; Sivesind, *supra* note 51, at 321.
[71] Ranieri, *supra* note 66, at 32-33.
[72] Richard A. Brown & Susan E. Burnhouse, *Implications of the Supply-Side Revolution in Consumer Lending*, 24 ST. LOUIS U. PUB. L. REV. 363, 392 (2005). Private label mortgage-backed securities are also sometimes called non-agency securities in contrast to the older "agency" securitized mortgage loans issued by the GSEs. ANDREW DAVIDSON ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 288-89 (2003). Some commentators also refer to private label mortgage-backed securities as "nonconforming," since they do not meet the underwriting standards of the GSEs. *Id.*
[73] Ranieri, *supra* note 66, at 36.
[74] *Id.*, at 33.
[75] *Id.*
[76] Shenker & Colletta, *supra* note 64, at 1380.
[77] Following lobbying efforts of investment bankers, Congress passed legislation to clear out the legal obstacles to private securitization of home mortgages. Ranieri, *supra* note 66, at 37. The most important legal development was passage of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) in which Congress preempted a variety of state laws that inhibited private home mortgage securitization, including state retirement fund laws which prevented public pension funds from investing in private home mortgage securities. Pub. L. No. 98-440, § 106(a), 98 Stat. 1689, 1691-92 (1984) (codified at 15 U.S.C. §77r-1). SMMEA also preempted state blue sky laws to allow securitizers to avoid registering under state securities laws to the same extent that securities issued by Fannie Mae, Freddie Mac, or Ginnie Mae were exempt. *Id.* § 106(c), 98 Stat. at 1689 (codified at 15 U.S.C. § 77r-1(c)). In addition to preempting state laws, SMMEA authorized delayed delivery of home mortgage-backed securities in order to facilitate forward trading. *Id.* § 102-04, 98 Stat. at 1690-91 (codified at 15 U.S.C. §§ 78g(g), 78h(a), 78k(d)(1)). And, it permitted national banks, federal credit unions, and federal savings and loans associations to invest in

For purposes of this Article, three key innovations facilitated growth in private label home mortgage-backed securities.

The first crucial innovation facilitating securitization was the development of pricing models that could estimate the present value of the right to receive a portion of the revenue from a pool of loans. Because mortgage-backed securities issued by the government-sponsored enterprises held an implicit federal guarantee, investors felt comfortable in using the face value of those securities to make investment decisions. But in the private mortgage-backed securities market, there were no comparable assurances for investors. They had to carefully consider the possibility that securities would not pay out as promised when deciding whether or not to invest. When private label mortgage-backed securities first evolved, there was great uncertainty on how to go about making these judgments.[78] Initially, investment brokers used generalized rules of thumb to estimate value.[79] But, these estimations quickly gave way when mathematical models backed with empirical data became available.[80] First, academics and investment analysts came up with satisfactory pricing models.[81] Some of the early pricing models relied on public records of FHA mortgage histories. As mortgage-backed securities became more complex, Wall Street spent millions of dollars refining these models and generally researching ways to estimate the value of pools of home mortgages.[82] Ultimately, investment analysts and academics succeeded in creating models which gave investors sufficient confidence to create tradeable securities.[83]

A second innovation was the development of risk- and term-partitioned securities.[84] Early home mortgage-backed securities would simply transfer, or "pass through" consumer payments on each loan in the pool to investors.[85] Each investor received income from the investment as if they owned a small piece of each loan in the pool of mortgages. This created two key disadvantages for investors. First, investors could not specify ahead of time when they would be paid. For investors who had certain financial obligations, the long and uncertain return horizon on pass-through mortgage securities was a serious drawback. Taking an insurance company as an example, if it stored customers' premiums in mortgage-backed securities, it would run the risk that the company might need to liquify its participations in unfavorable market conditions in order to pay out insurance claims or satisfy state insurance regulatory reserve requirements. Similarly, if many borrowers in a pool of mortgages were to pay off their loans early (perhaps because declining interest rates induced refinancing), investors would not only get a smaller return than hoped for (because less interest would have accrued on the prepaid mortgages), but they would also get their money back sooner than expected. This development would force the insurance company to search for new investment options that often carry transaction costs that cut into their marginal return on assets. Furthermore, pass-through mortgage-backed securities offered only one equally shared credit risk to each investor. Different investors have widely varying tolerances of risk. Some choose aggressive higher-risk/higher return investment strategies, while others choose to play it safe. Pass-through mortgage-backed securities issued from a large pool of mortgages offered each of these investors only one potential investment: ownership of the income streams as paid by loans in the

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privately issued home mortgage-backed securities. *Id.* § 105, 98 Stat. at 1691 (codified at 12 U.S.C. §§ 24, 1757). *See* Shenker & Colletta, *supra* note 64, at 1386 (summarizing key SMMEA provisions).
[78] Ranieri, *supra* note 66, at 35-36.
[79] *Id.*, at 35.
[80] *See* DAVIDSON, ET AL., *supra* note 72, at 131-180 (introducing mortgage-backed security price modeling).
[81] Ranieri, *supra* note 66, at 35-36.
[82] Joel W. Brown & William M. Wadden IV, *Mortgage Credit Analysis, in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 315, 315 (Frank J. Fabozzi, ed., 5th ed., 2001). Early pricing models often relied on data collected on actual performance of FHA loans, giving a limited empirical foundation to pricing models. Lowell, *supra* note 59, at 39-40.
[83] Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 537 (2002); Ranieri, *supra* note 66, at 35.
[84] Brown & Burnhouse, *supra* note 72, at 392.
[85] PAVEL, *supra* note 26, at 4.

pool.

Partitioned securities were a response to these problems.[86] Instead of directly passing through loan payments to investors, the income created by loans in the pool was divided into different income streams suited to the time and risk preferences of investors.[87] Thus, investment bankers learned to tailor securities to the needs of different investors, making investment in mortgage-backed securities desirable to a broader range of potential investors.[88] Partitioned mortgage securities divide the income of mortgage pools into different "tranches" or "strips," each of which can be purchased by investors.[89]

By way of illustration, one security might entitle an investor to receive all the interest income—an "interest-only tranche"—from a pool of mortgages, while another security might entitle investors to receive all payment toward loan principle—a "principle-only tranche."[90] Because borrowers tend to refinance when interest rates go down, an investor who expects interest rates to drop will prefer to invest in a principle-only tranche over an interest-only tranche, since the investor is likely to quickly recoup her investment as borrowers pay their mortgages off in full.[91] An interest-only tranche would be less desirable because interest income would suffer as borrowers prepay and the outstanding number of loans within the pool generating interest declines.[92] Thus, by offering a variety of separate investment vehicles, security tranches allow investors to take strong market positions on expected movement in prepayment and interest rates.[93]

Mortgage pool trustees also learned to tailor tranches to appeal to investors that prefer investing at a variety of maturation levels.[94] For instance, insurance companies often know beforehand when the window will close on customer claims against a given insurance policy. These insurance companies may be particularly interested in a mortgage-backed security tranche with maturation dates designed to coincide with the closing of the insurance company's policy liability window.[95] Similarly, stripped mortgage-backed securities with short term maturations allow banks to invest in securities that match their short term deposit liabilities.[96] Investors sometimes call issuing of these investment vehicles "time tranching" in comparison to "credit tranching" which is based upon investment risk.[97] Collectively, different types of tranching allowed mortgage pool trustees to attract a wider variety of investors to their securities than would have been possible using "pass through" vehicles.

A final development facilitating a private label home mortgage securitization market was the introduction of rating agencies and credit enhancements. Most investors were willing to purchase government-agency-issued mortgage-backed securities purely on the strength of agency reputations and assurances.[98] But investors in private label mortgage-backed securities needed some additional assurance on whether private mortgage tranches would actually pay out as promised. For this information, investors

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[86] Lowell, *supra* note 59, at 25.
[87] Leon T. Kendall, *Securitization: A New Era in American Finance*, *in* A PRIMER ON SECURITIZATION 1, 8-9 (Leon T. Kendall & Michael J. Fishman eds., 1996).
[88] *Id.*
[89] Eggert, *Predatory Lending*, *supra* note 83, at 540. "Tranche" is French for "slice." Larousse French-English/English-French Dictionary 922-23 (Faye Carney ed., 1993).
[90] Eggert, *Predatory Lending*, *supra* note 83, at 540.
[91] Lakhbir Hayre et al., *Stripped Mortgage-Backed Securities*, *in*, THE HANDBOOK OF MORTGAGE BACKED SECURITIES 151, 151 (Frank J. Fabozzi ed., 2001).
[92] Eggert, *Predatory Lending*, *supra* note 83, at 540.
[93] Hayre et al., *supra* note 91, at 151.
[94] Ranieri, *supra* note 66, at 36-37.
[95] Hayre et al., *supra* note 91, at 155.
[96] Mortgage Research Group, Lehman Brothers Inc., *Collateralized Mortgage Obligations*, *in*, THE HANDBOOK OF MORTGAGE BACKED SECURITIES 169, 169-170 (Frank J. Fabozzi ed., 2001).
[97] Brown & Wadden, *supra* note 82, at 315.
[98] Ranieri, *supra* note 66, at 36.

turned to rating agencies.[99] Today, the three national rating agencies, Standard and Poor's, Moody's, and Fitch Investment Company, assist investors by collecting information and research on the risk posed by various investments.[100] After doing due diligence, ratings agencies issue a credit rating on each tranche, signaling to potential investors the likelihood that a particular instrument will pay interest and principle according to its terms.[101] In order to receive investment grade credit ratings on some tranches of the mortgage pool, credit rating agencies usually require the issuer to augment the reliability of those tranches through "credit enhancements."[102] Credit enhancements are contractual arrangements that increase the likelihood that a particular participation in the pool of loans will pay out according to its terms.[103]

Some analysts classify two basic types of credit enhancement: internal and external.[104] Internal credit enhancements manipulate the characteristics of the loan pool to make on-time repayment of some tranches more likely. Senior/subordinated credit structures, for example, enhance the credit risk of senior tranches by allocating losses to subordinate or junior tranches first.[105] Thus, senior tranche investors can expect on-time payment unless pool losses are so severe that junior tranches become saturated.[106] Another internal credit enhancement is commonly known as a "turbo structure."[107] Here investors purchase a promised payout on a tranche that is less than the aggregate assets of the underlying mortgages.[108] A turbo structure is secured by more collateral than would be necessary to pay on-time if none of the underlying mortgages underperform.[109] If the mortgages perform well, then the turbo tranches are retired early. If the mortgages underperform, the turbo tranche still pays off on time so long as the losses do not exceed the level of over-collateralization.[110] A final internal credit enhancement is a simple cash collateral account.[111] Here the security issuer funds a cash account which is held in trust for the benefit of investors who collect any tranche payout deficit out of the cash account. After all the enhanced tranches pay out, any remaining cash in the account is returned to the issuer.[112]

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99 DAVIDSON ET AL., *supra* note 72, at 24-25.
100 *See, e.g.*, Neil D. Baron, *The Role of Rating Agencies in the Securitization Process, in* A PRIMER ON SECURITIZATION 81, 81-83 (Leon T. Kendall & Michael J. Fishman eds., 1996).
101 *Id.* Investment credit ratings do not assess whether an investment will be profitable, but merely whether an instrument will pay according to its terms. *Id.* For instance, if an investor invests in mortgage-backed securities, and interest rates subsequently rise, then the investor will be stuck with a relatively low rate of return. Credit ratings do not address this sort of investment risk. *Id.*
102 Daniel Singer, *Securitization Basics*, *in* ACCESSING CAPITAL MARKETS THROUGH SECURITIZATION 13, 17 (Frank J. Fabozzi ed., 2001).
103 DAVIDSON ET AL., *supra* note 72, at 24-25.
104 *See* Singer, *supra* note 102, at 17-8; Frank J. Fabozzi et al., *Nonagency CMOs*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 267, 268 (Frank J. Fabozzi ed., 5th ed. 2001); Lina Hsu & Cyrus Mohebbi, *Credit Enhancement in ABS Structures*, *in* ACCESSING CAPITAL MARKETS THROUGH SECURITIZATION 35, 35-38 (Frank J. Fabozzi ed., 2001); DAVIDSON ET AL., *supra* note 72, at 25.
105 Singer, *supra* note 102, at 18. This form of internal credit enhancement relies on the participation of investors that specialize in subordinated tranche investment. Schwarcz explains, "[t]he originator . . . allocates certain repayment risks to these investors, who are in the business of assessing and accepting such risks and who consequently are willing to accept a higher level of risk than the average investor." *Steven L.*
Schwarcz, The Alchemy of Asset Securitization, 1 STAN. J. L. BUS. & FIN. 133, 143 (1994). One hopes he is correct. Another possibility is that residual tranche investors are making uninformed investment decisions. *See Wayne Passmore & Roger W. Sparks, Automated Underwriting and the Profitability of Mortgage Securitization, 28 REAL ESTATE ECON. 285, 285-86 (2000).* Still another possibility is that residual tranche investors are managers of servicing or origination companies that derive sufficient short term profit from fees excluded from the pooling and servicing agreement. These fees might be sufficiently profitable that managers would accept poor performance on longer term securities.
106 Hsu & Mohebbi, *supra* note 104, at 37.
107 *Id.* at 38.
108 *Id*.
109 *Id.*
110 *Id.*
111 Singer, *supra* note 102, at 18.
112 *Id.*

Conversely, external credit enhancement relies on some third party who is willing to guarantee some or all of the loan pool's returns.[113] External credit enhancement can take the form of insurance, letters of credit, or contractual guarantees.[114] External credit enhancement will usually cover tranche losses up to a written dollar amount for the duration of the life of the pool.[115] One limitation of this strategy is that, other things being equal, the credit rating given to the mortgage-backed securities will only be as high as the third party enhancer's credit rating.[116] Nevertheless, the potential rewards from home mortgage securitization were such that many companies, including some with outstanding credit ratings, were willing to insure or guarantee senior tranches.[117]

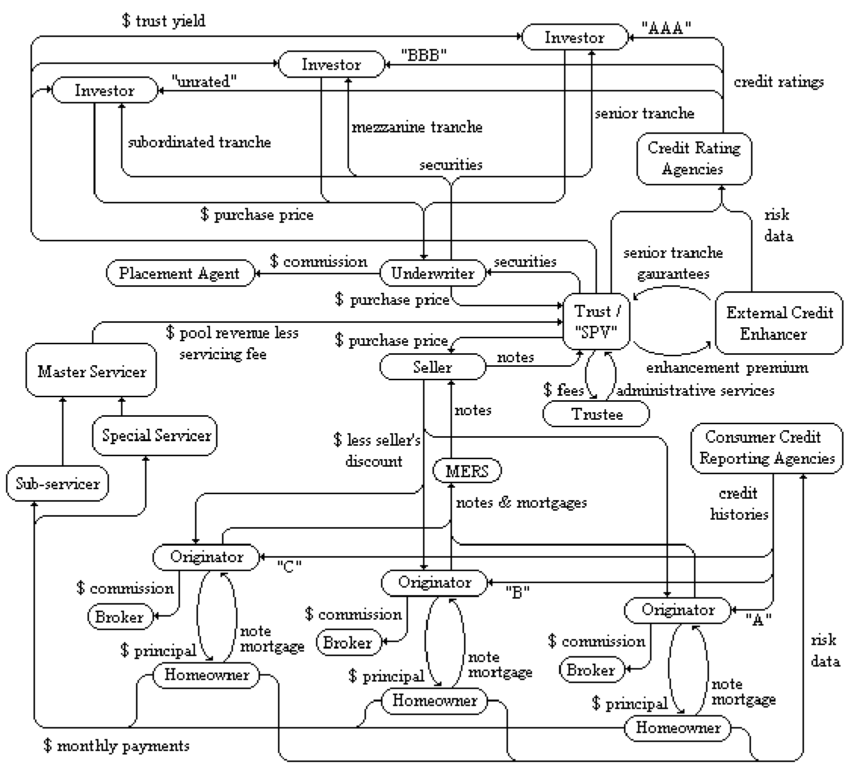
B. Securitization in Action: A Typical Contemporary Home Mortgage Securitization Conduit

These developments in the private label home mortgage-backed securities market facilitated a rapid increase in securitization.[118] Expanding far beyond home mortgages, Wall Street has securitized credit card debt, automobile loans, commercial loans, equipment leases, and loans to developing countries.[119] Indeed, receivables from virtually any income-producing asset have been securitized,[120] including physician and hospital accounts,[121] oil exploration,[122] lawsuit settlement proceeds,[123] entire business ventures,[124] or even baseball stadiums.[125] One firm famously led the way in intellectual property securitization by issuing "Bowie Bonds," with future royalties expected from pop-musician David Bowie's music portfolio.[126] More important for our purposes, throughout the 1990s, Wall Street investment banking firms created a host of complex and innovative financial conduits that funneled vast amounts of money through modestly capitalized consumer financial services companies into home

[113] Fabozzi et al., *supra* note 104, at 268; Hsu & Mohebbi, *supra* note 104, at 35. *See also* Robert D. Aicher et al., *Credit Enhancement: Letters of Credit, Guaranties, Insurance, and Swaps (The Clash of Cultures)*, 59 BUS. LAW. 897 (2004) (comparing litigation advantages of different forms of third party external credit enhancement).
[114] Aicher, *supra* note 113, at 898.
[115] Fabozzi et al., *supra* note 104, at 268.
[116] Hsu & Mohebbi, *supra* note 104, at 36.
[117] *Id.*; Fabozzi et al., *supra* note 104, at 268.
[118] Between 1994 and 1998 alone outstanding U.S. private label mortgage-backed securities doubled from approximately 200 billion to 400 billion. *See* DAVIDSON et al., *supra* note 72, at 288.
[119] Kendall, *supra* note 87, at 7.
[120] Suzanne Woolley & Stan Crock, *You Can Securitize Virtually Everything*, BUS. WK., July 20, 1992, at 78.
[121] *See* Charles E. Harrell & Mark D. Folk, *Financing American Health Security: The Securitization of Healthcare Receivables*, 50 BUS. LAW. 47 (1994); Gregory R. Salathe, *Reducing Health Care Costs through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549 (1994).
[122] *See generally* Charles E. Harrell et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885 (1997).
[123] *See generally* Walter Henry Clay McKay, *Reaping the Tobacco Settlement Windfall: The Viability of Future Settlement Payment Securitization as an Option for State Legislatures*, 52 ALA. L. REV. 705 (2001).
[124] *See generally* Claire A. Hill, *Whole Business Securitizations in Emerging Markets*, 12 DUKE J. COMP & INT'L L. 521 (2002); Vinod Kothari, *Whole Business Securitization: Secured Lending Repackaged: A Comment on Hill*, 12 DUKE J. COMP. & INT'L L. 537 (2002).
[125] Cynthia A. Baker & J. Paul Forrester, *Home Run! A Case Study of Financing the New Stadium for the St. Louis Cardinals*, 10(2) J. STRUCTURED FIN. 69 (2004).
[126] Sam Adler, *David Bowie $55 Million Haul: Using a Musician's Assets to Structure a Bond Offering*, 13 ENT. L. & FIN. 1 (1997); Lisa M. Fairfax, *When You Wish Upon a Star: Explaining the Cautious Growth of Royalty-Backed Securitization*, 1999 COLUM. BUS. L. REV. 441, 442; Jennifer Burke Sylva, *Bowie Bonds Sold for Far More than a Song: The Securitization of Intellectual Property as a Super-Charged Vehicle for High Technology Financing*, 15 SANTA CLARA COMPUTER & HIGH TECH L.J. 195 (1999). *See also* Jay H. Eisbruck, *Blockbuster or Flop? The History and Evolution of Film Receivables Securitization, 1995-2005*, 11 J. STRUCTURED FIN. 11 (2005); Andrew E. Katz, *Financial Alchemy Turns Intellectual Property Into Cash: Securitization of Trademarks, Copyrights, and Other Intellectual Property Assets*, 8 J. STRUCTURED AND PROJECT FIN. 59 (2003).

mortgage loans.[127] Much of this new credit was extended to borrowers with problematic credit histories (or borrowers with good credit histories that were nevertheless treated like borrowers with problematic credit histories). Although there is substantial variety in actual securitization conduits,[128] Figure A provides a graphic depiction that attempts to summarize the flow of capital and information in a typical contemporary private label securitization of subprime home mortgage loans.

Figure A -- Subprime Home Mortgage Securitization Structure



Initially, a mortgage broker identifies a potential borrower through a variety of marketing approaches including direct mail, telemarketing, door-to-door solicitation, and television or radio advertising. The originator and broker together identify a loan which may or may not be suitable to the borrower's needs. The home mortgage will consolidate the borrower's other unsecured debts, refinance a pre-existing home mortgage, or possibly fund the purchase price of a home. In determining the interest rate and other pricing variables, the broker and the originator rely on one or more consumer credit reporting agencies that compile databases of information about past credit performance, currently outstanding debt, prior civil judgments, and bankruptcies. Consumers are given a credit score, often based on the statistical models of Fair Issacson & Co., a firm that specializes in evaluating consumer repayment. Then, the borrower formally applies for the loan. At closing, which typically takes place a week or two later, the borrower signs all the necessary paperwork binding herself to a loan which may or may not have the terms originally described. Some brokers fund the loan directly using their own funds or a warehouse line of credit, while other brokers act as an agent using the originator's capital to fund the

[127] SECURITIZATION OF FINANCIAL ASSETS § 3.02[D] (JASON H.P. KRAVITT ED., 2002 & SUPP.)..
[128] Schwarcz goes so far as to say they are "limited only by the creativity of the professionals involved." Schwarcz, *Alchemy of Asset Securitization, supra* note 105, at 138. While this may go too far, it is certainly well beyond the scope of this Article to classify all of them. This exposition of securitization conduits is necessarily a generalization.

loan.[129] In any case, the originator establishes its right to payment by giving public notice of the mortgage through recording it with a county recorder's office.[130] Then, in a typical conduit, the originator will quickly transfer the loan to a subsidiary of an investment banking firm.[131] This subsidiary, which is alternatively called the securitization sponsor, or seller, then transfers the loan and hundreds of others like it into a pool of loans.[132] This pool of loans will become its own business entity, called a special purpose vehicle (SPV).[133] The SPV can be a corporation, partnership, or limited liability company, but most often is a trust.[134] Aside from the mortgages, the SPV has no other assets, employees, or function beyond the act of owning the loans. Under the agreement transferring the loans into the pool, the SPV agrees to sell pieces of itself to investors.[135] In a typical transaction, an underwriter purchases all the "securities"—here meaning derivative income streams drawn from payments on the underlying mortgages—issued by the pool.[136] Usually employing one or more placement agents who work on commission, the underwriter then sells securities to a variety of investors with different portfolio needs. In designing the SPV and its investment tranches, the seller typically works closely with a credit rating agency that will rate the credit risk of each tranche.[137] The credit rating agency investigates the credit risk of the underlying mortgages as well as the risks posed from pooling the mortgages together.[138] Inquiry as to the former, known as "mortgage risk," focuses above all upon borrower net equity over time—which is to say, the risk that foreclosure on a defaulting mortgage will not recoup invested funds.[139] Evaluation of "pool risk" looks at factors such as the size of the loan pool and the geographic diversity of underlying mortgages.[140] Credit

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[129] There are a variety of methods lenders and brokers use to initially fund home mortgage loans. Professor Eggert explains, "[m]ortgage brokers may originate the loans in their own names in three ways: (1) by using 'table funding' provided by the pre-arranged buyer of the loan; (2) by access to a warehouse line of credit; or (3) by supplying the broker's own funds." Eggert, *Predatory Lending*, *supra* note 83, at 538 (citations omitted).

[130] Unrecorded mortgage loans may become uncollectible if a subsequent creditor lends against the same residence or if the residence is sold without permission from the mortgagee. *See* LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 337-352 (5th ed. 2005) (providing introduction to the mortgage recording system). Typically, when a mortgage lender assigns one if its loans, the assignee must re-record its mortgage (and pay another fee) with the county recording office or risk losing its priority vis-à-vis other creditors or purchasers. *Id.*

[131] Eggert, *Predatory Lending*, *supra* note 83, at 538.

[132] Sometimes the loan will be held in an SPV that is a wholly-owned subsidiary of the originator or the underwriter while awaiting assignment into an independent SPV that will issue securities. *See, e.g.*, Schwarcz, *Alchemy of Asset Securitization*, *supra* note 105 , at 142 (describing advantages of "two tier" securitization conduit structures).

[133] Shenker & Colletta, *supra* note 64, at 1377-78. Some commentators use the equivalent term special purpose entity, or "SPE."

[134] Hill, *supra* note 69, at 1067 n.25, 1098 n.162.

[135] Eggert, *supra* note 83, at 539 n.156.

[136] Although the term "securities" is commonly used to describe investors' participations interests in asset pools, the actual legal rights may or may not be securities for purposes of federal and state securities laws. Hill, *supra* note 69, at 1067-68; Shenker & Colletta, *supra* note 64, at 1378-79.

[137] A Kirkland and Ellis partner specializing in securitization colorfully summarizes this process:

> Obtaining rating agency approval is no mean feat. The rating agencies are thorough and cautious, and they can be idiosyncratic. Rating agency bashing is a popular sport in asset-backed circles, but it must be admitted that the rating agencies have a difficult assignment. They are provided with reams of data and documents and are put under a lot of time pressure. It is reasonable to assume that at any given time the average rating agency analyst has more deals than fingers. Even the best intentioned analyst may have so many deals ahead of yours that delay is inevitable.

Kenneth P. Morrison, *Observations on Effecting Your First Asset-Backed Securities Offering, in* ACCESSING CAPITAL MARKETS THROUGH SECURITIZATION 41, 44-45 (Frank J. Fabozzi ed., 2001).

[138] Michael F. Molesky, *An Overview of Mortgage Credit Risks from a Rating Agency Perspective*, *in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES, AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 317, 318, 324 (Jess Lederman ed., 1987); Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 544 (2001).

[139] Molesky, *supra* note 138, at 318. Net equity is defined as "the market value of the home less the outstanding balance of the mortgage less the selling costs." *Id.*

[140] Larger loan pools are less likely to vary from credit rating agency pricing models, which are based on loan performance data from extremely large populations. *See* Molesky, *supra* note 138, at 334. Geographic diversity of homes securing the loan pool

ratings on each tranche are essential, since they obviate the need for each individual investor to do due diligence on the underlying mortgages in the pool.[141] The rating agency will typically require some form of credit enhancement on some tranches to assign them higher investment ratings. Often this enhancement will take the form of a third party guarantee from an insurance company on losses from mortgage defaults and prepayments.

The seller also arranges to sell the rights to service the loan pool to a company which will correspond with consumers, receive monthly payments, monitor collateral, and when necessary, foreclose on homes.[142] Sometimes the originator retains servicing rights which has the advantage of maintaining a business relationship with homeowners.[143] But often servicing is done by a company specializing in this activity.[144] Increasingly, pooling and servicing agreements allow for several different servicing companies with different debt collection roles. A master servicer may have management responsibility for the entire loan pool. Similar to a subcontractor in construction, the master servicer may subcontract to subservicers with a loan type or geographic specialty.[145] The pooling and servicing agreement may also allow for a special servicer that focuses exclusively on loans that fall into default or have some other characteristics making repayment unlikely.[146] Some servicing agreements require servicers to purchase subordinated tranches issued from the mortgage pool in order to preserve the incentive to aggressively collect on the loans.[147] Servicing rights also change hands often, "in some cases several times a year for the same loan."[148] If, for instance, a servicing company is not meeting collection goals or is charging the trust too much, the trustee may contract with a new servicer.

In many securitization deals, sellers and trustees agree to hire a document custodian to keep track of the mountains of paperwork on loans in the pool.[149] A related role is commonly played by a unique company called Mortgage Electronic Registration System, Inc. (MERS, Inc.).[150] MERS, Inc. is a corporation registered in Delaware and headquartered in the Virginia suburbs of Washington, D.C.[151] With the cooperation of the Mortgage Bankers Association of America and several leading mortgage banking firms, MERS, Inc. developed and maintains a national computer networked database known as the MERS. Originators and secondary market players pay membership dues and per transaction fees to MERS, Inc. in exchange for the right to use and access MERS records. The system itself electronically tracks ownership and servicing rights of mortgages.[152] Currently, more than half of all home mortgage

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protects investors from severe losses due to regional economic downturns. Anthony B. Sanders, *Commercial Mortgage-Backed Securities*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 661, 667 (Frank J. Fabozzi ed., 5th ed. 2001).

[141] *See* Eggert, *Predatory Lending*, *supra* note 83, at 540; Morrison, *supra* note 137, at 45; Schwarcz, *Alchemy of Asset Securitization*, *supra* note 105, at 136.

[142] R.K. Arnold, *Is There Life on MERS*, 11 PROP AND PROB. 32, 34 (July/August 1997).

[143] Elizabeth Renuart, *An Overview of the Predatory Mortgage Lending Process*, 15 HOUSING POL'Y Debate 467, 473 (2004).

[144] Arnold, *supra* note 142, at 34; Eggert, *Predatory Lending*, *supra* note 83, at 544.

[145] SECURITIZATION OF FINANCIAL ASSETS, *supra* note 127, at § 16.05[A][6].

[146] Poindexter, *supra* note 138, at 537-38; Eggert, *Predatory Lending*, *supra* note 83, at 544.

[147] Richard Levine & Phoebe J. Moreo, *An Investor's Guide to B Pieces*, *in*,TRENDS IN COMMERCIAL MORTGAGE-BACKED SECURITIES 172, 180 (Frank J. Fobozzi ed., 1998).

[148] Arnold, *supra* note 142, at 35.

[149] Poindexter, *supra* note 138, at 539.

[150] In the past few years MERS registration has grown very rapidly. At the beginning of 2001 MERS had registered 3.5 million mortgages in its system—"less than five percent of all the outstanding mortgages in America." Dale A. Whitman, *Chinese Mortgage Law: An American Perspective*, 15 COLUM. J. ASIAN L. 35, 61 (2001). But, by September of 2002, this figure rose to ten million. *MERS registers 10 Million Loans*, INSIDE MERS (MERS Inc.), Nov.-Dec. 2002, at 1. In November of 2003 MERS registered its 20 millionth loan—a growth rate in loans registered of almost 200% per year. *MERS Registers 20 Million Loans*, INSIDE MERS (MERS Inc.), Jan.-Feb. 2004, at 1. The MERS website proclaims that the corporation's "mission" is to "register every mortgage loan in the United States." MERS, About MERS, available at http://www.mersinc.org/about/index.aspx (last visited June 9, 2004).

[151] Arnold, *supra* note 142, at 33.

[152] MERS, Inc. does not currently handle notes as an agent for holders. Whitman, *supra* note 150, at 61.

loans originated in the United States are registered on the MERS system.[153]

In addition to keeping track of ownership and servicing rights, MERS has attempted to take on a different, more aggressive, legal role. When closing on a home mortgage, participating originators now often list MERS as the "mortgagee of record" on the paper mortgage.[154] The mortgage is then recorded with the county property recorder's office under MERS, Inc.'s name, rather than the originator's name—even though MERS does not solicit, fund, service, or ever actually own the loan. MERS then purports to remain the mortgagee of record for the duration of the loan even after the originator or a subsequent assignee transfers the loan into an SPV for securitization. MERS justifies its role by explaining that it is acting as a "nominee" for the parties.[155]

The parties obtain two principal benefits from attempting to use MERS as a "mortgagee of record in nominee capacity." First, under state secured credit laws, when a mortgage is assigned, the assignee must record the assignment with the county recording office, or risk losing priority vis-à-vis other creditors, buyers, or lienors.[156] Most counties charge a fee to record the assignment, and use these fees to cover the cost of maintaining the real property records. Some counties also use recording fees to fund their court systems, legal aid organizations, or schools. In this respect, MERS' role in acting as a mortgagee of record in nominee capacity is simply a tax evasion tool. By paying MERS a fee, the parties to a securitization lower their operating costs.[157] The second advantage MERS offers its customers comes later when homeowners fall behind on their monthly payments. In addition to its document custodial role, and its tax evasive role, MERS also frequently attempts to bring home foreclosure proceedings in its own name.[158] This eliminates the need for the trust—which actually owns the loan—to foreclose in its own name, or to reassign the loan to a servicer or the originator to bring the foreclosure.[159]

Altogether, these businesses created an extremely powerful and lucrative device for marshaling capital into home mortgage loans. Securitization appeared to decrease the information costs for investors interested in investing in home mortgages. By pooling mortgages together and relying on a rating agency to assess the securities funded by the pool, investors thought they had relatively reliable prediction of expected returns without investigating each individual originator and each individual loan.[160] Also, securitization allowed loan originators to make great profit from origination fees by leveraging limited access to capital into many loans. Even lenders with modest capital could quickly assign their loans into a securitization conduit, and use the proceeds of the sale to make a new round of loans.[161] These characteristics led to an unprecedented increase in consumer access to purchase money mortgages, home equity lines of credit, and especially cash-out refinancing—many of which are today in serious arrears.

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[153] R.K. Arnold, *Viewpoint*, INSIDE MERS (MERS Inc.), May-June 2004, at 1.
[154] Alternatively, the originator may close in its own name and then record an assignment to MERS. Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO. L. REV. 805, 806-7 (1995).
[155] Slesinger and McLaughlin attempt to explain:

> Consistent with mortgage participations where a lead participant holds legal title on behalf of the other participants, and with secondary market transactions where mortgage servicers hold legal title on behalf of their investors, MERS will serve as mortgagee of record in a nominee capacity only. After registration, all subsequent interests will be established electronically.

Slesinger & McLaughlin, *supra* note 165, at 806-7.
[156] Arnold, *supra* note 142, at 35-36.
[157] Whitman, *supra* note 150, at 61.
[158] BAXTER DUNAWAY, 2 LAW OF DISTRESSED REAL ESTATE § 24:20 (2003).
[159] Arnold, *supra* note 142, at 35. (asserting "foreclosures can be done in the name of MERS without the need to reassign the mortgage."). There remain significant unsettled legal issues regarding MERS' authority to foreclose. Some courts have dismissed foreclosure suits brought by MERS insisting that the foreclosure must be brought by the actual owner of the loan. *See* Mortgage Electronic Registration Systems, Inc. v Dewinter, Case No. 16-2004-CA-002440-XXXX-MA, Division CV-H, Fourth Judicial Circuit, Florida (2005).
[160] Hill, *supra* note 69, at 1086-87.
[161] Eggert, *Predatory Lending*, *supra* note 83, at 546.

III. CONCLUDING REMARKS: OBSERVATIONS ON THE ROLE OF SECURITIZATION IN THE SUBPRIME FORECLOSURE CRISIS

The secondary market for privately securitized home mortgages helped facilitate the subprime mortgage crisis in at least three significant ways. First, securitization allowed small lenders and brokers with minimal reputational capital to churn out vast mortgage loan volume with little or no accountability.[162] Because securitizing originators quickly assigned their loans, their own capital was only invested in any given loan for a short period of time. Once a loan was sold, the originator could use the proceeds of the sale to find a new consumer for another loan, and so on. In effect, securitization allowed Wall Street capital to transform relatively small businesses into multi-million dollar institutions with a tremendous impact on the lives of entire communities. The difficulty of monitoring loan brokers for poor underwriting and consumer protection law violations, the complexity of measuring risk in pool securities, the incentive of wall street investment bankers to push through deals to generate fees, commissions and revenue, all led to a system-wide culture of emphasizing loan quantity over credit quality.

Second, an outdated legal and regulatory system failed to provide an incentive against poor underwriting and abusive practices. Federal and state consumer protection laws were written before the evolution of privately securitized mortgages. As a result, many of the key consumer protection laws, such as the Truth in Lending Act, the Fair Debt Collection Practices Act, and the Federal Trade Commission's holder in due course notice rule presume antiquated business practices and were thus ill-suited to regulate the subprime market. Take the definition of the term "creditor" in the Truth in Lending Act as a simple example. The statute defines a creditor as "the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness."[163] This definition is important since the private cause of action creating the possibility of liability under the act extends only to "any creditor who fails to comply" with the Act's requirements.[164] While this definition resonates with the notion of a lender as we commonly think of it, this notion is increasingly discordant with reality. In the vast majority of subprime home mortgage loans, most of the actual tasks associated with origination of the loan, including especially face-to-face communication with the borrower, are conducted by a mortgage loan broker.[165] Because brokers usually do not fund the loan, they are not the party to whom the loan is initially payable. Because the statute presupposes a unitary notion of a single individual or business that solicits, documents, and funds a loan, the most basic term defining the scope of the act does not reflect the simple reality of typical business practices. The absurd result is that the federal statute which purports to promote useful and accurate disclosure of credit prices, does not govern the business or individual that actually *speaks* to a mortgage applicant. Rather, liability for the statute is confined to errors in the complex paperwork, which many consumers have difficulty reading, and which are typically ignored in hurried loan closings long after borrowers arrive at a decision on which broker and/or lender to use. Far from an extraordinary example, the inapplicability of the Truth in Lending Act to mortgage

[162] Eggert, supra note 83, at 546; Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?* 15 HOUSING POL'Y DEBATE 715 (2004); Diana B. Henriques with Lowell Bergman, *Mortgaged Lives: A Special Report: Profiting From Fine Print With Wall Street's Help*, N.Y. TIMES, March 15, 2000. at A1; Bobbi Murray, *Wall Street's Soiled Hands*, THE NATION, July 15, 2002, available at http://www.thenation.com/doc/20020715/murray2.
[163] 15 U.S.C. § 1602(f).
[164] 15 U.S.C. § 1640(a).
[165] Many mortgage market insiders have begun to discard terms "lender" and "broker" instead using "mortgage-makers". *See, e.g.*, Jesse Eisinger, *Long and Short: Mortgage Market Begins to See Cracks as Subprime-Loan Problems Emerge*, WALL ST. J., Aug. 30, 2006, at C1 ("The worry has been that in the rush to gain customers during the housing boom, mortgage-makers lowered their lending standards. During the boom times, investment banks overlooked these concerns because they had no problem finding buyers for their mortgage and debt products.").

brokers is similar to basic exemptions for securitization participants from liability in virtually every federal statute. In the end, our finance technology outpaced our consumer protection law, in effect deregulating the most vulnerable segment of the mortgage market.

Third, securitization made enforcement of what consumer protection law that did apply to structured finance deals much more expensive for consumers. Discovery, negotiation, loan modification, settlement, and litigation in general are all more difficult for consumers with securitized loans than for loans funded by the traditional publically sponsored secondary market. Unlike traditional financial institutions that originated and serviced loans themselves, in structured finance deals, the many different companies and investors involved have differing incentives. Whereas forty years ago, a borrower might need to serve one party, to bring the full range of predatory lending claims and defenses to bear on a subprime securitization conduit can require litigating against ten or more different businesses. This is a daunting task indeed, since at the outset, the consumer will almost always have no knowledge of the name, address or other contact information for many of these firms. Indeed, counsel for the foreclosing party herself probably does not know which businesses were involved in performing the various functions associated with the loan. Phone calls to the loan's servicer are frequently ignored, subject to excruciating delays, and typically can only reach unknowledgeable staff who themselves lack information on the larger business relationships. For their part, securitization trustees are not in the business of counseling the thousands of mortgagors pooled in each of the many real estate trusts they oversee. Policy makers must not underestimate the staggering difficulty of reconstructing the facts involved in only one loan.[166] Securitization creates an opaque business structure that consumers have great difficulty forgathering.

With the recent seizure of Fannie Mae and Freddie Mac by the federal government and the scarcity of investors willing to risk their assets in private mortgage-backed securities, the future of American home finance is uncertain. One suspects that governance minimalists will attempt to use the inability of the Fannie Mae and Freddie Mac to adjust to the housing depreciation caused by private subprime securitization as a pretext for dismantling the federal secondary mortgage market infrastructure that has served our nation well since the Great Depression. Irrespective of how the home mortgage market of tomorrow will be funded, it is clear that a comprehensive overhaul of the nation's consumer finance law and regulation is the *sine qua non* of any meaningful new housing policy.

[166] Bobbi Murray, *supra* note 162.