The Securitization of Mortgages in the United States: A Market of Mass Destruction

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One can make the case that the worldwide recession has been caused by the secondary mortgage market in the United States. This has been achieved largely through the new vehicle called securitization. According to one commentator:

> Securitization received a significant stress test and not only failed miserably, but also helped drag down much of the world's economy with its failure. The current recession is, to a surprising extent, caused by the effects of securitization itself. While other factors also played a role in the meltdown, subprime securitization may represent one of the greatest structurally-caused financial implosions of the modern world.[1]

It seems that, in modern times, no lender in the United States would dream of holding a mortgage to maturity. Rather, the mortgage is originated and flipped to some buyer in the secondary market. "Today's mortgage lenders are paid out of points, fees, and commissions at closing, as well as the proceeds of assignment of the note, limiting the incentive of the lender to adopt practices which guarantee future repayment and minimize liability risk."[2] The secondary market states in advance what the criteria are for mortgages they are willing to buy. Buyers of mortgages hold the whip hand as to what actually appears in a mortgage agreement between a home owner and an originator.[3]

In the real estate bubble in the decade of the "aughts,"[4] these criteria deteriorated, resulting in foolish lending practices. The losses from the subprime market are basically losses in the secondary market. Although many mortgage originators failed,[5] they have failed only to the extent they could not successfully flip their mortgage assets into the secondary market. Or they have failed because they have invested in the products of the secondary market--lately called "toxic assets."[6]

Within my lifetime, American mortgage lending was limited to banks and savings and loans. In those days, states could prohibit even nationally chartered such institutions from having branches, even if the banks were federally chartered, thereby denying to the large banks the ability to compete with the small-town single-branch banks.[7] Typically, these small banks would take deposits from local townsfolk and use these deposits to finance mortgage loans. Then they would hold the mortgages until maturity. Where banks lent conservatively, they could not help but being profitable, as they paid no interest at all on checking accounts. Or, to the extent they issued certificates of deposit, they of course

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[1] Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 Conn L. Rev. 1257, 1259 (2009).

[2] Christopher Lewis Peterson, *Predatory Structured Finance*, 28 Cardozo L. Rev. 2185, 2273 (2006).

[3] Henry T. Greeley, *Contracts as Commodities: The Influence of Secondary Purchases on the Form of Contracts*, 42 Vand. L. Rev. 133, 147-48, 168-70 (1989); Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. Colo. L Rev. 1, 71 (2009).

[4] Between 1997 and 2005, the average value of an American home rose from $150,000 to $250,000. Eggert, *supra* note 1, at 1266.

[5] In 2007 alone, 150 mortgage originating firms, employing over 50 persons per firm, went out of business. Eggert, *supra* note 1, at 1261.

[6] Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State*, 76 U. Chi. L. Rev. 1613, 1627-28 (2009),

[7] The Riegle-Neal Interstate Banking and Branching Efficiency Act, Pub. L. No. 103-328 (1994), preempted such local legislation. Today, banks may have branches in every state.

had to be sure that their return exceeded the interest owed on such certificates.

Savings and loans, meanwhile, were limited by law as to how much interest they could pay on deposits. And the criteria for lending was carefully regulated. Basically, savings and loans could only lend on 80% of the appraised value of real estate, which they were required to take as collateral.

With regard to banks and S&Ls, the federal government assured all deposits less than some substantial amount. This was a signature achievement of Roosevelt's New Deal, and the capstone in the federal effort to prevent runs on banks (of the sort Jimmy Stewart staved off in *It's a Wonderful Life*). In effect, a deposit was risk free and so banks had to pay little enough interest to depositors, where they paid any at all. And just in case, S&L interest rates were fixed by law.

With the advent of the Reagan administration in 1981, the United States lost its taste for such strict regulation of its financial institutions. Prior to the Reagan administration, the life of a banker was boring. But now S&Ls could lend on anything. The limits on the amount of interest they could charge was repealed. Meanwhile, the federal government continued to insure S&L deposits.

Reagan-era legislation paved the way for subprime mortgages. The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted state-law interest rate caps, thereby allowing for free floating interest rates on mortgages.[8] The Alternative Mortgage Transaction Parity Act of 1982 permitted adjustable rate mortgages and balloon payments.[9]

Private developments changed the S&L and mortgage origination business. National exchanges were set up whereby any S&L could offer a CD to any investor nationwide. Since S&Ls could compete on price and had instant access to depositors nationwide,[10] it became possible for start-up S&Ls, often set up in the garage of a suburban split-level home, to get many millions in capital very fast. A notorious case was the Penn Square Bank, which quickly obtained substantial capital based on government-insured CDs peddled nationwide. Penn Square then made foolish loans, mostly in the energy market, with high yields. These loans they sold in the secondary market. When the energy industry went into recession in 1982, these loans went bad, and many venerable banking institutions failed along with Penn Square.[11]

The Reagan and first Bush administrations responded with an S&L bailout, as the federal government was seriously on the hook for its guaranties of deposits. Legislation created the so-called Resolution Trust Co., which became the receiver of failed S&Ls. The RTC would typically seize S&L assets and liquidate them. Often guaranties were made to buyers of these assets. Federal exposure to the "toxic assets" of failed S&Ls was high, but, significantly, the RTC ended up making a profit for the government before it was finally closed down in the late 1990s.

During this era of de-regulation, banks and S&Ls grew tired of holding mortgages to term. Rather, they sold them, thereby raising cash for further loans. This allowed banks to collect fees up front, instead of waiting for interest income over time. Banks and S&Ls found that they need or could not depend on deposits so heavily. The proceeds from the secondary mortgage market could much more efficiently generate the needed liquidity. No capital reserves were required under bank adequacy regulations, where the mortgage assets went off the books, to be replaced with cash.[12] Meanwhile, with the rise of mutual funds and money markets, consumers lost interest in low-return bank deposits.[13]

Indeed, the secondary mortgage market created a boom in firms that were not banks or S&Ls, but were simply mortgage brokers, essentially, who financed themselves with flips and a little bridge financing. What made this possible was the advent of securitization.

Securitization stemmed from a United States Supreme Court opinion, *United Savings*

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[8] Pub. L. No. 96-221, 94 Stat. 132.

[9] 12 U.S.C. § 3801-06 (2000).

[10] Carl Felsenfeld, *The Savings and Loan Crisis*, 59 Fordham L. Rev. S57 (1991).

[11] Willis R. Buck, *Bank Insolvency and Depositor Setoff*, 51 U. Chi. L. Rev. 188 (1984).

[12] Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Federal Conglomerates and the Origins of the Subprime Financial Crisis* 41 Conn. L. Rev. 963, 984-85 (2009).

[13] Felsenfeld, *supra* note 10, at S20.

Association of Texas v. Timbers of Inwood Forest Associates, Ltd.,[14] certainly the most important American bankruptcy decision ever. This ruling held that companies in bankruptcy reorganization did not have to pay interest to undersecured creditors, while the bankruptcy was pending. This was an enormous competitive advantage to capital-intensive companies financed by secured debt. These firms could park in bankruptcy proceedings and live interest-free for the duration of the proceeding.

Now what does this have to do with the secondary mortgage market, you may ask? Financial markets invented a product to respond to this judicial opinion. Hence securitization was born. Initially, it was designed to replace secured loans with the sale of assets. Imagine a company with accounts receivable. Rather than wait for the accounts to be paid, the company uses the accounts as collateral for a secured loan. This is precisely the province of *Timbers of Inwood Forest*, which amounts to a "bankruptcy tax" on secured lending. A firm that has borrowed with assets as security owed no interest compensation to the extent the secured loan was underwater. But if the accounts could be sold once and for all time, the bankruptcy tax could be avoided. Thus, securitization, in its origin, was a tax avoidance procedure, based on the formal difference between secured loans and sales. Of course, lawyers loved to make the sales as close to secured loans as possible, to remove residual risk from the buyer/lender back to the seller/borrower. The question in securitization was always, how much recourse could the buyer have against the seller without sacrificing the all-important concept of the "true sale" of accounts.

In securitization, the accounts are supposedly "sold." The buyer is a "special purpose vehicle," or "special purpose entity." These entities would be organized as subsidiaries of the "originator." The SPV would raise cash by selling short term debt to the public. The idea of securitization was the promise of bankruptcy remoteness. The SPV could not possibly go bankrupt, supposedly, because it had only liquid assets easily valued and only short-term debt incurred solely to buy those assets. Meanwhile, if the originator was bankrupt, the SPV (not the originator) controlled the cash flow, so that the bad incentive created by *Timbers of Inwood Forest* could be evaded. In short, the product, through contractual arrangement, avoided the bankruptcy tax of *Timbers*. This is proof of the Coase Theorem, which preaches "who cares about law when the transaction costs of contracting are low?"

Very soon after the invention of securitization, mortgage originators found it a convenient way to sell their mortgages in the secondary market. To the extent originators were banks or S&Ls, they were ineligible for bankruptcy reorganization, so a product that promised to be bankruptcy-remote expanded into financial media for firms that, by law, were already bankruptcy-remote. Securitization is where most subprime mortgages traded in the secondary market.

By far the most significant factor in the secondary mortgage market are two federally chartered companies nicknamed Fannie Mae[15] and Freddie Mac.[16] These entities were created in the mid-twentieth century to buy mortgages, thereby creating liquidity in the mortgage lending industry. Unlike banks that, at the time, had geographic restrictions, Fannie and Freddy were chartered by the federal government and could operate anywhere. Fannie and Freddie would set criteria for mortgages they were willing to buy. Mortgages were written strictly to accommodate them. Mortgages that adhered to the rules of Freddie and Fannie were called "conforming loans" or "prime loans," as opposed to the subprime mortgages that proved so poisonous to the worldwide economy.

The way Freddie and Fannie would finance themselves was to issue mortgage passthrough certificates. These are what later would be called collateralized debt obligations (CDOs) or mortgage-backed securities (MBSs). They were non-recourse notes issued on a designated number of mortgages

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[14] 484 U.S. 365 (1988).

[15] The official name is the Federal National Mortgage Association (FNMA), created by congressional legislation in 1938.

[16] Short for the Federal Home Loan Mortgage Corp. Freddie was created by the Emergency Home Finance Act of 1970. The difference between Fannie and Freddie was that the former bought mortgages from banks and the latter from S&Ls. But this distinction has long since been erased. The two corporations are now simply competitors. There is also the Government National Mortgage Association (GNMA), or Ginnie Mae. Ginnie Mae, spun off from Fannie Mae in 1968, guarantees selected mortgages and buys them only if there is a default. Properly, it is a government agency, not a privately held corporation and is not part of the story of the secondary mortgage market.

bundled together by Freddie or Fannie. In effect these were securitizations *avant la lettre*.

Some of the story of the worldwide recession turns on Freddie and Fannie. Although they dealt in conforming loans, toward the height of the real estate bubble, these entities could not resist buying up subprime and so-called Alt-A loans,[17] to the point where Fannie held one in three of all subprime loans and two out of three Alt-A loans.[18]

Freddie and Fannie have now been thrown into receivership under special legislation passed in the frenetic autumn of 2008.[19] The future of these companies is a matter of vigorous debate. For the moment, the Obama administration plans to perpetuate these firms on the ground that they really have lowered the cost of debt service that American home owners must pay.

American financial institutions were far from prepared to sacrifice the profits in the secondary market to Freddie and Fannie. And so they offered competing securitized products--CDOs. These often contained subprime mortgages, but they could also contain risky credit card receivables and other junky payment intangibles. It became popular to sell off these CDOs in tranches. The highest tranche would often be guaranteed and so would obtain a AAA rating.[20] The lower tranches would be riskier. By this trick, AAA securities could be wrung out of junk.

Because the secondary market was so vigorous, the United States developed an entire set of mortgage originators that were not banks. These originators might deal with Freddie and Fannie, but they also had other arrangements, resulting from the fact that Fannie and Freddie (as well as other securitizers)[21] would force sellers to take back mortgages if they went into default too quickly. Having taken back these so-called "scratch-and-dent" mortgages, these too had to be sold in order for the originator to stay liquid. This led to the practice of repurchase agreements, or repos. A repo is supposed to be bankruptcy-remote--that is to say, the sold item was thought not to be part of the bankruptcy estate of the originator. Hence, an originator, having repo'ed an asset, might not be liquid enough to buy back the item as promised, but the sold item would be out of the bankruptcy estate and so it could be sold. Originally, the repo market was limited to federal treasury securities and, significantly, Freddie and Fannie mortgage passthrough notes, because these were fungible. The obligation of the repo seller was to buy back an instrument *like* the sold item (not to buy back the exact item sold). But soon enough mortgage originators wished access to the repo mechanism. To accommodate this, Congress amended the Bankruptcy Code in 2005 to make "whole loan repos" immune from the automatic stay, which enjoins any disposition of property of a bankruptcy estate once the bankruptcy petition is filed. Whole loan repos are not really repos. There is no fungibility. If I sell you a mortgage note involving 1325 Elm Street in Fairview NJ, I promise to buy back that exact mortgage and not one that resembled it, such as the mortgage on 1323 Elm Street. The reason for no fungibility is that the boiler in 1323 Elm might be shot, but is in good shape at 1325 Elm. Repo sellers were not about to empower the buyer to substitute inferior properties for the prime stuff originally sold.

Although these are not repos, nevertheless, courts have so far upheld the immunity of the whole loan repo from the bankruptcy estate, on the theory that this what Congress must have intended.[22] Ironically, none of this made a difference when the subprime market went bad, since the repo partner found no one would touch the repo'ed mortgage, and the repo partner was forced to absorb the loss, just as any secured lender would.

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[17] Alt-A loans are made to "borrowers who have prime credit scores but cannot provide full income documentation, or otherwise pose a higher risk." Zywicki & Joseph D. Adamson, *supra* note 3, at 7.

[18] David Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 Ala. L Rev. (2010), at 27 (forthcoming); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039, 2061 (2007).

[19] The Housing and Economic Recovery Act of 2008.

[20] There are three rating agencies in the United States: Moody's, Standard & Poor's, and Fitch Investment Co. All three are currently garnering heavy blame for rating as AAA investments that within months or weeks would sell for 40 cents on the dollar.

[21] Engel & McCoy, *supra* note 18, at 2062-63.

[22] In re American Home Mortgage Holdings, Inc., 411 B.R. 181 (Bankr. D. Dela. 2009).

The secondary mortgage market has been accused in complicity with predatory lending.[23] Suppose a mortgage lender violates the law with regard to a mortgage loan. But then the mortgage loan is securitized or repo'ed out. The buyer is often not liable for the original sin of the mortgage, especially where the mortgage is connected with a promissory note.[24] The secondary market therefore serves to immunize the ultimate investor from any claim sounding in predatory lending.

With mortgage foreclosure so prevalent, the messy procedures tolerated in the secondary mortgage market now causes legal difficulties in actually foreclosing. Borrowers have learned that the ostensible owner of the mortgage cannot really prove its ownership rights. It doesn't possess the underlying note. Its interest is not recorded in the real estate records. On the other side of the coin, borrowers discover that there is no one out there who can agree to a workout. There is usually a collection agent, who is typically the originator,[25] but, while this entity can collect or foreclose, but it cannot usually not bind the principals to the workout.[26]

This latter problem could be solved in bankruptcy. A bankruptcy court might value the property and approve of a reorganization plan, whereby the lender is forced to take restructured payments reflecting the reduced value of the underlying property. Such a deal, if properly administered, would make the borrower and the assignee of the mortgage better off. But such a power, called "cram down" in American legal patois, has never been allowed in the home mortgage market,[27] even though it is routinely allowed for other kinds of secured loans. President Obama actually campaigned on the issue of expanding cram down to home mortgages, pointing out that Senator McCain, his opponent, owned seven houses and could legally cram down six of seven mortgages, whereas the typical beleaguered borrower could not get a cram down of his one principal residence. This political initiative, however, seems to be dead politically. It was killed off by the banks, who undoubtedly used some of their federal bailout money to pay lobbyists to kill off the legislation. I should add that this bankruptcy proposal is scary for mortgage lenders. As it now stands, they are basically immune from consumer bankruptcies. Under the cram down proposal, they would have to hire a bankruptcy lawyer because house valuations are big money for the lenders. As there are over a million consumer bankruptcies a year in the United States, most of them involving mortgage debt, this would be a major change in lifestyle for the lenders.

An emerging market solution to the problem that securitization causes for workouts is for firms to buy the properties at foreclosure sales. But this is done only after the firm has agreed with the homeowner on some new mortgage agreement that the homeowner can actually afford. Whereas no one has the power to agree to the workout before closure, the firm buys a fee simple absolute estate and can make whatever deal it wants with the homeowner or anyone else. These firms promise to keep homeowners in their houses on economically realistic terms. Any losses would be visited upon the SPV owning the mortgage note. Of course, the homeowner will have a personal obligation to repay the mortgage, where the winning bid is below the face amount of the mortgage note. So the homeowner might have to supplement the deal with a personal bankruptcy in which the personal recourse against the homeowner might be discharged.

So what reforms are Americans now considering?

It has been suggested that subprime mortgages be banned, to the extent that mortgage payments do not match the income cashflow of the borrower.[28] Or that the possible mortgage agreements be

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[23] For a list of actionable predatory lending practices, see David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla St. L. Rev. 985, 999-1000 (2006).

[24] An exception is the Home Ownership and Equity Protection Act, which imposes strict liability on assignees of carefully defined "high cost loans.". 15 U.S.C. § 1641(d)(1).

[25] Engel & McCoy, *supra* note 18, at 2063. Often originators will sell the right to collect to some more efficient economy-of-scale firm. *Id*. at 2075.

[26] Engel & McCoy, *supra* note 18, at 2078.

[27] 11 U.S.C. § 1322(b)(2).

[28] Alan M White, *The Case for Banning Subprime Mortgages*, 77 U. Cin. L. Rev. 617 (2008).

reduced to a series of standard terms, which differ only in terms of easily identified price terms.[29]

One reads proposals that buyers of mortgage notes be subject to setoffs against predatory lender claims by borrowers.[30] But this may be difficult to achieve. In one famous incident, the state of Georgia passed such legislation. In response, Standard & Poor's (one of the rating agencies) issued a press release stating that it would no longer give a AAA rating to a securitization involving a Georgia mortgage. The outcry from Georgia originators was so high that the Georgia legislature sheepishly had to water down its legislation with damage caps until Standard & Poors was mollified.[31] So, if you were wondering who is the more powerful, a sovereign state within the United States of America or a rating agency, clearly the rating agency is the more sovereign.

Another type of proposal concerns Fannie and Freddie. It is bandied about that these firms enjoyed an implicit guaranty by the federal government. That is to say, they are too big to fail. Believing this to be so, buyers of MBSs from these firms pay lower than market prices, meaning that Fannie and Freddy have lower cost of funds than competing firms. This allows the shareholders to earn duopolist profits. For this reason, many commentators think that Fannie and Freddie should lose their federal charters and should shown to Highway 495, the fastest route from Washington to Delaware. The idea here is to end the implicit federal guaranty and thereby force Freddie and Fannie to sacrifice their advantage in cost of funds.

Many people are exploring ways to remove from the rating agencies the incentive to inflate their opinion of securitizations in exchange for fee revenue. Typically, it is suggested that the rating agency be appointed by the Securities & Exchange Commission, and that the fee be paid into a pool in such a way that a rating agency no longer connects the rating directly with receipt of the fee.

A proposal being pushed by some congressmen is that originators should be forced to keep a piece of every mortgage, so that the originator has the incentive to make good loans. This requirement has privately been imposed by securitization on originators through the requirement that the originator buy the lower tranches, but originators have often been able to dump these low-grade tranches into yet other securitizations, which they then sell off.[32] Obviously this reform will require some legal requirement that the retained residual interest not be alienated--perhaps a difficult requirement to engineer.

Few, however, are calling for a direct ban on securitization. Most commentators think that it is a cheap method for raising funds for mortgage origination. And, in the end, will it be possible to regulate away a real estate bubble? I doubt it. The "greater fool" theory of markets has a powerful allure. No doubt the bubble will always haunt market economies.

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[29] Zywicki & Joseph D. Adamson, *supra* note 3, at 72.

[30] Engel & McCoy, *supra* note 18, at 2081.

[31] Christopher Lewis Peterson, *Predatory Structured Finance*, 28 Cardozo L. Rev. 2185, 2244 (2006); Reiss, *Rating Agencies*, *supra* note 23, at 1033-36. For a similar New Jersey tale, see *id*. at 1051-53.

[32] Engel & McCoy, *supra* note 18, at 2067.