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# FLAWED INSTITUTIONS AND MARKETS: FROM THE SAVINGS & LOAN DEBACLE FORWARD

## Smoke and Mirrors: Predatory Lending and the Subprime Mortgage Loan Securitization Pyramid Scheme

Navid Vazire\*

Many recent accounts of the mortgage market's ongoing meltdown, which is at the heart of the broader economic crisis, have identified numerous flaws in the manner in which mortgage loans were sold and securitized in recent years. A number of authors have paid particular attention to excessive risk-taking by Wall Street firms and investors, and have expressed much concern about preventing such behavior and its grave consequences in other financial markets. These authors have identified a number of causes contributing to the current crisis including: (1) the unprecedented complexity of financial instruments and transactions,<sup>1</sup> (2) the conflicts of interest facing credit ratings agencies,<sup>2</sup> (3) the over-

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1. See generally, e.g., Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008); Aaron Unterman, *Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53 (2009).

2. See generally, e.g., U.S. SECURITIES & EXCHANGE COMM'N, REPORT ON

collateralization of real estate based on an unrealistic expectation of perpetually increasing values,<sup>3</sup> (4) the inadequacy of disclosures made to securities investors,<sup>4</sup> (5) regulatory failures,<sup>5</sup> and (6) the incaution of securities issuers and investors who poured money into a complex system that they did not fully understand.<sup>6</sup> Most of these commentators have identified mortgage loan securitization's evisceration of mortgage originators' incentives to make sound loans as a key factor in causing the crisis. However, these authors have not explored the manner in which originators responded to those changed incentives. Rather, these criticisms—spurred by the massive and unforeseen depreciation of mortgage-backed securities (“MBS”)<sup>7</sup>—are addressed to the modern financial system as a whole, rather than specifically to the subprime mortgage crisis, and are almost entirely focused on limiting investor losses and systemic collapse. Other authors have described the growth of predatory mortgage lending and the

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THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (2003), *available at* <http://www.sec.gov/news/studies/credratingreport0103.pdf>; Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization*, 30 MICH. J. INT'L L. 125 (2008); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985 (2006).

3. *See generally, e.g.*, Unterman, *supra* note 1; Yuliya S. Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* (Dec. 5, 2008) (unpublished manuscript, on file with the Social Science Research Network), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1020396](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396) (follow “Download”); John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets* (Int'l Monetary Fund, Working Paper No. WP/07/188, 2007), *available at* <https://www.imf.org/external/pubs/ft/wp/2007/wp07188.pdf>.

4. *See generally, e.g.*, Erik F. Gerding, *Laws Against Bubbles: An Experimental-Asset-Market Approach to Analyzing Financial Regulation*, 2007 WIS. L. REV. 977 (2007).

5. *See generally, e.g.*, Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271 (2008); Vincent Di Lorenzo, *Federalism, Consumer Protection and Regulatory Preemption: A Case for Heightened Judicial Review*, 10 U. PA. J. BUS. & EMP. L. 273 (2008); Gerding, *supra* note 4; Schwarcz, *supra* note 1; Unterman, *supra* note 1; Paul M. Schwartz, Note, *Where Do We Go From Here? The Battle Against Predatory Subprime Lending*, 3 BROOK. J. CORP. FIN. & COM. L. 213 (2008).

6. *See generally, e.g.*, Kiff & Mills, *supra* note 3.

7. *See infra* note 51.

culpability of securities issuers and investors in permitting this practice to occur.<sup>8</sup> However, few scholars have closely explored the causal connection, beyond simply asserting it, between the occurrence of predatory mortgage lending on the one hand and the rise of subprime mortgage loan securitization and the eventual collapse of the MBS market on the other.

In fact, the fraudulent and abusive mortgage lending tactics that have been documented were facilitated and even provoked by the securitization of mortgage loans. First, securitization removed two important risks customarily associated with mortgages, namely (1) the risk of the lender's bankruptcy, and (2) the risk of debt-unenforceability because of some illegality in the origination of the loan.<sup>9</sup> The decoupling of these risks from securitized mortgage loans rendered the securitizers<sup>10</sup> and investors indifferent to the business practices of originators, no matter how flagrant, abusive, and ultimately unsustainable they were. Second, originators' compensation depended on both the volume of loans they originated and on the unfavorability of the terms of those loans.<sup>11</sup> Originators collected up-front fees from borrowers, thereby encouraging them to drive up costs. In addition, they collected "outside of closing" fees from securitizers that were based on loan terms, including interest rates, prepayment and other penalties, and loan amounts.<sup>12</sup> As a result, aggressive originators sought to

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8. See generally, e.g., Brescia, *supra* note 5; Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303 (2006); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007); Schwartz, *supra* note 5. These authors tend to limit the blame they assign to securitizers and investors to facilitation rather than active promotion of predatory lending practices, and thus do not analyze the manner in which these parties benefited from originators' abusive practices.

9. See discussion *infra* Part I.

10. I will use the term "securitizers" to refer to the various entities involved in purchasing mortgage loans from originators and selling securities backed by those loans to investors. Securitizers include the following: (1) the financial institutions who purchase and pool the loans and issue securities, (2) the companies who rate the securities, (3) the companies who are enrolled to collect monthly payments from borrowers and transmit them to the appropriate parties, (4) the entities who review loan files for compliance with underwriting guidelines, and (5) the entities who maintain the numerous documents relating to the loans, mortgages, and agreements between the various parties.

11. See *infra* notes 84-86 and accompanying text.

12. See *infra* notes 84-86 and accompanying text.

close many loans with large principal amounts and with terms that were expensive for the borrowers (and thus lucrative for securitizers and investors). Because originators sold these loans within months or sometimes even days, they were not concerned with ensuring a borrower's ability to repay the debt.<sup>13</sup> Third, securitizers and investors—who did bear the risk of borrower defaults and thus could reasonably have been expected to perform adequate due diligence to ensure the long-term viability of loans they purchased—devised convoluted and unprecedented loan terms that, at least in the medium run, turned defaults from sources of loss to sources of massive profits.<sup>14</sup> Indeed, mortgage loan unaffordability was central to the rate of the mortgage market's growth in recent years, as it directly led to millions of refinances by borrowers who were unable to keep up with their rising mortgage payments,<sup>15</sup> which in turn ultimately led to the market's crash.

The mortgage industry did not always suffer from these infirmities. Traditionally, mortgage loan originators, typically savings and loan associations, held the vast majority of loans they made in their portfolios until those loans were fully paid, often years after origination.<sup>16</sup> This meant that lenders were committing substantial amounts of capital, for long periods of time, to each loan they made. When a borrower defaulted on her loan, the originating lender bore the cost of collection and any resulting loss. Consequently, lenders carefully scrutinized every borrower's ability to repay a proposed loan, required substantial equity (a down payment in the case of a purchase money loan—the most common kind of mortgage loan at the time), and lent on terms that could reasonably be expected to be affordable to the borrower in the long run.<sup>17</sup> Because the

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13. See *infra* notes 84-86 and accompanying text.

14. See discussion *infra* Part III(A)(2).

15. Data provided through the Home Mortgage Disclosure Act of 1975 ("HMDA") § 302, 12 U.S.C. 2801 (2006), demonstrates that in 2004, a majority of new conventional mortgage loans, including new "higher-priced" loans, were refinanced loans rather than purchase money loans. See generally, e.g., Lei Ding et al., *Neighborhood Patterns of High-Cost Lending: The Case of Atlanta*, 17 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 193 (2008).

16. See Peterson, *supra* note 8, at 2191-94 (discussing the origins of the American mortgage industry).

17. *Id.*

transaction was relatively simple, a borrower could easily compare various offers and make an educated decision about which available loan was the most favorable. While the system was not perfect, lenders had a limited ability and desire to induce borrowers to take on more than they could afford. However, because lenders were investing their own capital, the number of loans they were able to make was constrained.<sup>18</sup>

The limited availability of funds to lend to property owners made the costs of borrowing prohibitive for many would-be homeowners. Because each lender made relatively few loans and was particularly vulnerable to defaults, they were comparatively inefficient. The recent widespread use of securitization has enabled individual lenders to close many more loans and streamline their procedures.<sup>19</sup> Because many of these new mortgage lenders were not banks, they were not subject to capital reserve requirements and other regulations, which further impeded efficiency.<sup>20</sup> In addition, there has been

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18. The Federal Government did ease this constraint to some extent by creating several entities, most notably the Federal National Mortgage Association (Fannie Mae), *see* 12 U.S.C. § 1716 (2006), and the Federal Home Loan Mortgage Corporation (Freddie Mac), *see* 12 U.S.C. § 1452 (2006), to purchase and securitize mortgage loans in order to free up lenders' capital and allow them to make more loans. These companies' ability to buy mortgages, however, paled in comparison to that of the investors worldwide who would later enter the market. More importantly, as explained below, the government-created entities carefully devised lending criteria for lenders whom they financed, requiring them to vet borrowers in a manner similar to that which they had traditionally used. *See* discussion *infra* Part I(A).

19. *See* Giovanni Dell'Ariccia, Deniz Igan, & Luc Laeven, *Credit Booms and Lending Standards: Evidence From the Subprime Mortgage Market* 31 (European Banking Ctr., Working Paper No. 2009-14S, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1100138](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1100138) (follow "Download") (noting that the volume of mortgage loan originations covered by HMDA grew from \$1.184 trillion in 2000 to \$3.031 trillion in 2005); Kiff & Mills, *supra* note 3, at 6 (noting that total mortgage originations were slightly greater than \$500 billion in 1995, and reached more than \$3.5 trillion in 2003); Atif R. Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence From the U.S. Mortgage Default Crisis* 9 (Dec. 12, 2008) (unpublished manuscript, on file with the Social Science Research Network), available at <http://ssrn.com/abstract=1072304> (follow "Download") (finding that "[t]he annualized growth rate of originations for home purchase [within the studied zip codes] jumps from 14.4% from 1996 to 2002 to 19.4% from 2002 to 2005," and noting that "the aggregate U.S. mortgage market is approximately \$10 trillion").

20. The National Bank Act, ch. 106, 13 Stat. 100 (1864) (codified as amended in scattered sections of 12 U.S.C.), today, provides for numerous regulations of bank activities by the Office of the Comptroller of the Currency

greater diversity among MBS investors than there was among savings and loans investors regarding their tolerance for risk.<sup>21</sup> Some investors were therefore willing to invest in riskier loans than banks had traditionally been willing to make and own. This opened up the availability of credit, to a large segment of the population, which had been considered intolerable credit risks and thus had been systematically shut out by traditional banks.<sup>22</sup> These are the often professed virtues of securitization—more loans, at lower costs, extended to a wider range of people. The perception of these benefits and the enormous profitability of securitizing subprime mortgage loans blinded many people, in particular lawmakers and regulators, to the market's flaws, including its creation of harmful incentives to place millions of homeowners into unaffordable mortgage loans by almost any means.

### I. The Evolution of the Mortgage Lending Market

Over the last century—particularly the last twenty years—the mortgage lending industry has changed in ways that significantly modified the roles and responsibilities of the participating businesses. Over time, mortgage lending has become more common as the result of the introduction of two participants: the Federal Government and private investors. As these market participants increased their involvement and influence, the role and responsibilities of the front-line makers of loans (i.e., the originators) were vastly reduced, utterly transforming their incentives and behavior. Law and policy have failed to keep pace with these drastic changes, and have

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(for national bank associations) and the Office of Thrift Supervision (for savings associations). *See, e.g.*, 12 U.S.C. § 59 (2006) (prescribing the method by which a national bank may reduce its capital); 12 U.S.C. § 1464(t) (2006) (directing the Office of Thrift Supervision to impose “capital standards” on savings associations).

21. *See* Unterman, *supra* note 1, at 57, 61 (explaining that securitization enabled investors to “specifically tailor their desired risk exposures” and describing the incrementalization of risk through the use of “tranches”).

22. Racism was an important component of the refusal to lend to the supposedly non-credit-worthy. *See generally, e.g.*, Shelby D. Green, *Disquiet on the Home Front: Disturbing Crises in the Nation's Markets and Industries*, 30 PACE L. REV. 7, 13 n.25 (2009). This phenomenon—known as redlining—is beyond the scope of this Article. *See also infra* note 93 and accompanying text.

left borrowers, investors, and financial markets vulnerable to gross distortions in traditional apportionment of risk.<sup>23</sup>

A. *The Traditional “Two Party” and “Three Party” Models of Mortgage Lending*<sup>24</sup>

Originating in the nineteenth century, the evolution of mortgage lending in the United States has been both complicated and haphazard. A number of scholars have clearly and comprehensively described the particulars.<sup>25</sup> For the purposes of this Article, the most salient characteristic of pre-New Deal mortgage lending was the source of lending capital. Lenders at that time did not have access to outside sources of financing and did not sell the loans they made; thus they lent entirely from their own capital.<sup>26</sup> The number of loans that a lender could make was therefore limited by the funds actually held by that lender. In addition, because lenders continuously owned the mortgage loans they made, they bore the full risk of borrower default. That risk compelled lenders to carefully assess each borrower’s ability to repay the loan, and to decline to lend to anyone who posed even a minimal risk of default.<sup>27</sup> The careful assessment of risk was coupled with requirements that few people could satisfy, including significant equity ratios (normally forty percent) and short terms to maturity (usually one to five years).<sup>28</sup> In addition, lenders were typically staunchly discriminatory and refused to lend to both racial minorities and women.<sup>29</sup> Only a small minority of today’s mortgage borrowers—affluent, white men—would have

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23. For a more thorough description of the various lending schemes discussed in this section, see Peterson, *supra* note 8, at 2191-2213.

24. I have adopted the terms “two party” and “three party” to describe these lending models. *See id.* at 2191-97 (utilizing the terms).

25. For a comprehensive account of the complexity of this evolution, see *id.* at 2191-94.

26. In most cases, that capital consisted mainly of deposits by members of the institutions, who were originally the only ones entitled to borrow those funds. Insurance companies and individual property sellers also commonly made mortgage loans.

27. *See id.* at 2191-92.

28. *Id.*

29. *Id.* at 2192-93.



qualified for a loan under such circumstances.<sup>30</sup> The pre-New Deal mortgage industry was characterized by simple funding mechanisms, severely limited lending capital, and generally ardent lender caution.<sup>31</sup>

The many Federal Government initiatives meant to stimulate stagnating industries during the Great Depression included efforts to shore up real estate sales and residential construction.<sup>32</sup> Over the course of the Great Depression, more than half of all residential mortgage borrowers defaulted on their loans.<sup>33</sup> This prompted a massive foreclosure stampede and subsequent devaluation of real estate, and consequently put an emphatic end to further mortgage lending.<sup>34</sup> In order to recapitalize and reassure hard hit lenders, the Roosevelt administration purchased many of their non-performing loans.<sup>35</sup> This practice removed liabilities carrying significant uncertainty from the lenders' books and shored up their depleted capital reserves.<sup>36</sup> The government quickly followed these purchases with the creation of the Federal Housing Administration ("FHA"),<sup>37</sup> which insured privately-made mortgage loans that met FHA-established conditions and thus protected lenders from the risk of borrower defaults on such loans.<sup>38</sup> The FHA-imposed conditions promoted caution by establishing affordability measures.<sup>39</sup> The FHA also promoted

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30. *Id.*

31. As Professor Peterson points out, however, mortgage lenders began financing their operations through bonds secured by the mortgage loans they made in the 1880s. *Id.* at 2193-94. This early experiment with securitized funding of the mortgage lending market collapsed in the 1890s. *Id.*

32. *Id.* at 2194-97.

33. *Id.* at 2194.

34. *Id.* at 2194-97.

35. *Id.* at 2195-96.

36. This practice also enabled the Federal Government to refinance the troubled mortgages, thus allowing many borrowers to remain solvent and resume their economic participation. One could argue that purchasing the "trouble assets" as they might be called today, may have led to a moral hazard and improvident lending practices. As described in the following paragraphs, however, the other policies instituted on the heels of these purchases, constrained lender behavior in a manner that reduced such incentives.

37. The National Housing Act, ch. 847, 48 Stat. 1246 (1934) (current version at 12 U.S.C. § 1701 (2006)).

38. *See* Peterson, *supra* note 8, at 2195-96.

39. *Id.*

the extension of credit to a far broader array of borrowers by reducing, but not eliminating, the equity ratio requirements that had been traditionally imposed, and by extending loan maturities to a period up to thirty years, thereby spreading repayment over a much longer period of time and reducing the monthly repayment burden placed on borrowers.<sup>40</sup> The most revolutionary development was the creation of the Federal National Mortgage Association (FNMA or “Fannie Mae”), which was charged with purchasing qualifying mortgage loans from lenders, thus freeing them to make more new loans.<sup>41</sup> Instead of having their capital tied up in mortgage loans for thirty years, lenders could quickly sell qualifying loans to Fannie Mae (and later to the Federal Home Loan Mortgage Corporation—“Freddie Mac”)<sup>42</sup> and reuse that same capital to make more loans.<sup>43</sup> Lenders could thus make far more mortgage loans than their capital would otherwise have allowed without bearing the risk of borrower default on those loans.

An important constraint on mortgage originators was that mortgage loans had to meet the GSEs’ criteria in order to be sold. By strictly enforcing their underwriting and other criteria, the GSEs were able to keep mortgage originators’ incentives nearly constant. The considerations that had factored into the decision to lend before the government’s involvement, although generally somewhat relaxed by the GSEs’ requirements regarding borrower income and other financial characteristics, included the property’s equity reserves and the loan’s terms. This relaxation was crucial to maintaining the same originator practices, which had previously been driven entirely by their own large stake in each mortgage they made. The fundamental change in the originator business model would have had the potential to drastically affect their behavior absent some countervailing pressure from the GSEs upon whom originators depended for

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40. *Id.* at 2196.

41. *Id.* at 2197-99. *See also supra* note 18.

42. *See supra* note 18.

43. Peterson, *supra* note 8, at 2196. The Federal Housing Association (“FHA”), Fannie Mae, the Government National Mortgage Association (“Ginnie Mae,” which was Fannie Mae’s spin-off), and Freddie Mac will hereinafter be referred to as the Government Sponsored Enterprises (“GSEs”).

revenue.

### B. *The Private Securitization Model*

When private entities, mainly traditional banks and investment banks, began purchasing mortgage loans and issuing associated securities whose values were derived from MBS,<sup>44</sup> they essentially replicated and amplified the GSEs' roles, but used different criteria for mortgage origination. Over time, as the private label MBS market matured and stabilized, underwriting criteria were relaxed further in order to meet investors' growing demand for MBS.<sup>45</sup> By the height of the subprime mortgage boom, in the period 2004-2006, it was common for securities to be based, at least in part, on mortgage loans with varying interest rates, varying payments (that were sometimes not based on interest rates), and non-amortizing monthly payments, without any documentation of borrowers' incomes or assets (sometimes despite the borrowers' having supplied extensive documentation to their loan officer who, for whatever reason, deemed it undesirable).<sup>46</sup> The subprime loans made during this era differed from traditional mortgage loans in ways that made them far less viable over their thirty-year terms. In addition, loan amounts were increasing at a rapid pace and home equity was vanishing despite rising property values.<sup>47</sup> Thus, a great number of large loans were secured by newly created property values and owed by homeowners who were not nearly affluent enough to repay them.

Securitizers and investors had ample information about

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44. MBS are special cases of asset-backed securities ("ABS") which can be backed by any number of assets, including other consumer debts, such as credit card receivables, automobile loans, and consumer merchandise loans.

45. See Kiff & Mills, *supra* note 3, at 6 (stating that "[u]ntil 2003, the majority of mortgage originations were 'prime conforming' loans" that could be purchased by GSEs, but that "by 2006, over half of all originations did not meet the GSEs' 'conforming' criteria," indicating a progressive deterioration of standards from 2003 until 2006).

46. See discussion *infra* Part III(A)(2).

47. See, e.g., Demyanyk & Van Hemert, *supra* note 3, at 28-29 (arguing, in part, that rising loan-to-value ratios ("LTVs") contributed to the subprime mortgage market's bust, meaning that equity must have been vanishing as loan amounts were increasing). See also *infra* note 70 (discussing LTVs).

the changes in lending standards and the glaring incompatibility of subprime mortgage loan terms with their borrowers' incomes.<sup>48</sup> But the securities backed by these loans were rated extremely safe and were far more profitable than comparable securities,<sup>49</sup> so no efforts were made to curb the increasingly risky lending schemes. In fact, the MBS market experienced massive expansion just as the soundness of subprime mortgage loans went from dubious to implausible.<sup>50</sup> By the time the market reached its peak—in terms of hundreds of billions of dollars of outstanding securities—its securities were based on mortgage loans so fantastically detached from their borrowers' financial means that by early 2009, two-thirds of those securities were in default, and of those, the senior-most third of these securities lost approximately 68% of their value, while the rest lost roughly 95% of their value.<sup>51</sup>

## II. Consensus Diagnosis: Failure by All Parties to Appropriately Assess Risk of Real Estate Downturn

A number of scholars have studied the evolution of subprime mortgage loan securitization, forming limited consensus about some of its consequences but diverging about others. The consensus—to the extent it exists—is that investor demand for MBS increased sharply during the last several years of the market's boom, leading to the significant deterioration of lending standards, which in turn resulted in a greater-than-tolerable percentage of unsustainable mortgage loans.<sup>52</sup> There is also near consensus that this overreach

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48. Demyanyk & Van Hemert, *supra* note 3, at 32.

49. See, e.g., Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1289-90 (2009) (describing the unusually high rate of default for modern collateralized debt obligations of a certain rating, as compared with corporate bonds receiving the same rating in the ten previous years).

50. See Kiff & Mills, *supra* note 3, at 7 (explaining that “private label” securitization increased sharply between 2002 and 2006).

51. See Gillian Tett, *Time is Nigh to Put the True Value of CDOs Out in the Open*, FIN. TIMES (London), Feb. 27, 2009, at 22.

52. See, e.g., Dell’Ariccia, Igan, & Laeven, *supra* note 19, at 3 (finding widespread “decline in lending standards,” and a correlation between the extent of the deterioration and prevalence of subprime mortgage loans and securitization of loans); Kiff & Mills, *supra* note 3, at 6-7 (noting the shift from “prime conforming” loans purchased by the GSEs, which constituted the

occurred primarily with respect to “subprime” mortgage loans.<sup>53</sup> One implication of these conclusions is that subprime mortgage loan securitization directly contributed to the market’s eventual collapse. However, there is widespread disagreement regarding the causes that led to the wholesale disregard of subprime MBS’s infirmities.

As indicated above, various authors have suggested the following—mostly compatible—explanations for the current crisis: (1) the failure of credit rating agencies to honestly disclose the credit risks associated with the securities they rated,<sup>54</sup> (2) the unrealistic optimism of mortgage borrowers regarding their financial means,<sup>55</sup> (3) the inadequacy of traditional individual credit score ratings for the purpose of mortgage lending,<sup>56</sup> (4) the complexity of the financial instruments which led to unintentional risk-taking by investors,<sup>57</sup> (5) the failure of financial regulators to limit the rapid rate of financial innovation,<sup>58</sup> and (6) the sheer incaution of investors.<sup>59</sup> While several authors acknowledge that predatory lending practices may have led to the making of bad loans, none examine the extent to which this happened, the

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“majority” of mortgage loans prior to 2003, to securitized subprime loans which did not meet the GSEs’ criteria, as well as “strong investor appetite for higher-yielding securities in 2005-06 [which] probably contributed to looser underwriting standards”).

53. See Dell’Ariccia, Igan, & Laeven, *supra* note 19, at 2-3; Kiff & Mills, *supra* note 3, at 6-7.

54. See generally, e.g., U.S. SECURITIES & EXCHANGE COMM’N, *supra* note 2; Bruner, *supra* note 2; Reiss, *supra* note 2.

55. See, e.g., Kiff & Mills, *supra* note 3, at 7 (noting that “borrowers were financially overstretching via risky ‘affordability products,’” and concluding, without explanation, that “many [borrowers] apparently [lied] about their financial resources to get loans”).

56. See Benjamin J. Keys et al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans* (Dec. 25, 2008) (unpublished manuscript, on file with the Social Science Research Network), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1093137](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1093137) (follow “Download”) (explaining that lenders tended to perform less screening of borrowers with higher credit scores, resulting in more reckless lending to higher-rated borrowers, and thus undermining the correlation between high borrower credit score and ability to repay the particular loan).

57. See generally, e.g., Gerding, *supra* note 4; Schwarcz, *supra* note 1; Unterman, *supra* note 1.

58. See generally, e.g., Brescia, *supra* note 5; Di Lorenzo, *supra* note 5; Gerding, *supra* note 4; Schwarcz, *supra* note 1; Unterman, *supra* note 1; Schwartz, *supra* note 5.

59. See generally, e.g., Kiff & Mills, *supra* note 3.

ways in which it may have been facilitated, or the potential it had to distort the MBS market.<sup>60</sup>

One especially noteworthy account holds that the securitization of mortgage loans protected investors from the risk of originators' bankruptcy, and in the process, distorted the incentives of market participants in a manner that encouraged excessive risk-taking.<sup>61</sup> In particular, this account finds that investors who did not bear the risk of mortgage originators' insolvency had little reason to scrutinize the business practices of originators to ensure their sustainability.<sup>62</sup> Had the mortgage loans backing the MBS remained within the reach of the bankruptcy estates of mortgage originators, then investors whose securities' values were based on those mortgage loans would have had considerable incentives to invest in mortgages unlikely to be caught up in bankruptcy proceedings.<sup>63</sup> But because that possibility was drastically reduced by the securitization mechanisms devised by modern securities issuers, this particular "bankruptcy tax" was eliminated.<sup>64</sup> As a result,

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60. A number of scholars, most notably Christopher Peterson, have shown connections between securitization and predatory lending. See generally Peterson, *supra* note 8. These efforts, however, have largely been confined to the behavior of mortgage originators and have not closely examined the incentives of other market participants that may have fueled the destructive origination practices or the effect that these practices could have on the market at large. See generally Brescia, *supra* note 5; Di Lorenzo, *supra* note 5; Forrester, *supra* note 8; Peterson, *supra* note 8; Allison De Tal, Comment, *Knowledge is Power: Consumer Education and the Subprime Mortgage Market*, 11 CHAP. L. REV. 633 (2008); Schwartz, *supra* note 5.

61. See generally, e.g., Unterman, *supra* note 1 (explaining that the bankruptcy remoteness of mortgage lenders led their creditors to disregard the risky nature of their conduct).

62. *Id.* at 79-80 (noting that financial institutions that financed subprime lenders were aware of, and disregarded, the lenders' risky lending practices).

63. Indeed, the failure of mortgage originators contributed to the 1890's crash of the mortgage-backed bond market. See Peterson, *supra* note 8, at 2193-94.

64. See Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1564-80 (2008) (discussing the "bankruptcy tax"). A separate and far less significant bankruptcy tax was created instead. Namely, investors still bore the risk that the Special Purpose Vehicles ("SPVs"), created to own the mortgage loans, see Unterman, *supra* note 1, at 59, would themselves become bankrupt. But because those SPVs did literally nothing other than own loans, they were far less likely to become bankrupt for any reason other than

subprime mortgage originators were free to engage in many types of highly risky behaviors without suffering any losses in business from investors, via the securitizers, who ultimately funded their businesses.<sup>65</sup> The identification of such a shift in incentives, which went unmatched by a corresponding shift in regulation or policy, alerts us to an opportunity to correct the regulatory and policy failure.

The works of the various authors who have addressed the mortgage market bust are, to varying degrees, persuasive explanations of some of the causes of the market's meltdown. Some of these causes were probably fatal on their own. This paper is consistent with the various explanations that have been offered, but seeks to add another that has received insufficient consideration—that is, another single-handedly fatal cause of the crisis had to do with the manner in which the lending industry interacted with the borrowers whose mortgage payments ultimately underpinned the MBS's values. The fraudulent and abusive tactics that were often employed to enroll homeowners into mortgage loans were intimately connected to the features of subprime loans that made them both highly profitable for securitizers and investors in the short-run and unsustainable in the long-run.

### III. Changes in the Mortgage Lending Industry Caused a Seismic Shift in Incentives that Law and Policy Failed to Acknowledge

The progression from two party and three party mortgage transactions that dominated the twentieth century, to the many-party transactions that were emblematic of subprime mortgage lending during the 1990s and 2000s, fundamentally transformed the behavior of market participants. In order to focus on the most consequential of these changes, securities

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the loans' own failures to perform, in which case the investors would suffer losses anyhow. *See id.* at 59-60.

65. The one kind of risk that this did not excuse originators from taking had to do with making risky loans. The disposal of that kind of risk is the subject of this paper. The risks disposed of by the elimination of the bankruptcy tax included the risks posed by (1) under-capitalization, (2) illegal activity subjecting the company to liability, (3) poor business judgment and management, and (4) business downturns and other "natural" losses of revenue.

issuers and sellers, trusts and trustees, depositors, document custodians, and servicers will often be treated collectively as “securitizers,” although it will sometimes be necessary to distinguish between these various parties. Similarly, mortgage originators and brokers will often be treated collectively as “originators.” Borrowers and MBS investors’ behaviors will also be examined.<sup>66</sup>

#### A. *Mortgage Originators*

One aspect of mortgage lending that has not changed much over the years is what may be called the “front-end,” namely, the originators who are the borrowers’ only contacts within the vast mortgage lending industry.<sup>67</sup> As discussed above,<sup>68</sup> when an originator makes a loan that it will hold in its portfolio, the transaction is either a “two party” or a “three party” transaction.<sup>69</sup> In a two party transaction, the originator will lend its own capital and will bear the full risk of the borrower’s possible default. Defaults can be very expensive for a mortgage loan holder because curing the default can involve numerous collection efforts and other communications with the borrower, extensive analysis of her new financial situation, reappraisal of the property’s value, and an analysis of the mortgagee’s own financial condition in order to determine which course of action is warranted. Possible resolutions include renegotiation of the

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66. Confusingly, originators and servicers often use the term “investor” to refer to some or all of the members of the group of entities that I have labeled “securitizers,” especially trustees. Recall that it is the trustee, on behalf of the trust, that has legal ownership of the mortgage loans and therefore, absent collateral agreements assigning its rights elsewhere, has control over the handling of the trust’s loans, including their enforcements, sales, and modifications.

67. Sometimes, especially recently, a borrower would interact principally (or even solely) with a mortgage broker, who in theory was charged with helping the borrower find a loan particularly suited to his or her situation. Brokers often also act on behalf of lenders. They can be compensated by both the borrower and the lender for bringing the parties together. Borrowers often do not understand the dual nature of the mortgage broker and assume that the broker’s loyalties lie only with them. However, for the purpose of this discussion, I will assume that borrowers interact directly with originators (as is often the case) because originators and brokers have very similar incentives and usually treat borrowers similarly.

68. See discussion *supra* Part I.

69. See discussion *supra* Part I.



loan's terms, forbearing from collecting on the loan for a period of time in order to allow the borrower to recover from her troubles, or foreclosing on the loan and seizing the property, which may not recover the entire amount owed and may lead to litigation even in non-judicial foreclosure jurisdictions. All of these courses of actions are costly. The originator who holds a loan in portfolio, therefore, has a strong incentive to ensure—at the time of the loan's inception—that the borrower will be able to fully repay the loan and that there is sufficient equity or collateral in the property to protect it if the borrower does default and the property is liquidated in foreclosure or in an open market sale.<sup>70</sup>

There are two main precautions taken by a two party mortgage lender to ensure a borrower's ability to repay. First, such a lender is likely to seek to make the borrower's monthly mortgage payments predictable and consistent. If the amount of future payments is capable of changing, especially in a manner unknown at the time of origination, it is difficult to ensure that the loan will always be affordable. A lender could structure a loan so that payments will be constant for a long enough period of time so that when the payment amount does change, there will be ample equity in the property to cover the remaining debt.<sup>71</sup> However, even such a loan poses a risk because collecting on a defaulted loan may be costly even if the full amount of the debt is fully secured by a comparatively high property value. As a result, the vast majority of loans that were made prior to the private label securitization era had fixed interest rates and were fully amortizing (meaning that no debt would remain after the final monthly payment was made).<sup>72</sup> This maximized the predictability of future payment amounts.<sup>73</sup> Second, the monthly mortgage payments must not

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70. The measure of equity compared to the mortgage amount is called the loan-to-value ratio ("LTV"). LTV limits were commonly sixty percent before the 1930s, and eighty percent for GSE-insured or purchased loans. See *infra* note 77 and accompanying text.

71. A simple version of such a loan is one that has a balloon payment at maturity—i.e., a loan that is not fully amortizing.

72. See discussion *supra* Part I(A).

73. The possibility of changing payment amounts was not fully eliminated by fixed-interest, fully-amortizing loans because reinstating a defaulted loan by, for example, renegotiating the loan's terms or by recapitalizing the arrears, could cause the loan's principal, interest rate, or maturity date to change and thus affect the payment amounts.

strain the borrower's budget so severely as to pose a risk that she will default on the loan. The lender therefore examines the borrower's debt-to-income ratio ("DIR") and endeavors to keep that ratio below a certain percentage, which may vary depending on the lender's tolerance of risk. Because two party lenders tend to be risk-averse, in light of the costs of borrower defaults, the DIR is likely to be low enough to prevent default in the case of short-term, unexpected losses of income or increases in expenses. The acceptable DIR may vary from lender to lender and even from borrower to borrower.

These lender precautions are not meant to benefit borrowers. Rather, they are meant to protect mortgagees—who, in two party mortgage transactions, are also the originators of the mortgages—from the potentially high costs of default by borrowers.<sup>74</sup> Payment stability and affordability, while usually desirable for borrowers, are crucial for risk-averse lenders engaging in two party mortgage transactions. But they do leave some room for lenders to take advantage of unsophisticated borrowers who might have obtained better terms if they had been more aware of both their own financial means and the lenders' criteria. Thus, a lender who determines that a particular DIR is appropriate for a particular loan may well make the borrower's monthly payments as high as possible without exceeding that DIR, even though lower payments would still have been profitable. However, it is usually extremely undesirable for a lender in such a transaction to place the borrower in a situation that risks leading to default. Therefore, while the loan may not be optimal, it will usually not be catastrophically expensive either.

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74. Since these measures, implemented by mortgage loan originators, are meant to protect those originators from default on loans the originators hold in portfolio, one expects such measures to be absent where the originators do not intend to hold the mortgage loans. Indeed, this is the case. See Amiyatosh K. Purnanandam, *Originate-to-Distribute Model and the Sub-Prime Mortgage Crisis* 29 (Sept. 18, 2009) (unpublished manuscript, on file with the Social Science Research Network), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1167786](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1167786) (follow "Download") (concluding that the "originate-to-distribute model," wherein a lender intends to sell (or "distribute") the loans it originates, lowers the quality of the loans originated by those lenders, and that the reduction in quality is caused by the "lack of screening incentive created by the separation of origination from the ultimate bearer of the default risk").

### 1. Federal Government Maintained Originator Incentives in Place

The Federal Government's participation in the mortgage market had the potential to drastically change mortgage originators' incentives and behaviors. After all, if the government was going to insure an originator against losses or buy its loans outright, it did not really matter anymore whether borrowers defaulted on their mortgage loans. However, the GSEs instituted strict underwriting guidelines that limited the kinds of mortgages eligible for insurance or purchase, thereby constraining originators who wished to benefit from these programs.<sup>75</sup> The government essentially sought to preserve originators' incentives to ensure borrower affordability and guard against loss through the imposition of DIR, LTV, and other requirements. The government's initiatives were meant to promote homeownership among those who had traditionally not had access to mortgage loans because they could not meet lenders' strict requirements, and they therefore relaxed some of the more stringent criteria.<sup>76</sup> For example, the LTV limit was raised to eighty percent, from what had typically been sixty percent, in order to allow purchasers to make smaller down payments.<sup>77</sup> Mortgage terms were also extended from five years or less to periods of up to thirty years, thus reducing the amount of monthly mortgage payments needed to pay off the loans by their maturity dates and enabling more borrowers to meet the DIR requirements.<sup>78</sup> These policies were intended to expand the middle class.<sup>79</sup> Thus, in order to exclude affluent borrowers who could obtain credit without government assistance, the GSE programs also capped the principal amount and thereby excluded expensive homes. The GSEs also dealt exclusively with certain government-supervised originators, excluding many of the more aggressive and unstable originators that would appear over the course of the market's boom.

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75. Peterson, *supra* note 8, at 2172. See also Kiff & Mills, *supra* note 3, at 3-7.

76. Peterson, *supra* note 8, at 2195-98.

77. See *id.* at 2195-96; *supra* note 70.

78. Peterson, *supra* note 8, at 2196.

79. See *id.*

The market for MBS, including those backed by mortgage loans ineligible for GSE insurance or purchase, emerged when investment banks began purchasing, pooling and securitizing loans, much like Fannie Mae and Freddie Mac had been doing with certain conventional loans.<sup>80</sup> Lenders justified the imposition of less favorable terms, namely higher interest rates and closing costs, by pointing to the greater risk of default posed by unconventional loans,<sup>81</sup> which in turn rendered the associated securities potentially more profitable. Many of these borrowers were called “subprime,” a reference to the credit risk they supposedly posed.<sup>82</sup> As the market expanded throughout the 1990s and this past decade, many new originators appeared and existing originators shifted their emphasis to meet and stoke the growing demand.

Subprime mortgage loan originators increasingly made loans with the intention of selling them quickly into the secondary market, and thus needed comparatively little capital to support large numbers of loan originations. Originators’ de-emphasis of portfolio lending led to a corresponding and predictable de-emphasis of careful underwriting. Because they would no longer bear the long-term (or sometimes even short-term) risk of borrower default, originators became unconcerned with ensuring their loans’ viability. Instead, originators’ new concern was ensuring that there would be a secondary market purchaser for each loan. This gave the investment banks that pooled and securitized the mortgage loans great leverage over originators, enabling them to dictate the loan characteristics that they wanted originators to market to borrowers. It also allowed investment banks, like the GSEs before them, to demand assurances that the loans were sound. This was usually done by imposing certain underwriting criteria and by requiring originators to repurchase loans that defaulted within

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80. See, e.g., Kiff & Mills, *supra* note 3, at 6-10.

81. After all, the government (and government-created) entities refused to insure or purchase these loans precisely because they did not meet their criteria for soundness. In addition to this implication of risk, the lack of government-backing for the loans itself shifted the risk of borrower default onto mortgagees and investors.

82. See Brescia, *supra* note 5, at 287 (quoting *Mortgage Market Turmoil: Causes and Consequences: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (testimony of Roger T. Cole, Director, Federal Reserve, Division of Banking Supervision and Regulation)).

a certain, usually very short, period of time.<sup>83</sup> Ultimately, the banks were poised to dictate both the precise loan terms that originators should offer to borrowers with certain profiles and the steps that originators should take to verify borrowers' financial means. Many originators sought only to meet the banks' criteria, which diminished considerably over time, and made no additional efforts to evaluate the viability of the mortgage loans they made. Thus, a crucial and longstanding check on reckless lending was eviscerated.

Even more damaging than the loss of originators' incentives to rigorously scrutinize their customers' financial means, was the pressure to originate, or "churn,"<sup>84</sup> loans at as high a rate as possible. Because originators no longer held many of the loans that they made for more than a few months, they no longer derived much revenue from interest payments on those loans. Instead, originators became almost entirely dependent upon the upfront fees they charged borrowers and any compensation they received from the secondary market purchasers of loans. Originators therefore profited most from closing as many loans as possible and doing so efficiently, i.e., as quickly as possible, which made them all too happy to oblige the secondary market's voracious demand for ever greater numbers of loans. Rather than spend the time and resources to carefully vet each borrower, many originators sought to simply induce borrowers to accept offers as quickly and effortlessly as possible. It was not long before fraudulent practices became rampant in the mortgage origination industry.<sup>85</sup> It no longer mattered whether a borrower could afford to repay the loan offered, or whether the borrower's property was worth enough to support the amount of the debt. Unscrupulous originators thus began misrepresenting the cost of repayment to borrowers, eliciting fraudulent appraisals to justify ever larger mortgages, and sometimes even masking immediate defaults by borrowers by falsifying loan files they sold on the secondary

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83. Common underwriting criteria included LTR ratio, debt-to-income ratio, credit score, and other information relating to the borrower's ability to repay the loan.

84. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 546 (2002).

85. See discussion *infra* Part III(A)(2).

market.<sup>86</sup>

## 2. Loss of Government Influence and the Emergence of Deceptive Origination Practices

By offering complicated and unusual loan products with shifting interest rates, shifting payment amounts, and less than fully-amortizing payments, ambitious mortgage originators were able to convince unsophisticated borrowers to accept excessively costly and ultimately harmful mortgage loans. These unusual and complex loans were euphemistically called “affordability products” by the mortgage industry because they created, for a short time, an appearance of affordability by putting off the true cost of the loans until later in the term.<sup>87</sup> Adjustable Rate Mortgages (“ARMs”) became increasingly common in the subprime mortgage industry as the market for subprime MBSs expanded. One reason is that many ARMs had “teaser rates,” or initial interest rates that were low and fixed for a short period of time (commonly somewhere between six months and five years), and which then changed at regular intervals over the remainder of the loan term according to a formula based on a common interest rate index plus a fixed margin. Teaser rates were much lower than the projected fully-indexed rates, meaning that ARMs with this feature were expected to experience significant increases in required monthly payments after the teaser period, even if prevailing interest rates did not change. These loans are often referred to as “1/29,” “2/28,” “3/27,” and so on, according to the number of years during which the teaser rate lasts and the number of years during which the interest rate will be based on the formula. An inexperienced borrower could easily be led by a determined broker or loan officer to believe that the payments due during the “fixed” teaser period would actually be the same payment amounts that would always be due throughout the course of the loan.

In addition to deceptively manipulating interest rates,

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86. *See, e.g.*, Two Former Principals of Olympia Mortgage Indicted on Conspiracy, Wire Fraud, and Bank Fraud Charges, REUTERS, May 8, 2008, <http://www.reuters.com/article/pressRelease/idUS246343+08-May-2008+PRN20080508>.

87. *See, e.g.*, Kiff & Mills, *supra* note 3, at 7.

lenders also began creatively manipulating the amortization of their loans. This process began with the introduction of interest-only and balloon mortgage loans. The monthly payments made by borrowers with these kinds of loans were not sufficient to fully repay the debt by the loan's maturity date, and therefore a balloon payment would be due at that date.<sup>88</sup> Some loans had interest-only periods that did not last the entire term of the loan; these loans often had five- or ten-year interest-only periods, after which they became fully amortizing. The combination of opaque and deceptive interest rate manipulations with unusual amortization schedules made it exceedingly difficult for borrowers to determine what their payments would be and just what principal those payments would actually go towards paying off. This consequently facilitated originators' misrepresentations to borrowers about the cost of their loans, thus enabling the originators to induce borrowers to accept loans that seemed far more affordable than they truly were.

The true cost of many subprime mortgage loans did not usually affect borrowers until one or two years after origination. A borrower nearing or just reaching payment shock was likely to be contacted by a number of mortgage brokers and lenders, often including the one who had provided the loan, offering to lower the borrower's payments by refinancing the loan. By offering yet another convoluted loan product, the new loan would likely lower that borrower's monthly payments for a short while, taking the borrower through the very same ordeal all over again. At this point, another feature of many subprime loans—the prepayment penalty—takes effect. Many subprime loans require a borrower who pre-pays his or her loan within a certain amount of time of origination—usually six months to three years—to pay a penalty. A borrower who refinanced out of a subprime loan with a prepayment penalty at the end of the teaser period was likely to be charged a penalty for doing so. Thus, by

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88. An interest-only loan is a special type of balloon loan in which the monthly payments are in the exact amount of the interest generated each month. At the time of maturity, the principal balance is thus exactly the same as it was at origination (i.e., these loans are non-amortizing). Other balloon mortgages typically have principal balances at maturity that are slightly less than the original amount (i.e., these loans are amortizing, but not fully amortizing).

flipping borrowers from loan to loan, originators and brokers were able to charge significant fees and penalties several times to each borrower. This, of course, had the effect of depleting large amounts of borrowers' equity without providing them much, if any, benefit. Eventually, mixtures of the kinds of exotic terms discussed in this section were devised to ensure the continuation of the cycle of default and refinance with calculated precision and predictability, thus enabling lenders to decide when they would force a particular borrower to take her next loan.

By the time a subprime mortgage borrower experienced payment shock, the loan had often long been sold and securitized and the originator was only involved as the servicer, if at all. The originator could therefore credibly claim to no longer have the authority to help the borrower. Even worse, numerous subprime originators were mere fly-by-night shells—requiring very little capital to operate their businesses—who had shut down by the time many of their borrowers ran into trouble. This left those borrowers to try to explain their predicament to a servicer operating as the front for a group of entities with a convoluted set of interests in that loan, all of whom claimed to have had nothing to do with the originator's practices and were unable to rectify the resulting problems. Borrowers who found themselves in this situation were made to feel like the only options available to them were to either sell their homes or try their luck with one of the many new loans being peddled to them.

Lenders mastered the practice of obfuscation and deception when they developed the Payment Option ARM ("POARM").<sup>89</sup> A POARM typically has an extremely low teaser rate lasting no more than a few months, during which time the borrower makes fully amortizing payments. As a consequence of the near-zero teaser rate, the payment amount is quite small. That payment amount is then locked in before the interest rate

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89. Many POARMs were marketed as Alt-A loans, rather than subprime loans, and were thus intended to be safer investments. While it is true that POARM interest rates were generally capped slightly lower than those of other subprime loans, their terms were so confusing and risky, especially because they were aggressively marketed to seniors and other borrowers with limited and fixed incomes who were incapable of withstanding the certain payment shock, that they presented at least as high a risk of default as any subprime loan product.



changes, often to four or five times the initial rate, after its brief teaser period. As a result, the monthly payments do not suffice to even pay the interest that accrues each month, thus producing negative amortization. However, an inexperienced borrower who assumes that her monthly payments bear some relation to her interest rate will not realize that this has happened, and will therefore assume that she has an affordable loan. This situation cannot, of course, last for thirty years. Therefore, the amount that the principal can reach is capped by the terms of the loan to some percentage of the original amount, usually either 110% or 125%. When the negatively amortizing principal reaches that cap, the borrower is required to make fully amortizing payments, which can be in an amount several times that of the prior monthly payments, all but ensuring default.<sup>90</sup> POARMs typically have long and severe pre-payment penalties, which increase over time because they are based on the outstanding principal balance. They are often projected to remain in effect when the loan becomes fully amortizing, thus adding significantly to the cost of paying off the loan. This product truly perfected the practice of trapping a mortgagor into an inscrutable loan and then bleeding her of a tremendous amount of her home's equity.

Because the fees generated by a loan are largely based on the amount borrowed,<sup>91</sup> originators have an incentive to lend the largest amount possible. To that end, originators pressured borrowers to consolidate all of their debts, including unsecured debts, into their mortgages. For the same reason, originators also encouraged borrowers to take some cash—perhaps to make much needed home repairs, pay off utility and other bills, or to just take that much deserved vacation.<sup>92</sup> Similarly,

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90. The payment shock is exacerbated by the increased principal and, at this point, the now slightly reduced time left until maturity.

91. This is largely due to certain consumer protection laws' discouragement of fees in excess of a certain percentage of the loan amount. *See, e.g.*, Home Ownership and Equity Protection Act of 1994 ("HOEPA"), Pub. L. 103-325 § 151, 108 Stat. 2190 (codified at and amending scattered sections of 15 U.S.C.) (imposing various additional disclosure requirements in connection with loans whose interest rates exceed certain baselines).

92. Including a cash component has two additional benefits: (1) it allows a lender to tarnish the credibility of the borrower who later sues it by pointing to the borrower's greedy depletion of his or her own home equity and to thus provide an alternate explanation for the borrower's "choice" of the particular loan; and (2) it ensures the borrower's ability to make mortgage

originators were compensated by the secondary market purchasers for imposing an interest rate greater than that for which the borrower had qualified. The result was that originators had incentives to originate mortgage loans that were large and which had high interest rates for borrowers who were considered to have questionable abilities to repay.

An obvious limitation of the expansion of the subprime market was the shortage of people who could be characterized as reasonably capable of repaying expensive and large subprime mortgage loans and who did not already have access to prime lending. This was primarily dealt with in two ways. First, traditional lenders had largely refused to lend in minority communities, leaving a considerable portion of the population with little access to credit. This phenomenon was known as redlining.<sup>93</sup> The large and relatively inexperienced group of minority potential borrowers was aggressively pursued by subprime mortgage originators. The extent and egregiousness of predatory practices targeted at members of minority communities, regardless of income or other credit risk factors, strongly suggests that subprime mortgage loans were foisted upon anyone who could be persuaded to take them, regardless of whether those borrowers were qualified for better loans.<sup>94</sup> Second, as investor demand for MBS grew, underwriting criteria and securitizers' due diligence efforts

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payments for at least several months, which increases the likelihood that the borrower will not default before the loan is securitized or before the expiration of the originator's obligation to repurchase any defaulted mortgage.

93. See, e.g., Michael H. Schill & Susan M. Wachter, *The Spatial Bias of Federal Housing Law and Policy: Concentrated Poverty in Urban America*, 143 U. PA. L. REV. 1285, 1309 (1995) (describing the overtly racist borrower rating criteria used by federal agencies beginning in the 1930s); Adam Gordon, Note, *The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and Out of Reach for Blacks*, 115 YALE L.J. 186, 207 (2005) (describing the origin of the term "redlining").

94. See generally CAL. REINVESTMENT COAL. ET AL., PAYING MORE FOR THE AMERICAN DREAM: A MULTI-STATE ANALYSIS OF HIGHER COST HOME PURCHASE LENDING (2007), available at <http://www.calreinvest.org/system/assets/47.pdf>. For discussions of mortgage redlining and subprime lenders' reverse redlining, see, e.g., Christopher A. Bracey, *The Cul de Sac of Race Preference Discourse*, 79 S. CAL. L. REV. 1231, 1302 n.232 (2006); Brescia, *supra* note 5, at 282-83 & n.41; Ding et al., *supra* note 15, at 194-95; Allison De Tal, *supra* note 60, at 645 n.100.

vanished.<sup>95</sup> The increasingly common practice of fabricating borrowers' financial records in order to make them appear capable of repaying expensive mortgage loans was partially mooted by securitizers' concoction of "low-" and "no-documentation" loan products, such as "stated income," "stated assets," "no income," "no assets," and absurd combinations such as "no-income, no-assets" or "NINA," loans, which not only permitted, but required, mortgage originators to make no mention of the borrower's income or assets.<sup>96</sup> The obvious risk inherent in purchasing securities backed by such recklessly originated mortgages was used to justify even more onerous loan terms, facilitating the extension of credit to nearly anyone with a pulse who could be convinced to sign the paperwork.

### B. *Borrowers*

For the reasons given above, borrowers could traditionally rely on their lenders to carefully scrutinize their financial means and lend on terms that did not threaten their ability to manage their expenses, even in the long term.<sup>97</sup> When the structure of the mortgage lending industry began to fundamentally change, leading to unprecedented risk-taking and deception by mortgage originators, borrowers were slow to adjust. In large part, that failure was due to the changes occurring on the back-end of mortgage transactions, which were invisible to borrowers. The industry's interaction with borrowers was entirely limited to originators, and therefore did not reflect the significant shift in incentives that had taken

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95. See Kiff & Mills, *supra* note 3, at 11-12. See generally, e.g., Dell'Ariccia, Igan, & Laeven, *supra* note 19; Demyanyk & Van Hemert, *supra* note 3; Benjamin J. Keys et al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans* (Dec. 25, 2008) (unpublished manuscript, on file with the Social Science Research Network), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1093137](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1093137) (follow "Download"); Purnanandam, *supra* note 74.

96. Many borrowers had no idea that their mortgage loans had been underwritten according to such outlandish criteria. In fact, many borrowers had very stable and easily verified income and provided documentation to their lenders, only to have those lenders ignore the documents in order to either (1) more easily falsify the borrower's financial information, or (2) place the borrower in a low- or no-documentation loan product in order to reap the higher fees and interest rate, or both.

97. See discussion *supra* Parts I, III(A).

place when private label securitization began.

Many scholars have speculated upon the ability of mortgage brokers and originators to repeatedly dupe borrowers into accepting harmful mortgage loans. While this question is beyond the scope of this Article, several factors that surely contributed to this phenomenon can be easily noted. First, as explained above, there was a very strong racial component to predatory lending by aggressive mortgage originators.<sup>98</sup> Minorities were primed for such practices due to the traditional banks' longstanding practice of redlining those communities.<sup>99</sup> Second, brokers and originators engaged in high pressure sales tactics—tactics that had been better regulated in other contexts but had not existed in the mortgage lending industry until relatively recently—thus enabling them to evade meaningful oversight.<sup>100</sup> Third, a borrower struggling to make his or her unexpectedly rising mortgage payments was unlikely to find anyone willing, or arguably able, to work with the borrower to make his or her mortgage more affordable. The borrower had no contact with the true owner of the mortgage loan, and as discussed below, even those owners stood to benefit from borrower defaults in a manner that traditional portfolio lenders did not.<sup>101</sup> Many unsophisticated and desperate borrowers, already saddled with bad loans, were therefore trapped, forced to either sell and move out of their homes, or to refinance their mortgages and hope for better deals.

### C. *Securitizers*

For the purpose of this subsection, the various entities involved in the purchase, pooling and securitization of mortgage loans, the rating and sale of those securities to

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98. *See infra* note 107 and accompanying text.

99. *See id.*

100. *See generally* discussion *supra* Part III(A)(2). These tactics include repeated vague promises of low payments, changing paperwork at the last minute in order to conceal the true terms of a loan, rushed closings meant to deprive the borrower from reading paperwork, convoluted contracts and other documents, discouragement from retaining counsel or seeking any outside advice, and promoting the sense of a limited one-time offer to purchase or save the borrower's home that could not be matched elsewhere.

101. *See* discussion *infra* Part III(D).

investors, and the managing of trusts and loan documents are treated collectively. These entities all participate in the process of purchasing loans from originators and packaging them in a manner that will entice a variety of investors to purchase securities backed by those loans. The purchasers of the securities, or the investors, do not acquire legal ownership of the loans.<sup>102</sup> Rather, the loans in a particular pool are usually owned by a trust that is set up for the investors' benefit, and whose purpose is to enable the borrowers' loan payments to be passed on to investors according to the terms of the various securities transactions.<sup>103</sup> Therefore, the securitizers retain ownership of the mortgage loans and sell only the associated revenue stream.<sup>104</sup> Despite this formality, the risk of borrower default is mostly passed on to investors because it is they, and generally not the securitizers, who will suffer losses should borrowers fail to make full payments on their loans.

Securitizers must take steps to assure investors that the underlying assets—the loans—are sound and profitable. To that end, securitizers employ credit ratings agencies to opine on the risk posed by the various kinds, or tranches, of securities backed by a particular pool of loans, and usually provide “credit enhancements” to guard against possible borrower defaults up to a certain level.<sup>105</sup> The ratings agencies profit only if the securities are sold, which creates an obvious and troubling conflict of interest. Securitizers also impose underwriting criteria on loans they purchase. These criteria vary in order to appeal to a broad range of investors with differing tolerances for risk, and they relate to DIR and LTV requirements, the amount of documentation of income and assets to be collected from the borrower, the borrower's credit score, and other factors bearing upon the risk of default. MBS issuers prepare detailed reports regarding numerous features of the loans and pools of loans backing the securities they offer in order to provide investors with information about assets

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102. For a description of mortgage securitization, see generally Unterman, *supra* note 1.

103. *Id.* at 56-60.

104. *Id.*

105. *Id.* at 60-63.

underlying each class of securities offered.<sup>106</sup> The various parties to the securitization process also draw up intricate contracts explaining the role of each entity in the transaction. Investors are thereby given extensive information about the likely profitability of the loans in a given pool, though the information's reliability is constrained by the accuracy of the originators' and appraisers' representations regarding the pool's loans and properties. Any obfuscation, exaggeration, or misrepresentation not detected by the securitizers' due diligence efforts may be passed on to investors.

The securitizers profit by successfully issuing securities to investors. Pointing out risky features of the mortgage loans backing the securities, however, obviously reduces profits. Similarly, reducing the number of loans available to back securities, which in turn reduces the number of securities that can be issued, reduces securitizers' profits. Securitizers therefore have an incentive to encourage originators to make as many loans as possible and to make those loans appear as sound as possible.<sup>107</sup>

The refinancing of subprime mortgages into new and bigger subprime mortgages had a multiplier effect that was just as profitable for securitizers as it was for originators, since securitizers also depended on volume to generate profits. A high rate of relatively quick refinancing had the potential of driving away securities investors who might otherwise have deemed the securities to be unprofitable, given the relatively small total payments made on loans still in their early years. Securitizers, however, offered many classes of securities in relation to each pool of mortgage loans. Thus, an investor could essentially bet on the likelihood of an early payoff.<sup>108</sup> Furthermore, much of the costs of early payoffs were passed on

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106. Such a report, often included in such filings from the U.S. Securities and Exchange Commission as prospectuses (or prospectus supplements, or free-writing prospectuses), can easily run to 1,000 pages. For a thorough discussion of the information exchange between securities issuers and investors, see generally Gerding, *supra* note 4.

107. Again, the cash-out feature of refinance loans is crucial to making a loan affordable for a long enough period of time to allow the sale of securities without any sign of unaffordability. See *supra* note 106 and accompanying text.

108. For example, purchasers of classes of securities backed by interest payments stood to lose from early payoffs, while purchasers of classes of securities backed by principal payments, stood to gain from early payoffs.

to borrowers in the form of prepayment penalties (which were themselves securitized).<sup>109</sup> In addition to providing investors with a choice regarding exposure to the risk of prepayment, subprime mortgage loans were, as discussed above, precisely tuned to maximize the predictability of default, and thus payoff (often through refinance),<sup>110</sup> which enabled investors to assess the likely number and timing of refinances in the pool. Notably, there was little need to forecast the performance of a subprime mortgage loan deep into its thirty-year term because the borrower was expected to fully repay the loan, either through refinance or sale, long before then. The convoluted structure of subprime mortgage loans thus facilitated not only originator misrepresentations to borrowers, but also the minimization of uncertainty about loan performance for MBS purchasers, and thus the marketing of those securities to a broad group of investors.

#### D. *Investors*

The massive explosion of the MBS market, and thus the mortgage lending market itself, was partly fueled by the short-term and repeated refinancing of subprime mortgage loans that were not sustainable over their full terms. Loans were essentially repaid with home equity rather than with borrower income.<sup>111</sup> This process was so carefully and tightly

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109. A prepayment penalty is a fee imposed on a borrower who pays more than a certain amount—for example, twenty percent of the outstanding balance—during a certain period, usually the first year, two years, or three years after origination of the loan. *See also* discussion *supra* Part III(B).

110. *See* discussion *supra* Part III(A). The time of default (i.e., refinance) could not be perfectly predicted because ARMs were based on indices whose future fluctuations could not be known in advance. All other things being equal, reductions in an index (and thus in mortgage interest rates) would lead to a greater number of refinances (since cheaper mortgages would be available), and vice versa.

111. A large portion of a subprime mortgage loan's payments were made out of the property's equity—loans that did not fully amortize did not pay particularly well while they were in repayment, but led to large payoffs when they were refinanced. It was the next loan that made the prior loan lucrative, not just the borrower's payments. The same is true of mortgages with large interest rate increases—even though the borrower may not make many of the payments due after the increase, those payments will have to be made when the next mortgage pays off the current one. Similarly, equity was often liquidated by a refinance loan in the form of cash and then used to

manipulated by the entities that created and sold the securities that it was massively profitable for these entities and their investor clients. But the perpetuation of that profitability depended upon two crucial conditions: that residential property values increase rapidly and perpetually. Property values needed to increase rapidly enough to sustain the periodic refinances which, because they were loaded with fees, costs, and consolidation of all imaginable kinds of other debts, were often significantly larger in amount than their predecessor loans. The methodical and unrelenting cycle of subprime loan flipping likely contributed substantially to the rise in property values, especially once those values reached levels that virtually no one, without exceptionally high income, could possibly afford to sustain over the full course of any reasonable thirty-year mortgage.

As for the other condition upon which the MBS market depended, it is now obvious that property values could not continue their vertiginous climb in perpetuity. But because each subsequent round of subprime loans was larger in market value and less viable than the previous loans, the need for rising property values became increasingly acute and the potential consequences of price stagnation or depreciation became increasingly dire. This was a classical pyramid scheme situation: (1) each new round of investors paid off the previous round of investors; (2) each new round of investment, because it paid off prior investments, was larger than the previous one; (3) finding enough new investments to sustain the cycle became increasingly difficult, leading to the erosion of underwriting standards in making new mortgage loans; and (4) ultimately, the entire market crashed when it was revealed that the value of assets backing the investments was grossly insufficient to justify the prices of the securities. One notable difference between this pyramid scheme and others is that the MBS investors had ample information about what they were purchasing.<sup>112</sup> Arguably, they understood, or should have understood, that they were investing in an unsustainable asset bubble. Therefore, they were simply betting that they would be able to get out before the market's collapse.

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make payments on the subsequent loan. *See generally* discussion *supra* Part III(A)(2).

112. *See* discussion *supra* Part III(D).



### E. *The Collapse*

As the subprime MBS market grew, the individual subprime mortgage loans became increasingly difficult for borrowers to repay and the rate and rapidity of borrower defaults increased.<sup>113</sup> Perhaps for this reason or perhaps for entirely unrelated reasons, investors decided to pull out. The vast majority of MBS were rated extremely safe, and even a minimal increase in defaults may have persuaded cautious institutional investors to abstain. Whatever the reason for investors' departure from the MBS market, securitizers either did not notice their absence or they merely assumed that it was due to a temporary decline in the market. Many of the largest securitizers, therefore, continued to purchase and pool subprime mortgage loans for a long time after they began having difficulty selling their securities. By the time securitizers realized that they had missed the contraction, they already had significant backlogs of mortgage loans that they could not securitize. This caused them to suddenly cease or cancel subprime loan purchases, leading to a quick succession of originator failures and bankruptcies.<sup>114</sup> At this point, many borrowers were stuck with mortgage loans that they could neither afford nor refinance. In addition, borrowers could not escape their mortgages by selling their properties because purchasers could no longer obtain financing. The result was a massive real estate depreciation that left homeowners in default on their mortgage loans with outstanding balances far in excess of their homes' new values. The prospects for MBS owners—which at this point included all of the securitizers who had been caught with unmarketable mortgages—to recover anything approaching the face value of their securities were

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113. See, e.g., Purnanandam, *supra* note 74, at 8-13 (discussing the four-fold increase in mortgage charge-offs from the first through the fourth quarters of 2007); Kiff & Mills, *supra* note 3, at 7-9. In addition, Demyanyk and Van Hemert assert that “securitizers were, to some extent, aware of” the progressively deteriorating quality of mortgage loans over a period of six years leading to the current crisis. Demyanyk & Van Hemert, *supra* note 3, at 5.

114. See Kiff & Mills, *supra* note 3, at 9 (noting that firms “representing about 40 percent of 2006 subprime originations, have either closed down operations, declared bankruptcy, or been bailed or bought out”).

dim and in decline.

#### IV. Solutions

The incentives created by the private-label subprime mortgage securitization market led its various participants to engage in, abet, or simply turn a blind eye to, a wide range of grossly abusive practices by mortgage originators. Altering the incentives of any of the participants in a manner that would make such conduct unfeasible could prevent such a massive buildup of highly overvalued assets from accumulating in the future. Efforts had long been made to improve borrowers' bargaining positions by requiring lenders to make extensive disclosures regarding the loans they offered.<sup>115</sup> This had no appreciable effect for the following reasons: (1) the high pressure tactics employed by predatory lenders included rushing borrowers through closings in order to deprive them of a meaningful opportunity to read the disclosure documents; (2) additional disclosures merely added to the large volume of paperwork present at mortgage closings, making it harder for borrowers to pick out the few truly important documents; and (3) subprime loan terms had become so convoluted that most borrowers would not have understood them even if given the opportunity to carefully and repeatedly scrutinize them.

Attempts to reform originators' corrupt incentives have also been made, namely through the passage of the very same consumer protection laws meant to inform borrowers.<sup>116</sup> Many

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115. At the federal level, these efforts are primarily embodied by the Truth in Lending Act of 1968 ("TILA"), Pub. L. No. 90-321 § 102, 82 Stat. 146 (codified as amended at 15 U.S.C. § 1601 (2006)), HOEPA § 151, and the Real Estate Settlement Procedures Act of 1974, Pub. L. No. 93-533 § 2, 88 Stat. 1724 (codified as amended at 12 U.S.C. § 2601 (2006)). Many states have also enacted various disclosure laws similar to, and in some instances more comprehensive than, the federal statutes. *See, e.g.*, GA. CODE ANN. §§ 7-6A-1-13 (2009); MD. CODE ANN., COM. LAW § 12-127 (West 2008); MD. CODE ANN., COM. LAW § 12-311 (West 2002); MD. CODE ANN., COM. LAW § 12-409.1 (West 2008); MD. CODE ANN., COM. LAW § 12-1029 (West 2002); MASS. GEN. LAWS ANN. ch. 183C, § 1-19 (West 2006); N.M. STAT. ANN. §§ 58-21A-1-14 (West 2008); N.Y. BANKING LAW § 6-1 (McKinney 2008); S.C. CODE ANN. §§ 37-23-10-85 (2009).

116. Many of these laws simply imposed the ineffective disclosure requirements, established in the consumer protection statutes such as those cited in *supra* note 115.

of the predatory origination tactics discussed above violate federal and state laws and can lead to monetary damages and even invalidation of the debt.<sup>117</sup> However, these laws only impose liability on originators who,<sup>118</sup> because they tend to be thinly capitalized fly-by-night operations and because they are often sued by numerous victims, are rarely able to make aggrieved borrowers whole and often cease to exist entirely by the time that borrower discovers the wrongdoing and seeks legal assistance.<sup>119</sup> Indeed, the ephemeral nature of many subprime mortgage originators makes them poor targets of direct policy influence. Rather, these companies are the most responsive to the incentives created by their financiers—the securitizers and, indirectly, the securities investors.

Most jurisdictions hold assignees liable for the acts of their assignors, up to the amount of the debt.<sup>120</sup> However, that general rule has been gutted by the holder in due course (“HIDC”) doctrine established by the Uniform Commercial Code (“UCC”).<sup>121</sup> That doctrine provides that purchasers of negotiable instruments who take ownership according to certain minimal criteria are only liable for a very limited

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117. These laws, including common law fraud, unfair and deceptive practices statutes, TILA, and civil rights statutes, are inadequate in a number of ways, but that subject is beyond the scope of this Article.

118. There are a few very narrow provisions for assignee liability in some statutes, but they have proved to be insignificant. *See, e.g.*, 15 U.S.C. § 1641(d) (2006); N.Y. U.C.C. LAW § 3-306 (McKinney 2001) (providing that an assignee who is not a “holder in due course” of a negotiable instrument—and where mortgage loan notes are usually deemed negotiable instruments—is subject to most defenses to the instrument’s enforcement).

119. *See* Peterson, *supra* note 8, at 2273 (describing undercapitalized originators as “disposable filter[s]: absorbing and deflecting origination claims and defenses until those claims and defenses render the business structure unusable”).

120. *See, e.g.*, Vig v. Nix Project II P’ship, 212 P.3d 85, 91 (Ariz. Ct. App. 2009) (“An assignee steps into the shoes of her assignor. She can stand in no better position than the assignor and [a]n assignment cannot alter the defenses or equities of the third party.”) (internal quotation marks and citation omitted); Mid-Am. Appliance Corp. v. Federated Fin. Co., 109 N.W.2d 381, 383 (Neb. 1961) (“An assignee generally acquires no greater right than that possessed by the assignor. The assignee stands in the shoes of the assignor and is bound by the terms of the contract to the same extent as the assignor.”) (internal citations omitted); Int’l Ribbon Mills, Ltd. v. Arjan Ribbons, Inc., 325 N.E.2d 137, 139 (N.Y. 1975) (“It is elementary ancient law that an assignee never stands in any better position than his assignor.”).

121. U.C.C. § 3-302 (2004).

number of defenses against enforcement.<sup>122</sup> These defenses generally do not include any of the consumer protection claims arising from predatory lending that borrowers have against originators. As a result of the judgment-proof nature of subprime originators' businesses and the liability laundering effect of the sale of mortgage loans into the secondary market, flagrantly illegal lending practices were permitted to go unremedied. Securitizers and investors operated in a veritable regulatory and legal black hole. The resulting lack of accountability permitted originators, securitizers, and investors to act recklessly and then shift the costs of their recklessness entirely onto the borrowers whose promises to pay, whether unwitting or careless, were at the core of the MBS market.

Shifting that cost back onto the lenders, by making the current owners of mortgage loans liable to borrowers, would have two principal and salutary effects. First, it would counteract the otherwise unchecked incentive to make unsustainable loans by discouraging fraud and other illegal practices. This would be accomplished by enlisting securitizers and investors in the effort to curb origination fraud. If these parties bore the costs of originators' illegal practices, they would be far more likely to scrutinize originators' conduct and to demand that originators comply with the law. Second, securitizers would have an incentive to purchase loans from well-capitalized originators with sustainable business practices. Such originators are far more likely to remain in business for a long time and thus to be available to indemnify securitizers and investors who are eventually held liable to borrowers. This would reverse the current incentive to do business with transient originators whose disappearances deprive borrowers of redress and thus discourage borrowers from challenging the validity of their loans.

Far from being novel, such wholesale assignee liability already exists, and is in fact mandatory, in a number of other industries. High-pressure deceptive practices of the kinds mentioned in this article have long been widespread, especially

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122. *See id.* One requirement is that the assignment be taken in good faith, which arguably is often not the case. Delving into this inquiry, however, is expensive, and evidence of bad faith by entities whose dealings are largely closed to scrutiny is difficult to unearth.

in the very same minority communities in which predatory mortgage lending has been rampant.<sup>123</sup> It was once common for salesmen of consumer goods, automobiles, insurance, and numerous other products to unlawfully induce customers into financing purchases of their merchandise on unfavorable terms.<sup>124</sup> These debts were then sold onto the secondary market and were thus laundered of consumers' protections against enforcement by the holder in due course doctrine.<sup>125</sup> The Federal Trade Commission ("FTC") decisively curbed this problem by issuing its Holder Notice rule in 1975.<sup>126</sup> This rule required all financing contracts in certain affected industries to contain language defeating the negotiability of the debt instrument, thereby effectively abrogating the holder in due course status of any subsequent purchaser.<sup>127</sup> It is only a historical accident that resulted in the omission of mortgage lending from the list of protected industries; private label mortgage securitization was not yet significant and thus predatory mortgage lending practices were not yet rampant. It would simply take the extension of the FTC's holder notice rule to the mortgage lending industry to realign lender incentives and return some measure of responsibility and prudence to that market.<sup>128</sup>

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123. *See, e.g.*, *Heastie v. Cmty. Bank of Greater Peoria*, 727 F. Supp. 1133, 1135-36 (N.D. Ill. 1989) (discussing abuses prompting the adoption of the holder notice rule); David A. Szwak, *The FTC "Holder" Rule*, 60 CONSUMER FIN. L.Q. REP. 361, 361-62 (2006); Julia Patterson Forrester, *Constructing a New Theoretical Framework For Home Improvement Financing*, 75 OR. L. REV. 1095, 1105-07 (1996) (discussing fraudulent practices and the effect of the holder notice rule in the home improvement industry).

124. *See, e.g.*, Szwak, *supra* note 123.

125. *See, e.g.*, S. REP. NO. 103-169, at 1912 (1993) (noting that "[t]he F.T.C. rule has not significantly restricted the flow of consumer credit and or interfered with the securitization of auto loans").

126. 16 C.F.R. § 433.2 (2006).

127. *Id.*

128. It bears noting that Peterson does not consider the extension of the Holder Notice rule to mortgage loans, or the extension of assignee liability generally, as a sufficient remedy to the problems discussed in this Article. He argues that the extension "would not bring the law up to date" and that it would merely constitute "a transition from blaming the victim to blaming the patsy," (namely, the investor) and thus would in some sense "go too far by forcing relatively innocent investors to bear the brunt of large punitive damage awards." Peterson, *supra* note 8, at 2275. Strangely, Peterson favors the extension of shared liability doctrines such as common law conspiracy,

## V. Conclusion

Numerous mistakes were made during the MBS market boom, which all combined to amplify the resulting damage. Other authors have identified steps that investors could have taken in order to limit their exposure to overvalued securities.<sup>129</sup> But few have addressed the structural features of the mortgage and securities markets that encouraged the overvaluation of subprime mortgage loans in the first place. One such feature was the elimination of the bankruptcy tax resulting from depositing loans into bankruptcy-remote SPVs. Unfortunately, few plausible solutions have been offered to negate the distortion of securitizer and investor incentives caused by this feature. At any rate, the elimination of the bankruptcy tax is not the only significant distortion that must be addressed in order to restore prudence and sustainability to mortgage lending. Another such distortion is the reduction, to near elimination, of legal liability for fraudulent and other abusive lending practices.

There are compelling reasons to effectively prevent predatory lending practices by subprime mortgage loan originators that are unrelated to the proper functioning of financial markets. Those practices have devastated large communities and brought thousands of families to financial ruin. But even leaving those concerns aside, predatory mortgage lending has caused unacceptable damage and loss, which warrants strict regulation and enforcement. The changes in the fundamental organization and operation of the

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aider-abettor, and joint venture theories, over consumer protection statutes. *Id.* at 2275-79. It is difficult to see how this approach differs from the currently inadequate doctrines which shift the burden onto borrowers to prove assignees' bad faith or complicity before allowing them any recovery from those assignees. Ultimately, it is a disagreement about how to most effectively influence the behavior of securitizers. Peterson argues for joint or imputed liability for those acts undertaken in furtherance of originators' illegal behavior, which places the burden of proof on the plaintiff. I, however, argue that holding investors liable for originators' illegal behavior will inherently prevent securitizers from encouraging such illegality because investors will refuse to invest in such enterprises, without the substantial impediments for the borrower-plaintiff that Peterson's preferred model imposes.

129. *See supra* notes 1-8.

mortgage lending market led to equally significant changes in lenders' incentives and behavior. Deceitful marketing went from being bad business to being the engine that drove the massive growth of the subprime MBS boom. But it also ensured that the growth was predicated upon unsustainable long-term promises by borrowers and unrealistic expectations of perpetually increasing property values. The result was a pyramid scheme that ensnared millions of institutional investors worldwide who placed hundreds of billions of dollars at stake. The inevitable collapse of this illusory market has been catastrophic, with consequences likely to last years and cost trillions of dollars.