Securitization’s Role in the Collapse of the Subprime Mortgage Market

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SECURITIZATION’S ROLE IN THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET

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INTRODUCTION

The costs of the subprime mortgage meltdown are sweeping the nation, from the homeowners on Main Street to the investment firms on Wall Street. Everyday the news reveals the devastation, the fear, and the uncertainty that people are facing. Millions of homeowners are on the brink of losing their homes, and millions have already faced foreclosure. The victims of predatory mortgage loans are not the only ones that are suffering from reckless lending. Even people with prime credit histories are falling behind on payments for home loans, auto loans and credit card loans. For example, 5.7% of all home equity loans were delinquent or in default in 2007, up from 4.5% in 2006, and 7.1% of all auto loans were delinquent or in default in 2007, up from 6% in 2006.1 To prevent future losses banks have started to cap home equity loans in areas with falling real estate prices and some credit card companies are reducing lines of credit for risky customers.2

With the banks tightening their lending practices, it is now more difficult for borrowers to secure financing to purchase homes. As a result, new home sales have plunged to their lowest rate in over 12 years.3 When the values of homes were consistently and steadily rising, homeowners felt secure and comfortable borrowing against the equity in their home to finance tuition payments, car payments and vacations. However, because the prices of homes are now

2 See Id.
falling and credit is difficult to come by, these homeowners are now facing a reduced amount of equity or even negative equity, forcing some to sell their homes reluctantly at a loss.

The broadest result of the subprime crisis is great economic uncertainty. Our nation is on the brink of experiencing stagflation because job growth has slowed, the prospect of growing unemployment is looming, and there are fears of inflation. At the end of 2007 wages grew slower than inflation, so it is not surprising that Americans were exceptionally thrifty during the holiday season, to the detriment of retailers. As predictions of a recession run rampant, it seems as though everyone is experiencing financial stress.

Many people are asking who’s to blame for the subprime mortgage meltdown and its accompanying messy consequences? Where should the angry finger be pointed? Multiple theories as to blameworthiness have developed. Some buyers are blaming their real estate agents and have taken it to the next level by bringing suit against them. They are claiming the agent, in fear of losing his commission, concealed information from them that similar homes in the area were selling for less. Brokers are not appraisers and do not have to opine as to value, but those who made valuation statements in the wake of the housing collapse may be receiving letters from attorneys representing angry buyers.

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4 Stagflation is a macroeconomics term used to describe a period of inflation combined with stagnation (that is, slow economic growth and rising unemployment, possibly including recession). In a stagflation scenario the problems of inflation and slow economic growth co-exist. Recently the Federal Reserve has been cutting the interest rate in an attempt to fix both falling home values and rising consumer prices. This is a difficult task because cutting rates may improve economic growth but it has the effect of stimulating the consumer’s purchasing power, which in turn may increase inflation. See, eg., Wikipedia, The Free Encyclopedia, [http://en.wikipedia.org/wiki/Stagflation](http://en.wikipedia.org/wiki/Stagflation) (last visited Apr. 7, 2008).


With respect to the securities that were backed by the subprime mortgages, former SEC commissioner Joseph A. Grundfest was quoted as saying “Anybody who touched the security in the process of creating or selling it is going to be subject to litigation.”\textsuperscript{7} New York state prosecutors began investigations into whether Wall Street banks withheld material information from investors regarding the risk factors involved with the subprime loans. The IRS has opened an inquiry into the trusts that are created to issue the mortgage backed securities. The law firm Cadwalader Wickersham & Taft is being sued for malpractice in connection with work it has done in mortgage backed securities.\textsuperscript{8} Apparently none of the prestigious and sophisticated institutions involved in the creation and sale of mortgage backed securities were able to foresee the sweeping repercussions of their involvement. As a result, not only did individual homeowners fall victim to the effects of this financial process, the financial institutions themselves eventually fell victim as well.

Foreclosed homes, stingy banks, financial insecurity, finger pointing, investigations and litigation. How did we get to a point where everyone, from the individual homeowner to the multi-million dollar financial institution, is suffering from such devastating economic and non-economic damage? A comprehensive overview of the complex financial process of securitization will help to explain the cause of the current economic crisis.

\textbf{Securitization: An Overview}

Securitization is the process of transforming a liquid\textsuperscript{9} asset, such as a residential mortgage, into a tradable security.\textsuperscript{10} In residential mortgage backed securities (“RMBS”), the


\textsuperscript{8} Id.

\textsuperscript{9} Liquid is defined as “consisting of or capable of ready conversion into cash.” Merriam-Webster Online Dictionary, http://www.merriam-webster.com/dictionary/liquid (last visited Apr. 14, 2007).
creation of the new financial instrument represents an undivided interest in a segregated pool of residential mortgages. This is accomplished by using the following financial structure. The loan originator pools individual loans and then sells the loan pool to a special purpose vehicle (“SPV”), a bankruptcy-remote entity established in the form of a trust by the issuer. The SPV is owned by but legally distinct from the originator. The SPV’s only assets are the properties being financed, which the originator sold to the SPV in exchange for the RMBS formed by the proceeds from the mortgages.11 This transaction is structured in this way for the purpose of isolating the loan pool from the originator. Bankruptcy remoteness boosts the ratings of securitized offerings.

The investment bank for the issuer carves the principal and interest payments into tranches12 of bonds. Each class of RMBS is a tranche, and the rating agencies rate the credit risk of each tranche separately. Once the investment bank has a rating it will price the RMBS and sell them to investors via public offering or private placement.13 At issuance the investors are typically paid a fixed coupon14 and their payments of principal are also based on a fixed schedule. The RMBS tranche system has a senior-subordinate structure under which the junior tranches do not receive principal payments until the senior tranches have been retired or paid off.

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10 Webinar: Holding Wall Street Accountable (David Berenbaum of the National Community Reinvestment Coalition, Oct. 30, 2007).

11 Id.

12 A tranche is defined as a “division or portion of a pool or whole; specifically an issue of bonds derived from a pooling of like obligations (as securitized mortgage debt) that is differentiated from other issues especially by maturity or rate of return.” Merriam-Webster Online Dictionary, http://www.merriam-webster.com/dictionary/tranche (last visited Apr. 14, 2007).


14 A coupon is defined as “an interest or dividend certificate that is attached to another instrument, such as a bond, and that may be detached and separately presented for payment of a definite sum at a specified time.” BLACK’S LAW DICTIONARY (8th Ed. 2004).
As a result, the junior tranches have higher coupons and longer lives. They are also the first to absorb any losses resulting from default. This structure protects the senior tranches from these losses.\textsuperscript{15} This tranche system provides investors with a number of options, depending on what levels of risk to which they are willing to be exposed. It follows the general rule that the investors who are the most risk averse get paid first but have lower coupons.

**The Process of Creating Mortgage-Backed Securities**

The process of creating mortgage-backed securities involves the undertaking of many steps by various parties. Because securitization can be quite difficult to grasp, the following steps provide a basic understanding of the structure. First, the originator (or lender) originates the loans. Next, the originator pools the loans together and the securitization structure is added, as described above. The originator then sells or assigns certain assets to a SPV which is typically a subsidiary of the bank and legally insulated from management. In order to guarantee against loss for the investor, the loan pools then go through credit enhancement\textsuperscript{16} (examples of which are discussed further below) and rating agency review. After the rating agency rates the assets, the SPV issues the debt, dividing up benefits and risks among investors on a pro-rata basis. The SPV uses the proceeds from the issuance to pay the loan originator. Over time the borrowers make principal and interest payments which are used to repay the investors.\textsuperscript{17}

\textsuperscript{15} Engel & McCoy, *supra* note 13, at 2047.

\textsuperscript{16} Credit enhancements are financial cushions that can be either internal (provided by the lender themselves) or external (provided by insurers, guarantors and banks).

\textsuperscript{17} *Holding Wall Street Accountable, supra* note 10.
PLAYERS IN THE RMBS MARKET

The securitization process involves the efforts of several parties. The role of each party, whose respective involvement varies in degree and takes place at certain points of time throughout the process, is described below.

**Originator/Lender**

The originator/lender issues new loans to borrowers in a process called loan origination. Institutions such as commercial banks, investment banks, insurance companies, and finance companies can all play the role of originator. Before the originator determines and issues the loan amount, it must assess the borrower’s ability to make timely payments on a loan. To do this they (1) assess the value of the property and (2) review the creditworthiness of the borrower, which involves looking at past credit performance, current income, and cash reserves.\(^{18}\)

The originator’s counsel works within rating agency guidelines in structuring the transaction and preparing the loan documents.\(^{19}\) After the originator issues the loan to the borrower and records the debt onto a title, it sets up a SPV and places the loan into the trust. At this point the originator no longer plays an active role in the transaction.\(^{20}\) As discussed further below, the only obligation the originator retains is a repurchase obligation in the event it breaches a representation in connection with the sale of the loan to the SPV.

In addition to originating the loan in the ordinary course of business, these institutions also purchase and assemble these loans.


\(^{19}\) Holding Wall Street Accountable, supra note 10.

\(^{20}\) Jan de Beur & Chaubey, supra note 18.
**SPV/Issuer**

The SPV issuer’s role in the securitization process is to find willing investors to whom they can issue RMBS. This issuance funds the issuer’s purchase of the loans from the originator. The issuer combines the loans into an asset pool and structures the cash flows from the pool into a set of tranches, or bonds, and then sells these bonds as securities to investors. Issuers also play a role in providing liquidity or a secondary market for these securities.21

**Underwriters/Placement Agencies**

The underwriter22 is a crucial link between the lender and the investor because its task is to understand the collateral by verifying the value of the properties underlying the loan pool.23 The underwriter usually plays the principal role in structuring the RMBS transaction and they take on the risk of having to sell the securities.24 If they can not find enough investors to purchase all the securities then they end up having to hold some securities themselves. The underwriter pays the issuer with part of the proceeds they collect from the investors who purchase the securities, and the price difference represents the underwriter’s profit.

**Trustee**

The trustee is usually a bank (or another entity that is authorized to act in such capacity) appointed pursuant to the trust agreement to act as the gatekeeper of the SPV’s assets. The trust

21 *Id.* at 7.

22 Securities underwriting is the way business customers are assessed by investment houses for access to either equity or debt capital. This is a way of placing a newly issued security, such as stocks or bonds, with investors. A syndicate of banks underwrite the transaction, which means they have taken on the risk of distributing the securities. *See, eg.,* Wikipedia, The Free Encyclopedia, [http://en.wikipedia.org/wiki/Underwriter](http://en.wikipedia.org/wiki/Underwriter) (last visited Apr. 7, 2008).


24 *Holding Wall Street Accountable, supra* note 10.
agreement is the legal document between the trustee and the originator that creates the SPV.\textsuperscript{25} The trustee’s responsibilities include holding the receivables (loans) and maintaining the mortgage files, collecting payments on the receivables from the borrowers (by way of the servicer) and passing these payments on to the security holders.\textsuperscript{26} They are also responsible for providing statements regarding distributions and carrying out trust tax reporting. The trustee holds legal title to the properties underlying the loan pool on behalf of the investors and has a legal obligation to protect their interests. They also are obliged to supervise the servicer (whose role is discussed below) to ensure that they act in accordance with the servicing agreement.\textsuperscript{27}

**Investor**

The investor is the ultimate purchaser of the RMBS. They own the present and future economic value of the assets. The diverse and global institutional investor base includes banks, insurance companies, retirement funds, government sponsored entities (“GSEs”), and others.\textsuperscript{28} Each investor has their own preference for risk and return and may choose investments accordingly.

**Rating Agencies**

The rating agencies enter the securitization process early on and assist in structuring the transaction. The three primary agencies are Moody’s Investors Services, Standard & Poor’s and Fitch IBCA. Their role is to protect investors, but they are hired by the underwriter to assess and assign credit ratings to the credit quality of pools of mortgages. The rating agencies are considered the “gatekeepers” of RMBS because bonds need to be rated before the issuers and

\textsuperscript{25} Id.
\textsuperscript{26} Id.
\textsuperscript{27} See Jan De Beur & Chaubey, supra note 18, at 8.
\textsuperscript{28} Holding Wall Street Accountable, supra note 10.
underwriters can sell them. “The lack of a rating from at least one of the privileged raters, which effectively grant regulatory licenses to institutions that wish to issue securities, is the financial equivalent of a death sentence for a residential mortgage-backed securities offering.” 29 The S.E.C. and other government regulators granted these agencies a nationally recognized statistical rating organization status (NRSRO), but they were not assigned a reciprocal responsibility to the public. This is a problem because the rating agencies are not held accountable to anyone. Therefore, they can enjoy their privileged regulatory status and their unaccountability up until the investors can no longer rely on them.

Credit ratings are private and purportedly independent opinions about credit. The development of credit ratings for RMBS increased investor confidence in these securities. 30 While these rating are not a legal requirement, most investor’s investment guidelines require credit ratings on securities. Ratings range from triple-A (high) to triple-C (low) and they have a major influence on structure and pricing. The rating process begins with the issuer providing the rating agency with relevant information including but not limited to, the issuer’s background, strategy, operations systems, and historical performance data. The issuer then explains the deal structure, the nature of the underlying assets, and the operations of the originator of the assets. 31

The rating agency assessment includes: (1) an evaluation of the risk of RMBS default and likelihood of timely payments; (2) a comparison of the loan pool’s characteristics with historical

30 See id. at 1007.
31 See id. at 1014.
data; and (3) a forecast of the tranche’s performance. They do not assess the underlying loans or individual borrowers.\textsuperscript{32}

The credit ratings are reflective of the agencies’ holistic approach to evaluation; they evaluate everything related to credit including (1) the real estate, (2) loan terms, (3) credit support structure, (4) legal structure, (5) pooling effects, and (6) all parties to the transaction. The external factors that are considered include the state of the economy, as well as relevant accounting, legal, tax, regulatory and other external influences. Their evaluation of loss potential includes a consideration of (1) frequency of default along with the severity of loss, (2) pool characteristics, (3) credit enhancement, and (4) deal structure.\textsuperscript{33}

After this evaluation and assessment and before rating the securities, the rating agencies provide advisory services to the investment firms on how to package the RMBS so as to gain higher credit ratings.

In addition to their initial ratings, the agencies continue to monitor these transactions and adjust the ratings as credit conditions change. The rating agencies also reevaluate the securities when states pass anti-predatory lending acts, because these measures cause the investors to back away from RMBS.\textsuperscript{34} The agencies tend to overestimate credit risk at first, so when they

\textsuperscript{32} This is in contrast to commercial mortgage backed securities (“CMBS”) where, “At the loan level, components of a transaction are evaluated in terms of likelihood of payment, implying the capacity and willingness of the borrower to meet the financial commitment in a timely manner, in addition to the provisions of the mortgage.” JAN DE BEUR & CHAUBEY, supra note 18, at 10. This difference is due in part to the impracticability of assessing the huge volume of residential mortgage loans that make up the pool. On commercial deals, an assessment of the underlying loans is more practical because there are many fewer loans in the pool, and the larger loan dollar amounts for each loan increase the debt concentration risk to levels beyond that of RMBS, making the individual assessments quite necessary. Also, in CMBS there are many additional variables to assess, such as appraisal methodologies, sponsorship, environmental issues, local market issues, tenant issues, and lease issues.

\textsuperscript{33} Reiss, supra note 29, at 1014.

\textsuperscript{34} Holding Wall Street Accountable, supra note 10.
reevaluate the securities on the secondary market they can upgrade a tranche due to its performance. Traditionally, upgrades outpace downgrades in subprime RMBS. This initial conservative risk assessment by the rating agencies may induce investors to purchase these RMBS because there is a good possibility of a future upgrade.\textsuperscript{35}

The criticism of rating agencies is becoming more widespread as people wonder why it has taken them so long to respond to the financial crisis.\textsuperscript{36} Critics point to the frequent disagreement in RMBS ratings between the agencies and claim that this is evidence that they fail to provide accurate information.\textsuperscript{37} They also claim that the agencies’ good reputations are attributable to the power they derive from “their sale of regulatory licenses,” or the right to be in compliance with regulation.\textsuperscript{38}

The rating agencies face criticism for failure to comply with state and federal antipredatory lending statutes. These statutes are one of the external factors that the rating agencies review when evaluating RMBS loss potential. In particular, they look for assignee liability and damages provisions. “In states where there is both assignee liability and unquantifiable damages, some of the privileged raters have refused to rate transactions containing mortgage loans from such jurisdictions” and this “can effectively shut down the entire mortgage market of a state that passes strong anti-predatory lending legislation.”\textsuperscript{39} As a result, the rating agencies effectively have a veto over state predatory lending laws. On the federal level, The Home Ownership Equity Protection Act (“HOEPA”) places limits on certain practices

\textsuperscript{35} See Engel & McCoy, \textit{supra} note 13, at 2056.


\textsuperscript{37} Reiss, \textit{supra} note 29, at 1021.

\textsuperscript{38} \textit{Id.}

\textsuperscript{39} \textit{Id.} at 1024-1025.
if made in connection with high cost loans.\textsuperscript{40} HOEPA abrogates the holder in due course doctrine\textsuperscript{41}, however, HOEPA’s protections only extend to a small part of the mortgage market.\textsuperscript{42} The rating agency’s interests conflict with the antipredatory lending statutes because the agencies are not held responsible to the public. The agency’s guidelines reflect the interests of issuers and investors, and not borrowers. The rating agencies are not interested in reducing the number of predatory loans; rather, they are interested in the growth of the RMBS market because they have a financial stake in it.

The rating agency process is an area of great concern and focus because of the conflict of interest created by the institutional pressure from the issuers and underwriters (who are responsible for paying the agency’s fees) on the rating agencies to assign high-quality ratings to RMBS. This is in conflict with the rating agencies’ duty to provide objective and independent ratings to investors. Investors should question if it is their interests that are really being protected in this process. More oversight is needed in this area, as evident by the recent S.E.C. decision to launch an investigation into whether the rating agencies improperly inflated their ratings of RMBS.\textsuperscript{43}

\textbf{Servicer}

The servicer is the party that actually deals with the receivables on a day to day basis, collecting the payments on the mortgages in the trust and transferring funds to accounts controlled by the trustee. In most RMBS transactions the originator acts as servicer.


\textsuperscript{41} The holder in due course doctrine immunizes investors as good faith purchasers of the mortgage notes. Borrowers that were defrauded by lenders can not hold the investors liable. \textit{See, eg.}, Reiss, \textit{supra} note 29, at 1026. Therefore, the investors are protected, but it is to the detriment of the borrowers.

\textsuperscript{42} \textit{See} Reiss, \textit{supra} note 29, at 1024-1025.

originator with huge servicing operations, such as Countrywide or Wells Fargo, retains servicing because it brings in big revenue. In addition to collecting monthly payments from borrowers, the servicer’s responsibilities include (1) monitoring delinquent or problematic loans, (2) deciding between foreclosure or refinance when necessary\(^44\) and (3) reporting information and remitting funds according to the pooling and servicing agreement.\(^45\)\(^46\)

**Government-Sponsored Entities (GSEs)**

The Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) are both government-sponsored entities that were formed to provide a secondary market for residential real estate loans. The U.S. government acts as guarantor of the loans and therefore Fannie Mae and Freddie Mac can borrow or sell at lower interest rates than private entities. This enabled tens of millions of borrowers to obtain mortgage credit at much lower costs.\(^47\)

Fannie Mae was created in 1938 as a part of FDR’s New Deal to raise the levels of homeownership and affordable housing. Its role was to provide private banks, who were discouraged by the Great Depression from making mortgage loans, with money to finance home mortgages. Fannie Mae is a “corporate instrumentality” of the government; it is a quasi-private corporation with stock that trades on the public market. It does not receive a government subsidy and is taxed like any other corporation. Fannie Mae purchases conforming mortgages

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\(^{44}\) *See* CONNOR, *supra* note 23, at 8.

\(^{45}\) A pooling and service agreement is “a legal contract defining the responsibilities and the obligations of the...servicers in managing a CMBS transaction, including required advances.” JAN DE BEUR & CHAUBEY, *supra* note 18, at 199.

\(^{46}\) *See* JAN DE BEUR & CHAUBEY, *supra* note 18, at 8.

\(^{47}\) *See, eg.*, Reiss, *supra* note 29, at 1006 and 1010.
from the Federal Housing Administration (“FHA”), pools these mortgages and then issues securities using the pool of mortgages as collateral. Holders of Fannie Mae certificates are guaranteed full and timely payment of principal and interest. Fannie Mae began purchasing subprime loans in 1999 but limited the purchases to the most creditworthy segment of the subprime market in order to adhere to their own buying guidelines.

Freddie Mac is another “corporate instrumentality” of the government. The Federal Home Loan Banks hold stock under the regulatory control of the Department of Housing and Urban Development (“HUD”). Under the direction of the Federal Home Loan Bank Board, Freddie Mac is entrusted to purchase mortgages from savings and loan associations (S&Ls) to enhance their role in and provide liquidity to the secondary market for single family mortgages (i.e. a mortgage not backed by a government agency) and then issue securities using the pool of mortgages as collateral. Freddie Mac began purchasing subprime loans in 1997.

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48 The Federal Housing Administration was created by Congress in 1934 to provide mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. U.S. Department of Housing and Urban Development (HUD), http://www.hud.gov/offices/hsg/fhahistory.cfm (last visited Apr. 14, 2008).

49 See, eg., JAN DE BEUR & CHAUBEY, supra note 18, at 188.

50 See Reiss, supra note 29, at 1011.

51 The Federal Home Loan Banks are 12 privately-owned regional banks without publicly traded stock. They were congressionally chartered in 1932 to create affordable housing opportunities. They provide stable, low-cost funds to financial institutions for home mortgage, small business, rural and agricultural loans. FHLBANKS: A Nation of Local Lenders, http://www.fhlbanks.com/ (last visited Apr. 14, 2008).

52 A savings-and-loan association is “a financial institution -- often organized and chartered like a bank -- that primarily makes home-mortgage loans but also usually maintains checking accounts and provides other banking services.” BLACK’S LAW DICTIONARY (8th Ed. 2004).

53 See, eg., JAN DE BEUR & CHAUBEY, supra note 18, at 189.

54 See, eg., Reiss, supra note 29, at 1011.
The Emergency Home Finance Act of 1970 allows the GSEs to purchase and securitize “conforming” mortgages. GSEs are limited to purchasing “conforming” loans, which are loans with loan-to-value ratios of 80% or less. They may not buy mortgages with principal amounts greater than an amount set each year. For example, the loan limit for 2008 on a single unit home is $417,000. The 2008 conforming loan limits are identical to the 2007 and 2006 conforming loan limits.

Fannie Mae and Freddie Mac, not private entities, are the dominant purchasers of residential mortgages in the nation’s secondary mortgage market. Investors appear to be provided with reassurance and a sense of protection when the securities they are purchasing are endorsed by a government backed entity. The investors in Fannie Mae securities are guaranteed full and timely payment of principal and interest. Fannie Mae’s securities are classified as “U.S. agency securities” because Fannie Mae was created and exists pursuant to a federal law that serves the public mission of providing housing to Americans, but these securities are not backed by the full faith and credit of the U.S. Government.

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55 See, eg., id. at 1006.
56 The loan-to-value ratio is “the principal amount on a mortgage at origination to the current appraised value of the property. The ratio is commonly expressed to a potential borrower as the percentage of value a lending institution is willing to finance. The ratio is not fixed and varies by lending institution, the borrower’s credit history, the property type, geographic location, size and other variables.” JAN DE BEUR & CHAUBEY, supra note 18, at 194.
57 See, eg., Reiss, supra note 29, at 1010.
59 When the issuer of securities is a private entity, those transactions are referred to as private label/non-agency securitizations.
THE POPULARITY OF RMBS

Many of the parties mentioned above became involved in the securitization process because they could derive vast financial benefits from participation. Unfortunately, while these parties were experiencing financial success, it was to the detriment of unsuspecting borrowers.

WHY LENDERS LIKE RMBS

RMBS grew exponentially in the past few years and took the global financial world by storm. These complex and difficult to value assets were risky but reaped high rewards for the lender. In RMBS transactions the lender receives the present value of future cash flows, providing the lender with cash for immediate spending or investment. When the lender sells the rights to the future cash flows to investors, they are passing on the benefits of possible profits but they are also transferring the risk of that profit not emerging.

In general, lenders deem real estate to be good collateral because property in buildings and land needs less monitoring than personal property collateral. However, the individual residential mortgages themselves are not easily tradable because they would require their own extensive monitoring. RMBS help the lender overcome this problem. Technological advances have made it possible to estimate and price the risk of subprime home loan pools. Today lenders securitize almost 80% of subprime mortgages. Because of subprime aggregation, even marginal lenders with low credit ratings are able to obtain financing and borrow funds at better rates because the cash flows these lenders are securitizing are deemed to be quality because of the strength of the underlying collateral and other credit enhancements.

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61 See Reiss, supra note 29, at 1005.
62 Engel & McCoy, supra note 13, at 2045.
63 See, eg., Engel & McCoy, supra note 13, at 2065.
Notwithstanding the high rewards, some of these marginal subprime lenders said that the big investment banks encouraged and pushed them to make the risky loans. The subprime lenders claim the investment banks pressured them to loosen their lending standards so that the investment banks could package more loans into securities. However, this was the wrong time to ease credit because interest rates were rising and home prices had reached their peak. The investment banks encouraged the issuance of these risky loans to troubled borrowers because the banks reaped a windfall by packaging them as investments for hedge fund clients. The investment banks pushed for more and more loans to be made as demand for RMBS grew hot, even if the borrowers were not creditworthy. RMBS brought in big revenue so the lenders processed loans as quickly and as often as possible. Therefore, lenders did not mind making “stated income” loans because the lender could process these loans quickly. These are loans where the information provided by borrowers and brokers are not verified by the loan officers with tax returns, pay stubs or other documentation. Simply put, money trumped lending standards. The absence of governmental oversight in this area adds to the power of the investment bank in the securitization process. The investment banks have the power to securitize risky, non-conforming subprime mortgage loans because they are not required to meet GSE underwriting standards.

**WHY THE INVESTMENT BANKERS LIKE RMBS: BONUSES**

Investment banks operate on a “pay for performance/profit” system. The more net revenue you generate, the bigger your bonus. After the dot.com collapse, collateralized debt

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66 See Bajaj, supra note 64.
67 See CONNOR, supra note 23, at 10.
obligations (“CDOs”) such as RMBS replaced the tech stocks as the hot products for investment banks to sell to investors. The hot housing market set the background of RMBS as a fast growing sector. The boom in subprime mortgages created pressure on investment bankers to feed the machine; in order for them to take home big bonuses they had to grind out the RMBS transactions. As a result, they focused on quantity, while letting their standards of quality slide. A look at just a few numbers reveals that the growth in the subprime mortgage market did in fact lead to the growth in RMBS. While CDOs were virtually nonexistent 10 years ago, in 2004 CDO issuance amounted to $157 billion and two years later in 2006 it amounted to a whopping $550 billion. A look at the 2006 CEO bonuses for the Wall Street banks who invested in CDOs supports the contention that the growth in the CDOs strengthened revenues. Their bonuses combined amounted to $130 billion. Broken down, the CEO at Goldman Sachs earned $53.4 million, at Morgan Stanley $40 million, at Merrill Lynch $47.3 million, at Lehman Brothers $10.9 million, and at Bear Stearns $14.8 million.

**WHY INVESTORS LIKE RMBS**

Investors like RMBS because the volume of loans is sufficiently large and homogenous, and this facilitates statistical analysis of the loan pool (history of rates, defaults, delinquencies, and prepayments). The large size of the pool of assets also reduces the likelihood of cash flow interruptions. Investors like how RMBS provides sufficient diversification with respect to geography and socio-economics because this diversification spreads the risk and reduces vulnerability to economic stresses. As previously discussed, the pool of assets provides more

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70 *Id.* at 6-7.
liquidity than the individual underlying assets. Loan pools are transferable and unencumbered. Due diligence costs associated with investing are reduced because this task is delegated to the rating agencies. The rating agencies are capable of evaluating and approving the lenders’ basic credit quality standards.  

**Securitization and the Problem of Adverse Selection**

Securitization allows lenders to shift the loan performance risk to the investor. How can RMBS investments be successful if securitization enables lenders to sell their worst loans to investors and it blocks the investor’s access to data regarding the borrower’s credit quality? Why would investors purchase RMBS if they know the lenders are able to fraudulently represent the quality of the loans?

Originators have an incentive to sell their riskiest loans to investors because if they hold onto these loans they are in the position to bear the high risk of default. Before the securitization of residential mortgages grew hot, originators themselves would underwrite, finance the mortgage, service the loan and hold the loan until maturity. With RMBS they have no problems with providing loans to the risky borrowers to whom they would have never lent money if they had to hold the loans themselves. Furthermore, the lenders have less reason to underwrite the loans carefully knowing they will sell them anyway.

Like many other investments, RMBS involve risks that make investors hesitant about investing, but the RMBS tranche system’s senior subordinate structure is successful in shifting these risks.  

In the subsections below, the investment risks are discussed first, followed by the solutions and protections that are available to investors.

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71 *Holding Wall Street Accountable, supra* note 10.
72 *See, eg.*, Engel & McCoy, *supra* note 13, at 2054.
Credit Risk

To put the credit risk in context, it is helpful to compare the subprime RMBS to the prime RMBS. Pools of subprime mortgages have a large variance in credit risk covering the entire risk spectrum (A to the weakest D borrowers), whereas prime pools are limited to the most creditworthy borrowers (mostly A), which represents only a narrow band of credit risk. Subprime borrowers have impaired credit and are more likely to miss payments, sending the loan into default. On top of that, lenders make loans that they know borrowers cannot afford, so default is almost a foregone conclusion.

Investors do not have the data on borrower credit quality. As discussed above, any due diligence is limited in scope because the investors depend on the ratings and the senior-subordinate structure to protect them from credit risk, rather than due diligence. Lenders may try to take advantage of this and conceal the credit flaws of subprime borrowers, knowing that investors do not have access to this information.

Prepayment Risk

Investors do not want to face the risk of prepayment. When borrowers pay off their principal before maturity the investor’s cash flow is disrupted by (1) accelerating the return of principal and (2) canceling future cash flows from interest payments. Subprime borrowers prepay for two very different reasons. The first is on a voluntary basis; they have improved their credit scores and now want to refinance into prime mortgages to take advantage of lower rates. The second reason for prepayment is involuntary. This happens when they are the victims of

73 Corporate credit ratings have letter designations, usually with AAA as the highest rating and D as the lowest. For example, Standard & Poor’s rating scale is as follows: AAA, A+, A, BBB, BB, B, CCC, CC, C, D.
74 See, eg., Engel & McCoy, supra note 13, at 2050.
75 See, eg., id. at 2060-2061.
“loan flipping,” which is when lenders persuade or even force subprime borrowers to refinance their loans repeatedly at short intervals in order to extract high fees. To facilitate this, lenders can structure the original loans so that the borrowers are eventually unable to pay and have to refinance.76

**Litigation Risk**

Investors face the risk that borrowers will sue the SPVs that hold the securitized loans for wrongdoing in the origination of the loans. If the borrower wins large compensatory and punitive damages awards this can have a big impact on the investor’s returns.

**Protections**

Investors are provided with a number of protections to eliminate the aforementioned credit, prepayment and litigation risks.

- The sequential tranches provide investors with options. Investors who are the most risk averse get paid first. These conservative investors will not be offered the high coupons but they are in the best position to avoid risk.

- Investors can rely on diversification to alleviate the risks. The more diverse the pool of subprime loans (with respect to geography, credit risk, prepayment risk, and legal risk), the lower the risk that the investors will suffer losses.77 For example, even if there are 100 defaults in a pool of 1,000 loans, 900 are still ok and bringing returns to the investor.

- The risk can be shifted through pricing. Investors demand a risk premium in the form of price reduction. This is passed on to the borrower who will be charged higher interest rates and prepayment penalties. For example, lenders steer customers who qualify for prime products towards subprime products which forces them to overpay for credit. These terms generate higher prices when the originator sells or packages them for securitization. Moreover, the prepayment penalties actually push the cost of subprime loans to the lender above their risk-adjusted price paid by the borrower. Prime loans, on the other hand, usually do not have these penalties.78

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76 See id. at 2051.
77 See id. at 2056-2057.
78 See id. at 2058-2059.
• Investors can purchase credit insurance as a part of an investment.

There are deal provisions that protect investors by shifting the credit risk back to lenders. Although assignee liability is limited by the holder in due course doctrine, many of the representations and warranties made by the mortgage lender about the quality of the loans survive the securitization process and are still enforceable against assignees.\(^{79}\) The language of these provisions focus on issues of fraud and misrepresentation. The following are examples of these provisions.

• Representations and warranties: The lender warrants that all loans in the loan pool comply with applicable laws such as consumer protection laws.

• Recourse and collateral substitution: This requires the lender to take back loans if specific events occur, such as borrower default, and substitute performing loans for the loans that are going into default. These clauses are common but are not consistently enforced.\(^{80}\)

• Retention of servicing rights: This should have the effect of causing lenders to be concerned about the borrower’s creditworthiness. Servicing costs go up as default risk rises, and under this provision if loans go into default they bear the costs.\(^{81}\) However, it is rare for lenders to retain servicing rights.\(^{82}\)

• Internal credit enhancements: These come in at least three forms. The first is excess spread, which is the difference between the interest rate received on the underlying mortgage and the coupon on the issued security. When loan payments are in default, the coupon payment can still be made. The second is overcollateralization, which provides a support structure of an underlying loan portfolio with a face value that is larger than the RMBS it backs. Like with excess spread, even when loan payments are in default, principal and interest payments on the RMBS can still be made. The third internal credit enhancement is a reserve account, which is created to reimburse the SPV for losses up to the amount allocated for the reserve.\(^{83}\)

\(^{79}\) See id. at 2061-2062.

\(^{80}\) See id. at 2073.

\(^{81}\) See id. at 2063.

\(^{82}\) See id. at 2075.

External credit enhancements: These come in at least four forms. The first is surety bonds, which are insurance policies that reimburse the SPV/Issuer for any losses. The second form is wrapped securities, which are insured or guaranteed by a third party. The third party may agree to reimburse the SPV/Issuer for losses up to a specified amount, advance principal and interest, or to buy back any defaulted loans. The third form is a letter of credit, which is when a bank provides a certain cash amount to reimburse the SPV in the event of default for losses up to the allocated credit support amount. The fourth external credit enhancement is a cash collateral account, which is when the issuer borrows the required credit support amount from a commercial bank and then deposits this cash in short-term commercial paper that has the highest available credit quality.84

THE LACK OF DUE DILIGENCE

When investors are faced with quick decisions about investments they do not have time to do their own due diligence, and therefore they must rely on the lenders, the rating agencies, and the underwriters. This is notwithstanding the fact that these three institutions do not have the same interests as the investor. In the nonconforming loan market private entities are free to adopt their own internal due diligence standards, and it is questionable whether there is any real self-policing involved. This internal due diligence can be limited to lender compliance with state and federal consumer protection laws. This becomes a problem in the numerous states that do not have strong anti-predatory lending laws. On the other hand, in the conforming loan market the GSEs impose stringent due diligence requirements on the lender. Fannie Mae and Freddie Mac have best practices standards that require substantive screening of subprime loans. Critics argue that both underwriting firms and rating agencies relax their due diligence standards as a response to pressure from the lenders, who may threaten to move their business elsewhere.85

85 See Engel & McCoy, supra note 13, at 2070.
HOW THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET IS EFFECTING HOMEOWNERS AND COMMUNITIES

The subprime mortgage loans that generate RMBS harm the borrowers, who usually lack effective bargaining power when dealing with sophisticated institutional lenders. The borrower is sucked into a mortgage that he or she will eventually be unable to afford, and the harmful effects of this situation spread far beyond the individual borrower to the entire community. As homeowner after homeowner must foreclose, the abandoned and deteriorating properties “strain city resources and threaten the vitality and stability of neighborhoods.”86

The national homeowner vacancy rate, which measures how many vacant homes are ready for sale, rose to 2.8% in 2007. Foreclosure filings rose 75% in 2007 to 2.2 million. Unlike the firms on Wall Street, the mortgage field servicing firms that service foreclosed homes are currently experiencing a booming $1 billion business. Mortgage lenders who are foreclosing on a home often hire these firms. “Lenders faced with growing housing inventories they need to sell are pushing servicers to handle more houses, faster, piling on the pressure.”87 Homeowners may encounter difficulties in selling their homes because they must compete with the sale of foreclosed homes in their neighborhoods, which may offer a more attractive price to buyers.

Homeowners have also experienced the noneconomic effects of the subprime mortgage crisis. As the rates of foreclosure rise, animal shelters are filling to their capacities with abandoned pets. Many evicted pet owners are forced into housing that is not pet-friendly.

86 Id. at 2042.
Luckily, there are a few shelters that are offering temporary housing for evicted pets until the owners are able to take them back in.88

**HOW THE COLLAPSE OF THE SUBPRIME MORTGAGE MARKET IS EFFECTING THE U.S. ECONOMY AND OTHER NATIONS**

Investors are now turning away from RMBS. The securities will go bad as more foreclosures occur and people lose their homes. Ironically, the destructive consequences will even reach the investment banks that created the RMBS.89

It is clear that the United States economy is hurting from the collapse of the subprime mortgage market. Investment banks are being stingy about making loans because of the current uncertainty concerning the value of collateral. The loosened lending standards are now a thing of the past, because these banks have stepped up demands for more cash and collateral, sometimes in the form of higher interest rates as they restrict the money they are willing to lend.

Investors do have money, but they don’t want to invest it because they are nervous about the uncertainties of RMBS; no one is quite sure what price these securities should be trading at and they do not trust anyone to repay a loan.90 As a result, liquidity has dried up. The markets have effectively shut down because there are no buyers. The meltdown of the subprime mortgage market has caused a detrimental chain reaction within the financial world. A model of this chain reaction begins with financial institution A, which cannot sell its RMBS to the wary investors, and consequently cannot raise enough cash to make the payment it owes to institution B for borrowed funds. In turn, institution B then does not have cash to pay or to loan to

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89 See Eric Dash and Landon Thomas Jr., *Credit Turmoil Bruised Most on Wall Street, but Pain Was Not Shared Equally*, N.Y. TIMES, Sept. 21, 2007.
institution C. The effects of this paralysis has spread to the lender’s capability to make more traditional home loans, business loans and even to corporate borrowing for billion-dollar leveraged buy-outs. The meltdown has created a general fear of credit quality coupled with a collapse of confidence.91

**How the subprime mortgage meltdown has already effected the investment banks**

In the last quarter of 2007 there were numerous reports of slowdowns, losses, firings, job cuts, and write-offs. The following are cases in point.

- **Goldman Sachs** experienced a vast slowdown in their RMBS business. In the first nine months of 2006 they securitized $55.2 billion of residential mortgages compared to $22.9 billion in the first nine months of 2007. They only securitized $2.86 billion of residential mortgages during the period of June to August of 2007. In this same period in 2006 they securitized $18.63 billion.92

- **Bear Stearns** reported that they were cutting 310 jobs from their mortgage origination units. They announced that they would be making risk management a priority over growth.93

- **Merrill Lynch** dismissed two senior executives from their fixed-income division, apparently holding them accountable for succumbing too fast to the credit and buyout boom. They also announced a write down of at least $4 billion.94

- **Citigroup** wrote off $5.9 billion in the 3rd quarter, causing profits to drop 60%.95

The collapse of the subprime mortgage market in the United States led to a credit squeeze that has even constrained global markets, making it difficult for lenders abroad to raise money.

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95 Id.
The rate that British banks charge to lend pounds to each other has soared. In fact, the Bank of England made money available to Northern Rock, a British mortgage lender, because it had trouble securing loans from other banks who were suffering from the meltdown of the American subprime mortgage market.

In recent years, British mortgage lenders, like their American counterparts, began offering loans that exceeded the value of the properties on which they were secured. This easy availability of credit led to increases in property prices and it also fueled speculation in the real estate market. As with RMBS in the United States, this practice has backfired and the lenders now must suffer through the unfortunate but arguably foreseeable consequences. Northern Rock, whose shares dropped 36% to a 7 year low, had relied heavily on raising money in capital markets. Share prices also dropped drastically for other British lenders. Alliance & Leicester shares fell 31% and Bradford & Bingley shares fell 15%. HSBC Holdings (France), Societe Generale (France) and Deutsche Bank (Germany) shares have also declined.

**Writedowns due to subprime securities**

2008 has brought a new wave of bad news for Wall Street. RMBS have gone from a lucrative financial product to the reason for massive devaluations. Investors in subprime RMBS are suffering losses, and this brings down the value of the securities. The investment banks that have invested in RMBS must devalue these securities by billions of dollars. This process is called a “writedown.” The following are examples of the writedowns that are plaguing Wall Street.

- **Citigroup** reported devastating numbers in January. They announced that they would be writing down $22.2 billion, cutting dividends by 41%, and laying

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off at least 4,000 employees. The bank’s revenue had fallen 70% and their net income dropped 83%. They also announced that they appointed a chief talent officer, which was a new position that they created, and that they would be reorganizing the company. Analysts predicted that things could get even worse because Citigroup has “heavy exposure to complex mortgage investments.” Talks of a recession has resulted in Citigroup executives setting aside billions of additional dollars to cover future losses on “home equity loans, credit card debt and personal loans.”

- **Merrill Lynch** reported that it expected to suffer $15 billion in losses related to mortgage investments that went sour. Merrill, like many other firms, are looking to wealthy foreign governments to raise additional capital.

- **JPMorgan Chase & Co.** reported that its fourth quarter profit fell 34% due to exposure to subprime mortgages. The firm’s net income had fallen to $2.97 billion, which was down from $4.53 billion one year earlier.

- **Credit Suisse Group** reported that its fourth quarter profit fell 72% due to writedowns for investment banking and money-market funds.

**What is in the forecast for the future?**

It is “impossible to predict what is going to happen with the American economy because of its size and complex nature combined with the intervention of global finance.” Still, the forecast for the near future is dim. On the individual level, the falling prices of homes mean that homeowners can no longer borrow against them, and this tightens consumer spending. In turn, businesses will have to cut back in hiring and in giving raises. The Homeowners earnings will not be able to keep up with inflation, and as a result they will no longer be able to afford their monthly mortgage payments. On the financial institution level, more foreclosures mean more

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losses and writedowns for the banks, who in turn will not be able to lend as much money as they would have. This slows economic activity across the globe.

Instead of pointing fingers the focus should be on getting out of this mess and getting the economy moving again. Federal Reserve Chairman Ben S. Bernanke noted, “Developments have prompted banks to become protective of their liquidity and balance sheet capacity and thus to become less willing to provide funding to other market participants.” The Federal Reserve has been reducing interest rates since September 2007 to make banks feel more secure, but they remain wary of risky borrowers. The most recent cut in March 2008, a response to the fear of a deep recession, “capped the most aggressive Fed intervention in a quarter-century.”103 Because of our large economy, it will take time to see if the rate cuts will provide the desired boost and if any federal legislation (provided that Washington will be able to agree on fiscal policy in an election year with the White House and Congress controlled by two different parties) will provide a solution. In the interim everyone will continue to feel the strain of the subprime mortgage meltdown. Well, not quite everyone; Bank of America announced that it agreed to pay $4 billion to acquire Countrywide Financial. The deal is expected to close in the third quarter, and as borrowers continue to lose their homes due to Countrywide’s loose lending practices, the Chief Executive will be entitled to walk away with an exit package of over $70 million.104