



Subprime Mortgage Market Turmoil:
Examining the Role of Securitization –
A hearing before the U.S. Senate Committee on Banking,
Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment

Written Testimony
of
Christopher L. Peterson
Associate Professor of Law
University of Florida

April 17, 2007

It is an honor to appear today before this Subcommittee. Thank you for the opportunity to share some thoughts on the turmoil in the subprime mortgage markets. My name is Christopher Peterson and I am a law professor at the University of Florida where I teach commercial law and consumer law classes. I commend the Subcommittee for organizing this hearing and for inviting me to share some thoughts on this important and timely national issue. I have been asked to discuss the instability, widespread foreclosures, and questionable business practices in the current marketplace. In my testimony I will discuss: (1) the basic background history and structure of securitization; (2) how evolving commercial practices have outdated existing consumer lending law; (3) how securitization raises the costs of objecting to unethical and illegal behavior for consumers; (4) how securitization shelters assets facilitating immunity from punishment for illegal behavior; and, (5) some necessary reforms.

I. The Mechanics of the Subprime Mortgage Securitization Process

The nature of securitization cannot be understood without some historical context. To briefly provide that background I suggest picturing the American residential mortgage market as having three basic time periods. In the first period of mortgage lending, which might be thought of as the “two party” period, mortgage loans were generally originated and held by the lender. In this period, which extended from the founding of the Republic through the Great Depression most mortgages were made by a seller of land to help the buyer acquire title. Mortgage lending by financial institutions included cooperative building societies (modeled after similar British institutions), mutual savings banks, private mortgage lending firms, and some insurance companies.

In this era most mortgages required a large down payment of around 40 percent of the home purchase price. Moreover, early twentieth century mortgage loans had terms typically averaging between three and six years. These short repayment durations necessitated high monthly payments often followed

by a large balloon payment of the remaining balance due at the end of the loan term. Relatively few families could overcome these financial hurdles. Moreover, lenders had both formal and informal policies discriminating against minorities and women. As a result, none but the most affluent men of European ancestry had reliable and widespread access to home finance.

The second period in American residential mortgage finance, which can be called the “three party” era, followed the Great Depression. When millions of people lost their jobs the prices for goods, services, and land all dramatically declined. Agricultural prices were so low, family farmers could not profit from selling their crops. Demand for goods and the investment capital from the stock market both dried up, forcing manufacturers to lay off workers. In the mortgage lending market, lenders were forced to call in their loans as *half* of all single-family mortgages fell into default. In foreclosure, real estate prices were so low, lenders could not recoup their investment by selling seized homes. Because lenders were understandably reluctant to continue making uncollectible loans, the mortgage finance and housing construction industries ground to a halt.

To restart the economy, Congress stepped in and created a fundamentally new secondary market infrastructure to facilitate residential mortgage finance. Through a series of acts, Congress created federal institutions that provided liquidity for mortgage loans. While a catalogue of these laws, programs, and institutions is beyond the scope of this hearing, it is important to recognize what all of these programs shared and continue to share: a unifying theme of federal government sponsorship and oversight. The three party model of mortgage finance was (and continues to be) characterized by a borrower, a lender, and some government affiliated institution that purchases, insures, or in some way exercises some underwriting oversight in the capitalization of the loan. As a condition of participating in this market, government affiliated institutions have required originating lenders to follow relatively strict and uniform underwriting guidelines that have stabilized the marketplace. Moreover, these underwriting guidelines have created an important hedge against participation in the market by unscrupulous, over-aggressive

companies and individuals. In this model, which financed the development of the American middle class, the federal government's leadership created high standards of safety and soundness as well as origination and servicing integrity. It is worth noting that the current turmoil in mortgage lending has, by and large, not affected the prime market overseen by government sponsored enterprises.

The third era of mortgage finance can be thought of as the era of private-label securitization. This period is generally thought to have begun in 1977 when Bank of America and Salomon Brothers (with some assistance from Freddie Mac) first created a trust which pooled mortgage loans and then passed through income from those loans to investors that acquired interests in the trust. After a variety of pricing, tax, and liquidity hurdles were resolved over the course of the 1980s and early 1990s, this market experienced explosive growth. Unlike the two and three party mortgage finance models, the private label securitization model of mortgage finance has ten or more different parties that all play an independent role in originating, pooling, structuring, and servicing mortgage loans. While there is tremendous variety in the way mortgage loans are securitized, Figure A nevertheless provides a graphic depiction that attempts to summarize the flow of capital and information in a typical contemporary private label securitization of subprime home mortgage loans.

week or two later, the borrower signs all the necessary paperwork binding herself to a loan which may or may not have the terms originally described. Some brokers fund the loan directly using their own funds or a warehouse line of credit, while other brokers act as an agent using the originator's capital to fund the loan. In any case, the originator establishes its right to payment by giving public notice of the mortgage through recording it with a county recorder's office. Then, in a typical conduit, the originator will quickly transfer the loan to a subsidiary of an investment banking firm. This subsidiary, which is alternatively called the securitization sponsor, or seller, then transfers the loan and hundreds of others like it into a pool of loans.¹ This pool of loans will become its own business entity, called a special purpose vehicle (SPV). The SPV can be a corporation, partnership, or limited liability company, but most often is a trust. Aside from the mortgages, the SPV has no other assets, employees, or function beyond the act of owning the loans. Under the agreement transferring loans into the pool, the SPV agrees to sell pieces of itself to investors. In a typical transaction, an underwriter purchases all the "securities"—here meaning derivative income streams drawn from payments on the underlying mortgages—issued by the pool. Usually employing one or more placement agents who work on commission, the underwriter then sells securities to a variety of investors with different portfolio needs. In designing the SPV and its investment tranches, the seller typically works closely with a credit rating agency that will rate the credit risk of each tranche. The credit rating agency investigates the credit risk of the underlying mortgages as well as the risks posed from pooling the mortgages together. Credit ratings on each tranche are essential, since investors rely on these ratings in deciding whether to invest in the pool of mortgages. The rating agency will typically require some form of credit enhancement on some tranches to assign them higher investment ratings. Often this enhancement will take the form of a third party guarantee from an insurance company on losses from mortgage defaults and prepayments.

¹ Sometimes the loan will be held in an SPV that is a wholly-owned subsidiary of the originator or the underwriter while awaiting assignment into an independent SPV that will issue securities. See, e.g., Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994) (describing advantages of "two tier" securitization conduit structures).

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

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

originated in the United States are registered on the MERS system.²

In addition to keeping track of ownership and servicing rights, MERS has attempted to take on a different, more aggressive, legal role. When closing on a home mortgage, participating originators now often list MERS as the “mortgagee of record” on the paper mortgage.³ The mortgage is then recorded with the county property recorder’s office under MERS, Inc.’s name, rather than the originator’s name—even though MERS does not solicit, fund, service, or ever actually own the loan. MERS then purports to remain the mortgagee of record for the duration of the loan even after the originator or a subsequent assignee transfers the loan into an SPV for securitization. MERS justifies its role by explaining that it is acting as a “nominee” for the parties.⁴

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

² R.K. Arnold, *Viewpoint*, INSIDE MERS (MERS Inc.), May-June 2004, at 1.

³ Alternatively, the originator may close in its own name and then record an assignment to MERS. Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO. L. REV. 805, 806-7 (1995).

⁴ Slesinger and McLaughlin attempt to explain:

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

name, or to reassign the loan to a servicer or the originator to bring the foreclosure.

Altogether, the goal of this complex system was to marshal capital into home mortgage loans. It was thought that securitization would decrease the information costs for investors interested in investing in home mortgages. By pooling mortgages together and relying on a rating agency to assess the securities funded by the pool, investors thought they had a reliable prediction of expected returns without investigating each individual originator and each individual loan. Also, securitization allows loan originators and brokers to make great profit from origination fees by leveraging limited access to capital into many loans. Even lenders with modest capital can quickly assign their loans into a securitization conduit, and use the proceeds of the sale to make a new round of loans.⁵ These advantages have increased consumer access to purchase money mortgages, home equity lines of credit, and cash-out refinancing. And while, in general, this is a positive development for American consumers, it has had profound and less beneficial consequences for some borrowers and investors.

II. Current Consumer Protection Laws Presume an Antiquated Model of Consumer Mortgage Finance

Securitization of subprime mortgage loans has proven extremely adept at generating high volume. But, as a system, it has not yet proven capable of reliably providing high quality services to consumers and investors. I believe this problem stems from the legal incentives actors in the system operate under. The one uniform feature of residential mortgage law is its failure to recognize and account for the complex financial innovations that have facilitated securitization structures. Most of the relevant consumer protection law, including the Truth in Lending Act (1968), the Fair Debt Collection Practices Act (1977), the Equal Credit Opportunity Act (1974), the Fair Housing Act (1968), and the Federal Trade

Slesinger & McLaughlin, *supra* note 165, at 806-7.

⁵ Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002) (Professor Eggert helpfully characterized this process as “churning”).

Commission's holder in due course notice rule (1975) all preceded widespread securitization of subprime mortgages by over a decade. While this time frame is not meaningful in itself, it hints at a fundamental structural problem in the law. The authors of these laws wrote definitions and rules that are poorly adapted to the current marketplace. Left without a meaningful vocabulary amenable to regulation of securitized consumer loans, courts and regulators have struggled to crowbar satisfactory policy outcomes out of legal rules and concepts which only vaguely relate to the commercial reality they purport to govern.

Taking one of many possible examples, the Truth in Lending Act and the Home Ownership and Equity Protection Act only govern the behavior of "creditors". This word suggests a unitary notion of a single individual or business that solicits, documents, and funds a loan. A creditor is currently defined as "the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness."⁶ This definition is important since the private cause of action creating the possibility of liability under the act extends only to "any creditor who fails to comply" with the Act's requirements.⁷ While this definition resonates with the notion of a lender as we commonly think of it, this notion is increasingly discordant with reality. In the vast majority of subprime home mortgage loans, most of the actual tasks associated with origination of the loan, including especially face-to-face communication with the borrower, are conducted by a mortgage loan broker.⁸ Because brokers usually do not fund the loan, they are not the party to whom the loan is initially payable. The absurd result is that the federal statute which purports to promote useful and accurate disclosure of credit prices, does not govern the business or individual that actually *speaks* to a mortgage applicant. Rather, liability for the statute is confined to errors in the complex paperwork that many consumers have difficulty reading and are

⁶ 15 U.S.C. § 1602(f).

⁷ 15 U.S.C. § 1640(a).

⁸ Many mortgage market insiders have begun to discard terms "lender" and "broker" instead using "mortgage-makers". See, e.g., Jesse Eisinger, *Long and Short: Mortgage Market Begins to See Cracks as Subprime-Loan Problems Emerge*, WALL ST. J., Aug. 30, 2006, at C1 ("The worry has been that in the rush to gain customers during the housing boom, mortgage-makers lowered their lending standards. During the boom times, investment banks overlooked these concerns because they had no problem finding buyers for their mortgage and debt products.").

typically ignored in hurried loan closings long after borrowers arrive at decision on which broker and/or lender to use.

This problem is made acute by the fact that in the subprime market mortgage loan brokers and originators have fundamentally inefficient incentives. These actors are not paid out of the monthly payments borrowers make on their loans. Rather brokers and originators are paid out of the closing costs and the proceeds of selling loans to secondary market participants. Generally speaking, the more loans originated the more money the broker or originator makes. Similarly, other things being equal, the larger the loan, the higher the commissions, closing costs, and sale proceeds that a broker or originator earns. These simple facts create strong short term incentive for brokers and originators to cut corners in the underwriting process—creating a dangerous and sometimes fraudulent disparity between company policies and company practices. It also creates an incentive for brokers and originators to encourage consumers to borrow more money than they can afford. Moreover, brokers and originators in the current system have an incentive to put tremendous pressure on appraisers to appraise home values higher and higher in order to facilitate ill-advised loans.

Similar problems exist for many of the other core concepts in the consumer protection law. Subprime mortgage servicers are usually outside the scope of the Fair Debt Collection Practices Act. The great majority of subprime originators are beyond the scope of the Home Ownership and Equity Protection Act. And the secondary market financiers that design the capital engine generating questionable loans are usually beyond the scope of assignee liability rules which purport to create an incentive for investors to police the market. All of these examples illustrate how the secondary market has evolved out of the reach of consumer protection law—in effect deregulating the most important and volatile consumer lending market.

III. Securitization Makes the Process of Objecting to Unethical and Illegal Lending More Costly

for Consumers

Another, equally important, critique of the effect of securitization lies in the impact it has on civil procedure. Discovery, negotiation, and litigation in general are more expensive for consumers with securitized loans than for loans funded by the traditional secondary market. One of the principal characteristics of securitization is that it tends to erect many barriers that prevent consumers from complaining effectively about unethical, unfair, or illegal treatment by loan brokers, originators, or servicers.

In traditional two and three-party mortgage markets, consumers and their counsel had a clearer idea of whom they were borrowing from and who might seek to foreclose upon them if they failed to repay. Service of process, interrogatories, depositions, and negotiations could be expected to involve only one company which was responsible for all, or nearly all, the relationship functions associated with the loan. In comparison, selling a loan into a contemporary structured finance conduit can force consumers to communicate with and litigate against many more business entities. Even simple litigation tasks, such as service of process and requests for production of documents, are much more complicated in structured finance. Whereas forty years ago, a borrower might need to serve one party, to bring the full range of legal claims and defenses to bear on a securitization conduit can require serving ten or more different businesses.⁹ This is a daunting task indeed, since at the outset, the consumer will almost always have no knowledge of the name, address or other contact information for many of these firms. Indeed, counsel for the foreclosing party herself probably does not know which businesses were involved in performing the various functions associated with the loan. Phone calls to the loan's servicer are frequently ignored, subject to excruciating delays, and typically can only reach unknowledgeable staff who themselves lack information on the larger business relationships. Indeed, since consumers cannot shop for their servicer,

⁹ These include: a broker, originator, MERS, master servicer, sub-servicer, special servicer, trustee, seller, underwriter, and an underwriter's due diligence contractor. If servicing rights have changed hands during the life of the loan, the consumer could require discovery from both old and new servicers.

these companies have virtually no market based incentive to provide useful customer service, such as the provision of vital information or correcting accounting and legal errors. For their part, securitization trustees are not in the business of counseling the thousands of mortgagors pooled in each of the many real estate trusts they oversee. Policy makers must not underestimate the staggering difficulty of reconstructing the facts involved in only one loan. Securitization creates an opaque business structure that consumers have great difficulty navigating.

These characteristics of securitized residential lending are troubling because even marginal increases in the cost of dispute resolution can have a dramatic impact on subprime mortgage borrowers. Consumers who are facing home foreclosure will not have the funds to hire counsel to assert their rights—after all, if they had the money, they would have made their payments. Organizations that provide free legal help, such as legal services organizations and law school clinics uniformly lack sufficient investigatory, paralegal, and administrative support. These organizations simply cannot handle even a small fraction of the volume of default generated by securitization structures even in strong market conditions.

The traditional civil justice system response to this type of disparity in dispute resolution resources has been the class action mechanism. But class actions are not generally viable in foreclosure defense, because each case has individual claims and facts that play out on unique time lines. Furthermore, courts often tend to refuse to certify classes alleging fraud, on the theory that the reliance element is an individual question not common to the class. Moreover, under the questionable guise of the Federal Arbitration Act, some courts have begun enforcing mandatory arbitration agreement clauses which waive altogether consumers' rights to proceed as a class. This development is particularly troubling because it also prevents the common law from innovating new legal incentive structures as a response to securitization, since arbitrators do not publish opinions. Most of the abusive and questionable subprime loan disputes may never reach the court system because they will be dealt with in high cost, secret, private

meetings rather than in a transparent public institution following the bedrock principle of *stare decisis*.

In consumer protection law, as in other areas of the law, substantive rights are only meaningful if there is some procedural vehicle for enforcing those rights. Even if securitization did not change the substance of consumer legal rights, the fact that litigation of those rights is much more costly for consumers must be seen as a fundamental disadvantage of securitization in general. Securitization sharpens the mortgage industry's comparative advantage in managing dispute costs. Not unlike a chess grand master making even piece trades down to checkmate after gaining a slight edge, predatory lending strategists can use their advantage in managing litigation costs to hide from judicial scrutiny within large structured finance deals. Higher dispute resolution costs associated with securitization significantly corrode the substantive consumer protection rights cast by our existing law. The result has been that consumers have little or no competent legal advice on how to deal with unfair, unethical, and illegal treatment in the mortgage subprime lending industry. With no watchdogs on the beat, even well-meaning companies have gradually begun to grow more, and more comfortable with questionable behavior simply to remain competitive.

IV. Securitization Can be Manipulated to Shelter Assets, Protecting Wrongdoers from Liability for Unethical and Illegal Behavior

Because securitization allows an originator to quickly resell its loans, the originator can make many loans while exposing only minimal assets to liability. As Professor Eggert has explained, this “churning” of capital “allows even an institution without a great amount of fixed capital to make a huge amount of loans, lending in a year much more money than it has.”¹⁰ As a result, when a class of predatory lending victims attempts to satisfy a judgment, their damages may far exceed the value of all the lender's assets. If an individual victim succeeds, or is about to succeed in obtaining a judgment, the lender can

¹⁰ Eggert, *Predatory Lending*, *supra*, at 546 (footnotes omitted).

negotiate a settlement. If an individual or class of victims obtains a large judgment, the lender's management can simply declare bankruptcy, liquidate whatever limited assets are left, and possibly reform a new company a short time later. Management of predatory lenders are indifferent because they are typically paid in full, or even give themselves raises, as their companies plow into bankruptcy.¹¹

Moreover, because the securitization conduit divides various lending tasks into multiple corporate entities—a broker, an originator, a servicer, a document custodian, etc.—the conduit tends to prevent the accumulation of a large enough pool of at risk assets to attract the attention of class action attorneys, which tend to be the only actors capable of obtaining system-impacting judgments. Legal aid attorneys and private counsel that bring individual claims often struggle with the length of litigation and the tremendous discovery problems presented in dealing with counsel for each individual entity in the conduit. The FTC and state attorneys general, of course, fare much better, but their limited budgets and personnel guarantee their cases only address the high profile offenders while the vast bulk of the market remain undisturbed.

These contentions are bolstered by the disturbing number of bankruptcies amongst subprime brokers and originators. Consumer advocates have complained that the subprime mortgage origination market has been saturated with “fly by night” lending operations.¹² These critics argue that individual business persons have learned to flip loans and then disappear, leaving consumers with no remedy.¹³ A

¹¹ The Orange County Register reported:

Executives at the region's controversial subprime lenders, including BNC Mortgage and First Alliance, provided investors with fresh reasons to dislike the industry. While BNC profits fell 24 percent, CEO Evan Buckley and President Kelly Monahan took home whopping pay increases of 79 percent and 83 percent, respectively. The folks over at First Alliance were just as cheeky. As earnings tumbled 71 percent, and government probes into the company's allegedly predatory practices widened, top executives took no pay cut.

James B. Kelleher & Jennifer Hieger, *Generous Executive Pay Often Fails to Bring Generous Shareholder Results*, ORANGE COUNTY REG., June 12, 2000, available at 2000 WLNR 6366186.

¹² Bert Caldwell, *Borrowing trouble: Predatory Lenders Rely on Consumer Desperation; Ignorance, by Deliberately Boosting Credit; and Offering Unrealistic Loan Terms*, SPOKESMAN REV. Jan. 20, 2002, at D1 (Washington State Executive Director of the housing consortium explaining that “dozens of companies move in and out of the local refinance market, doing 20 deals one year, just one the next. Some agents and brokers draw fees from multiple companies. ‘It’s kind of like hitting a moving target’”)

¹³ NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES, § 6.6.1.1 (2001 & Supp.). See also Tamara Loomis, *Predatory Lending Law Has Investment Firms in Arms*, 229 N.Y. L. J., March 27, 2003, at 1 (“Consumer groups say assignee liability is critical in the fight against predatory lending because many of the loan originators are shady individuals who

common pattern has developed where mortgage loan originators follow a boom and bust cycle. Indeed, in recent years, many of the nation's largest subprime lenders have followed this model, "leaving a vast number of subprime borrowers without any remedy" for predatory lending.¹⁴ Literally "hundreds of small and mid-size mortgage banks" periodically go bankrupt.¹⁵ As for the largest lenders, between 1988 and 2000, most of them helped themselves to judgment lien immunity from borrower lawsuits with respect to a staggering 125 billion of home mortgage dollars by declaring bankruptcy.¹⁶ Unlike consumer borrowers, investment analysts fully recognize this boom-bust cycle, and cautiously dissect where in the cycle any given lender is at a given point in time.¹⁷ The result is that when a judgment or series of judgments might substantially shape origination practices, these judgments will usually be defeated by the insolvency of the offending lender. The latest round of bankruptcies among subprime mortgage originators is simply a continuation of a systemic pattern created by the legal incentives in the industry.

In the older three party mortgage markets, the strict underwriting guidelines associated with government sponsored enterprises significantly limited the number of predatory lending victims. Why make a predatory loan if the only significant source of liquidity for the loan—the federal government—would refuse to purchase or guarantee it? In the new market place, mortgage loan originators serve not only an intake function—using marketing strategies to line up borrowers—but also a filtering function. As thinly capitalized originators make more and more loans, *claims against the lender accumulate, while the lender's assets do not*. The lending entities are used like a disposable filter: absorbing and deflecting origination claims and defenses until those claims and defenses render the business structure unusable. At

flip the loans and disappear.”).

¹⁴ Eggert, *Predatory Lending*, *supra*, at 603.

¹⁵ Robert Julavits, *Warehouse Lenders Struggle Through Merger Boom*, AM. BANKER, Oct. 23, 2000, at 9A..

¹⁶ See also Erick Bergquist, *Preparing for a Bad-Loan Boom*, AM. BANKER, Oct. 6, 2000, at 1 (“Since the liquidity crisis of October 1998, most of the major subprime mortgage lenders have filed for bankruptcy. Given that these failed lenders have issued \$125 billion of mortgage- and asset-backed securities over the past three years, . . . it would not be a surprise if 10% to 20% of the loans underlying those securities go bad.”).

¹⁷ See, e.g., Laura Mandaro, *Wamu Goal: 500 Café Loan Sites*, AM. BANKER, June 21, 2001, at 1 (analyzing whether Washington Mutual boom will lead to a bust); Aaron Elstein, *Analysts: No End in Sight to Consolidation: Panelists Doubt Thoroughness of Due Diligence, Question Large Writeoffs*, AM. BANKER, July 23, 1998, at 16 (analyzing investment credit risk from overpriced

the point when exit costs are less than the marginal expected utility of using a business entity subject to the wrath of the court system, the lender declares bankruptcy and/or reaches a questionable settlement neither of which preserve the homes of those who were wronged nor deter future predatory conduct. The result: the individuals who engage in predatory behavior and the individuals who engineer capital structure to facilitate that behavior are judgment-proof.

V. What Should be Done? Necessary Reforms to Restore Balance in the Mortgage Market

Unfortunately, there is no simple, silver bullet solution to the current mortgage market problem. For example, I do not believe that an agreement by key industry insiders to new best practices will change these structural problems. Nor do I believe that a “wait and see” approach of hoping that stabilization in home prices will solve these problems. The recent downturn in home prices only exposed the underlying inefficiencies in the market that have been festering for some time. Instead, I believe it is time for the Congress to consider adopting *comprehensive reform* of the nation’s consumer lending laws.

In my view, these reforms should include four policy areas: servicing reform, disclosure and closing reform, price regulatory reform, and liability reform.

A. Congress Should Adopt Comprehensive Reform of Consumer Mortgage Servicing Law

These reforms should include applying federal standards that attempt to prevent servicer errors and misbehavior. Servicers should be required to maintain complete and accurate files on all mortgage loans, including information on the loan’s history, assignments, and servicing rights. Moreover, because of the opacity of the current marketplace, consumers ought to have the right to view all the documentation in their loan file. Servicers and nominees should only be allowed to bring foreclosure actions on behalf of the holder of a loan when that holder has agreed to allow the consumer to assert claims or defenses

available against the holder against servicer or nominee. Moreover, at a minimum, the federal Fair Debt Collection Practices Act should be amended to govern all collection of home mortgage loans.

B. Congress Should Pass Comprehensive Reform of the Consumer Credit Disclosure and Closing Law

The Truth-in-Lending Act and the Real Estate Settlement Procedures Act should be integrated to provide consumers with a seamless, easily understood, scientifically tested price tag for all mortgage loans. Consumers must be able to learn the best pricing and terms a lender can offer up front, while the consumer is still shopping for the best deal. To this end, Congress should eliminate RESPA's misleading and toothless "good faith estimate". In its place Congress should require that lenders and brokers provide guaranteed closing cost quotes. Truth in Lending regulations should be amended to tighten the finance charge definition. The policy behind the finance charge regulations should come to reflect expenses incurred by the borrower rather than charges received by the lender. Finally, Congress should consider expanding the required borrower counseling for reverse mortgages to all subprime mortgages.

C. Congress Should Reform Federal Usury Preemption Laws

Under current federal law, there is no limit to the prices lenders can charge families for residential mortgages. Congress preempted interest rate restrictions on residential mortgages in an inflationary era when many states still insisted on general usury laws that are generally thought to be too low by modern standards. To this end, preempting state interest rate limits for residential mortgages was a good idea. But there is a reasonable middle ground between complete preemption and no preemption at all. In the home mortgage market, Congress should consider preempting state price limitations, but only those limitations which dip below a reasonable yield spread. There is no satisfactory justification for preempting state price regulation on mortgage loans with interest rates of more than eight percentage points above comparable term treasury notes. Moreover, it is time for Congress to restore the common-sense rule that in cross-state-border lending, the consumer's home state pricing law applies, rather than the bank or thrift's home

state law. The Supreme Court's price exportation doctrine established in *Marquette National Bank of Minneapolis v. First Omaha Service Corp.*¹⁸ has served the useful purpose of helping clear the way for the establishment of a national credit economy. Nevertheless, the important public policy of deterring the most extreme consumer lending abuses has suffered as a result. Today's leaders are should be ready to find a middle ground prohibiting the most dangerous and anti-social loans while facilitating the credit we as a society have come to embrace. Setting federal preemption floors would give states the opportunity to experiment with new methods of constraining predatory lending, while simultaneously preventing state governments from undermining lending within widely accepted limits.

D. Congress Should Adopt Comprehensive Mortgage Market Liability Reform

As a first step, either Congress or the Federal Trade Commission should expand the time-tested FTC holder-notice rule to cover all home mortgages, rather than just those that finance the acquisition of consumer goods or services. This rule has governed automobile financing for a generation, without inhibiting the flow of credit. Still, while amending the FTC holder-notice rule to include home mortgages would bring mortgage assignment law out of the nineteenth century, it would not bring the law up to date. The FTC holder-notice rule, along with promising proposals to create tiered assignee liability rules based on the extent to which assignees comply with due diligence standards,¹⁹ both hold investors responsible for the misdeeds of other businesses. Most investors have little opportunity to learn about predatory practices associated

¹⁸ 439 U.S. 299 (1978).

¹⁹ Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?* 15 HOUSING POL'Y DEBATE 715 (2004).

with pool loans. Stepping-up assignee liability is an improvement over the current legal system which tends to allocate losses from predatory lending to victims. But assignee liability rules merely shift predatory lending losses to investors. The change is, in effect, a transition from blaming the victim to blaming the patsy. Policy makers must come to terms with the notion that contemporary predatory mortgage lending is an economic artifice with two classes of casualties: consumers *and* investors. For this reason, proposals which create unlimited assignee liability may go too far by forcing relatively innocent investors to bear the brunt of large punitive damage awards. Is it fair to punish investors with unlimited punitive damage awards because they relied on unmet promises of due diligence from sellers and underwriters? It is true that investors could, in theory at least, bring lawsuits against these architects of a securitization deals seeking indemnity for damages. But judicial economy counsels against this approach. In order to levy damages on the responsible party, two separate victim classes would be required to win two separate lawsuits. The high transaction costs of such an enforcement system seem likely to undermine its deterrent value. The FTC's holder-notice rule steers a responsible middle road on this question by capping investor liability at the amount paid by a consumer under the loan in question.

This is not to say, however, that uncapped punitive damages have no place in deterring predatory mortgage lending. Rather, the full weight of judicial sanctions against predatory commercial behavior should be born by the businesses and individuals that abet, conspire, or co-venture that behavior. Congress should adopt legislation requiring that where securitization underwriters or sellers either knew or should have known that they were assisting in the securitization of illegal loans, those investment banks should bear imputed liability for aiding

and abetting that conduct. This rule would reverse the current incentive of the architects of securitization deals to avert their eyes to the seamy details of loans they channel to investors.

In conclusion, subprime mortgage market lacks the steady and consistent influence of the federally sponsored secondary mortgage market infrastructure that served our country so well throughout most of the twentieth century. Because there is no public actor exercising an underwriting function, the subprime mortgage market must rely instead on the rule of law. Unfortunately, this is precisely what is lacking in the current regulatory environment. What imperfect consumer protection legislation we have, has been rendered moot by commercial change. Moreover, even if our consumer laws meaningfully applied to subprime loans, the opacity of securitization deals makes successful consumer enforcement of their rights cost prohibitive. Finally, the capital structure of subprime mortgage lenders tends to render the most culpable parties immune from judicial sanctions. While no one wishes to return to the two-party mortgage market where consumers had little access to home loans, the current system of lawless illusory underwriting is not satisfactory either. Congress must lead the way in creating a system that corrects the current legal system's perverse incentives. Otherwise, the subprime market will continue to suffer from inefficiency and injustice.