How the Residential Mortgage-Backed Securities Market Impacts Dirt Lawyers and Their Clients

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By David J. Reiss

I want to demonstrate that the secondary mortgage market is relevant to the day-to-day practice of real estate lawyers. To do so, I will review the changes in the residential mortgage market for those of you who haven’t spent much time thinking about this; describe how these changes are now affecting borrowers; and indicate how these changes have led to a potential financial crisis of extraordinary magnitude.

Let me start by distinguishing the primary mortgage market from the Secondary Mortgage Market. The primary mortgage market is the market for originating loans with individual borrowers. If you have seen It’s a Wonderful Life, you pretty much know where it started in earnest, with Savings and Loans like the Bailey Building and Loan. Local depositors put money in the Savings and Loan to earn interest and local borrowers borrow money from it, paying interest. The problem with this financing model is that rich and low-growth communities will tend to have lots of deposits and not make many loans. Poor and growing communities will tend to have few deposits and a great demand for loans.

The Secondary Mortgage Market is the market where lenders and investors buy and sell mortgages that were made in the primary mortgage market. The secondary market acts to spread deposits from savers wherever they are (the Northeast, for instance) to borrowers wherever they are (the Southwest, for instance). Originating lenders often sell mortgages in order to get new capital to make new loans. Investors buy mortgages for the same reasons that they might buy any other investment product—to meet their “rate of return” and risk expectations.

The secondary market for prime loans that we know today was created in large part by government-chartered but publicly traded Fannie Mae and Freddie Mac. Fannie and Freddie were specially created by the federal government to encourage homeownership. By offering to purchase loans made by lenders on certain standardized terms, Fannie and Freddie offered liquidity and stability to what had been an informal secondary market.

In the last two decades, Fannie and Freddie became the darlings of Wall Street as they reported growth and profits year after year by borrowing money at low rates and using it to purchase residential mortgages that pay interest at higher rates. Indeed, as of September 30th of last year, Fannie and Freddie had $4.35 trillion in mortgage-related obligations. That’s a lot of trillions. The magnitude of this number can be understood only in comparison to the amount of U.S. government debt owned by the public—$4.84 trillion at that time. So the difference between the two is pretty much a rounding error.

Fannie and Freddie have been wildly successful in parlaying their government charters into humongous for-profit enterprises. The success of the secondary market dramatically changed the role of the originating lender in a mortgage transaction—no longer was it acting like Bailey Bros.—it is now often no more than a thinly funded entity with a credit line at a bank and an agreement to sell its loans to a mortgage-backed securities issuer.

Historically, the secondary market had focused on prime borrowers: those with steady incomes, good credit histories and significant down payments. It has also offered a limited array of mortgage products—например, a fixed interest rate loan with a 30-year term. In the last ten years, residential lenders and secondary market investors have become comfortable extending credit to homeowners who do not have all of those prime characteristics, the so-called “subprime” borrowers.

That is the subprime market, a market not nearly as standardized as the prime market. Simultaneously, it has begun to offer a dizzyingly wide array of mortgage products. What is of note is that the prime market is starting to mimic some of the behaviors of the subprime market. Historically, Fannie Mae and Freddie Mac, knowing the value of their unique privileges, were protective of homebuyers, refusing to purchase loans that had predatory terms. This impacted the practice of many loan originators who wanted the option of selling their loans to Fannie and Freddie. But the new loan market, with its exotic mortgages and with its pressures to increase growth and profits, has greatly eroded this institutional consumer protection. Indeed, Fannie and Freddie, in order to increase market share and profits, are now purchasing more and more of these exotic products, giving them an unofficial seal of approval.

Now, lenders try to advertise the lowest possible introductory rate, planning to make their profit after the introductory period expires and through poorly disclosed points and fees. Let me give you two examples. The Wall Street Journal recently had an article about a lawsuit over an Option ARM with a 1.95% introductory interest rate. The plaintiffs—the borrowers—understood the fixed period of the interest rate to be for 5 years because the disclosure statement said that the loan was a “5-year fixed” loan. The lender—a legitimate bank, I might add—said that the phrase “5-
year fixed” referred to the payment schedule, not the interest rate that was to be charged. The district court sided with the borrowers, holding that the Truth in Lending Act disclosures were unclear and confusing.4

A reporter at the Wall Street Journal, who is doing a story on predatory practices in the Secondary mortgage market, gave me my second example. It’s my personal favorite from the brave new world of mortgage finance. He described a product being marketed by a national lender: It had a two-year teaser cap on payments combined with a three-year prepayment penalty period. This, of course, can create a perfect storm for a borrower. Once the artificially low payments of the 2-year teaser period end, the borrower might find it difficult to make her payments on the loan. But if she tries to refinance to a more appropriate product at that point, she will be forced to pay a prepayment penalty to avoid default, thereby ensuring that the lender wins one way or another. So it’s clear that today’s Secondary mortgage market has changed radically from the days when relatively benign lenders like Savings and Loans and the old-school Fannie and Freddie lent to homeowners on relatively simple terms. In the Wild West of today, even conservative Fannie and Freddie are starting to feel the pressure to participate heavily in the subprime and exotic mortgage markets.

There are three things about the modern residential Secondary mortgage market that I think are worth noting. First, there has been a dramatic move from local standards to national, and now international standards regarding real estate law and practice. Second, there has been another dramatic move from a safe environment for borrowers to a predatory environment for some borrowers. And finally, there has been a dramatic move from localized risk in the real estate market to the globalization of risk in the real estate market.

I’d like to spend some time on this last point. There are two relatively new and material risks that the securitization of residential mortgages has produced. First, a tidal wave of easy money, as seen with the explosion of subprime lending, is now turning into a tidal wave of bad loans in the hands of homeowners and investors. We have not yet seen how this will play out. Second, there has been a concentration of residential mortgage risk in a small number of hands, in particular, in Fannie Mae and Freddie Mac, the mortgage finance behemoths.

As to the first risk, we have all been reading articles about how that tidal wave of 3/1, 5/1 and 7/1 ARMS are about to reset at significantly higher interest rates over the next couple years. This is happening at just the same time that home prices are falling in many markets throughout the country. This is, of course, bad news for many homeowners who might be forced into short sales of their homes. But it will also be bad for investors who have purchased these mortgages as well as the loan originators who may be contractually required to buy back some of these loans from investors.

Let’s move on to the second risk. The concentration of risk in Fannie Mae and Freddie Mac is more systemic and dangerous. Fannie’s and Freddie’s overall success in exploiting the benefits of their government charters has concentrated an extraordinary amount of risk in those two companies. This has been compounded by their successful efforts to expand their market share by winning additional privileges from Congress and by moving into subprime and exotic mortgage markets. Despite—or, perhaps, because of this concentration of risk in the two companies—it is received wisdom on Wall Street that the federal government would bail out Fannie Mae and Freddie Mac if they could not pay their debts—even though they are for-profit, privately owned mortgage finance companies. This is because of their government charters and because of their public mission of encouraging homeownership. Fannie’s slogan is, after all, “Our business is the American dream.”

The seemingly remote possibility of a bailout of what had been seen to be two highly profitable companies has become more likely as wave after wave of accounting scandals involving the misstatement of earnings sweep over them. The risk that these scandals pose has been compounded by the fact that Fannie and Freddie’s hedging strategies expose them to serious risks: if the interest payments that the two companies owe to their lenders become mismatched with the interest payments they receive from homeowners whose mortgages they own, the companies can become insolvent. While only a handful of policy wonks focus on this arcane issue, the cost to taxpayers of a bailout could be hundreds of billions of dollars, easily dwarfing the cost of the Savings and Loan crisis of the 1980s. Hundreds of billions of dollars: That figure should make you all sit up and take notice.

As the Fannie and Freddie scandals have lapped onto the shores of Capitol Hill, Congress has considered a variety of regulatory reforms that are all decidedly incremental and none of which would eliminate the implicit guarantee. Indeed, the current House bill (one that Treasury Secretary Paulson is supporting) would just minimally increase the regulatory oversight of the two companies. It would also make a small portion of their profits go into an affordable housing trust fund. And that’s it in terms of actual reform.

At the same time that it imposes these modest burdens on Fannie and Freddie, the bill would actually increase the conforming loan limit in certain high-cost markets like New York and California—thereby allow-
ing Fannie and Freddie to increase their market share. And, most importantly, the House proposal does nothing to protect the taxpayer from picking up the bill if one of these entities were to become insolvent. It does not appear that Congress is willing to confront the serious risks posed by Fannie and Freddie.

Thus, I propose that the Federal Reserve should act independently to limit that exposure as much as possible until Congress is able to come up with a proportionate response to this brewing crisis. Alan Greenspan and Ben Bernanke, the past and current chair of the Federal Reserve Board, have both recognized this precise risk. So the good news is that the Federal Reserve, an independent agency, can start taking actions that would reduce the magnitude of the threat that these companies pose to the international financial system and the American taxpayer. (Yes, these companies are so large that the failure of either one would present a serious risk to the entire international financial system.)

The Federal Reserve Board grants Fannie and Freddie significant privileges that treat them as instrumentality of the federal government. These special privileges reinforce the implied guarantee that has allowed Fannie and Freddie to issue such extraordinarily large amounts of securities and thus become such risky ventures for the entire financial system. The Federal Reserve should unilaterally stop granting such privileges to Fannie and Freddie.

This will work to reduce the amount of Fannie and Freddie securities that are outstanding by making them less attractive investments. It will also send a strong signal to investors that the federal government will not necessarily guarantee those securities. Such a course will have the short-term benefit of reducing the risk that such debt poses as well as the long-term benefit of putting pressure on Congress and Fannie and Freddie themselves to hammer out a solution that meaningfully protects the American taxpayer.

So let me now tie this back to my original point: the residential secondary mortgage market is relevant to the issue of regulation. Well, I would make three claims. It is relevant to our clients; it is relevant in our practice; and it is relevant to us as citizens, in particular, as citizens with expertise in this area of the law.

The impact of the brave new world of residential mortgage finance and refinance on your clients is not just the new real estate lawyers. But we should be prepared for greater risk in finance options for your clients, not just in the sub-prime but also in the prime market. Your counsel will be of greater and greater value as you help your clients navigate their options. As a New York judge in a recent mortgage fraud case recently noted, "Had claimants been represented by counsel, this litigation would probably not be before the court." Here was a case involving what appeared to be a straightforward refinance with mainstream lenders and the court still found gouging on their part. That is the new world we operate in. We need to advise borrowers about the risks that they face not only when they finance their home purchases but also when they refinance. To do this, we need to educate them about the risks posed in this new world.

It is relevant to your practice in the New York as we see that the state government has less and less of a say in how real estate transactions are handled here and finance corporations with a global reach set the agenda even more and more. Federal preemption of state laws is always on the horizon. Rating agencies set the agenda for mortgage finance companies, which in turn set the agenda for states. Luckily, we now have a governor who is very jealous of the prerogatives of the states—and should be open to thoughtful proposals that allow New Yorkers to both access the global financial system and protect themselves from rapacious lenders.

Academics have some role to play in this. We are slowly confronting the idea that people are rational actors and finding that no, in fact, people are only somewhat rational actors—think of, perhaps, your father, your sister, yourself. Thus, we should draft statutes that protect New Yorkers in the rare but important real estate transactions that they engage in over the course of their lives. Protect them from the mortgage finance companies that have modeled human behavior so well in their so-called automated underwriting systems that they know us better than we know ourselves—at least when it comes to mortgage payment behaviors. And these companies know that we don’t always act rationally in this sphere.

Working from the insights of Nobel Prize winner Daniel Kahneman and others regarding the cognitive basis for common human errors—a field known as behavioral economics—academics now have a theoretical framework and vocabulary to discuss how and why people make bad decisions. This research should, of course, inform efforts to implement appropriate consumer protection legislation that does not shut off cheap credit for New Yorkers.

Finally, the Secondary Mortgage Market is relevant to you as citizens in that we should have some say in how this all plays out. Do we, as citizens of New York state, want global finance corporations setting the important real estate finance standards for New York in an area of the law where New York has often thought it important to set its own consumer protection standards? Do we, as taxpayers, accept the irresponsible concentration of risk in Fannie Mae and Freddie Mac? We, as members of the real estate bar, have a responsibility to take leadership roles in these debates.
Endnotes

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