Hearing on "Securitization of Assets: Problems and Solutions" before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

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During the housing bubble, private-label securitization financed the majority of subprime and nontraditional mortgages.[1] This system proceeded on the assumption that housing prices would keep going up. When housing prices fell and people could not refinance out of unaffordable loans, investors lost confidence in private-label mortgage securitization and the system collapsed in August 2007.

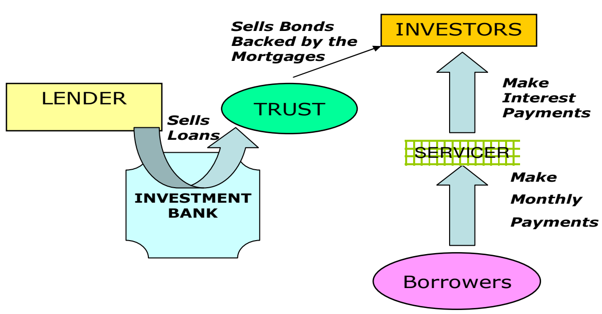
This statement begins with a thumbnail sketch of securitization. Then I describe the role played by securitization in the financial crisis. Following that, I analyze the inherent flaws in private-label mortgage securitization. The statement goes on to describe current conditions in that market. I close by describing needed reforms.

I. An Introduction to Securitization

Back in the 1970s, banks had to hold home mortgages in portfolio until those loans were paid off. This destabilized banks that made mortgages because they got their financing from demand deposits, but invested those deposits in illiquid mortgages. This "term mismatch" between assets and liabilities was a direct cause of the 1980s savings and loan crisis.

Starting in the late 1970s, securitization burst on the scene and eliminated the need for lenders to hold their mortgages in portfolio. The idea behind securitization is ingenious: bundle a lender's loans, sell them to a bankruptcy-remote trust, repackage the monthly loan payments into bonds rated by rating agencies, back the bonds with the underlying mortgages as collateral, and sell those bonds to investors.

A Simplified Flowchart of Mortgage Securitization



Investment banks "structured" these securitization deals by dividing the bonds into "tranches" (French for "slice"). The best tranche, with the lowest expected default rate, carried an AAA rating, was

[1] I use the term "nonprime" to refer to subprime loans plus other nontraditional mortgages. Subprime mortgages carry higher interest rates and fees and are designed for borrowers with impaired credit. Nontraditional mortgages encompass a variety of risky mortgage products, including option payment ARMs, interest-only mortgages, and reduced documentation loans. Originally, these nontraditional products were offered primarily in the "Alt-A" market to people with near-prime credit scores but intermittent or undocumented income sources. Eventually, interest-only ARMs and reduced documentation loans penetrated the subprime market as well.

paid off first, and offered the lowest rate of return. The lower tranches were rated AA, A, etc., on down to the junior-most tranche, known as the equity tranche. The equity tranche was paid off last and was the first to absorb any losses from the loans.

Securitization was prized for accomplishing four things. First, lenders were able to get their mortgages off their books. Second, securitization appeared to manage the risks of mortgages by slicing and dicing those risks and spreading them among millions of investors with assorted tolerances for risk. Third, securitization opened up huge new pools of capital to finance home mortgages. Finally, securitization freed lenders from relying principally on insured deposits in order to make loans. Instead, in a continuous cycle, lenders could make loans, sell those loans through securitization, and then plow the proceeds into a new batch of loans, which in turn would be securitized. This paved the way for a new breed of nonbank subprime lenders, who had little in the way of capital reserves, were free from federal banking regulation, and were inured to the reputational constraints of banks and thrifts.

At first, securitization was limited to prime loans, which were mostly securitized through the two government-sponsored entities (GSEs) Fannie Mae and Freddie Mac. Once the market gained confidence about its ability to price subprime mortgages, securitization expanded to the subprime market in the early 1990s. Although the GSEs made limited forays into the subprime market and later expanded those forays around 2005, most subprime securitizations did not take place through the GSEs, but rather through the "private-label" securitization market. The private-label market lacked the same degree of public accountability that was expected of Fannie Mae and Freddie Mac as GSEs. By 2006, two-thirds or more of subprime mortgages were being securitized through the private-label market.

II. The Role of Securitization in the Financial Crisis

A. How Private-Label Securitization Increased the Risk of Mortgage Lending

Before securitization, lenders usually did it all: they solicited loan applicants, underwrote and funded the loans, serviced the loans, and held the loans in portfolio. Lenders earned profits on loans from interest payments as well as from upfront fees. If the loans went into default, the lenders bore the losses. Default was such a serious financial event that lenders took care when underwriting loans.

All that changed with private-label securitization. Securitization allowed lenders to offload most of the default risk associated with nonprime loans. Under the "originate-to-distribute" model, lenders could make loans intending to sell them to investors, knowing that investors would bear the financial brunt if the loans went belly-up. Similarly, securitization altered the compensation structure of nonprime lenders. Lenders made their money on upfront fees collected from borrowers and the cash proceeds from securitization offerings, not on the interest payments on loans.

Lenders liked the security of being paid in advance, instead of having to wait for uncertain monthly payments over the life of loans. And, because they could pass the lion's share of the default risk onto faceless investors, lenders had less reason to care about how well their loans performed. In my examinations of internal records of major nonprime lenders, including federal thrift institutions and national banks, too often I found two sets of underwriting standards: high standards for the loans they kept on their books and lax standards for the loans that they securitized.

At their peak, investment grade,[2] nonprime residential mortgage-backed securities (RMBS) were considered excellent investments because they supposedly posed minimal default risk while offering high returns. Investors clamored for these bonds, creating demand for ever-riskier loans.

Lenders were not the only players in the chain between borrowers and investors. Investment banks played significant roles as underwriters of nonprime securitizations. Lehman Brothers, Bear Stearns, Merrill Lynch, J.P. Morgan, Morgan Stanley, Citigroup, and Goldman Sachs underwrote numerous private-label nonprime securitizations. From 2000 through 2002, when IPO offerings dried up during the three-year bear market, RMBS and CDO deals stepped into the breach and became one of the hottest profit centers for investment banks.

Investment banks profited from nonprime underwriting by collecting a percentage of the sales proceeds, either in the form of discounts, concessions, or commissions. Once an offering was fully distributed, the underwriter collected its fee in full. This compensation system for the underwriters of subprime offerings caused Donna Tanoue, the former Chairman of the Federal Deposit Insurance Corporation, to warn: "[T]he underwriter's motivation appears to be to receive the highest price . . . on behalf of the issuer - not to help curb predatory loans."

Tanoue's warning proved prophetic. In February 2008, Fitch Ratings projected that fully forty-eight percent of the subprime loans securitized by Wall Street in 2006 would go into default. Despite that dismal performance, 2006 produced record net earnings for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. That year, manager pay reflected the bottom-line importance that investment banks placed on private-label RMBS, with managing directors in the mortgage divisions of investment banks earning more on average in 2006 than their counterparts in other divisions.

B. How Securitization Fueled Contagion

Ultimately, private-label mortgage securitization turned out to be an edifice built on a rotting foundation. Once that foundation gave way, rising nonprime delinquencies mushroomed into international contagion for a number of reasons. For example, the same loan often served as collateral for multiple bonds, including an RMBS, a CDO, and a CDO of CDOs. If the loan went into default, it would jeopardize repayment for all three bonds. In addition, if defaults led to downgrades on those bonds, those assets were highly correlated. If rating agencies downgraded one issue, other issues came into question as well.

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[2] The top four ratings issued by a rating agency are "investment grade" ratings. For Standard & Poor's, these are ratings of AAA, AA, A and BBB; for Moody's, Aaa, Aa, A and Baa. Any rating below investment grade is considered junk bond status.

Collateral is another reason why nonprime loans infected other markets. Many large institutional investors bought nonprime bonds that they later pledged as security for other types of loans. Banks, for instance, pledged their nonprime bonds as security for short-term loans from other banks on the market for interbank credit. Major corporations borrowed money from other corporations on the short-term commercial paper market by issuing paper backed by nonprime bonds. As the value of nonprime bonds fell, lenders began calling loans and ultimately the interbank lending and asset-backed commercial paper markets slowed to a crawl.

Banks also reinfected themselves with subprime risks by buying private-label RMBS and CDOs and effectively taking those risks back on their books. When they sustained major losses on those bonds, they reined in their lending, adding fuel to the recession.

General investor panic is the final reason for contagion. Even in transactions involving no nonprime collateral, concerns about the nonprime crisis had a ripple effect, making it hard for companies and cities across-the-board to secure financing. Banks did not want to lend to other banks out of fear that undisclosed nonprime losses might be lurking on their books. Investors did not want to buy other types of securitized bonds, such as those backed by student loans or car loans, because they lost faith in ratings and could not assess the quality of the underlying collateral. Stocks in commercial banks, insurance companies, and Wall Street firms took a beating because investors did not know where nonprime assets were hidden and feared more nonprime write-downs. Because they did not know exactly who was tainted by nonprime, investors stopped trusting practically everyone.

III. Inherent Flaws in Private-Label Mortgage Securitization

A. The Lemons Problem

In hindsight, private-label mortgage securitization turned out to resemble the used car business in one respect. Both businesses have motivations to sell "lemons." In other words, they have structural incentives to sell products carrying hidden defects and a heightened risk of failure.

There are two main reasons for this lemons problem. First, securitization resulted in a misalignment of compensation and risk. Each company in the securitization process was able to collect upfront fees, while shifting default risk to downstream purchasers. Although investors tried to protect themselves through recourse clauses and structures making lenders retain the equity tranches, those contractual safeguards often broke down. Lenders were able to hedge their equity tranches or shed them by resecuritizing them as CDOs. Similarly, too many originators lacked the capital to honor their recourse obligations in full.

Second, securitization fueled a relentless demand for volume and volume-based commissions. In the process, the quest for volume pushed lending standards steadily downward in order to maintain market share. This became a challenge in 2003, when interest rates began rising again, ending the refinancing boom. Securitizers needed another source of mortgages in order to increase the rate of securitization and the fees it generated. The "solution" was to expand the market through nontraditional mortgages, especially interest-only loans and option payment ARMs offering negative amortization. Lenders also relaxed their underwriting standards on traditional products to qualify more borrowers. This expansion of credit swept a larger portion of the population into the potential homeowner pool, driving up housing demand and prices, and consumer indebtedness. Many big investment banks, including Lehman Brothers and Bear Stearns, went so far as to buy subprime lenders in order to have an assured pipeline of mortgages to securitize.

In short, the incentive structure of securitization caused the lemons problem to grow worse over time. Not only did private-label securitization sell lemons, those lemons grew more rotten as the housing bubble grew. In the process, securitization actors played the ends against the middle, injuring borrowers and investors alike.

B. Harm to Borrowers

Private-label securitization hurt numerous borrowers. First, investor appetite for high-yield RMBS caused originators to peddle risky mortgages, to the exclusion of safer loans. Second, compensation methods such as yield spread premiums saddled many borrowers with costlier mortgages than they qualified for. Third, borrowers whose loans were securitized lost important legal rights without their consent.

On the first point: As mentioned above, in order to maintain volume while satisfying investor demand for high-yield bonds, investment banks and lenders had to continually tap new groups of borrowers with lower credit scores and less disposable income. For many of these cash-strapped borrowers, low monthly payments were a primary consideration. In order to offer the lure of lower initial payments, lenders concocted bafflingly complex loans combining a host of risky features, including adjustable-rate terms, teaser rates, high margins, stiff prepayment penalties, and no amortization or even negative amortization. Evidence is now coming to light that investment banks or large investors in many cases dictated those underwriting guidelines to originators.

The front-end payments of these hazardous mortgages were attractive to unsuspecting borrowers and usually lower than the payments on a plain vanilla fixed-rate mortgage. But the back-end risks of those mortgages were daunting, yet difficult or impossible for borrowers to discern. Worse yet, to qualify individual borrowers, lenders often threw full income verification out the window.

There was a second way in which investor demand for higher yield hurt many borrowers. Because investors paid more for higher yields, lenders offered mortgage brokers higher compensation in the form of yield spread premiums to convince borrowers who probably qualified for cheaper loans to unwittingly pay higher interest rates. The Wall Street Journal estimated that by year-end 2006, 61% of subprime mortgages went to borrowers with high enough credit scores to qualify for cheaper prime loans.[3] Yield spread premiums artificially inflated the interest rates that borrowers had to pay, substantially increasing the likelihood that nonprime loans would default and go into foreclosure. Economists have estimated the size of this risk. For every one percent increase in the initial interest rate of a home mortgage, the chance that a household will lose its home rises by sixteen percent a year.

Finally, under the Uniform Commercial Code in many states, borrowers whose loans are securitized lose valuable legal rights without their consent or financial compensation. This doctrine, known as the "holder-in-due-course rule," prohibits borrowers whose loans are securitized from raising common types of fraud or other misconduct in the making of their loans against all subsequent purchasers of their loan notes. In many case, this shields investment banks, rating agencies, and investors from borrower suits for fraud. Although borrowers can still raise fraud as a claim or defense against their mortgage brokers and lenders, many of those entities are bankrupt today and thus judgment-proof. More importantly, once a loan is securitized, any suit for foreclosure will be brought by the investor or securitized trust, not the mortgage broker or lender. In those cases, the holder-in-due course rule prevents borrowers who were defrauded from even raising the fraud as a defense to foreclosure.

C. Harm to Investors

The lack of transparency in securitization also hurt investors. The securities disclosures for private-label RMBS lacked crucial information to investors. In addition, product complexity made it difficult or impossible for investors to grasp the risks associated with many offerings. Finally, both problems caused investors to place undue reliance on credit ratings, which proved to be badly inflated.

1. Inadequate Securities Disclosures

For most of the housing bubble, the Securities and Exchange Commission (SEC) had no rule requiring disclosures specifically tailored to RMBS or CDOs. The SEC adopted Regulation AB in an attempt to redress that gap, but the rule did not go into effect until January 1, 2006, too late to cover earlier private-label offerings.

Once the rule went into effect, it was riddled with holes. First, Reg AB only applies to public offerings of asset-backed securities. An investment bank could simply bypass Reg AB by structuring the offering as a private offering limited to big institutional investors. In private offerings, SEC disclosures are lighter or left to private negotiation, based on the idea that institutional investors have clout to demand the information they need. Wall Street took full advantage of this loophole, meaning that CDOs were almost always sold through private offerings with seriously deficient disclosures.

Even when Reg AB did apply – i.e., in public offerings of asset-backed securities – the disclosures were too skimpy to be of use. The SEC modeled many of Reg AB's disclosures on the reporting requirements for corporate issuers. Corporations usually have track records to speak of, so

3 Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-worthy*, WALL ST. J., Dec. 3, 2007, at A1.

securities disclosures for those issuers focus on recent past performance. But past performance was irrelevant for most offerings of RMBS and CDOs, which involved relatively new mortgages. In essence, Reg AB puts the wrong information under the microscope.

Instead, investors in nonprime bonds needed standardized information on the risk characteristics of the individual loans in the loan pool. But Reg AB does not require that level of detail. While the rule encouraged investment banks to make tapes with loan level data available to investors online, it did not force them to do so. Instead, Reg AB simply mandates a summary of the aggregate characteristics of the loan pool. That made it difficult to discern whether the riskiest loans were going to the strongest borrowers or to the worst borrowers in the loan pool.

Similarly, too many prospectuses and offering memoranda for private-label offerings stated that the lenders reserved the right to make exceptions to their underwriting standards in individual cases. In 2006 and 2007, there were offerings in which the exceptions – in other words, loans that flunked the lender's underwriting standards – outweighed the number of loans that conformed to the lender's stated standards. The exact (and often high) percentage of exceptions was not disclosed to investors.

Nor does Reg AB make investment banks disclose the due diligence reports they commissioned from outside firms, even when those reports contained evidence of deteriorating lending standards. Too often, investment banks withheld those reports from investors and ratings agencies.

Reg AB is also deficient regarding the performance of individual loans. While Reg AB requires some reporting on loan performance, it is only for the first year following the offering, not for the life of the loans.

All told, there was a dearth of useful publicly available information on the loan pools underlying private-label RMBS and CDOs. The SEC disclosure scheme for nonprime RMBS and CDOs was so misbegotten and riddled with exceptions that those securities operated in a fact-free zone. Investors and analysts who wanted to do serious due diligence could not get the facts they needed to figure out the true risk presented by the loans. Without those facts, investors often overpaid for those securities. Furthermore, the dearth of key public information also impeded the development of a healthy resale market in those bonds, which became a big problem later on when banks tried to unload toxic subprime assets off their books.

2. Complex Products

Many private-label RMBS and CDOs were so complex that due diligence was too costly or impossible for investors. CDOs are a good example. Typically, a CDO consisted of junior tranches of RMBS from different offerings, sometimes paired with other types of asset-backed securities involving receivables from things like credit cards or auto loans. At best, the investor received data on the quality of the underlying bonds. But it was impossible for the investor to x-ray the offering in order to analyze the underlying home mortgages, credit card borrowers, or auto loans themselves. That was even more impossible when the CDO was a "synthetic CDO" made up of credit default swaps on RMBS and asset-backed securities.

Even in regular RMBS, complexity was a big problem. One issue was the sheer number of tranches. Another was the fact that many private-label RMBS offerings featured complex credit enhancement rules about who would receive cash flows from the mortgages in what amounts, depending on changes in the amount of subordination or overcollateralization. This meant that investors could not just stop with estimating expected losses from the mortgages. They also had to analyze who would get what cash flows when, based on a changing kaleidoscope of scenarios.[4] In addition, too many offerings were made on a "to be announced" or "TBA" basis, which meant that investors could not scrutinize the underlying loans because the loans had not yet been put in the loan pool. Finally, many securitization deals involved custom features that undermined standardization.

Of course, this discussion begs the question whether investors would have done adequate investigation in any case when the housing bubble was at its height and euphoria prevailed. But back then, even investors who wanted to do serious due diligence would have met insuperable obstacles. More recently, lack of transparency and complexity have blocked the formation of an active, liquid resale market that would enable banks to remove impaired RMBS and CDOs from their books.

3. Overreliance on Credit Ratings

Poor disclosures and overly complex deals caused investors to over rely on credit ratings. Meanwhile, the rating agencies had financial incentives to understate the risks of nonprime RMBS and CDOs. The investment banks that underwrote nonprime securitizations paid the rating agencies to provide them with investment-grade ratings. The rating agencies touted the top-rated nonprime bonds – ranging from AAA down to A -- as hardly ever defaulting.

Under banking and insurance laws, banks and insurance companies can only invest in types of bonds permitted by law. Private-label RMBS and CDOs carrying investment grade ratings are on the permissible list, so long as those ratings are rendered by rating agencies designated Nationally Recognized Statistical Rating Organizations (NRSROs) by the SEC. These regulatory rules encouraged institutional investors in search of higher yields to buy the top-rated nonprime RMBS and CDOs.

During the housing bubble, rating fees on private-label RMBS and CDOs were the fastest-growing sector of the rating agency business. Issuers paid the rating agencies handsome fees from these deals, spurring the rating agencies to rate offerings for which there was scant historical default data. Similarly, the rating agencies used flawed models which assumed never-ending housing price

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4 Ingo Fender & Janet Mitchell, *The future of securitization: how to align incentives?*, BIS QUARTERLY REVIEW 27, 30, 32 (Sept. 2009).

appreciation and were not updated with new default data. Nor did most investors realize that an AAA rating for an RMBS offering was different than, and inferior to, an AAA rating for a corporate bond.[5]

D. Impediments to Loan Modifications

Deal provisions in private-label securitizations have also paralyzed constructive workouts of many distressed home loans. Today, securitized trusts, not lenders, hold the vast majority of those loans. The complexity of the securitized deals often pits servicers against investors and investors against each other. Too often, the servicers opt for foreclosing on property, instead of arranging workouts that would allow homeowners to stay in their homes. The irony of this approach is that, in many cases, workouts in the form of loan forbearance or loan modifications would result in a higher recovery.

There are several explanations for this seemingly irrational behavior, including inadequate staffing levels and compensation clauses that cause servicers to earn more money from foreclosures than workouts. But the main reason why more workouts do not occur is that many pooling and servicing agreements place constraints on servicers' ability to negotiate loan workouts. Some limit the percent of the loan pool that can be modified. Others have vague prohibitions allowing modifications only to the extent they are in the best interests of the investors. Even when those agreements give servicers latitude to modify loans, servicers are reluctant to modify loans because they fear lawsuits by warring trancheholders for breach of fiduciary duty.

This hold-up problem has stymied federal regulators' attempts to speed up loan modifications and halt the vicious cycle of falling home prices. With no federal legislation to force modifications, regulators have only had limited success. Meanwhile, loan workouts are crawling at a snail's pace, leading foreclosed homes to be dumped on the market in record numbers and pushing home prices further down in the process.

IV. Current Conditions in the Private-Label Securitization Markets

Due to the problems just described, the markets for private-label RMBS and CDOs are essentially dead. The securitization markets for auto loans, credit cards, and student loans are open, but their volume has dropped sharply due to general concerns about the soundness of the securitization process.

For all intents and purposes, the federal government has become the financier of first resort for residential mortgages. In 2008, agency mortgage-backed securities – in other words, RMBS issued by Fannie Mae, Freddie Mac, and Ginnie Mae (FHA loans) -- accounted for over 96% of the U.S. RMBS market. Private-label mortgage-backed securitization accounted for less than 4% of the market that year.

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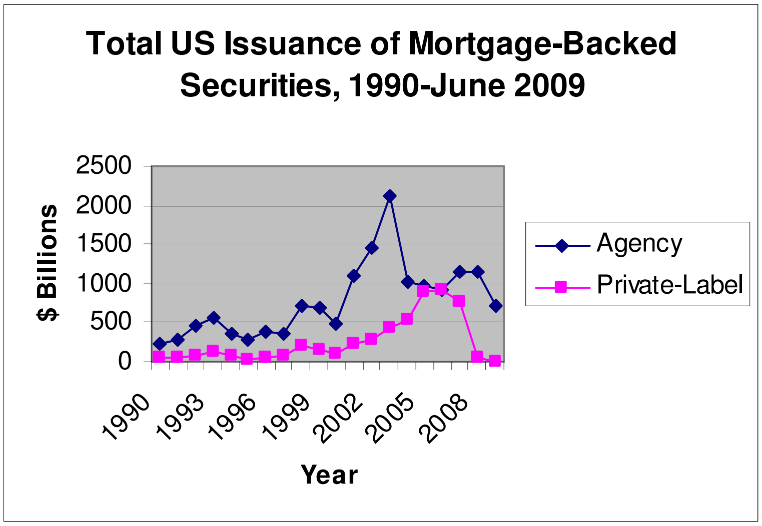
5 In large part, and in contrast with corporate bonds, this is because downgrades of a tranched RMBS tend to make downgrades of other RMBS tranches more likely. Fender & Mitchell, *supra* note 4, at 33.



Source: Securities Industry and Financial Markets Ass'n

This disparity widened in the first six months of 2009, when the relative market shares of agency and private-label mortgage-backed securitization were 99% and 1%.[6] In second quarter 2009, moreover, 38.4% of private-label RMBS transactions were re-REMICs of old loans that were repackaged into tranches of good and bad loans. According to the Securities Industry and Financial Markets Association (SIFMA), the "private label market remains dormant due to reduced lending, lack of investor demand, low liquidity," and rising delinquencies and foreclosures.[7]

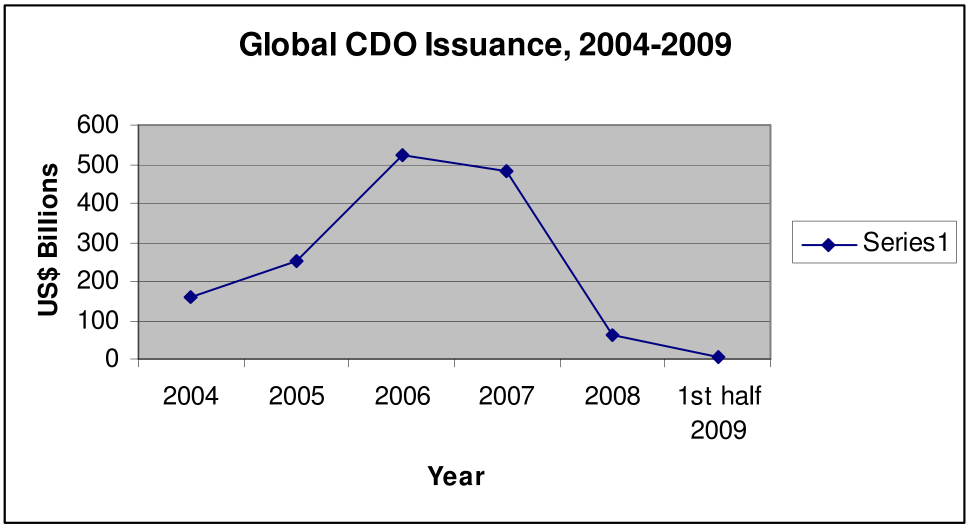
As these numbers suggest, private investors are largely shunning the private-label mortgage securitization market in favor of other investments, including agency RMBS. In the meantime, the Federal Reserve has become a major investor in agency RMBS, having begun purchases in this market in December 2008. The Fed has pledged to buying up to $1.25 trillion in agency RMBS before the end of this year, in an effort to help lower home mortgage interest rates.

Other securitization markets associated by investors with mortgages are also dormant. SIFMA reports that the private-label commercial MBS primary market "remains closed."[8] Similarly, global issuance of CDOs has essentially come to a halt.

6 I use the term "agency" to refer to GNMA, Fannie Mae and Freddie Mac mortgage-backed securities and collateralized mortgage obligations. The term "private-label" includes RMBS and CMOs.

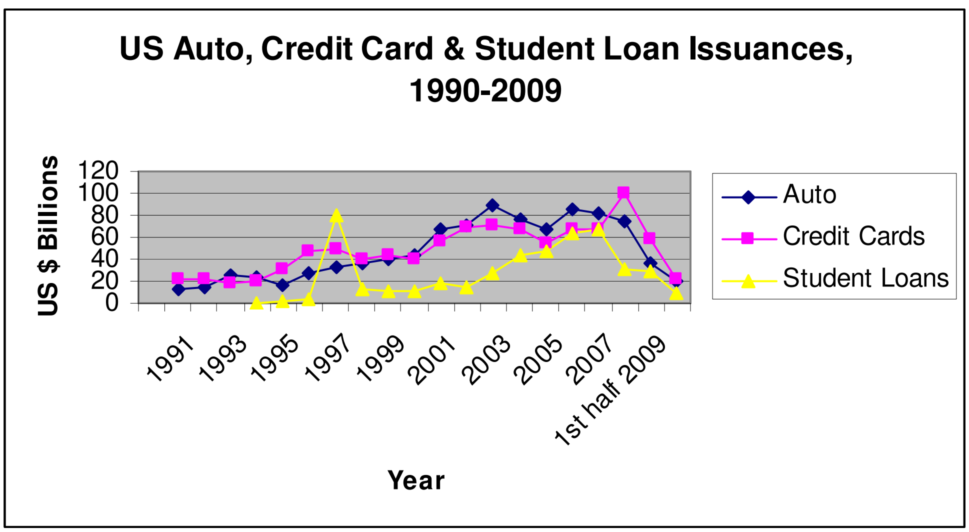
7 Securities Industry and Financial Markets Association, Research Report 2009 Q2 (August 2009), at 2, 9.

8 Id. at 9.



Source: Securities Industry and Financial Markets Ass'n

Outside of the mortgage sector, auto loan, credit card, and student loan securitizations have fallen by over half since 2007. All three sectors became paralyzed in mid-2008, prompting the Federal Reserve to revive these markets with the Term Asset-Backed Securities Lending Facility (TALF). Spreads soared in 2008 and have since fallen, although have not completely recovered. This suggests that investor concerns about the general integrity of the securitization process spilled over to other sectors.



Source: Securities Industry and Financial Markets Ass'n

Although TALF has helped to revive these markets, particularly in the auto and credit card areas, delinquencies and charge-offs continue to climb.

V. Needed Reforms

Private-label mortgage securitization will undoubtedly return in one form or another. And just as certainly, investors will eventually forget the lessons from this crisis. To avoid repeating the mistakes of the past, it is essential to put private-label mortgage securitization on sound footing going forward.

A. Proposals to Realign Incentives

Discussions about reforming private-label securitization often revolve around proposals to realign the incentives of originators and investment banks. The idea is to give them sufficient "skin in the game" to care about soundly underwritten loans. Thus, the Obama Administration has proposed[9] requiring securitizers to retain at least five percent of the credit risk on each asset in the asset-backed securities that they issue.[10] Securitizers would also be barred from resecuritizing or hedging that retained risk. Section 213 of the Mortgage Reform and Anti-Predatory Lending Act, H.R. 1728, passed by the House of Representatives on May 7, 2009, contains a similar proposal.

There are other incentive-based proposals to improve loan underwriting. One involves increased capital: in other words, requiring commercial and investment banks – especially too-big-to-fail banks – to hold more capital, both against the tranches they retain and against other aspects of securitization that could come back to haunt them, such as recourse clauses and structured investment vehicles.

Another proposal is to realign originators' compensation with loan performance. Accounting standards could be changed to eliminate immediate recognition of gain on sale by originators at the time of securitization. And there are two promising proposals to curb reckless originations by independent mortgage brokers. One would prohibit pay incentives such as yield spread premiums for steering customers to costlier or riskier loans. H.R. 1728, § 103. Another proposal would make full payout of compensation to mortgage brokers contingent on good performance of the loan.

A final idea along these lines is to require lenders and securitizers to make stronger representations and warranties to investors, accompanied by stiffer recourse provisions for loans that violate those reps and warranties. The American Securitization Forum has advanced this reform.

All of these proposals are good ideas. However, they are not enough, together or alone, to ensure sound underwriting. Take the risk retention requirement, for example. It is doubtful whether the ban on hedging is even enforceable, since "sometimes firms pool their risk and set hedges against several positions at once."[11] More importantly, requiring risk retention does not solve the fact that banks, once they got loans off of their books through securitization, assumed that risk again by investing in toxic subprime RMBS and CDOs.

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9 Financial Regulatory Reform Proposal, Title IX, § 951, www.treas.gov/initiatives/regulatoryreform/.

10 The implementing agencies would also have to adopt provisions allocating the risk retention obligation between the securitizer and the originator.

11 Fender & Mitchell, *supra* note 4, at 41.

As for capital requirements, more capital is essential for depository institutions and investment banks. But capital is no panacea. Banks have proven adept at evading minimum capital requirements. Furthermore, the credit crisis raised serious concerns about the newly adopted Basel II capital standards, which were designed to *lower* capital and allow large internationally active banks – i.e., too-big-to-fail banks – to set their own minimum capital.

Stronger reps and warranties, backed by stiffer recourse, are likewise advisable. But the crisis has shown that recourse provisions are only as good as a lender's solvency. Since the credit crisis began, most nonbank subprime lenders have gone out of business. In addition, 126 banks and thrifts have failed since 2007. Some institutions failed precisely due to their inability to meet investor demands for recourse.[12]

Even when recourse can be had, negotiations can be long and drawn-out. Moreover, if a recourse provision is not ironclad, a solvent lender may be able to escape it. For example, any provisions that would condition recourse on the lender's knowledge that the reps and warranties were violated – creating a Sergeant Schmidt "I know nothing" defense -- usually would be meaningless if the misconduct in question was committed by an independent mortgage broker. That would include situations where the lender failed to adequately supervise the broker, which often was the case.

For all of these reasons, having "skin in the game" is not enough to ensure sound loan underwriting. As discussed below, more is needed in the form of minimum underwriting standards.

B. Improved Due Diligence by Investors

Meanwhile, investors need the ability to do better due diligence. Three major reforms are needed to provide investors with the information that they need to make sound investment decisions about private-label mortgage-related bonds. First is improved transparency, second is product simplification and standardization, and third is rating agency reform.

Transparency – The SEC should require securitizers to provide investors with all of the loan-level data they need to assess the risks involved. See Obama Administration Proposal, Title IX, § 952. In addition, the SEC should require securitizers and servicers to provide loan-level information on a monthly basis on the performance of each loan and the incidence of loan modifications and recourse. These disclosures should be made in public offerings and private placements alike. In addition, TBA offerings should be prohibited because it is impossible for investors to do due diligence on those loan pools.

Product Simplification and Standardization – The government should encourage simpler, standardized securitization products, whether through the REMIC tax rules or rules governing permissible investments by insured banks and thrifts. Similarly, the government should explore ways to build a liquid secondary trading market in private-label RMBS and other bonds.

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[12] See, e.g., Office of Inspector General, Department of the Treasury, "Safety and Soundness: Material Loss Review of NetBank, FSB" (OIG-08-032, April 23, 2008), www.ustreas.gov/inspector-general/audit-reports/2008/OIG08032.pdf.

Rating Agency Reform – The most critical rating agency reform is banning the "issuer pays" system, in which issuers pay for ratings. That would help ensure that rating agencies serve the interests of investors, not issuers. In addition, it is necessary to require the rating agencies to create a new, different ratings scale for mortgage structured finance to distinguish it from the ratings for corporate bonds. Finally, NRSRO designations need to be abolished.

The Obama Administration's proposal takes a different approach. The proposal would subject NRSROs to enhanced SEC oversight, including expanded public disclosures. In addition, the Administration would require rating agencies to have systems to "manage, and disclose" their conflicts of interest. Title IX, subtitle C.

While better investor due diligence is necessary to improve private-label mortgage securitization, it is not enough. At the height of every business cycle, memories grow dim and euphoria takes hold. During bubbles, when default rates are low, investors are apt to cast aside basic due diligence precautions to grab the chance of a high-yield investment. This temptation is particularly great for institutional money managers, who have cash they need to put to work and face pressure to report the same high returns as their competitors. For all of these reasons, minimum federal underwriting standards are a needed supplement to investor due diligence.

C. Protecting Borrowers and the Financial System

We cannot assume that investors will monitor adequately or that standardization will be achieved. Furthermore, none of the measures outlined above addresses the obstacles to loan modifications. Two additional measures are needed to protect borrowers and the larger economic system from reckless loans and unnecessary foreclosures.

1. Uniform Minimum Underwriting Standards Enforceable by Borrowers

The downward spiral in underwriting standards drove home the need for uniform consumer protection standards that apply to all financial services providers. In fact, a new study by the Center for Community Capital at the University of North Carolina (Chapel Hill) finds that states that mandated strong loan underwriting standards had lower foreclosure rates than states without those laws.[13]

The Federal Reserve's 2008 rule for higher-cost loans accomplished part of this goal,[14] but all loans need protection, not just subprime loans. The Obama Administration proposal, H.R. 1728, and H.R. 3126 would solve this problem by creating one set of uniform federal laws that apply to all financial services providers across the country, regardless of entity, charter, or geographic location. To prevent a

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13 Center for Community Capital, *State Anti-Predatory Lending Laws* (October 5, 2009), http://www.ccc.unc.edu/news/AG_study_release_5[2].10.2009.pdf.

14 Federal Reserve System, *Truth in Lending: Final rule; official staff commentary*, 73 FED. REG. 44522, 44536 (July 30, 2008). The Board intended to cover the subprime market, but not the prime market. *See id*. at 44536-37.

race to the bottom in which regulators compete to relax lending standards, the Administration proposal and H.R. 3126 would consolidate the authority to administer those laws in a new Consumer Financial Protection Agency. Under both, the standards would constitute a floor, in which weaker state laws are federally preempted. States would remain free to enact stricter consumer protections so long as those protections were consistent with federal law.

These federal standards do three things. First, the standards would ensure proper loan underwriting based on the consumer's ability to repay. Second, the standards would prohibit unfair or deceptive practices in consumer credit products and transactions. Finally, the standards would promote transparency through improved consumer disclosures. Bottom-line, the proposed standards would help make it possible for consumers to engage in meaningful comparison shopping, with no hidden surprises.

In the event these standards are violated, injured borrowers need an affirmative claim for relief as well as a defense to foreclosure. Both the claim and the defense should be available against loan originators. Limiting relief to loan originators does not help borrowers with securitized loans, however, if their loans later go into foreclosure or their originators become judgment-proof. When a securitized loan is foreclosed on, for example, the lender is not the plaintiff; rather, foreclosure is instituted by the servicer, the owner of the loan, or its designee (generally the Mortgage Electronic Registration Systems or MERS). Consequently, fairness requires allowing injured borrowers to raise violations as a defense to foreclosure against those entities. Similarly, giving borrowers an affirmative claim against assignees for violations of federal lending standards by originators will spur investors and investment banks to insist on proper underwriting of loans and afford injured borrowers relief when their originators are judgment-proof or a securitized trust sues for foreclosure. The Administration's proposal and H.R. 1728, § 204, both contain assignee liability provisions designed to accomplish these objectives.

Some fear that a borrower right of action against securitized trusts and investment banks would reduce access to credit. A 2008 study by Dr. Raphael Bostic et al. examined that question by looking at the effect of assignee liability provisions in nine state anti-predatory lending laws on the availability of subprime credit. The study found "no definitive effect of assignee liability on the likelihood of subprime originations, even when the [assignee] liability provisions are in their strongest form." Subprime originations rose in six of the nine states studied that had assignee liability, relative to the control state. Results were mixed in the other three states, depending on how subprime lending was defined. No state reported a consistent drop in subprime originations.[15]

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[15] Raphael Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross, and Susan Wachter, *The Impact of Predatory Lending Laws: Policy Implications and Insights*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 138 (Nicolas P. Retsinas & Eric S. Belsky eds., Joint Center for Housing Studies of Harvard University and Brookings Institution Press, 2008), working paper version at http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-9_bostic_et_al.pdf.

In short, assignee liability is not likely to impede access to credit. To the contrary, borrower relief will provide needed incentives for originators, Wall Street, and investors to only securitize loans that borrowers can repay. Providing that relief would go a long way toward avoiding the biggest threat to access to credit, which is a repeat collapse of private-label securitization.

2. Remove Artificial Barriers to Cost-Effective Loan Modifications

Right now, too many distressed loans are needlessly going to foreclosure despite the availability of cost-effective loan modifications. Not only do these foreclosures oust homeowners from their homes, they needlessly depress home values for everyone else. It is time to cut this Gordian knot.

Most securitized loan pools are created as "Real Estate Mortgage Investment Conduits," or REMICs, under the federal tax code. Any securitization vehicle that qualifies for REMIC treatment is exempt from federal income taxes. Congress or the Internal Revenue Service should amend the REMIC rules to disqualify future mortgage pools from favored REMIC tax treatment unless pooling and servicing agreements and related deal documents are drafted to give servicers ironclad incentives to participate in large-scale loan modifications when specific triggers are hit.[16]

[16] See Michael S. Barr and James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages* (Center for American Progress April 2008).