

After the Bailout: SOME FURTHER STEPS TO AVOID A REPEAT PERFORMANCE

By Barlow Burke[†]

Low interest rates. New money for mortgages.¹ Securitization.² More new money for mortgages.³ New procedures for mortgage underwriting.⁴ More securitization. Lower interest rates, higher prices for homes. This sequence of events produced the largest housing and credit bubble in American history. When the bubble burst, America's houses lost 20–30% of their value—and may lose even more in the near future. With such losses, Americans recently purchasing homes often owe more on their houses than they are worth. In the popular phrase, they are “underwater.” This is a situation ripe to produce rising foreclosures rates and abandoned houses.

When the American economy as a whole uses real estate as its driver, the situation gets even worse because the housing bubble spreads into the economy's financial system. Recent events

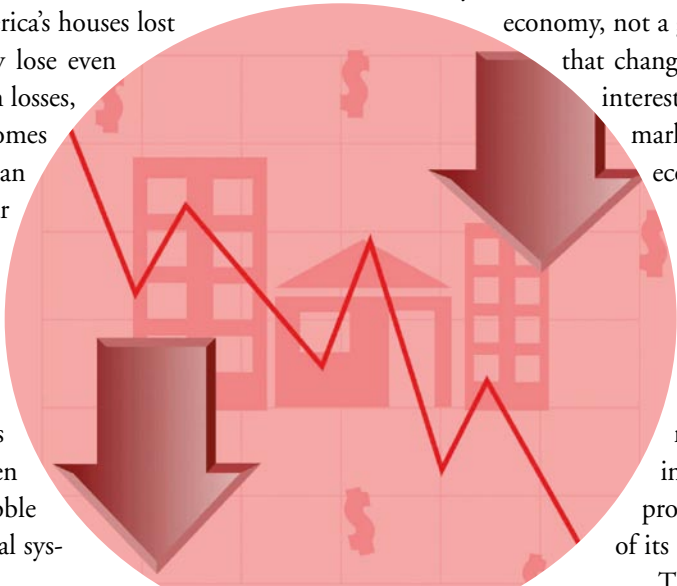
are the startling results of the situation: governmental takeovers of major securitizers, Fannie Mae and Freddie Mac; the disappearance of the five largest investment banks by takeovers, bankruptcy, or their rebooting themselves as commercial banks; the takeover of the largest insurance company to guarantee securitized mortgages (American Insurance Group); the extension of government deposit insurance to cover money market funds⁵; temporary bans on short selling⁶ of about 900 financial stocks; Congressional pledges to buy up to \$700 billion in troubled mortgage related securitized assets and then, to use part of the \$700 billion to buy a stake in the holders of those assets – all this followed in the space of two months in 2008.⁷ A financial system that needs such aid is not one that deserves high marks. A government that runs just ahead of the troubles in its financial system, increasing its gross liabilities by more than \$1 trillion (more than twice the cost of the war in Iraq) is one that deserves low marks.

But all that is the story of the last several months.

It's a wonder that real estate, usually a follower of economic trends, has led the recently completed cycle of economic growth in this country. Real estate mortgage interest rates traditionally trail rates payable on corporate bonds. Housing starts are traditionally seen as an indicator of the underlying health of the economy, not a generator of economic trends. All of that changed in the last eight years when low interest rates stirred the mortgage capital markets to life in ways not seen in many economic cycles.

A real estate transaction is essentially a local business. That fact is its traditional strength, but also contains the seeds of one of its greatest weaknesses. Securitization put mortgage capital markets in territory unfamiliar to it, where those inexperienced in its ways ventured for profits without concern or knowledge of its underlying risks.

The mortgage securitization process has depended, over the last several decades, on mortgage brokers.⁸ These brokers have always been crucial to the transfer of mortgage capital from capital-rich areas of the country to capital poor areas, the latter generally being located on the West Coast, the Southwest, and the Southeastern parts of the country. With securitization, however, their business expanded into retail or residential mortgage brokerage, and the real estate recession of the late 1980s and early 1990s accelerated this trend. Everywhere these brokers must be licensed by the state in which they are doing business. They are paid in the same way that other real estate brokers are—by commissions available at the closing of a mortgage loan.⁹ Their entitlement to a commission may arise when a loan commitment is made and accepted by a borrower employing them, but they are in most situations paid when the loan is closed.¹⁰ In effect, the practice is: no closing, no commission. Mortgage brokers have no interest in the loan or the parties to it after that. With many real estate investment opportunities, when the person arranging the investment gets all of his or her fee “up front,” that is a cause for concern because the investor wants the arranger to have a stake in the outcome of the investment.



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The arranger's advice is more trustworthy on that account. In recent years, in the mortgage market, however, once the loan is out the door, the broker has no interest—he must turn to generating other loans and volume counts. Brokers live by the rule that a predictable percentage of their loans will close.

In the future, stricter regulation of mortgage brokers is required to break this cycle. Three types of regulations come to mind. One such might require that a lender funding the commission defer a portion of the brokerage fee until the borrower has an established record of repaying the loan—say one third of the commission on closing, with the rest deferred. Title insurers regularly maintain such accounts to pay the premiums of their insurance agents, and lenders shouldn't resist an idea that defers paying out funds. A second regulation might require longer periods of apprenticeship for mortgage brokers, higher educational requirements, and surety bonds for brokers. When loans do not close as promised, borrowers might, by a third type of regulation, be given a right to sue for double or treble damages. Double damages might be awarded in a case involving a conventional loan, treble damages in a case involving a subprime loan.¹¹ This type of regulation would give attorneys an incentive to represent disappointed borrowers forced to seek loans at interest rates higher than promised. That type of incentive seems to have worked in cases involving tenants suing for the recovery of security deposits owed them by their landlords. State regulation of mortgage brokers have seldom been tailored to this type of brokerage, and such tailoring is now overdue. The statutory definitions of mortgage brokerage might also be up-dated, and might then provide even greater incentive for attorneys to take such brokerage cases.

Often the loan is closed at a title agency, an escrow agency, or a title attorney's office. The mortgage lender entrusts the funds for the mortgage loan to the firm closing the loan, often knowing little about the honesty and trustworthiness of the closing agent. This understandably makes lenders anxious, and so the title insurance company insuring a lender's lien usually issues an "approved agent closing letter." This letter is often a one page agreement. It is not really insurance; it is more akin to a surety bond issued to indemnify the lender and the borrower against the agent's misrepresentations, fraud, or embezzlement of the funds. When the loan turns out to be subprime, the letter might



provide a basis for suit against its issuer. Most cases have construed such letters as requiring "actual fraud" on the agent's part,¹² and when an agent or firm turns out many subprime loans, this pattern might well be sufficient to show such fraud.¹³ One subprime loan out the door and securitized doesn't constitute a pattern, but a hundred might. Thus

a lender dealing with a mortgage broker or title agency closing many subprime loans should have a duty to investigate borrowers' finances or else be found to have participated in a fraudulent scheme. Subprime loan in such cases are often advertised as "second chance" loans so the lender should be put on inquiry by that account alone.¹⁴

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the loan's owner would never change, no matter how many hands the stream passed through. The practical effect of this change would be to leave foreclosure powers in the hands of the originator of the loan, who then would also be subject to any defenses by the borrower springing from the closing of the loan, such as usury violations, violations of state deceptive practice acts, and misrepresentations of the terms of the mortgage.

Subprime loans should be accorded special treatment in foreclosure. Automatic moratoria on foreclosure, a right to reinstate the loan with a reworking of the loan's terms (a foreclosure cram-down¹⁶), and new limitations on or the elimination of deficiency judgments¹⁷ following a foreclosure would all be appropriate ways of protecting the subprime borrower in foreclosure. Subprime loans have extended the reach of mortgage markets; that's a good thing, since the extension provides home ownership to many borrowers that the market would not otherwise reach. But with the extension, and with the more onerous terms of subprime loans, should also come additional controls on the lender's remedies for a default. In some ways, a subprime loan is a sucker punch, and the lender should not be permitted to go on punching once the borrower is down.

Foreclosures for subprime loans might look different, too. They might be conducted so that the purchaser in foreclosure is solicited and dealt with, in ways that are more like a voluntary purchase and sale of the property on the open market, instead of being conducted by auction on the courthouse steps or by a trustee under a power of sale in a deed of trust. Bankruptcy trustees' sales of property are often conducted this way, with the bankruptcy court approving the terms of the sale at the end of the process. This works well, and lenders should not object to the change, because the property should yield a higher price as a result. When purchasers realize the sale is a forced one, the purchase price of the property normally goes down. The foreclosure process encourages this. Why should it? Some states are already experimenting with this change in foreclosure procedures.¹⁸

More generally, subprime loans might handily be the subject for civil rights suits for "reverse redlining." "Redlining" is the practice of refusing to extend credit to targeted neighborhoods because of its income, racial or ethnic characteristics. "Reverse redlining" refers to extending mortgage credit on unfair or predatory terms.¹⁹ Causes of action for reverse redlining are already well recognized in both administrative and judicial settings.

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system. Each step in that process might have appeared prudent at the time, but taken altogether, their consequences have been unintended and severe. As to the level at which future regulation should occur, brokers and title insurers' regulation traditionally has been a matter of state law. Brokers are regulated by the Real Estate Commission or a similar agency in state government. Title insurers are regulated under a state's insurance code. This need not be so because federal regulation is possible, too. In the case of the insurers, Congress ceded the authority to regulate title insurers—and all other types of insurance companies—to the states in the 1940s,²⁰ but that cession could have been repealed. In

the case of brokers, the courts have already found that for some purposes real estate and mortgage brokerage is a part of interstate commerce, so federal regulation is authorized for them as well.²¹ Federal regulation would bring uniformity to regulation and would help avoid brokers' shoddy practices in states with lax regulatory structures, ending a race to the

regulatory bottom between the states. As previously mentioned, the need for regulatory reform is particularly great in the instance of mortgage brokerage.

Any type of loan can be securitized with others of like type. Recently, various types of mortgages have been assembled into large pools for securitization purposes, then graded or "tranching" and then retransched according to risk and expected maturity so that the security can be sold to different types of investors. In the future, Congress should legislate prohibitions or at least regulatory controls on tranching a mortgage pool for risk. The secondary market started out securitizing only residential mortgage loans, which was the original purpose in chartering Fannie Mae and Freddie Mac, but both of those agencies eventually began securitizing pools of loans of many types, residential and commercial. In a more tightly controlled secondary market, only residential mortgage loans should be securitized. In these pools,



risks are more predictable and are spread more thinly over a larger number of loans. Recapitalizing the residential or consumer market for mortgages, the original purpose of the secondary market as it was envisioned in the 1960s and 1970s, is now in order. Perhaps too, limiting pools of mortgage loans to those with certain characteristics—say in terms of fifteen years or more, or loan to value ratios of eighty percent or less—would be appropriate ways of minimizing the risk to secondary market investors.

Other solutions will doubtless be proposed and debated in the near future, but the terms of the debate should focus on the structural deficiencies in the mortgage market that have so

recently brought our economy low. Otherwise we will ease the flow of credit only to bring on another round of hyper-mortgaging our economy. Curing our present housing crisis is not enough. Reform and re-regulation of our financial system will take time, as it should if it is done carefully. The economy needs to come back from this brink with a greener housing market, greener consumer durables, a renewed and rebuilt infrastructure, and an overhauled energy system—these three drivers for our economy should be the things that promote future growth. Relying on the housing market alone has proven an idea that has come and gone. **BLB**

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¹ By using the term “mortgage” the author also means to refer to a deed of trust, and for present purposes, he is using these terms interchangeably.

² Securitization is a process of taking an illiquid asset producing cash flow and turning it into a security collateralized by the cash. Any asset can be securitized. The Rolling Stones securitized a concert tour in the 1980s, and car loans have long been securitized.

³ In this case, the proceeds of the prior sale of the securities referred to in note 1, *supra*.

⁴ “Subprime mortgage loans” are not necessarily new types of mortgages. Instead, they more typically are loans originated using new and untested underwriting standards and guidelines. Thus a “no doc” loan is one that requires no documentation of the borrower’s income. It has been touted as preserving the borrower’s privacy and might properly be used only when a borrower has the highest credit rating; in fact, it has recently been used for many type of borrowers as “low doc” loans—loans for borrowers whose income is irregular, and perhaps paid in cash. Sometimes such loans are also referred to as “Alt-A” loans, but this phrase has also come to mean loans that, besides having little income documentation, also have violations of traditional underwriting guidelines for the type of property involved, its loan to value ratio, and/or the borrower’s debt to income ratio. See <http://www.floridahomeloan.com/2005/10/explaining-no-doc-loans.html>; see also http://www.investorwords.com/6734/alt_a.html.

⁵ See FDIC’s Temporary Liquidity Guarantee Program (announced Oct. 12, 2008), one component of which is the Transaction Account Guarantee Program (providing full deposit insurance coverage for non-interest bearing transaction accounts, regardless of dollar amount). All eligible institutions are automatically enrolled in the TLGP for the first 30 days at no cost, but thereafter banking organizations not wishing to participate had to opt out by Nov. 12; fees and regulations were imposed.

⁶ In a short sale of securities, a seller agrees to sell a security that the seller has borrowed and does not own, but that he is committed to repurchasing in the future (profiting from an expected decline in the security’s price). See *Short Sales* (2006) available at <http://www/sec.gov/answers/shortsale.htm>.

⁷ See *When Fortune Frowned*, THE ECONOMIST, Oct. 9, 2008, at 1-2.

⁸ The business of mortgage brokerage has been well described in two National Public Radio shows by Ira Glass, “This American Life.” See National Public Radio: *A Giant Pool of Money*, (May 5, 2008), available at www.thislife.org/Radio_Episode; National Public Radio: *Another Frightening Show about the Economy* (Oct. 3, 2008), available at www.thislife.org/Radio_Episode.

⁹ See, e.g., *Jones v. First Mortgage Co. of Nevada, Ltd.*, 915 P.2d 883, 885 (Nev. 1996).

¹⁰ See, e.g., *Madick Developers, Inc. v. Heritage Corp. of South Florida*, 563 So. 2d 1094 (Fla. App. 1990).

¹¹ “Subprime” loans are not literally subprime, in the sense that the interest rates on them are not less than the prime rate. It is actually their documentation that is subprime, and so the interest rate charged is higher than the prime rate. One court recently held, using federal statutes as a guideline, that a mortgage loan to a minority borrower, living in a minority neighborhood, and charged an interest rate that was more than three percent over a comparable rate for U.S. Treasury bonds, was presumptively an act of racial discrimination. See *M & T Mortgage Corp. v. Foy*, 858 N.Y.S.2d 567 (N.Y. Sup. Ct. 2008) (an action brought to reform a mortgage for a veteran on deployment).

¹² See, e.g., *Lawyers Title Ins. Corp. v. New Freedom Mortgage Corp.*, 645 S.E.2d 536 (Ga. App., 2007) (concerning fraud and misrepresentation claims based on the letter), *rev’d*, 264 S.E.2d 190 (Ga. App., Nov. 9, 2007) (holding that the language of the letter at issue required proof of actual, not merely constructive fraud, the letter stating that it covered “fraud or dishonesty of the issuing agent or approved attorney in handling ... funds or documents in connection with” covered closings), and *aff’d*, 655 S.E.2d 269 (Ga. App., Nov. 29, 2007).

¹³ See, e.g., *Roark v. Rydell*, 881 N.E.2d 333, 342 (Ohio App. 2008).

¹⁴ See *Mathurin v. Lost & Found Recovery LLC*, 854 N.Y.S. 2d 629, 631 (N.Y. Sup. Ct. 2008).

¹⁵ See *Skinner v. Preferred Credit*, 638 S.E.2d 203, 213 (N.C. 2006) (holding that the trustee cannot on that basis alone, be subjected to service in a class action involving the underlying loans in the trust). However, this holding is subject to considerable criticism and should be reversed.

¹⁶ A “cram down” is a term taken from bankruptcy law, referring to the trustee in bankruptcy’s authority in a Chapter 11, debtor-in-possession reorganization, to re-work the terms of the bankrupt’s debts such that the bankrupt is financially capable of meeting the new terms of repayment. Congress has debated reinstating this authority recently, but has so far refused to amend the Bankruptcy Code in this way.

¹⁷ Except in a few states, a deficiency judgment is routinely permitted a foreclosing mortgage lender when the foreclosure sale does not fetch the outstanding amount of the debt: lenders then routinely sue on the mortgage note, the borrower’s personal IOU, and in what amounts to a confession of judgment suit, recovers this deficiency, the amount between the foreclosure sale price and the outstanding debt. A few states require the lender to elect whether to foreclose or sue on the debt (a so called “one action” statute) or bar deficiency judgment for certain types of mortgage loans, for example, home acquisition loans; this latter type of statute could easily be extended to subprime loans.

¹⁸ See 735 ILL. COMP. STAT. ANN. 5/15-1101 (West 2008); see also Basil Mattingly, *The Shift from Power to Process: A functional Approach to Foreclosure Law*, 80 MARQ. L. REV. 77, 93-95 (1996); see generally Eric T. Freyfogle, Comment, *The New Judicial Roles in Illinois Mortgage Foreclosures*, 19 LOY. U. CHI. L.J. 933 (1988).

¹⁹ See *Hargraves v. Capital City Mortg. Corp.*, 140 F. Supp. 2d 7, 20 (D. D.C. 2000). This case is generally regarded as the leading case on the subject.

²⁰ See 15 U.S.C. §§ 1011-15; see also *St. Paul Fire & Marine Ins. Co. v. Barry*, 438 U.S. 531, 551 (1978) (reaffirming the principle of state regulation).

²¹ See, e.g., *McLain v. Real Estate Board of New Orleans*, 444 U.S. 232 (1980).