

The Story of Sub-Prime Mortgage Disaster*

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This Article outlines the problems in the securitization of sub-prime mortgages. One main problem was that the borrowers were not qualified. The terms of these mortgage loans became far more onerous after a certain period (usually two years) and prepayment penalties made refinancing very costly. In addition to the inappropriate borrowers, the sub-prime mortgage loans were granted on inflated real estate prices, which created a higher percentage of failures when the borrowers sought to sell their homes. The amount of such loans was very large. Therefore, the failure and home values created a financial crisis. The Article concludes by outlining the recent laws and regulations that attempt to reduce the losses and crises and the additional proposed regulation that await approval.

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Introduction

In October 2007, the board of directors of Merrill Lynch, one of the largest brokerage houses in the United States, accepted the request of its Chief Executive Officer for early retirement. The brokerage firm disclosed that it had lost over \$8 billion on its investments in sub-prime mortgage loans¹. Merrill Lyn-

ch was not the only financial giant to sustain enormous losses². These losses left little money for lending. The banks nearly ceased lending and the investors nearly ceased buying debt securities. The effect of these events spread abroad, and foreign regulators accused U.S. regulators of laxity – a drastic change of attitude from the usual complaints about U.S. strict regulation. More importantly,

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¹ Ryssdal, K. (2007), *Merrill Lynch's subprime losses pile up*, Oct. 24, available at http://marketplace.publicradio.org/display/web/2007/10/24/merrill_lynch/.

² See Grey, B. (2007), *Citigroup ousts CEO, warns of billions more in subprime losses*, Nov. 6, available at <http://www.wsws.org/articles/2007/nov2007/citi-n06.shtml>; see also Richard, C. (2007), *Subprime Losers Blame Bear*, Credit Suisse, JPM, Morgan Stanley, April 11, 2007, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=av134G5JBAjQ&refer=home>, speaking about an “illusion” of safety.

the threat of a depression has risen and is lingering³. The U.S. government has taken steps to ease the pressure⁴ but it is not clear how much “ease” would be enough. The U.S. government contribution enabled J.P. Morgan to purchase Bear Stearns, a venerable old firm for \$2 a share, which was then raised to \$10 a share⁵. It was feared that if Bear Stearns became insolvent the financial system would be shaken to the core⁶.

This crisis was triggered by securitized “sub-prime” mortgage loans. Like all good things, securitization involves not only benefits but also business and legal risks to the participants and sometimes to the financial system. The risks of securitization are reduced by lawyers’ designs⁷, by rating agencies and appraisers of the collateral, by market discipline, and by the regulators and the law⁸. Occasionally these protective mechanisms fail. It seems that in this case all failed.

This Article discusses the securitization of sub-prime mortgage loans that went wrong and offers a few suggestions designed to help prevent such a disaster

from happening again. Section One of the paper describes sub-prime mortgage loans. Section Two examines the benefits and risks that securitization poses to borrowers, lenders, sellers of the loans (Originators) and investors of mortgage-backed securities. Section Three surveys the laws and practices designed to reduce the risks posed by securitization. Section Four describes the sub-prime crisis and the environment leading up to this crisis. Section Five offers an analysis and conclusion.

Section One. The sub-prime mortgage loans

Sub-prime mortgage loans are loans secured by mortgages on real estate, mostly private homes. Mortgage loans are considered relatively secure loans because borrowers usually make every effort to meet the loan payments and avoid losing their homes. However, in the United States such loans pose a number of risks. Many of these loans cover most of the value of the collateral, up to

³ For the debate whether U.S. economy needs a depression see *Does America need a recession?* Aug. 23, 2007, available at http://www.economist.com/finance/displaystory.cfm?story_id=9687245, see also Stepek, J. (2007), *Do we need a recession?* Sept. 28, http://money.uk.msn.com/Investing/Insight/Special_Features/Moneyweek/article.aspx?cp-documentid=6252186; see also Brittan, S. (2001), *Why the US needs a recession*, FT, March 29, available at http://www.samuelbrittan.co.uk/text73_p.html.

⁴ Grey, B. (2007), *US government brokers scheme to bail out Wall Street banks*, Oct. 18, available at <http://www.wsws.org/articles/2007/oct2007/bank-o18.shtml>; see also Price, J.R. (2007), *Viewpoint: FHLBs' Critical Role in Restoring Liquidity*, Oct. 19, available at <http://www.americanbanker.com/article.html?id=200710185QH9T3MG&queryid=1433601750&hitnum=1>.

⁵ Irwin, N. and D. Cho, *Fed Takes Broad Action to Avert Financial Crisis*, *Washington Post*, A01 (March 17, 2008); *JP Morgan raises Bear Stearns bid*, available at <http://news.bbc.co.uk/1/hi/business/7311179.stm> (March 24, 2008).

⁶ Clark, A. (2008), *Sold for just \$2 a share - the bank once worth \$25bn*, *The Guardian*, available at <http://www.guardian.co.uk/business/2008/mar/17/jpmorgan.useconomy1?gusrc=rss&feed=networkfront> (March 17).

⁷ See Frankel, T. (2002), *The Law of Cross-Border Securitization: Lex Juris*, 12 Duke J. Comp. & Int’l L., 475 (2002).

⁸ See *supra*, section 3.

95% of the real estate value. In addition, if the homes are occupied (and they usually are), the cost of evicting the occupants and selling the buildings can be very high and take a long time. That is because real estate is relatively illiquid and because the occupants are protected by foreclosure and eviction laws. These protections are costly to the creditors in time and money⁹.

The meaning of the terms “prime interest rate” is ambiguous. Historically, this term meant the level of interest rate which most, if not all, major banks¹⁰ usually charged their best credit worthy, low-risk, “prime borrowers”¹¹. Since the mid-2000, however, the banks have charged different “prime rates”. The meaning of “sub-prime rate” is now

even more ambiguous. It may signal to borrowers less than the prime rate (sub-prime). It can suggest to lenders and investors low-risk “prime borrowers.” That is, those borrowers who pose lower risk than “prime rate” borrowers. This can be misleading.

In fact, sub-prime mortgage loans posed far higher risks than prime rate borrowers. The loans triggered *higher interest rates* after a grace period¹². Some loans amounted up to 125% of the value of the collateral¹³, which means that the loans were granted without any collateral. In some cases the lenders of sub-prime mortgage loans waived the requirement that borrowers show future income or cash flow¹⁴. High rates and other terms of these loans signaled high risk borrowers.

⁹ See Lehnert, A. and K.M. Pence, *The Price of Protection: Foreclosure Law and House Prices*, Dec. 20, 2003, available at <http://andreas.marginalq.com/Research/Foreclosure/fhp.pdf>; *Contra* Fox, J.B. (2002) Foreclosure protection not always the deal it seems, *Was. Bus. J.*, April 12, available at <http://www.bizjournals.com/washington/stories/2002/04/15/focus14.html?page=2>.

¹⁰ In some cases the definition of “prime rate” was more flexible *Id.* The court held that the borrowers’ breach of contract claim might be cognizable on a theory that the bank breached an obligation of good faith toward the borrowers in setting its prime rate. When the agreement unilaterally permitted the bank to determine the extent of performance, the bank was obligated to proceed in good faith under *Ga. Code Ann.* § 13-2-1 (1982). The court denied the borrowers’ motion for partial summary judgment.

¹¹ *Lum v. Bank of Am., et al.*, 361 F.3d 217 (3d Cir. 2004). The prime rate has been described as “murky, ill-defined term that rarely reflects the lowest rates available to corporate customers.” See Staff of House Comm. On Banking, Finance and Urban Affairs, 97th Cong., 1st Sess., *An Analysis of Prime Rate Lending Practices of the Ten Largest United States Banks 3* (Comm. Print 1981). Decisions supporting the lack of precision in the term “prime rate”: *Blount Fin. Serv. Inc. v. Walter E. Heller and Co.*, 819 F.2d 151, 152-53 (6th Cir. 1987); *Wilcox v. First Interstate Bank of Oregon*, 815 F.2d 522, 527-28 (9th Cir. 1987) considering prime rate to mean the average cost of a loan; *Center Cadillac, Inc. v. Bank Leumi Trust Co. of New York*, 859 F. Supp. 97, 103 (S.D.N.Y. 1994), *aff’d*, 99 F.3d 401 (2d Cir. 1995); *Lum v. Bank of America, et al.*, 361 F.3d 217 (3d Cir. 2004).

¹² LexisNexis (2007), *Subprime Lending: An Update of the Issues and Approaches*, Aug.; see also *Doyle v. Trinity Savings & Loan Association*, 869 F.2d 558 (10th Cir. 1989) footnote 2.

¹³ *In re Cmty. Bank of N. Va. & Guar. Nat’l Bank of Tallahassee Second Mortg. Loan Litig.*, 418 F.3d 277, 303 (3d Cir. 2005) 277, 2005 U.S. App. Lexis 17471 (3d Cir. Pa. 2005).

¹⁴ For the historical evolution of the prime rate especially in ARMs see *ARM Indexes: Prime Rate, 2000-present*, available at <http://www.hsh.com/indices/prime00s.html#explanation> (last visited Dec. 02, 2007); see also Lee, C. (2007), “*Slice of the System*” *Product Applicable Interest Rates for Delinquent Bills and Annual True-Up Adjustment*, Nov. 6, available at http://www.bpa.gov/power/psp/products/slice/interest_rates.shtml *McCloskey v. NovaStar Mortg., Inc.*, 2007 U.S. Dist. Lexis 62297 (E.D. Pa. Aug. 21, 2007); *In re Marriage of Chakko*, 115 Cal. App. 4th 104, 8 Cal. Rptr. 3d 699, 2004 Cal. App. Lexis 80, 2004 Cal. Daily Op. Service 585, 2004 D.A.R. 761 (Cal. App. 2d Dist. 2004).

Section Two. The process of securitization and its risks and incentives to the actors

The process. Securitization involves a number of steps. A lender makes loans. The lender sells the loans to an Originator, or serves as the Originator. The Originator transfers the loans to an entity, be it a trust or a corporation or any other recognized entity. The entity issues securities to investors. The investors' payments for the securities are transferred to the Originator. The pooled loans produce for the investors income and repayment of the capital. In fact, the investors become the ultimate lenders. Generally, the lender or Originator continues to service the loans by collecting the payments from the borrowers, and transferring the payments due to the investors¹⁵. In addition, the pool of loans is usually backed by guarantees that reduce the interest rate paid by investors and increases the Originator's revenues. Thus, securitization brings about fundamental changes in the lending process, the incentives of the intermediaries, and sometimes of the borrowers as well. The parties involved are initial lenders, ultimate lenders (the investors) and the borrowers. It is important to note that the process produces two lenders instead of the usual one, and individual borrowers as well as the aggregate of borrowers. The intermediaries involved are Originators, securities brokers, mortgage brokers (in the case of mortgage-backed securities), servicers, and rating agencies.

Benefits and risks for lenders, and other intermediaries. Making loans for sale enables lenders to transfer their lender-risks (e.g., borrowers default, collateral value deterioration, and interest rate changes). Further, the sales bring lenders immediate profits in contrast to the long-term profits of holding the loans and immediate cash for further lending or investing.

Moreover, by securitizing the loans they make, lenders can remove the loans from their balance sheets. Loans on the balance sheet require banks to retain reserves. Having sold the loans they make relieves banks of this constraint. In addition it enables banks to make additional loans with the cash they received from the sold loans. Banks have created fully-owned subsidiaries, transferred the loans they made to these subsidiaries, which then Originated and sold the securities. This benefit is not foolproof, however. There are situations in which the Originators and the other intermediaries in the chain may be obligated to buy back the securities backed by the loans at a loss. The Originators must keep an inventory of securities backed by the loans. If the prices of the securities fall and there are no buyers for these securities or if the securities must be sold at a very large loss, then the Originators sustain a loss. In addition, if the Originators sold the securities but the price of the securities fell significantly, market pressures may require them to buy back the securities from their customers at great losses¹⁶. And in addition, if the securi-

¹⁵ See generally Frankel, T. (2006), *Securitization - Structured Financing, Financial Assets Pools, and Asset-Backed Securities* §8.1 (2d ed.).

¹⁶ Banks and broker dealers might be hard-pressed to give the buyers guarantees, implicit or explicit,

ties were sold to fully owned subsidiaries, and the price of the securities plummeted, the Originators and sellers of the loans may have to put the loans or the securities back on their balance sheets. Citibank and Merrill Lynch have done precisely that, when the securitized loans, housed in their fully owned subsidiaries, sustained significant losses¹⁷. Similarly, if the lenders-sellers keep a large inventory of the securitized loans, the lenders may bear the risks of underwriters, if they could not sell the securities at a profitable price.

Making loans for sale may provide the lenders with incentives to make as many loans as possible and sell them as fast as they can. While lending and keeping the loans are constrained by the amount of capital the lenders have, lending for sale converts into incentives to make as many loans as possible, create more funds for lending, and gain from the sales.

In addition, making loans for sale reduces the lenders' incentives to secure high quality loans. Unless lending sellers are constrained by market discipline and regulation, they have strong incentives to expand their borrowers-base, which can lead to reduced loan quality. This incentive becomes stronger when the quality of the loans is hard to gage and the quality of the loan-backed secu-

rities is even harder to evaluate.

The lucrative lending and selling business enticed banks as well as financial intermediaries, such as securities brokers and new intermediaries such as mortgage brokers, to enter the field. The shorter the terms of holding the loans, the greater the turnover of the sales of the securitized loans, the more lucrative sales become. Their risks remained related mainly to large inventories that they might have to hold and promises that they might have to give about the quality of the securities backed by the loans.

Benefits and risks for borrowers. Borrowers benefit from securitization by access to funds, and sometimes from better credit terms¹⁸. In the case of securitized sub-prime mortgage loans, however, many borrowers could not afford such loans. Often they did not seek the lenders. The lenders, through the mortgage brokers, sought them out. These mortgage brokers focused on convincing people to borrow and create more loans for sale. The brokers did not always explain to borrowers the terms of the loans. Borrowers may not have read the terms of the loans, or could not read them or did not understand what they read, or decided to take the risks on the assumption that the value of the real estate would continue to rise. If the bor-

either to buy back the securities at the sales price, or guarantee market performance of the securities. If a legal obligation is attached to holding of the securities or to the process, the actors might have to add the guarantees to their liabilities on their balance sheets. But if the promises are implicit, there is no need to add the guarantees to the balance sheets, and yet when guarantees are due, market discipline would require the banks or brokers to buy back the securities or pay the losses to their investors.

¹⁷ Dey, I. (2008), US banks Citigroup and Merrill Lynch reveal fresh \$15bn loss, *The Sunday Times*, available at http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3671568.ece (April 13).

¹⁸ That is because investors might demand lower returns commensurate with their lower risk from distribution and diversification, and liquidity.

rowers sold their real estate at the peak of the bubble they gained much. Otherwise, they were likely to lose because when the interest rates under the mortgage terms rose, they were unable to make the payments. In addition, when they then wanted to escape payments by selling the homes, the prices fell.

In most cases the possible renegotiation of the loan terms was eliminated, because the borrowers lost contact with the initial lenders. The ultimate buyers of the securitized loans are pension funds or other institutional investors, whom the borrowers did not know. Under the terms of the loans, prepaying the loans was horrendously expensive, and these borrowers could not meet new loan requirements. Such borrowers are more likely to continue borrowing on their credit cards, at enormous interest rates, leading to bankruptcy.

Benefits and risks for investors. Investors benefit from investments, which they could not otherwise reach at attractive returns. However, investors take risks, such as the probability that securitized loans may be riskier than they are presented to be, even though a diversified pool of such loans may pose a lower risk. Essentially investors are unable to evaluate the price of the securities and the risks they pose. In the past, rating agencies valued the securities and appraisers appraise the real estate.

However, if these market actors are beset by conflicts of interest or if they are unable to make a realistic valuation, investors may sustain heavy losses.

In addition, depending on the applicable state laws, borrower might not have the right to prepay their loans without penalty¹⁹. Thus, if interest rates rise, the investors cannot gain if the interest rates in the loans are fixed. If interest rates fall, the investors are likely to be paid off, and could lend only at the lower rate. There are protections against these “prepayment risks,” but investors have to watch out for their availability. As noted, however, sub-prime mortgage loans were presumably designed in states that allowed the imposition of very high penalties on prepayment, as it was estimated that 70 percent of sub-prime loans have prepayment penalties, as compared to 2 percent of prime mortgages²⁰. Although some states have banned prepayment penalties, there is no broad prohibition²¹.

Securitization affects the financial system. The process can help increase lending capacity and distribution of risk. Yet, because it converts loans into securities it poses for the financial system the risks of excessive liquidity, the risks of the securities markets’ volatility and speculation, and the risk of lack of transparency. These risks, combined, can lead to a crisis. They actually did²².

¹⁹ Harmon, E.J., *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CLR 924, 923-938.

²⁰ Svaldi, A. (2007), Prepayment-ban length capped for mortgages, *Denver Post*, Dec. 18, 2007, at C-05, Lexis, News Library, Arcnws File.

²¹ See *supra* notes 80-81 and accompanying text.

²² See, e.g., David S. Evans and Joshua D. Wright, The effect of the Consumer Financial Protection Agency Act of 2009 on consumer credit, 22 Loy. *Consumer L. Rev.* 277, 292-93 (2010).

Section Three. The regulation of the parties involved in the sub-prime crisis

The parties involved in the sub prime-crisis are: the borrowers, investors, and the intermediaries, that is the lenders, Originators, sellers of the mortgage-backed securities, servicers of the payments and sometimes guarantors as well as rating agencies and appraisers of the collateral.

Historically, most lenders were banks and savings and loan associations. They were regulated with respect to the level of risk of the loans they can make²³ and the guarantees they could issue²⁴. In contrast, the lenders of sub-prime mortgage loans include unregulated private lenders that are not limited with respect to the risk they can take as lenders. In fact, these lenders were expected to lend to highly risky borrowers, who could not receive credit from banks.

It seems, however, that when regulated entities made loans for sale, and the loans were not reflected on their balance sheets, the level of the borrowers' risks rose, and the difference between the regulated and unregulated lenders diminished. From a bank regulatory point of

view, that was fine, since the regulated entities did not bear the legal risk. When banks and broker dealers sold the loans to their fully-owned subsidiaries that then issued securities to the public, it is unclear whether the lenders could disassociate themselves from these fully-owned subsidiaries and thus separate their assets from the values of the subsidiaries' assets²⁵. The conclusion is not clear. For example, brokers are usually also dealers and as such can obligate to buy back the securities that they sold customers. Therefore, it is unclear to what extent the broker-dealers must account for the buy-back obligations on their balance sheets. Protection of investors may conflict with protection of borrowers. In such a conflict, the interests of the borrowers can take precedence, but generally the transfer of loans among lenders is free of constraints. The assumption is that the borrowers are in no worse position if they have to pay one lender or another²⁶.

The securities acts regulate all Originators and sellers of mortgage-backed securities²⁷. The sellers must disclose the loan terms, and cause the units that issue the mortgage-backed securities to make appropriate disclosures²⁸.

²³ See Frankel, T. (2006), *Securitization* §7.9.1-4 (2nd ed., Ann Taylor Schwing ed.) (Frankel Securitization).

²⁴ Frankel Securitization at §7.10.4.

²⁵ See Morton, M.A. and M.K. Reilly (2004), *Stockholder Voting and Subsidiary Asset Sales After Hollinger*, available at <http://www.potteranderson.com/news-publications-0-42.html> (October), discussing *Hollinger Inc. v. Hollinger Int'l Inc.*, C.A. No. 543-N, 2004 WL 1728003, Strine V. C. (Del. Ch. July 29, 2004), appeal denied, C.A. No. 331-2004, 2004 WL 1732815 (Del. July 29, 2004).

²⁶ Frankel Securitization at §7.1.

²⁷ See generally Fabozzi, F.J. (2006), *The Handbook of Mortgage-Backed Securities*, 127 - 128 (McGraw-Hill).

²⁸ See *SEC Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets*, available at <http://www.sec.gov/news/studies/mortgagebacked.htm#seciii> (Jan. 2003).

The regulation of other intermediaries, such as brokers, differs from that of banks or issuers²⁹. But broker-dealers that sell securities, including mortgage-backed securities, are regulated by the Securities Exchange Act of 1934 and the National Association of Securities Dealers, as well as state laws³⁰.

Disclosure is the main form of investors' protection. However, disclosure in the case of securitized mortgage loans is not informative. These are complex securities that are very hard to value. The markets demanded, and the legislators have supported the demand for, additional verification of these securities' values. The verification is offered by rating agencies. Rating agencies have not been regulated by law until very recently, and the current regulation is relatively mild³¹. In fact, the agencies have been given credibility by the law³². They are mostly constrained by market discipline.

Rating agencies are not strictly regu-

lated even though their operations are riddled with inherent conflicts of interest. The agencies are paid by the entities that seek a high rating. These same entities are the source of information on which the agencies determine their ratings. Further, agencies have not performed their rating functions well. They focused mostly on the past performance of the rated securities, while the future terms and liquidity problems have not played a significant part³³. Moreover, the agencies have not reduced the rating in truly disastrous situations until it was too late, such as in the case of the Enron Corporation³⁴.

Similarly, real estate appraisers have only recently been regulated, in addition to their weak regulation under the common law³⁵. Like the rating agencies, however, these appraisers could be pressured by lenders and issuers to raise the appraisals of real estate and thereby justify lending higher amounts for the appraised real estate collateral³⁶.

²⁹ Frankel Securitization at §7.1.

³⁰ See *SEC Guide to Broker-Dealer Registration*, available at <http://www.sec.gov/divisions/marketreg/bdguide.htm> (April 2008).

³¹ Kormos, B.J. (2008), *Quis Custodiet Ipsos Custodes? Revisiting Rating Agency Regulation*, available at SSRN: <http://ssrn.com/abstract=1085132> (March 22, 2008). For a summary of recent rating agency regulation, see *supra* notes 72-74 and accompanying text.

³² See e.g., Rule 3a-7, 17 C.F.R. §275.3a-7 (2006) (exempting units that are used to securitize loans from the Investment Company Act of 1940, and including in one of the conditions that the securitized assets would be rated by a rating agency).

³³ Siew, W. (2008), *Rating agencies agree with NY to change practices*, available at <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSN0534583820080605> (June 5).

³⁴ Zamansky, J.H. (2008), *Sub-Prime Crisis and the Ratings Agencies*, available at <http://zamansky.blogspot.com/2008/01/sub-prime-crisis-and-ratings-agencies.html> (Jan. 29); see also Malhotra, H.B. (2007), *Are Rating Agencies to Blame for the Credit Market Crunch?*, *Epoch Times Washington* (Oct 21).

³⁵ Cocheo, S. (1996), *Appraisals: A trade under renovation*, 88 *ABA Banking Journal* 56 (Feb.). For a summary of recent appraiser regulation, see *supra* notes 75-79 and accompanying text.

³⁶ Perkins, B. (2005), *Appraisal Fraud Likely Greater Than Reported*, available at http://realtytimes.com/rtpages/20050415_appraisalfraud.htm (April 15, 2005); see also Max, S. (2005), *Appraisal fraud: your home at risk*, available at http://money.cnn.com/2005/05/23/real_estate/financing/appraisalfraud/index.htm (June 2).

In sum, intermediaries that engaged in securitization of sub-prime loans were regulated differently. Some were regulated by market discipline and others by the government, even though all these actors performed the same functions.

Section Four. The sub-prime loans crisis. The environment in which the failure of the loans occurred

At the beginning of the year 2000, interest rates soared in the U.S.³⁷. Consequently, the number of borrowers and loan securitizations fell³⁸, but investors' demand for loan products did not diminish. Loan Originators sought more borrowers, for their business, and to satisfy the market demand³⁹. These pressures drove Originators and intermediaries to make riskier loans, and to wrap such loans in enticing (short-term) terms for them. According to Freddie Mac only about 15% of the borrowers of sub-prime loans would have qualified for traditional loans, according to their credit score⁴⁰. The rest would not have qualified.

During the years 2000 to 2004 real estate prices were rising in part driven by abundant financing. Borrowers bought houses they could not afford⁴¹. They believed that real estate prices would continue to rise⁴² and that they could always sell their property for more than the amounts they owed. They hoped that interest rates would remain stable and the variable rates, which they would have to pay in the future, would not rise. Combined with a continuous appreciation of home prices, borrowing was very attractive, though risky. Yet, even borrowers who recognized the possible problems failed to realize their full extent⁴³.

Another reason for the rise of sub-prime mortgage loans was the abundance of money for lending. Not only securitization but also the Federal Reserve Board (FED) contributed to this high liquidity. During the years 2003 to 2006 the FED and other foreign Central Banks kept interest rates low⁴⁴. Low rates gave banks incentives to borrow, make loans for sale, and increase their

³⁷ *Id.*

³⁸ For the rise in demand of securities see LoPucki, L.M., *The Death of Liability*, 106 *Yale L.J.*, available at <http://ssrn.com/abstract=7589> or DOI: 10.2139/ssrn.7589 citing: Vogelstein, F. (1995), *Credit Cards Fuel Asset-Backed Issues*, *Wall St. J.*, Oct. 30.

³⁹ About the rise in demand of securities see LoPucki, L.M. (1996), *The Death of Liability*, *Yale L.J.*, October, available at <http://ssrn.com/abstract=7589> citing: Vogelstein, F. (1995), *Credit Cards Fuel Asset-Backed Issues*, *Wall St. J.*, Oct. 30.

⁴⁰ Blanton, K. (2007), *Dark side of subprime loans*, *Boston Globe*, Aug. 3, available at http://www.boston.com/business/personalfinance/articles/2005/08/03/dark_side_of_subprime_loans/

⁴¹ Wolf, M. (2007), *Questions and answers on a sadly predictable debt crisis*, FT, Sept. 5, 2007 at 11.

⁴² About the course of the mortgage interest rates from 1995 until 2006 and foreclosure activity see Gaines, J.P. (2007), *The Value of Subprimes*, *Tierra Grande*, July 3, 2007, available at <http://recenter.tamu.edu/tgrande/vol14-3/1824.html>

⁴³ Applewhite, S. (2007), *Greenspan: I saw loan dangers too late*, *Boston Globe*, Sept. 14, at C2. see also Wolf, M. (2007), *Questions and answers on a sadly predictable debt crisis*, FT, Sept. 5, at 11.

⁴⁴ North, G. (2007), *The Fed's next Moves*, Aug. 30, available at <http://www.lewrockwell.com/north/north563.html>; for statistical information on the Target Federal Funds and the Discount Rate see <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>; Lorimer Wilson, *The August 2007 Panic - What Happened and Why*, Aug. 22, 2007, available at <http://www.safehaven.com/article-8243.html>.

loan volume at great profits.

Rating agencies contributed to the rise of securitized sub-prime loans. The agencies signaled safety to investors⁴⁵. Both the future risks to borrowers and the risks to investors were not considered or revealed⁴⁶. Because securitized loans and the probability of their failure are very difficult to evaluate, investors trusted the transferors and the rating agencies to set the right price for the securities. If the valuation and pricing proved wrong, investors were likely to depress the market price by a mass selling of their securities and avoiding purchases. In the liquid market of mortgage-backed securities doubts about the value

of the securities can lead to a “run” on the securities⁴⁷.

Therefore, the importance of rating agencies’ judgment cannot be overly emphasized. They are viewed as a reliable and expert source of information and evaluation of debt securities. Most individual and institutional investors have no access to, or understanding of, the information that rating agencies process⁴⁸. Therefore, most investors must rely on the agencies.

Currently, there are criticisms about the way rating agencies have rated the sub-prime backed securities⁴⁹, and the environment of conflicts of interest in which they operate⁵⁰. The agencies did

⁴⁵ *Bankers Life Insurance Co. v. Credit Suisse First Boston Corp., et al.*, No. 07-690 (M.D. Fla. 4/23/07), available at <http://www.bankruptcylitigationblog.com/Binder1.pdf>, investors claimed that they did not possess material information on the status of the company’s MBSs which, if properly disclosed, would have resulted in the downgrade of the securities by Moody’s rating agency.

⁴⁶ The Enron Corporation disaster and sub-prime mortgage loans crisis have much in common. Both used securitization to convert assets into marketable financial assets. Both offered liquidity and distribution of risk, which are good. And both hid the absolute accurate value of the securitized assets. Both also enable the Originators of such loans to take their liabilities off their balance sheet while retaining liabilities, such as guarantees or obligations or understandings to buy back the securitized assets. Because the originators are also dealers, this obligation is linked to their business - dealer business. But the obligation to buy the customers’ securities if the market is thin is not truly optional for dealers. After all, dealers who refuse to buy back losing assets, which they sold, might tarnish their reputation as those who offer liquidity to investors.

⁴⁷ Wolf, M. (2007), *Life could yet follow death for the idea of securitization*, FT, Oct. 3, 2007 at 9.

⁴⁸ See Kenneth, L.G. and C.L. Cowan (2001), *Mortgage-Backed Securities; Developments and Trends in the Secondary Market* 1V, § 1:18 (2001) “An investment grade rating from one of the nationally recognized rating agencies is critical to the successful marketing of most large mortgage-backed securities issues. (Indeed, to qualify as a SMMEA security under current law, the security must be rated in one of the top two investment grades.) The rating agencies today rate mortgage-backed securities as a matter of course”.

⁴⁹ SEC: *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, at 9, available at <http://www.sec.gov/news/studies/credratingreport0103.pdf>; Manggi, Habir (2004), *The Role of Credit Rating Agencies*, Nov. 22, available at <http://www.adbi.org/conf-seminar-papers/2006/04/03/1760.credit.rating.agencies/>; see also Scannell, K. and D. Solomon (2007), *Unraveling the Subprime Mess*, *Wall St. J.*, Sept. 4, at A6.

⁵⁰ SEC: *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, at 19, available at www.sec.gov/news/studies/credratingreport0103.pdf (voicing similar criticisms in connection with the Enron and WorldCom scandals); SEC: *The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, Nov. 15 and 21, 2002, available at www.sec.gov/news/studies/credratingreport0103.pdf.

refine their analysis after the crisis⁵¹, but denied harmful conflicts of interest⁵². After all, the underwriters and issuers are the source of information that rating agencies need⁵³. That is why rating agencies are exempted from the regulation that prohibits outsiders the use of insider information⁵⁴. Nonetheless, paying issuers and underwriters who are the source of information are likely to influence the rating of their securities⁵⁵.

In the years 2006-2007 real estate prices had reached a peak and began to

decline. Sub-prime loans, that started with a “teaser” of a fixed rate for a period (few months to three years), or for a lower rate, reached the higher payment levels⁵⁶. As interest rates rose, and borrowers had to sell their homes, they depressed the demand for homes and caused prices to fall⁵⁷. Foreclosures rose⁵⁸. Rising defaults and deteriorating real estate prices fed on each other.

Doubts about the reliability of the rating agencies affected international regulation as well⁵⁹. For example, the

⁵¹ The rating agency, Moody’s, conceded in its September 26 and 27, 2007 testimony in Congress that the data on which the agencies have relied, concerning the creditworthiness of the borrowers and the value of the homes, was not always reliable. See John Mauldin, *The Panic of 2007*, 18. Aug., 2007, available at http://www.realclearpolitics.com/articles/2007/08/the_panic_of_2007.html

⁵² Scannell, K. and D. Solomon (2007), Unraveling the Subprime Mess, *Wall St. J.*, Sept. 4, at A6 (arguing that rating agencies failed to downgrade the financial assets in time).

⁵³ This situation would have presented problems for rating agencies under regulation FD. Regulation FD prohibits issuers of securities from communicating not publicly disclosed information to certain individuals. “(2) Paragraph (a) of this section shall not apply to a disclosure made:.... (iii) To an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available;”

⁵⁴ 17 CFR § 243.100(b)(2) (2007).

⁵⁵ In addition, this information could increase market volatility and promote a lack of transparency in the market. See SEC: *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, footnotes 90-92, available at www.sec.gov/news/studies/credratingreport0103.pdf. In addition, rating agencies could privilege their subscribers by offering them access to non-public material earlier than the other investors. Rating agencies defended their reputation by taking steps to avoid conflicts. For example, to avoid their analysts’ bias in favor of particular issuers the analysts’ compensation is not linked to specific deals; Scannell, K. and D. Solomon (2007), Unraveling the Subprime Mess, *Wall St. J.*, Sept. 4, at A6. There is no evidence that in the sub-prime mortgages crisis the rating agencies’ subscribers had better information than the public’s. In fact, the rating agencies seemed to be taken by surprise. The agencies have under-valued the risks posed by these securities and downgraded the securities later than they should have. The traditional rating methods reflect neither liquidity, nor signaling pricing. See McDaniel, R. in Scoltes, S. and C. Freeland (2007), *Moody’s to revise ratings by end of year*, FT, Oct. 12, at 22.

⁵⁶ Feldstein, M. (2007), Liquidity now!, *Wall St. J.* Sep. 14, available at [http://www.nber.org/feldstein/Wall St. J.091207.html](http://www.nber.org/feldstein/Wall%20St.%20J.091207.html); see also Jesse J. Holland, Mortgage woes spur ideas but no plan, *Boston Globe*, Sept. 4, at C1, according to the Senator Christopher Dodd, 1 to 3 million people could lose their homes just because of their onerous mortgage.

⁵⁷ Home building has fallen 20% at the lowest level of the decade. House prices have fallen 3.4% from the last 12 months. See Feldstein, M. (2007), Liquidity now!, *Wall St. J.*, Sep. 14, available at [http://www.nber.org/feldstein/Wall St. J.091207.html](http://www.nber.org/feldstein/Wall%20St.%20J.091207.html).

⁵⁸ Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, available at <http://www.bis.org/publ/bcbs128.pdf>.

⁵⁹ Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards. June 2006, Part 3: The Second Pillar: Supervisory Review Process, 757a, available at <http://www.bis.org/publ/bcbs128.pdf>.

provision in the international agreement of Basle II, which promoted reliance on rating agencies, became less certain⁶⁰. The failure of real estate appraisers to offer reliable appraisals deepened the crisis. The role of the real estate in mortgage lending is critical. Appraisals determine the value of the loan collateral. In the recent securitization of mortgage loans it seems that at least one large appraisal company has succumbed to the pressure of a client mortgage lender to raise its appraisals. The Attorney General of the State of New York recently sued First American Corporation and First American eAppraiseIT for succumbing to pressures to raise their appraisals⁶¹. New York law prohibits such pressures. In this case, the Attorney General of New York asserted that appraisers were under great pressure to provide ever-higher appraisals. If this is correct, then the securities backed by these loans and collateral were fraudulently over-priced. The effect of such appraisals, if they were sufficiently large and numerous, may have been to drive real estate prices higher.

Hedge funds played a role in this crisis.

A recent study concluded that hedge funds trading amounted to about 30% of all bond trading in the United States⁶². Arguably, hedge funds had substantially increased their leverage and their risks because they purchased and traded in significantly under-priced financial assets⁶³, including sub-prime mortgage loans. Hedge funds are free to leverage their portfolio. They are not regulated by the Investment Company Act of 1940, need not register under the Investment Advisers Act of 1940 (although some do), and might not be registered as broker-dealers. However, even if they do not offer their securities to the public, they are subject to the regulation of “private placements” under the securities acts⁶⁴. Therefore, hedge funds could have added to the bubble on sub-prime backed securities.

A market in risks trading has risen. The sub-prime market fueled the market for risks. Instruments providing risk shifting have been around for over 25 years with the development of swaps and their progeny. The idea was that lenders can

⁶⁰ Sloan, S. (2007), In Focus: Credit Woes Tilt Perspective on A Basel Pillar, *American Banker*, Sept. 10, available at <http://www.americanbanker.com/article.html?id=20070907M7YNVVNN>.

⁶¹ See press release of the New York State Attorney General (Nov. 1, 2007), available at http://www.oag.state.ny.us/press/2007/nov/nov1a_07.html; White, B. (2007), *Big real estate group accused of home price fraud with WaMu*, FT, Nov. 2, at 1; see also Dow Jones, Suit Claims Washington Mutual Pressed Appraisers, *American Banker*, Nov. 6, 2007, available at <http://www.americanbanker.com/article.html?id=2007110572PK7TE8&queryid=1746634224&hitnum=20>; see also Shenn, J. and S.L. Crenson (2007), *New York Subpoenas First American Appraisal Unit*, May 22, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=ayO8AMw7nMPc&refer=home>.

⁶² See Karmin, C. (2007), Hedge Funds Do About 30% Of Bond Trading, Study Says, *Wall St. J.*, Aug. 30, at C3 (suggesting that mortgage-backed securities were initially developed for highly sophisticated investors, such as the hedge funds, but later expanded to less sophisticated investors such as pension funds). This suggestion is questionable.

⁶³ Feldstein, M. (2007), Liquidity now!, *Wall St. J.*, Sept. 14, available at <http://www.nber.org/feldstein/Wall St. J.091207.html>.

⁶⁴ SEC *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, available at <http://www.sec.gov/answers/hedge.htm> (March 26, 2008).

exchange the risks stemming from the loan terms, for example, fixed interest and variable interest, to create more diversified portfolios for both lenders, without “swapping” their borrowers. What started as a swap of particular amounts evolved into swaps in notional amounts guaranteed by reliable large banks. The banks then matched the swaps for a certain amount of dollars fixed rate as against swaps for the same amount of dollars carrying variable rates. The issuing bank made sure that the parties were able and would indeed pay the amounts due if they lost and receive the amounts due if they gained. Thus, swaps involved payments by one party to the other depending on market interest rates.

At this juncture the step to speculation is short. Parties would bet on future interest rates and the one that bet wrong would pay to the one that bet correctly. Then came the market in shifting risk – instruments that allowed hedging against risks and trading in risks – Contingent Credit Default Instruments⁶⁵. Legally, the seller of loans does not incur the risks that the sold loans pose. However, when reputable institutions, such as banks, sell the loans they make, or securities backed by loans they made, and the buyers have sustained significant losses, the selling lenders are constrained to buy back the loans they sold. Otherwise, market discipline may punish them and clients will avoid them.

Therefore, the sale of the loans does

not fully protect the lenders (or Originators) from the risk that the loans pose. This is especially so if the loans made for sale are of lower quality than loans made for holding, and there is a greater chance that the buyers will demand compensation for their losses. The markets provided these lenders (and Originators) with coverage of this residual risk. For a price, another entity will ensure lenders (or Originators) against the risk posed by the loans these lenders made. If the loans resulted in losses, the other party “insurer” covered the lenders for the losses. So long as the “insurers” were reliable, the lenders could be covered from the risk posed by the loans they have produced.

The instruments representing such arrangements are similar to Credit Default Swaps, except that, unlike swaps, the obligations in these instruments are one-sided, similar to insurance for a premium. If the banks suffer losses, they can demand coverage from the insurers. If the banks do not lose, the insurers gain the entire premiums. To the extent that making risky loans exposed lenders to the risk of covering the losses of the loan buyers, the Contingent Credit Default Instruments reduced, if not eliminated, the risk.

At the beginning of the sub-prime loan movement banks and other reputable lenders sought and bought such “insurance” and there developed a market in these instruments. At some point it seems that the banks ceased to use

⁶⁵ de Teran, N. (2007), *FX & Derivatives: Contingent Credit Default Swaps, Come On Down* - In Bull Markets It Is Easy To Forget About Counterparty Credit Risk, But Recent Turmoil Has Brought It To The Fore And Placed Efficient Management Of Such Risk Back On The Agenda, *The Banker*, London: Nov 1: 1.

Credit Default Instruments to cover only their potential losses, but began issuing and trading these instruments as well. At this point hedging turned to speculation⁶⁶. The banks became insurers, as well as insured, and presumably matched their risks as insurers and their risks as insured. They became traders, diversifiers, and risk-hedgers of the risks posed by the loans they made. The Credit Default Instruments were extensively used during the sub-prime heydays⁶⁷. When such insurers failed, however, the insured failed as well and that started an unfolding of the system.

Lack of transparency and rating agencies. When traded instruments are too complex and when understanding and evaluating the instruments require significant data and expertise, the market participants must depend on the experts. Rating agencies that have been rating bonds offered a substitute for market evaluation. One reason for this service is that unlike stocks and other equity instruments, bonds are not actively traded, and their prices usually change with the volatility of the interest rates. The agencies' rating designates the risk that the issuing company will become insolvent, and that valuation lasts usually

throughout the life of the bonds. Asset-backed securities, when backed by mortgaged or receivables or other financial assets, are far more volatile. They do not depend on the well being of one company, whose financial health can be publicized, but on the financial health of many small borrowers, and the expected stream of payments that they will produce. Yet, even though the difference between bonds and asset backed securities is fundamental and important, rating agencies seem to have viewed asset-backed securities as bonds, and so did the market. Once the rating was given, the assumption was that the value changes would be minimal. Thus, not only did the market have no true means of pricing correctly the sub-prime mortgage backed securities, but the rating agencies did not do much better.

The sub-prime mortgage loan crisis has affected the financial system. The results of the bubble in the huge asset-backed securities markets and in the real estate markets caused significant losses to the financial infrastructure: the banks, underwriters and broker-dealers and to investors in the securities and the borrowers. Some gained enormously and some lost enormously. The system does

⁶⁶ For example, in Citigroup, the Credit Risk Management unit is responsible for Contingent Credit Default Swaps. Naturally, this unit was also dealing with the Credit Default Instruments. Working with the trading groups that originate and sell these instruments on behalf of the "insurer," the unit decides whether a risk can be held with or without hedging. If the decision is to hedge, the unit buys Credit Default Instruments from Citigroup's Counterparty Risk, for a premium, paid in advance. Citigroup Counterparty Risk then manages the risk by hedging it over the lifetime of the deal. Deutsche Bank on the other hand comments that it is difficult to find trading counterparts with the same, very particular positions - counterparts that are willing not only to sell protection on particular names, but also to link that protection to very specific undertakings.

⁶⁷ *Next Mega-Credit Problem Looming?*, available at <http://www.cbsnews.com/stories/2008/02/21/earlyshow/living/money/main3856688.shtml> (Feb. 21, 2008); see also Morrissey, J. (2008), *Credit Default Swaps: The Next Crisis?*, available at <http://www.time.com/time/business/article/0,8599,1723152,00.html> (March 17).

not seem to maintain its normal functions when it experiences shocks and the fears of “runs”. These pressures caused markets to come to a standstill, as liquidity dried up for lack of buyers.

Section Five. Analysis, proposal, the tightened regulation, and conclusion

The sub-prime crisis demonstrates the dark side of securitization: First, the process allows sellers to produce financial assets. Lenders (the producers) might be regulated with respect to the loans they make and hold, but in this case they made loans and sold them. Thus, the lenders’ incentives to ensure an adequate risk level is diluted and the level of risk of these loans could be higher. And it was. Sale of loans allowed and encouraged the separation of benefits from quality. In addition, the quality of financial assets is not easily determined by buyers. This fact as well induces laxity in the lenders’ creation and presentation of loans.

Often the sellers of the Instruments are insurance companies. As a result,

insurance companies are greatly affected by the sub-prime crisis and the Instruments that were based on sub-prime loans⁶⁸. During the past crisis in this area, traders like Morgan Stanley experienced losses in trading in Credit Default Instruments⁶⁹. There arose a problem of unconfirmed trades, which signaled the traders’ difficulties to meet their obligations⁷⁰.

A comparison with U.S. car manufacturers is instructive. During the 1950s car manufacturers began to manufacture cars with built-in obsolescence⁷¹. Consumers were conditioned to buy cars every five, four and then every three years (the 100,000 miles began to be the magical point). But long-term buyers sought more reliable cars and began to buy foreign cars. Manufacturers in the United States focused on short-term increased sales. They began to finance the buyers and even engaged in the financing business. Even when the issue of oil consumption became serious, car manufacturers continued to look at consumers’ desires, short-term, and produced large fuel consuming cars until the prices rose. It took time, but the

⁶⁸ Felsted, A. (2007), Insurers to reveal more on subprime writedowns; [Asia ed.] *Financial Times*, London (UK): Dec 5, 22.

⁶⁹ Data published by the New York FED shows a significant rise in the volume of these instruments in July. This increase was followed by a rise in unconfirmed trades, a sign that some dealers are unable to process trades in a timely fashion. See Croft, J. and B. White (2007), Fears spread on subprime impact; [London, 2nd ed.], *Financial Times*, London (UK): Nov 3, at 18; In the third quarter, JP Morgan wrote down \$339 million (net of hedges on collateralised debt obligations).

⁷⁰ Wolcott, R. (2007), *Credit derivatives: Trading backlog back again Euromoney*, London: Nov., at 1 (Several banks had signed up to the Corrigan letter in 2005 describing how they intended to resolve the unconfirmed trades problem. All the big credit derivative dealers and any counterparties executing more than four CDS trades a week are signed up to the Depository Trust & Clearing Corporation's (DTCC) Deriv/Serv platform. In addition banks have built in-house systems to manage these transactions. During the summer there were mismatches revealed that put at risk these trades. Duplicate transactions, lost trades, failed deliveries and out-of-sequence messages failed to be identified).

⁷¹ Tennant, D. (2004), *Art Car: Icon of Our Time*, available at <http://www.artcars.com/backtoschool/history/history.html> (April 1).

intense focus on sales and lower focus on quality and production caught up with these manufacturers. Only when the foreign car manufacturers took over part of the market did these manufacturers begin to focus on quality.

The sub-prime crisis reflects a similar malaise, but the results inflict losses on investors, lenders, even borrowers, and danger to the financial system as well. As the quality of the loans deteriorated, the lenders, and sellers in the chain of creating securities, gained. That is, so long as the separation of benefit from risk held. But the large regulated lenders did not part completely from the manufacturing of sub-prime-backed securities. Therefore, they, as well as the other investors, such as pension funds, lost when they remained holding the low quality loans. To return to the car manufacturers' example, the car manufacturers lost future buyers. There is a difference, however. Car manufacturers did not have to buy back the faulty cars. In the case of the sub-prime securities, the lenders had to buy back the losing securities at or near their sale price.

In sum, if the system were allowed to run without constraints, the incentives of the actors in the financial markets will be likely to increase: (1) lending capacity without limits; (2) rising risk lending and borrowing without limits; and (3) sales of the high risk loan-backed securities.

There is no doubt that securitization can be beneficial if these features are constrained. This would prevent lending capacity without limit and high-risk lending that is not diversified to reduce the risk to acceptable and predictable levels but not above it. There is a need to provide high-risk borrowers with a limited amount of credit, again, with limits, and offer investors securities at the right price. The question is what can be done to achieve these goals, without allowing the excesses that brought about the current crisis. The main purpose is to shelter the system from danger of ceasing to function and perform its services.

The tightened regulation. During the years 2006 to 2010 the United States Congress and regulators have tightened the law applicable to the securitization of subprime mortgages, including changes related to credit rating agencies, appraisers, and prepayment penalties. Following concerns about the role played by credit rating agencies in the crisis, Congress passed the Credit Rating Agency Reform Act of 2006, which requires rating agencies to register with the Securities and Exchange Commission (Commission), prohibits conflicts of interest and other abusive conduct, and imposes disclosure and reporting requirements⁷². Subsequently the Commission adopted implementing regulations⁷³. The Senate version of the pro-

⁷² Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 12, 15, 20, 23 U.S.C.) (prohibiting conflicts including those involving the manner of compensation by the issuer and other relationships with the issuer, and other abusive conduct including conditioning or lowering a rating based on issuer conduct; also authorizing Commission to deny registration if the firm "does not have adequate financial and managerial resources to consistently produce credit ratings with integrity" or for noncompliance with other requirements),

posed financial regulatory reform legislation would replace the current issuer-pays model by requiring the Commission to establish the Credit Rating Agency Board, a new self-regulatory organization that would assign a rating agency for an issuer's initial credit rating⁷⁴.

Regulators have also implemented reforms regarding appraisals. The Housing and Economic Recovery Act of 2008 requires appraisers for Federal Housing Administration (FHA) mortgages to be certified by the state where

the property is located or by a "nationally recognized professional appraisal organization"; and "have demonstrated verifiable education in the appraisal requirements established by the Federal Housing Administration"⁷⁵. In March 2008 Fannie Mae and Freddie Mac entered into an agreement with the New York Attorney General, with the approval of their regulator at the time, the Office of Federal Housing Enterprise Oversight (OFHEO), to adopt new appraiser independence rules⁷⁶. Simil-

⁷³ Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 55,857 (June 5, 2007), 72 Fed. Reg. 33,564 (June 18, 2007) (codified as amended at 17 C.F.R. §§ 240.17g-1 to -6 (2009), *as amended* by Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 61,050 (Nov. 23, 2009), 74 Fed. Reg. 63,832, 63,863-65 (Dec. 4, 2009)). Subsequent amendments to the regulations imposed additional requirements including additional conflict of interest prohibitions. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 59,342 (Feb. 2, 2009), 74 Fed. Reg. 6456 (Feb. 9, 2009) (codified at 17 C.F.R. §§ 240.17g-2(a)(2)(iii), (a)(8), (b)(7), (b)(8), (d), .17g-3(a)(6), (b), .17g-5(c)(5)-(7) (2009), *as amended* by Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 61,050 (Nov. 23, 2009), 74 Fed. Reg. 63,832, 63,863-64 (Dec. 4, 2009)); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 61,050 (Nov. 23, 2009), 74 Fed. Reg. 63,832 (Dec. 4, 2009) (to be codified at 17 C.F.R. §§ 240.17g-2(d), .17g-3(b)(9), (e)).

⁷⁴ Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. §§ 931-939D (as introduced in Senate Dec. 2, 2009) (to be codified if adopted in scattered sections of 12, 15 U.S.C.) (also authorizing Commission to suspend or revoke agency's registration; requiring Commission to issue new conflict of interest rules; requiring Commission to establish Office of Credit Ratings, which would conduct annual examinations of agencies and provide publicly available reports on the examinations; requiring Commission to adopt new disclosure requirements; requiring agencies to have boards of directors with at least half (and at least two) independent directors whose compensation is not linked to firm's business performance).

⁷⁵ Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1404, 2008 U.S.C.C.A.N. (122 Stat.) 2654, 2810 (codified at 12 U.S.C. § 1708(f)(5) (Supp. II 2006), *as amended* by Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 203(b)(1), 2009 U.S.C.C.A.N. (123 Stat.) 1632, 1643 (redesignated 2009) (current version to be codified at 12 U.S.C. § 1708(g)(5)); 24 C.F.R. § 200.202 (2009) (FHA regulation providing that eligible appraiser must be state licensed or certified and meet licensing or certification criteria of Appraiser Qualification Board of Appraisal Foundation).

⁷⁶ Bajaj, V. (2008). In Deal With Cuomo, Mortgage Giants Accept Appraisal Standards, *N.Y. Times*, Mar. 4, at C3, Lexis, News Library, Arcmws File. Under the rules, as amended, a lender may generally not use an appraisal prepared by the lender or an affiliate, nor may a lender or third party acting on its behalf attempt to influence the appraisal. A lender also may not accept an appraisal from an appraiser compensated by a mortgage broker or other third party not specifically authorized by the lender (such as an appraisal company or appraisal management company). The rules also provide for establishment of an Independent Valuation Protection Institute to receive complaints under the rules and publish best practices. *Fannie Mae, Home Valuation Code Of Conduct* (Dec. 2008), <https://www.efanniemae.com/sf/guides/ssg/relatedsellinginfo/appcode/pdf/hvcc.pdf>; *Freddie Mac, Home Valuation Code Of Conduct* (Dec. 2008), http://www.freddiemac.com/singlefamily/pdf/122308_valuationcodeofconduct.pdf.

arly, in September 2009 the FHA adopted new appraiser independence requirements⁷⁷. The proposed Wall Street Reform and Consumer Protection Act of 2009 would establish a Consumer Financial Protection Agency and require its director to lead a committee to adopt appraiser independence requirements for residential loans⁷⁸ and would amend the Truth in Lending Act to include appraiser independence requirements⁷⁹.

As noted, prepayment penalties made it costly for borrowers to refinance their mortgage loans. Since 2006, at least ten states have banned or restricted prepayment penalties on subprime loans, including some that have banned them on all mortgages⁸⁰. Legislation before Congress would amend the Truth in Lending Act to prohibit prepayment penalties on certain residential mortgages to consumers and restrict them on others. Prepayment penalties would be

prohibited on mortgages that are not “qualified mortgages”. To be considered a “qualified mortgage” a residential mortgage loan must generally meet ten criteria: (i) it does not have an adjustable rate; (ii) it does not allow deferral of principal or interest (and is not a “non-traditional mortgage”); (iii) its repayment schedule does not result in negative amortization; (iv) its terms are fully amortizing and there is no balloon payment; (v) the annual percentage rate does not exceed the average prime offer rate by more than a specified amount; (vi) the borrowers’ income and resources are verified and documented; (vii) the underwriting process must be “based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments”: (viii) the consumer’s monthly debts including the loan may not exceed a certain percent-

⁷⁷ U.S. Dep’t of Housing & Urban Dev., Mortgagee Letter 2009-28 (Sept. 18, 2009), <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-28ml.doc> (including a prohibition on lenders accepting an appraisal from an appraiser selected or compensated by a mortgage broker or a member of the lender’s staff compensated based on completion of the loan).

⁷⁸ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 4312 (as referred in Senate Jan. 20, 2010). The rules adopted by Fannie Mae and Freddie Mac would be sunset. *Id.* § 4312(c).

⁷⁹ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. §§ 9501-9506 (as referred in Senate Jan. 20, 2010) (to be codified if adopted in scattered sections of 12, 15 U.S.C.) (prohibiting, in consumer credit transaction secured by consumer’s principal dwelling, person with interest in transaction from attempting to influence appraisal of property offered as security in transaction; also prohibiting appraiser or appraisal management company from having interest in the property or transaction; requiring party involved in transaction to report any violation of appraisers’ professional standards or other illegal or unethical conduct; prohibiting creditor from extending credit without documenting its reasonable diligence regarding appraisal; regarding subprime mortgages, creditor would be prohibited from making subprime mortgage to consumer without written appraisal following physical property visit, and requiring second appraisal under some circumstances, and requiring appraiser to be certified or licensed in state where property is located and to comply with professional standards and Financial Institutions Reform, Recovery, and Enforcement Act of 1989; other amendments would include granting Appraisal Subcommittee of Federal Financial Institutions Examination Council new monitoring and regulatory authority).

⁸⁰ States aren’t waiting for Feds to clean up reckless lending, *PR Newswire*, July 11, 2008, Lexis, News Library, Curnws File.

age of gross income; (ix) the points and fees do not exceed two percent of the total loan; and (x) the term generally does not exceed 30 years⁸¹.

I believe that in addition we need a mechanism that would allow for moderation and flexibility. The mechanism should be simple but cannot be automatic. That is because moderation in the system's liquidity and level of risk can change depending on the environment and is unpredictable. Therefore, government must be allowed to calibrate these two items, yet do so with the minimal intervention in the market. In light of the analysis two changes in our current regulation are necessary. These are fairly simple; and some would say, simplistic. I would add to the regulatory changes the following.

First, every actor in the production and intermediation chain: the lenders, Originators, mortgage brokers, securities brokers, rating agencies and appraisers must retain a certain percentage of the loans or securities they make or sell or evaluate⁸². Lenders and Originators may choose to retain a percentage of the loans they make or sell, or acquire the securities backed by these loans. It matters not whether they hold the loans or securities in subsidiaries or affiliates. So long as they have control of the subsidiaries or affiliates, the loans or securities the subsidiaries hold are considered

owned by the parent or controlling affiliate.

Mortgage brokers, who receive a percentage of the loans they persuade borrowers to borrow, must receive a percentage of their pay in the securities backed by these loans. Rating agencies and appraisers must receive their fees in a percentage of the securities they rate or whose collateral they appraise. In addition, these intermediaries must keep the loans or securities for at least a number of years, for example, two years. The retained loans or securities must appear on the actors' books. The dates on which the retention was made must be verified by accountants or, in the case of small enterprises, by the heads of the organizations.

Second, the Federal Reserve Board (FED) should determine the percentage of loans or securities which the actors must keep, and the time period during which they may not sell the loans or securities. With respect to the securities part of the transaction, the FED must act with the consent of the Securities and Exchange Commission.

Third, the institutional market in risk in the various forms of derivatives must be evaluated and limited. Individuals may be allowed to gamble; but institutions upon which our financial system is based, may not.

This proposal meets a number of

⁸¹ Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 1074 (as introduced in Senate Apr. 15, 2010); Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 1075 (as ordered to be printed as passed May 27 (legislative day May 26), 2010).

⁸² See Simon, R. and K. Scannell (2010), Securities debate is all about trust, *Wall St. J.*, Mar. 30, at C1. Lexis, News Library, Wsj File (noting that Obama administration advocates that "lenders and companies that package loans into securities hold a portion of the loans on their balance sheets"; also noting Congressional proposal that they generally maintain five percent of the credit risk); Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 941 (as introduced Dec. 2, 2009).

objectives. First, keeping even a small percentage of manufactured loans and securities creates a measure of identity of interest with the buyers of the loans or loan-backed securities. It offers a barrier to unsafe lending. Amounts alone need not create the identity of interest with the buyers. The state of mind and the habit of making the comparison and identification are just as important. Therefore, there is a chance that even though risky borrowers will be able to borrow, the terms of loans such as sub-prime loans will not be offered on a massive scale⁸³. The tendency for restraint would apply to the other actors in the chain. To be sure, small brokers and mortgage brokers could be exempt; they cannot affect the system. But the large ones can and should be subject to the same identification requirement.

Second, this proposal offers the FED a mechanism to control liquidity (lending capacity) in the system, in addition to interest rates. If lending capacity is very high, as it was a few years ago, the FED can limit it by raising the percentage the lenders and intermediaries must keep on their books. And if liquidity dries up, the FED can reduce the percentage. In some situations this mechanism might be preferable to raising or

lowering the interest rates, and enable the FED to control liquidity not only through the banks but also through other sales mechanisms in the chain.

That is where the Securities and Exchange Commission should be involved as well. It regulates the securities markets and the securities brokers. It may well be desirable to include the mortgage brokers in the net of regulation either under the FED or the SEC or insurance regulators. That might depend on whose behalf they are acting, whether it is the banks, other lenders, or insurance companies, for example. The two steps – identification of sellers with buyers' interests, and using identification mechanism as a flexible limitation on liquidity – are likely to reduce the probability of a crisis such as we are facing today.

Securitization is a good and beneficial system. But, like all good systems, it can be abused. Abuse can be driven by good intentions, by greed and by short-term foolishness. While regulation should not stifle innovation and free enterprise, both innovation and free enterprise must be constrained when the actors benefit without being accountable, and their excesses can harm too many people, and the system as a whole.

⁸³ Mortgage loans are different from credit card loans in that if the borrower defaults, the rate of payment does not rise, as it is in the case of credit card. Thus, credit card lenders seek borrowers who can pay and are late in paying thereby paying penalty. But in the case of mortgage borrowers the cost of collection is high and there is no higher interest rate attached.