April 17, 2007

Testimony on 'Subprime Mortgage Market Turmoil: Examining the Role of Securitization'

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Testimony before the

Senate Banking, Housing, and Urban Affairs Committee's

Subcommittee on Securities, Insurance, and Investments

at a Hearing regarding

"Subprime Mortgage Market Turmoil: Examining the Role of Securitization"

April 17, 2007
3 p.m.
Dirksen Senate Office Building

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Introduction

I am Kurt Eggert, Professor of Law at Chapman University School of Law in Orange, California. I have written several law review articles on securitization, predatory lending, the subprime market and related topics, and have frequently spoken on these subjects at symposia and conferences. I currently sit on the Federal Reserve Board's Consumer Advisory Council, on which I also advise about these topics. Thank you for allowing me the opportunity to testify on this important topic.

My testimony today will focus on how securitization has transformed the American mortgage market, atomized the loan process, and to a great extent turned the regulation of the subprime mortgage industry over to private entities. Some aspects of the current meltdown of the subprime market, the increased default rate and threat of rising foreclosures, as well as the difficulty of crafting an adequate response to that meltdown, may be attributed to the effects of securitization. One of my articles, "Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine," 35 Creighton L. Rev. 503 (2002), examines in detail the effect securitization has had on the residential mortgage market and how it has contributed to the spread of predatory lending. Some of this testimony is adapted from that article. To understand the current problems in the subprime market, it is first important to understand how securitization works, how it has led to the creation of the subprime market as we know it, and how it is contributing to the turmoil that is currently enveloping that market While securitization has added significant liquidity to the mortgage industry, it has done so at a price, and that price is borne mostly by subprime borrowers. While securitization has created a smorgasbord of new investment possibilities, it has also brought new challenges and dangers to borrowers.

This testimony discusses how securitization has atomized the lending industry, and has allowed the subprime market to be regulated largely by rating agencies and securitizers. I discuss the advantages of securitization, primarily to investors and industry participants, and the hazards of securitization, mostly borne by borrowers. Among the hazards to borrowers are how securitization has allowed thinly capitalized non-bank lenders to access the capital markets and expand rapidly, quickly selling or securitizing their loans so that the loan buyers can claim holder in due course status in a suit by the borrower. Non-bank subprime lenders are regulated primarily by the rating agencies and Wall Street, which seek to protect their own self-interest and that of investors, but do not have as a primary mandate the protection of residential borrowers.

Securitization has also led to loosened and inconsistent underwriting standards. These changing standards first allowed many borrowers to obtain loans that, once the loans reset to a higher rate, the borrowers will be unable to repay. Then, with underwriting standards tightened, many borrowers will become unable to refinance their way out of increasingly inappropriate loans. Securitization also decreases the discretion to modify the loan in meaningful ways to prevent foreclosure, as servicers of the loan are restricted by the pooling and servicing agreement and by their conflicting duties to different investors.

The problems currently facing the subprime markets and borrowers in those markets have been well documented in recent Congressional testimony. The number of subprime borrowers defaulting on their loans shortly after origination has risen unexpectedly in recent months. As many adjustable rate loans reset to higher payment rates, the default rate may continue to grow. According to a recent study by the Center for Responsible Lending, as many as one in five recent subprime mortgages will end in foreclosure, with new hybrid mortgage products being one of the primary causes for the foreclosures. That study also indicated that as many as 2.2 million subprime borrowers either have already had their homes foreclosed or face the loss of their homes in the next few years, at the cost of $164 billion. Ken Rosen, an economist at the University of California, recently predicted that as many as 1.5 million borrowers could have their homes foreclosed, and that these foreclosures could significantly affect property values. Doug Duncan, chief economist of the Mortgage Bankers Association, has predicted that over one hundred lenders might fail in the coming months. Worse yet, we appear to be in relatively uncharted waters, given that we can only guess at the foreclosure rates of so far untested pools of mortgages with payments due to reset in the coming months.

Even before the recent subprime turmoil, securitization has permitted default and foreclosure rates in the subprime market that many find excessive and dangerous. Because securitizers have been able to price and spread the risk of defaults and foreclosures, and demand increased interest rates to justify that risk, they have accepted default and foreclosure rates year in and year out that might damage a depository institution, both reputationally and financially. While the recent "market correction" appears to be limiting some of the most risky lender practices, so far it has not changed many of the practices that have put borrowers at risk.

The Process of Securitization

Securitization is the process of aggregating illiquid assets, such as a large number of notes secured by mortgages or deeds of trust, and then selling securities backed by those assets. The securities thus created can trade on an open market in a way that would be difficult if not impossible for the illiquid assets that back the securities. Because the securities are typically backed by large pools of loans, the investors minimize the risk of default of individual loans by spreading that risk among many loans and many investors.

A typical securitization of a loan secured by a residence might proceed as follows. A borrower seeks the services of a mortgage broker in order to obtain a loan, and the broker either brokers the loan with a third party or originates the loan under its own name using another entity's funds. Either way, the loan is usually soon held by the provider of the funds. The holder may then either resell the loan to another financial institution that will securitize it, or the lender may add the loan to a pool for securitization. The loan is added to a pool of numerous other loans, which may come all from one lender or from a multitude of lenders.

The holder of the loans then transfers them to another entity, and then to a special purpose vehicle (an "SPV"), typically a trust that has the sole purpose of holding the pool of mortgages. Then, securities are created which are backed by the loans. These securities can be crafted numerous ways, depending on what attributes of the securities will appeal to investors. The unitary interest in the loans is divided into different classes of securities, each class representing a different aspect, or "strip," of the loans. The strips, or classes of securities, are also called "tranches," which is French for "strips." For example, one tranche might have the right to the first repayment of principal until the claims of that tranche are satisfied. Another tranche might not be entitled to any payment until the rights of all other tranches have been satisfied. The different tranches obviously would have different risk characteristics, and those with priority would be less risky than those that have to wait for payment. The tranches can also divide the payment of interest from the payment of principal.

Working with the seller to package the loan pool and its resulting securities are an underwriter and a rating agency. These examine the loans assembled in the pool and return to the originator loans that do not meet the risk standards set for the pool. The underwriters and rating agencies do not examine every loan, but instead sample some loans and rely, perhaps excessively, on detailed representations by the originators of the loans. Most pooling agreements give the intermediaries the right to force an originator to take back any loan that did not actually qualify for the loan pool, the inclusion of which would cause a breach of the originator's representations. Therefore, the originator of the loans may be forced to take back a loan if the borrower defaults.

The securities are typically rated by a national, independent credit-rating agency, unless the home mortgages are backed either by the U.S. government or by a government-sponsored entity. The credit quality of the different tranches of securities can be improved by various techniques of credit enhancement that reduce the risk of loss to the purchasers of the securities. Credit enhancements can be either internal, meaning they depend on the assets or credit of the originator, such as providing additional assets to the securitization pool, or external, involving the credit or assets of a third party, such as an insurer or a bank issuing a letter of credit. Credit enhancements can be so effective that they allow even delinquent and foreclosed loans to be securitized.

Once the securities are rated, they can be sold to investors. This sale is typically accomplished by private placement or public offerings. The buyers may include mutual and pension funds, insurance companies, other institutional investors, and private individuals.

The investors typically are relatively passive once they have had the opportunity to review and approve the offering documents, the loan pool's ratings, and any third party guarantees and have purchased the securities. The collection and distribution of the payments of principal and interest are made by servicers, companies who specialize in this collection and distribution of income and principal from pools of loans. The servicer is employed by the SPV and, since most SPVs are trusts, the trustee is legally at the helm, directing the activities of the SPV. However, the servicer typically is in charge of collection efforts.

Servicers are typically in charge of handling defaults and arranging foreclosures where necessary. If there is sufficient equity in the house securing the mortgage, the investors could conceivably make money on the foreclosure process, since the holder of the loan is often the sole bidder during the foreclosure sale and typically bids only the amount of the outstanding balance on the loan. In some states, the lender could foreclose on the property, purchase the property at an unreasonably low price that does not even pay off the lender's loan, and then seek a deficiency judgment against the borrower for the amount remaining on the loan.

The "Atomization" and Deregulation of the Residential Mortgage Industry

Securitization has accomplished what is known as the unbundling of the loan industry, disassembling the lending process into its constituent elements, and allowing a separate entity to undertake each element. Traditionally, lenders performed all of the functions of a loan: finding the borrowers, preparing the documentation for the loan, funding the loan, holding the mortgage during the course of the loan, and servicing the loan throughout its life. Securitization has, in the words of Michael G. Jacobides, "atomized" this process, so that one distinct entity, more often than not a mortgage broker, originates the loan, while another, perhaps a mortgage banker, funds the loan, and still another may securitize the loan and sell it to investors. These investors, through their ownership of securities issued by the SPV holding the mortgage in trust with a pool of other mortgages, claim the capital represented by the mortgage, while a separate set of entities, such as a master servicer under the trustee's direction, services the loan, accepting the mortgage payments and foreclosing if necessary.

This separation of the mortgage process confers on each entity in the chain a plausible deniability as to the actions of the others. The securitizer can claim to be unconnected to the broker and unaware of any of his activities, however improper. The SPV and the owners of its securities can claim to be holders in due course and protected from any accountability for the fraud of the mortgage broker, through their ignorance of any such fraudulent behavior. The mortgage broker can accurately claim, once the loan is out of his hands, that he can no longer help the borrower if the servicer attempts to foreclose.

Before the rise of securitization, borrowers typically dealt with large finance companies, which funded their own loans and held the loans in their own portfolios. Because these lenders continued to hold the borrowers' paper, were closely regulated, and were required by regulators to maintain sizeable assets, the finance companies had diminished incentive to commit outright fraud against the borrowers, as borrowers retained any defenses they had to the loans and the borrowers could also seek damages against the finance companies.

With the rise of securitization, the origination of subprime mortgages has largely been turned over to mortgage brokers and thinly capitalized lenders who are less regulated than their predecessors. National banks and their subsidiaries, which must comply with federal oversight regarding both safety and soundness and also consumer protection, made less than 10% of the subprime loans originated last year. By comparison, non-bank lenders made almost half of the subprime loans in 2006. Such lenders avoid the more conservative underwriting standards and other stricter regulation mandated for depository institutions, whether the depository institutions are state or federally chartered. State-regulated non-bank lenders and brokers are the least regulated lenders.

Although many non-bank lenders are nominally regulated by the states, there is little state enforcement of underwriting standards of such non-depository institutions. Instead, such non-bank lenders that securitize their loans are mostly policed by the rating agencies, which regularly rate lenders for their financial soundness and legal compliance, servicers for their financial soundness and ability to service the loan pools under their supervision, and the loan pools themselves for their risk characteristics, among other aspects. Wall Street and rating agencies, rather than state regulators or even lenders, largely decide what types of borrowers obtain subprime loans and how the loan products offered to borrowers are designed. According to Harry Dinham, president of the National Association of Mortgage Brokers, "In the end, Wall Street creates a demand for particular mortgages; underwriting criteria for these mortgages is set to meet this demand and this underwriting criteria, not the mortgage originator, dictates whether a consumer qualifies for a particular loan product." In this way, securitization has largely privatized the regulation of the subprime industry, as rating agencies have a much greater hand in regulating subprime lenders, determining underwriting standards, and approving new products than any governmental agency. However, unlike governmental agencies, rating agencies work both in their own financial self-interest and otherwise primarily at the behest of investors and do not have the mandate to ensure consumer protection. Under this de facto regulation, borrower default and foreclosure are significant to the extent that they affect investors.

As de facto regulators of the subprime industry, rating agencies have significant flaws. The decisions of rating agencies are not sufficiently transparent, nor is there typically a documented method to appeal those decisions formally. While governmental agencies are monitored by elected officials, rating agencies are not regulated in any meaningful way regarding their effect on borrowers. Rating agencies also have an institutional interest in preventing the passage of laws that might slow the securitization of subprime loans. In fact, rating agencies have acted to discourage the creation of strong anti-predatory lending laws at the state level, have threatened to withhold ratings in states with such laws, and have done so to protect investors. In this way, rating agencies have not only become the regulators of the subprime industry, but to some extent have become a super-legislature, overruling or seeking to overrule state lawmakers regarding what types of anti-predatory lending laws may be passed. Columnist Thomas Friedman said, perhaps half in jest, “There are two superpowers in the world today. There’s the United States and there’s Moody's Bond Rating Service ... And believe me, it’s not clear sometimes who’s more powerful.”

Rating agencies and other securitizing entities have an interest in increasing the number of loan pools that are securitized, since that is how the securitizers increase their income. This self-interest encourages rating agencies and other securitizers to focus excessively on the quantity of loans securitized, in contrast to traditional regulatory agencies, which focus more on the quality of loans made by depository institutions. Rating agencies do of course also examine the quality of loans in the pools that they rate. However, the recent loosening of underwriting standards and the accompanying defaults demonstrates that

that examination has not been sufficient.

Securitization thus emphasizes quantity of loans over quality in several parts of the securitization process. To the extent that originators of loans can transfer the risk of default to investors or minimize that risk, then securitization encourages originators to make as many loans as possible, provides them with the funds to make the loans, and reduces the risk of poor loans. At the same time, securitization rewards the de facto primary regulators of those same originators for that increase in the quantity of loans, furnishing another incentive to value quantity over quality.

The Advantages of Securitization, Primarily to Investors and Lenders

An advantage of securitization to the originator of loans is its extreme usefulness as a leveraging tool. By almost immediately securitizing its loans, a lender can receive payment for those loans quickly rather than waiting perhaps thirty years for repayment. The lender can use this infusion of capital to make a new round of loans. Quick churning of loan principal allows even institutions with little capital to make many loans, lending in a year much more money than they have. This leverage is particularly useful to smaller, disreputable companies that otherwise would have difficulty funding many loans.

Securitization has also benefited investors by giving them a rich banquet of new and varied investment possibilities, structured by the poolers of the assets to appeal to the different risk, diversification and income tastes of the investors. Securitization allows investors to reduce their information costs by relying on the rating agency. However, because of the complexity of how pools may be structured, the new mortgage products that can be securitized, and the potential for unstable economic conditions, past performance of other pools may not accurately reflect the risk inherent in new securitizations. Rating organizations have regularly upgraded or downgraded the ratings they have assigned to mortgage pools as the repayment and default rates have differed from expected. While historically, more loan pool ratings have been upgraded than downgraded, with the recent rise in defaults in loan pools formed in the last two years, rating agencies may have to significantly downgrade ratings for numerous loan pools.

Securitization has also benefited investors by allowing them to purchase an interest in the high interest rate loans or otherwise dubious loans that have been associated with predatory lending, while avoiding much of the risk of defaults and delinquencies that is associated with those loans. Investors are protected from much of this risk by two methods. The first method is the use of various contractual forms of recourse between the originator or seller of the loan and the entity that purchases them in the securitization process designed to protect the buyers of the loan at the expense of the sellers. Recourse can take several forms. The seller of the loans may make representations or warranties that, if violated, require the seller to repurchase the loan. Or the seller of loans may be contractually required to make cash payments to buyers or to repurchase the loans in the event of borrower default or to set up reserve accounts that fund losses. There are also more complicated schemes involving subordinated interests or excess servicing fees. These forms of recourse for the most part require the continued existence of a relatively solvent seller, of course.

Where the originator of the loan has gone bankrupt or otherwise disappeared, the loan buyers must depend on their second line of defense, the holder in due course doctrine. Under the holder in due course doctrine, bona fide purchasers of loans are protected from many of the defenses that the borrower might have against the originator. Therefore, the new holder of the note might be able to foreclose even though the borrower was the victim of many forms of fraud. A buyer may choose to rely on the holder in due course doctrine even where the loan seller is still in existence, where, for example, a single loan pool contains a large number of loans from one originator, so that forcing the originator to buy back all of the problematic loans could force the originator into insolvency. Or the buyer may conclude that it would be easier to rely on the holder in due course doctrine and foreclose against the borrower than it would be to force the seller to take back a problematic loan.

Even those commentators that sing the praises of securitization rarely mention in any great detail the effect of securitization on the homeowners whose loans have been securitized. At most, they have argued that, by obtaining access to lower cost capital markets, lenders will be able to offer loans at lower interest rates or with otherwise better terms to borrowers. Securitization by government-sponsored entities [“GSEs”] does seem to be positively correlated with lower interest rates for the borrowers with the best credit whose loans are sold to GSEs. While the GSEs claim that their securitization has led to lower interest rates, it is possible that securitization may not decrease interest rates. Instead, falling interest rates may lead to increased securitization, rather than the other way around.

<u>The Downside and Dangers of Securitization, Primarily to Borrowers</u>

Often ignored in the literature on the wonders of securitization are the ways it can cause significant harm to borrowers. First of all, securitization has encouraged lending by thinly capitalized lenders that can easily go out of business when trouble hits, stranding the borrower to deal with investors who can claim protected status as bona fide purchasers of the loans. Already, during the current subprime turmoil, even major subprime lenders have declared bankruptcy, and more than thirty subprime lenders have done so or otherwise gone out of business during the recent subprime turmoil. Many more subprime lender bankruptcies are likely in the offing. Such bankruptcies strip borrowers of much of the ability to sue the loan originators for redress for fraud or other violations of consumer protection arising from the origination of the loan.

Simultaneously, securitization encourages the most rapid creation of an assignee with holder in due course status by causing the originator of the loan to sell the loan almost immediately. Being a holder in due course is a defense to many of a cheated borrower's claims. Gone are the days when a lender would normally hold the loan for its full term, allowing recourse by a defrauded borrower. Instead, lenders now might hold the loan for only a few weeks, assigning it almost immediately to be securitized. Often, the loan will be sold before the first payment is even due, so that if the homeowner/borrower learns that her payments are much larger than had been represented to her, that defense has already been cut off as to the current holder of the note by the holder in due course doctrine. This combination (initial loan made by a thinly capitalized, poorly regulated lender who immediately negotiates the loan to a securitizer, so that the investors in the securities can claim holder in due course status) is a recipe for irresponsible and unethical lending, if not outright fraud.

Loosened or Inconsistent Underwriting Standards

Securitization has encouraged the decline of stringent underwriting and has caused underwriting to be strikingly inconsistent over the past few years. Careful underwriting reduces foreclosure by deterring lenders from making loans to borrowers unable to repay the loan. Consistent underwriting allows borrowers to plan, deciding, for example, to take out a loan that might require them to refinance, with the understanding that they can predict whether they will be eligible for refinancing in coming years. With inconsistent underwriting, borrowers who expected to refinance may find themselves stuck with a loan they cannot repay, unable to refinance it because underwriting standards have tightened in the interim.

As originators immediately sell their loans and face less risk of loss even if a borrower defaults, the originators have less motivation to spend time and effort screening potential loans for default, thus increasing the risk of lending to borrowers who will not be able to repay the loans. While banks once relied on subjective, individual, lender-driven underwriting, securitization instead depends on systemic controls that can be objectively verified, such as automated underwriting systems. In this way, banks step away from their great strength, which was the effectiveness and efficiency of their information gathering and regulation systems, in both selecting which loans to make and controlling those loans once made, and in using their long-term relationships with borrowers. With less lender supervision, borrowers are more likely to default on their loans and risk foreclosure, though the default and foreclosure would likely occur long after the original lender has assigned the loan. In the world of securitization, with its ever-churning markets, there are few long-term relationships, but only the financial equivalents of one-night stands.

This reduction of effective underwriting has been widely blamed for the current turmoil in the subprime markets. While underwriting standards have been at risk for years, the last two years have witnessed a dramatic shift in loan underwriting, first a loosening of standards so that more loans could be made, and then a recent tightening of underwriting standards.

After the mortgage market boomed in 2003 and then dropped off, originators looked for new markets in which to sell their loans. To reach new borrowers who would not have been eligible for carefully underwritten, fixed rate loans, lenders began push-marketing adjustable rate loans with low teaser rates, so that the initial payment requirements of the loans were far below that of fixed rate loans. These loan products, called hybrids and combining initial fixed rates with later adjustable rates, were often designed so that after the initial, "teaser" rate had expired, the borrower was required to repay the loan at above-market interest rates. When the loans reset, the loan payments can increase dramatically. Such loans are appealing to the secondary market because they can sometimes trap unwary borrowers who are not able to refinance above-market rate loans, while borrowers who refinance quickly may have to pay sizeable prepayment penalties. Adjustable rate mortgages (ARMs) have taken over the subprime market, with ARMs being almost 80 percent of those subprime loans that were securitized in early 2006. Many of these are so-called 2/28 or 3/27 loans, loans that reset quickly after a short initial fixed rate of two or three years, with 28 or 27 years of an adjustable rate loan.

By moving from fixed rate to adjustable rate loans, the subprime market has transferred much of the risk of changing interest rates from the holders of notes to borrowers. Successfully managing this risk may well be beyond the expertise of many subprime borrowers, as it would require them to understand how changing market interest rates might change their payment amount, what the risks of such changes are, and how likely they are to be able to recognize and refinance their way out of any difficulties caused by rising interest rates.

Some loans have different payment options, so that the borrower could pay so little that the loan would have negative amortization. These loans are much more complex than the straightforward fixed-rate loans that they replaced, and borrowers often enter into such loans without understanding how high their loan payments might become after the loan resets or how their different payment rates might affect them. The disclosure system, initially designed for relatively simple fixed-rate loans, does not function adequately for these complex loans and even with the best-designed disclosures, the mechanics of these loans may be difficult for some borrowers to understand. Furthermore, these loans have been too often underwritten based on the teaser rates, so that borrowers were considered eligible for loans even where they could not make the full payments once the loans reset to their higher rates. Such underwriting dooms to foreclosure those borrowers who are unable to refinance or sell their houses.

Underwriting standards have shifted dramatically in the last few years. Underwriting standards loosened, and lenders became more willing to accept loans with risk layering features, or multiple aspects that increase risk of default added one on top of the other. For example, lenders made many loans with little or no documentation, even though this requires the lenders to rely on unverifiable assumptions regarding the borrowers' ability to pay. In addition, lenders allowed loans to close with simultaneous second mortgages, which further increase the risk of default while at the same time reducing the borrowers' equity in the property and increasing their monthly mortgage payments. Simultaneous seconds do not provide the lender with the risk mitigation that private mortgage insurance (PMI), would give, even though simultaneous seconds are used largely to replace the need for PMI. Adding further risk in subprime loans, subprime lenders often do not require the escrow of funds for property taxes and hazard insurance, increasing the likelihood that subprime borrowers will fail to set aside sufficient funds for such purposes.

Lenders justified this risk layering with their use of risk-based pricing, using sophisticated and proprietary programs designed to determine the risk layered into the loan and increase the cost of credit as the risk increases. While increasing the cost of credit may protect lenders and investors in the secondary market, it does so to the detriment of borrowers, who may have no idea that they are paying higher interest rates because of the risk layering by lenders. Unfortunately, for much of the subprime market, there has been little significant regulatory guidelines dictating underwriting standards, and no one looking out for the interests of borrowers in determining what underwriting standards would be used. Instead, underwriting was determined by lightly regulated mortgage originators under the eye of rating agencies and other securitization participants. However, until late 2006, rating agencies and other entities involved in securitization did little to require careful underwriting and instead largely relied on the risk minimization built into the securitization process and the higher credit prices extracted from borrowers.

Underwriting standards changed significantly when subprime loans began to go into default at excessive rates, a tightening of underwriting standards caused in part by an October, 2006 guidance from federal regulatory agencies. That guidance directed regulated institutions to assess borrowers' ability to repay the loan throughout the life of the loan, including at its fully indexed rate and also including balances added because of negative amortization. This tightening of underwriting standards should help new borrowers avoid being trapped in loans that they cannot repay once the loans reset. It is unclear to what extent the de facto regulators of the subprime market have adopted the federal guidance and forced non-bank, state regulated originators to follow that guidance. Many of the risky loan types are still being made, such as 2/28 or 3/27 loans with low teaser rates, option payment loans that allow negative amortization, or loans where the borrower is not required to escrow funds for taxes or insurance. At the same time, the underwriting shift may make it harder for borrowers who already have hybrid loans to refinance those loans when their payment amounts reset. While limiting new problem loans, the shift in underwriting may, ironically, make life more difficult for borrowers who obtained problem loans in 2006 and before.

"Tranche Warfare" and How Securitization Reduces Lenders' Discretion in Resolving Borrowers' Difficulties

Securitization hurts borrowers by making it more difficult for a borrower with financial difficulties to arrange alternative payment terms that involve any change in the borrower's payment stream. Before the advent of securitization, homeowners typically borrowed from their neighborhood banks, which normally held the loans for their entire terms. Because of those long-term, local relationships, lenders were often aware of their borrowers' troubles even before the borrower missed a payment, because the lender might know of a factory closing or of a borrower's severe illness. This relationship allowed lenders to step in early and encouraged resolution of borrower difficulties without the need for formal collection efforts. While a borrower whose loan is held by a traditional bank might have some success in convincing the bank to restructure the loan, too much of this flexibility vanishes once the loan has been securitized. The originator has often washed its hands of the loan and has neither the ability to help nor the interest in helping the borrower change the terms of the loan. The trustee and servicer of the loan, even if either is the original lender, must follow the documented procedures that are normally included in the initial documentation of the securitization. That documentation often limits the discretion to alter the terms of the loans because the securities backed by the loan pool are based on the loans' original terms.

The trustee and servicer typically do have some discretion to create a loan repayment plan, a loan modification, or arrange a short sale. However, the rules providing that discretion may be so vaguely written that they either lead to disputes between investors and servicers or lead servicers to avoid exercising their discretion in order to avoid such disputes. Also, the servicer may be required to wait until the borrower is at least 30 days delinquent before offering the borrower any meaningful relief, even where it is clear to both borrower and servicer that default is likely. The willingness of servicers to work with borrowers is subject to the servicers' conflicting interests, as the servicer may be rewarded either for preventing foreclosures by instituting quick and successful repayment plans or, alternatively, for negotiating short sales by the borrowers or foreclosing as quickly and efficiently as possible. The servicer’s willingness to act quickly may also be affected by the fact that servicers often receive whatever late fees are generated by borrowers in distress.

Even in cases where the foreclosure criteria contained in the initial offering of the securities backed by mortgages give the trustee some discretion regarding when and whether to foreclose, and even where the trustee and servicer would want to help out a financially troubled borrower, the underlying structure of the securities creates obstacles to the exercise of that discretion. This is because once the loan has been securitized, it is no longer held as a unitary asset by one owner, but rather has been split into a number of tranches, each tranche representing different interests held by different sets of investors. One tranche might hold the right to any principal repayments made during the first year, another to interest payments during that year, yet another to interest payments the second year, and so on.

Restructuring the loan poses a substantial fiduciary dilemma to the trustee, because it would almost inevitably involve removing some part of a stream of income from one tranche and adding income to another tranche. This “tranche warfare," is a significant brake on the flexibility to restructure a loan. . If not for securitization, a bank could forego mortgage payments for the life of a borrower with little financial detriment, so long as there is sufficient collateral to secure the loan and a sufficient interest rate is added to the principal. But if the loan has been securitized into tranches divided by principal and interest and by the year principal or interest is received, the same agreement to forego payments would strip the tranches receiving early payments of principal or interest of all benefit from this particular loan. Restructuring loans, therefore, would force trustees to choose which of the tranches would receive extra money and which would receive less, leaving the trustee open to claims of favoritism and breach of fiduciary duty.

With the increase in defaults, servicers may be even more constrained. As subprime defaults mount, it may become even more difficult for borrowers to obtain appropriate loan modifications to help them save their houses. On the one hand, lenders and even securitizers have recognized the hazards of increased defaults, and have declared their intent to help borrowers save their homes. For example, EMC Mortgage, a unit of Bear Sterns Co., recently announced the creation of a “Mod Squad,” a team of loan modification experts charged with being “more counselors than collectors” in the attempt to help borrowers avoid foreclosure. Other market participants have also announced their willingness to work with borrowers who suffer financial hardships. However, the subprime lenders who today vow to work with borrowers to help them avoid foreclosure may soon be declaring bankruptcy, and so become powerless to intercede.

Loan modifications work best for borrowers whose loan problems are caused by temporary financial setbacks, rather than those who obtained loans that, once they reset, require loan payments greater than the borrowers would be able to repay even without any new financial downturns. For temporary problems, servicers can allow borrowers to defer payments temporarily or establish a payment plan to make up missed payments. For the permanent problem of loan payments that exceed borrowers’ ability to pay, relief would likely come only from reducing the principal or the interest rate, delaying payments for extended periods, or increasing the term of the loan, but these more significant changes are unlikely to be undertaken. One rating agency recently noted that loan modifications “are not a prudent alternative for borrowers who are fundamentally unable to afford their homes."

Increasing defaults may make it harder for individual borrowers to obtain relief. First of all, increasing defaults also increase the workload of servicers, requiring them to deal with many more troubled loans. It is not clear that servicers are willing to hire the new employees that the increased defaults may require. Also, perhaps one-third of bond deals restrict the number of loans that can be modified, as noted by Credit Suisse Group based on its analysis of thirty-one securitization transactions backed by subprime loans. For these loan pools, as defaults mount, servicers will be increasingly unable to offer borrowers any significant modifications, absent some change in these rules.

Servicers may also be limited to the extent that the rights to prepayment penalties have been separated from the right to collect principal or interest payments on the loans, where, for example, prepayment penalty rights have themselves been securitized. If so, then a servicer that reforms a loan may be deemed to have refinanced the loan, triggering the prepayment penalty. Because these penalties can be so large, the increase in loan principal that they would cause could undo much of the benefit of the loan reformation.

Regulatory supervision of servicers is limited. Servicers are not depository institutions, and so governmental regulators typically are not concerned safety and soundness issues. Instead, regulation of servicers focuses on preventing outright abuses, such as intentionally causing payments to be posted late, charging improper late fees, improperly force-placing insurance, and starting uncalled-for foreclosures. When the Federal Trade

Commission settled its action against a noted abusive servicer, it incorporated into the settlement a set of best practices that it hoped would be adopted by servicers generally. However, based on recent FTC efforts, it appears that these best practices have not been sufficiently adopted. While GSEs have rewards for servicers who use loss mitigation methods that prevent foreclosure, by and large, government regulators have little leverage to order that specific loss mitigation techniques be used.

The borrower cannot turn for succor to the investors who own the securities that are backed by the borrower's loan, since the investors are passive, beneficial owners, who depend on the trustee and servicer to control the assets. It would be difficult for a borrower even to learn the identities of the investors, let alone communicate with them. The investors are not notified of the default of an individual borrower. Even if investors wanted to overrule a trustee's order to foreclose on a homeowner, the trustee may be forbidden from accepting instructions that conflict with the terms of the securitization agreement. In effect, the securitization process erects a wall between the borrowers and the beneficial owners of the note, preventing them from working out mutually advantageous changes to the terms of the note. Once the deeds of trust are securitized, they enter into what Tamar Frankel has called “a kind of suspended animation," noting that "the sellers of the financial assets are no longer the owners. The buyers are only beneficial owners and the trustee controls the assets but does not benefit from them (except by fees)."

Similarly, securitization removes one sometimes-potent weapon in the hands of a borrower who needs to have her loan restructured. When loans were held by regional or local banks, those banks were susceptible to bad publicity and might be loath to foreclose on the home of, for example, an elderly borrower, especially one who was the victim of fraud. Banks have locally recognizable brand names, so that borrowers can threaten to picket a bank or bring discredit to the brand name unless the bank acts reasonably in helping borrowers resolve their problems. Banks also might have some interest in keeping their customers satisfied, with an eye to obtaining repeat business from the customer or new business from referrals.

Securitization, on the other hand, has allowed the markets to be unbundled, atomizing the mortgage origination and collection process. When a mortgage broker solicits the borrower, an SPV holds the loan, and a servicer collects the payments, whom would a defrauded borrower picket in order to obtain a loan forbearance? The originator may be long gone, as many subprime lenders have recently declared bankruptcy and gone out of business. The SPV is a business entity whose sole purpose is to hold a mortgage pool, and is completely immune from any threats to its good name, which is often something like "Security Pool #351." The servicer is similarly immune to threats or pleading, as it serves solely at the direction of the trustee. The servicer little depends on the happiness or good will of the homeowners who make payments to it, since the homeowners have no choice whatsoever regarding which servicer collects the payments on their loans. The trustee also does not need to keep the good will of the borrowing public, since it gets its business from originators, not the borrowers. Indeed, a reputation as a particularly ruthless collector of debts might well aid the trustee or servicer in gaining new originator clients. Furthermore, the trustee and servicer can always claim to be bound by the foreclosure criteria contained in the initial offering of the securities and absolve themselves of any responsibility to exercise discretion in dealing with a desperate homeowner.

Securitization almost completely depersonalizes the lending process and deprives the borrower of the advantages of a personal relationship with her lender. Securitization eliminates the ability of a borrower to pick his creditor, or even the type of creditor, such as a small bank instead of a large bank or an individual investor, as it sweeps up the vast majority of American mortgages into faceless, almost nameless, unknowable business entities.

The Myth That the Market Protects Borrowers

Defenders of the securitization process and critics of additional regulation have advanced two primary arguments. First of all, they argue that the market corrects itself, and that even though clearly there were problems in the subprime industry in 2006, the industry itself and its private regulators have largely resolved those problems, so that no further governmental action is necessary. Also, they argue that the interests of investors and of borrowers are largely congruent, so that as rating agencies and Wall Street investment houses take pains to protect investors, they will at the same time be protecting borrowers. Both of these arguments have significant flaws.

Concluding that the market corrects itself requires tunnel vision. The subprime industry has tightened underwriting, but many of the risky types of loans are still being made, and it is not clear to what extent ratings agencies have adopted the reforms from the recent federal guidances. Also, recent tightening of underwriting appears like the proverbial closing of the barn door after the horses escape. Subprime's defenders focus on the closing of the door, but once the horses are out, one needs also to round up the escaped horses and fix the latch so that the door will not spring open again. The borrowers who received problematic loans in the last few years cannot be ignored, especially since new underwriting guidelines which help new borrowers may increase the difficulty faced by existing borrowers. In addition, steps should be taken to prevent similar turmoil in the future. While the private regulators of the subprime industry appear presently committed to tightened underwriting, there is no guarantee that such commitment will persist. We could, in the future, see another round of loosening of subprime underwriting, increased defaults, and a subsequent underwriting tightening, to the detriment of the borrowers who received the most problematic loans.

Defenders of securitization have also argued that because investors and borrowers are both injured by foreclosures, their interests are congruent, and as rating agencies watch out for the interest of investors they also benefit borrowers. It is true that both borrowers and investors are harmed by an unexpectedly high rate of foreclosures. Investors depend on rating agencies' ability to predict loss rates in determining what credit enhancements are necessary and what rates of return justify such a risk of default. However, investors' interests diverge from that of borrowers in one important attribute. Investors are often willing to accept a higher rate of default and foreclosure if in return they could be guaranteed a higher rate of return through higher interest rates. But both high default rates and high interest rates harm borrowers, undermining any claim to congruent interests. Therefore, the interests of investors and of borrowers differ dramatically and securitization entities that protect the interests of investors may at the same time be acting to the detriment of borrowers by ensuring a high rate of return by investors.

Conclusion

Understanding how securitization affects borrowers, both positively and negatively, is crucial to crafting solutions for the problems facing subprime lenders and borrowers. Some claim that the market can correct itself. However, it is clear that structural characteristics of the securitization process can cause harm to borrowers, and that borrowers are too little protected in a subprime industry that closely heeds the mandates of rating agencies and investors and is too little overseen by governmental regulators.

By and large, rating agencies and Wall Street have supplanted other financial institutions as the driving forces in the subprime mortgage industry. They design the mortgage products, determine the underwriting criteria to be applied, and supervise the selling of loans on the secondary market. To be effective, any regulation that protects consumers from inappropriate loans must affect the actions of the Wall Street players that direct the securitization of subprime loans. A regulatory regime that purports to limit the harmful affects of predatory loans or loans unsuited to borrowers must include not only the lenders that originate the loans, but also the rating agencies and investment houses that create the loan products and determine the underwriting standards, and the servicers who put into effect the loss mitigation techniques that may determine whether borrowers save their homes or lose them to foreclosure.