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In Defense of Private-Label Mortgage-Backed Securities

Brent J. Horton

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ARTICLES

IN DEFENSE OF PRIVATE-LABEL MORTGAGE-BACKED
SECURITIES

*Brent J. Horton**

I. INTRODUCTION	828
II. MORTGAGE SECURITIZATION	835
A. <i>Types of Private-Label MBS</i>	835
B. <i>Are Private-Label MBS Really Securities?</i>	838
C. <i>Why Securitize Mortgages?</i>	842
III. THE DEVELOPMENT OF GSE MBS	843
IV. THE DEVELOPMENT OF PRIVATE-LABEL MBS	846
A. <i>Secondary Mortgage Market Enhancement Act of 1984</i>	848
1. Allowing Forward Trading of Private-Label MBS	849
2. Exempting Private-Label MBS from State Blue Sky Laws	853
3. Allowing National Banks to Invest in Private-Label MBS	854
B. <i>Rule 415 Shelf Registration</i>	856
C. <i>REMIC Provisions of the Tax Reform Act of 1986</i>	857
V. GOVERNMENT INTERFERENCE WITH PRIVATE-LABEL MBS	859
A. <i>GSEs Relegate Private-Label MBS Issuers to Securitizing Risky Mortgages</i>	859
1. Payment-to-Income and Loan-to-Value Ratios	861
2. Jumbo Mortgages.....	862
B. <i>Impact of the Community Reinvestment Act</i>	863
VI. A CASE STUDY: GMAC MORTGAGE.....	865
A. <i>The Impact of SMMEA and REMIC on GMAC</i>	865
B. <i>The Impact of CRA on GMAC</i>	867
C. <i>The Fall of GMAC</i>	868
D. <i>The Impact of Mark-To-Market</i>	871
E. <i>Systemic Financial Meltdown</i>	872

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VII. WHERE DO WE GO FROM HERE? 874
 A. *Rolling Back the Privatization of MBS* 874
 B. *Legislating Aversion to Risk—A Risky Proposition* 876
 C. *The Way Forward*..... 879

VIII. CONCLUSION 881

ABSTRACT

The House Financial Services Committee recently concluded that lack of regulation of private-label mortgage-backed securities (MBS) is to blame for the unsustainable housing bubble that peaked in mid-2006—and consequentially, the economic crisis that ensued when the bubble burst. It is true that the Secondary Mortgage Market Enhancement Act of 1984 largely exempted private-label MBS from securities regulation, however, this Article concludes that lack of regulation of private-label MBS did not cause the unsustainable housing bubble and resulting economic crisis. On the contrary, government interference caused the unsustainable housing bubble and resulting economic crisis through government sponsored entities competing in the MBS marketplace coupled with federal housing policy, particularly the Community Reinvestment Act, which encouraged banks to take undue risk.

I. INTRODUCTION

In the middle of the sixteenth century, the tulip arrived in Western Europe.¹ Detailing the flower’s rise to notoriety, Charles MacKay writes:

The tulip—so named, it is said, from a Turkish word, signifying a turban—was introduced into western Europe about the middle of the sixteenth century. Conrad Gesner, who claims the merit of having brought it into repute,—little dreaming of the commotion it was shortly afterwards to make in the world,—says that he first saw it in the year 1559, in a garden at Augsburg, belonging to the learned Counsellor Herwart, a man very famous in his day for his collection of rare exotics. The bulbs were sent to this gentleman by a friend at Constantinople, where the flower had long been a favourite. In the course of ten or eleven years after this period, tulips were much sought after by the wealthy, especially in Holland and Germany. Rich people at Amsterdam sent for the bulbs direct to Constantinople, and paid the most extravagant prices for them.²

1. CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS 92 (Three Rivers Press 1980) (1841).

2. *Id.*

As the demand for tulips increased so too did their price.³ And as the price increased, “[r]ich people no longer bought the flowers to keep them in their gardens, but to sell them again at cent per cent profit.”⁴ Early investors got rich, and tulips became like “golden bait” hung out before the people.⁵ The rich, the middle class, the poor—they all thought that the passion for tulips would last forever and that investing in tulip bulbs could only result in positive cash returns:

Nobles, citizens, farmers, mechanics, seamen, footmen, maid-servants, even chimney-sweeps and old clotheswomen, dabbled in tulips. People of all grades converted their property into cash, and invested it in flowers. Houses and lands were offered for sale at ruinously low prices, or assigned in payment of bargains made at the tulip-mart. Foreigners became smitten with the same frenzy, and money poured into Holland from all directions.⁶

At the height of the tulip price bubble, a *Semper Augustus* bulb sold for 5,500 florins, the equivalent of more than 172 fat swine.⁷ Eventually, the more prudent realized that the extraordinary prices could not last, and that the bubble must eventually burst.⁸ “It was seen that somebody must lose fearfully in the end.”⁹ “[T]his [conviction] spread, [tulip] prices fell, and never rose again.”¹⁰ Entire fortunes were lost—traded away for a few tulip bulbs which now no person would buy.¹¹

3. *Id.* at 94.

4. *Id.* at 98. A market for the sale of tulip futures was established on the Stock Exchange of Amsterdam. *Id.* at 97. The Dutch are credited with having the first modern financial system, including a securities market. See Christian C. Day, *Paper Conspiracies and the End of All Good Order Perceptions and Speculation in Early Capital Markets*, 1 ENTREPRENEURIAL. BUS. L.J. 283, 285–86 (2006).

5. MACKAY, *supra* note 1, at 97.

6. *Id.* at 97–98.

7. *Id.* at 94–95. To put the price in context, four fat oxen were worth 480 florins, eight fat swine were worth 240 florins, twelve fat sheep were worth 120 florins, two hogsheads of wine were worth 70 florins, four tons of beer were worth 32 florins, two tons of butter were worth 192 florins, 1,000 pounds of cheese were worth 120 florins, a complete bed was worth 100 florins, a suit of clothes was worth 80 florins, and a silver drinking cup was worth 60 florins. *Id.* at 95.

8. *Id.* at 98.

9. *Id.*

10. *Id.*

11. *Id.*; see Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225, 229 (2001) (“[T]he price bubble grew and grew and grew some more, eventually bursting and paupering many of those left holding a position in the relevant ‘asset.’”). But it should be noted that some scholars believe that the pricing of tulips in the seventeenth century was a rational response to their rarity, and that the price swings reported by MacKay are greatly overstated. Day, *supra* note 4, at 288–89 (arguing that “[l]ittle economic dislocation resulted from tulip speculation . . . [and that t]he surviving morality tales stem from the Dutch government’s campaign against such speculation.”); Peter M. Garber,

Economists cite the tulip bubble as the first example of a price bubble,¹² “a financial hysteria in which something . . . is subject to wild price escalation, eventually culminating in a total collapse of prices wiping out those unfortunate enough to have bought at, or held to, the end of the game.”¹³ Though the tulip was the first bubble, it would not be the last.¹⁴ In recent years, the United States witnessed the emergence of yet another price bubble—this time in housing.¹⁵ Constantly increasing prices meant that homes “came to be purchased only for resale after their price had risen.”¹⁶ What distinguished this recent housing bubble from earlier price bubbles was that lenders used mortgage securitization to pool mortgages they originated into private-label mortgage-backed securities (MBS).¹⁷ Lenders packaged these mortgages into a pool, and offered coupons that entitled each holder (an investor) to a share in the cash flows from the underlying mortgages (payments of principal and interest by the borrowers).¹⁸ The proceeds of the sale were then used to originate more mortgages, perpetuating the cycle and further inflating the housing bubble.¹⁹

The availability of easy credit for home purchasers made possible by the added liquidity fueled the housing bubble by increasing demand and consequently increasing housing prices. But these purchasers—many of whom agreed to adjustable rate mortgages (ARMs) or mortgages with low teaser rates that expired—soon found themselves unable to make payments.²⁰ When the resulting foreclosures flooded the market, the

Tulipmania, 97 J. POL. ECON. 535, 558 (1989) (“[T]he bulb speculation was not obvious madness, at least for most of the 1634–37 ‘mania.’”).

12. See Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 382 (2008) (comparing the tulip bubble to the recent housing bubble).

13. Arthur Allen Leff, *The Leff Dictionary of Law: A Fragment*, 94 YALE L.J. 1855, 2216 (1985).

14. The tulip bubble was followed by the South Sea bubble and the Florida land bubble to name just a couple examples. *Id.*

15. See Alan Greenspan, Editorial, *The Roots of the Mortgage Crisis*, WALL ST. J., Dec. 12, 2007, at A19 (likening the housing bubble to the tulip bubble).

16. ROBERT S. MCELVAINE, *THE GREAT DEPRESSION* 44 (1984). His words describing the irrational risk-taking in the run-up to the Great Depression apply equally well today.

17. MARK ZANDI, *FINANCIAL SHOCK* 41–43 (2009).

18. David Abelman, *The Secondary Mortgage Market Enhancement Act*, 14 REAL EST. L.J. 136, 136–37 (1985).

19. *Id.* at 137.

20. Nick Timiraos, *Banks and Investors Face ‘Jumbo’ Threat*, WALL ST. J., Jan. 28, 2009, at C1 (stating that the current subprime delinquency rate exceeds 17%). Payments adjusting upward could be due to adjustable rate mortgages (ARMs) or a balloon payment at the end of the loan. See NATIONAL CREDIT UNION ADMINISTRATION, STATEMENT ON SUBPRIME MORTGAGE LENDING 1 (2007), available at <http://www.ncua.gov/letters/2007/CU/St-SubprimeMortgageLending.pdf>. These non-traditional mortgages are the result of the Alternative Mortgage Transactions Parity Act (AMTPA). Pub. L. No. 97-320, 96 Stat. 1469 (codified at 12 U.S.C. §§ 3801–3806 (2006)). Specifically,

housing bubble burst (increasing supply deflated prices).²¹ With the first wave of foreclosures, home prices fell,²² pushing a second group of homeowners into foreclosure.²³ This second group, historically a bulwark against foreclosure because of their ability to draw upon their equity to refinance, was unable to refinance during the bubble because falling home prices wiped out their equity.²⁴ As this second group of homeowners faced foreclosure, the spiral downward accelerated. Increasing supply caused prices to fall. Falling prices increased supply. The end result is the current economic crisis.

Some in government blame the current economic crisis on a failure to regulate private-label MBS. For example, a newspaper article on the official website of Congressman Barney Frank, chairman of the House Financial Services Committee, hints that Congressman Frank believes that

AMTPA provides that “[i]n order to prevent discrimination against State-chartered depository institutions, and other nonfederally chartered housing creditors, with respect to making, purchasing, and enforcing alternative mortgage transactions, housing creditors may make, purchase, and enforce alternative mortgage transactions. . . .” 12 U.S.C. § 3803(a) (2006). In turn, an “alternative mortgage transaction” is defined as follows:

[A] loan or credit sale secured by an interest in residential real property . . . (A) in which the interest rate or finance charge may be adjusted or renegotiated; (B) involving a fixed-rate, but which implicitly permits rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule; or (C) involving any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions, including without limitation, transactions that involve the sharing of equity or appreciation

12 U.S.C. § 3802(1) (2006).

In short, the AMPTA allows for adjustable rate mortgages or mortgages with balloon payments. Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 419 (1994). The act also preempted state usury law. States could opt out, but only sixteen did so. *Id.* at 399–400.

21. See ZANDI, *supra* note 17, at 74–75.

22. See U.S. CENSUS BUREAU, *MEDIAN AND AVERAGE SALES PRICES OF NEW HOMES SOLD IN THE UNITED STATES 1–2* (2009), available at <http://www.census.gov/const/uspriceann.pdf> (stating that the median value of new homes rose from \$246,500 to \$247,900 between 2006 to 2007); see also Kelly Evans, *Home Prices, Sentiment Keep Sliding*, WALL ST. J., Jan. 28, 2009, at A3 (stating that the median home sale price was down by 15% from the previous year). In the next two years, it is estimated that median home values will drop an additional 20% in some markets. See James R. Hagerty, *Price Cuts Spur Home Sales*, WALL ST. J., Jan. 27, 2009, at A1 (indicating drops of at least twenty percentage points in the two years ending in third quarter 2010 in Miami, Las Vegas, Los Angeles, Phoenix, and Washington).

23. See ZANDI, *supra* note 17, at 169.

24. *Id.* at 169–70. That is to say, homeowner's mortgages were “underwater.” A mortgage is “underwater” where the homeowner owes more on the mortgage than his or her home is worth. President Barack Obama, Remarks at Dobson High School in Mesa, Ariz. on the Home Mortgage Crisis (Feb. 19, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-mortgage-crisis/.

the private sector (i.e., private-label MBS) triggered the economic crisis:²⁵

During [the bubble years] . . . private investment banks . . . dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages. . . . Fueled by low interest rates and cheap credit, home prices between 2001 and 2007 galloped beyond anything ever seen, and that fueled demand for mortgage-backed securities, the technical term for mortgages that are sold to a company, usually an investment bank, which then pools and sells them into the secondary mortgage market.²⁶

This attack on private-label MBS as the cause of the current economic crisis was repeated in public statements. For example, in a *Financial Times* op-ed, Congressman Frank decried “widespread securitisation” and “securities based on bad loans—often originated by unregulated institutions.”²⁷ According to the Financial Services Committee, or at least

25. See David Goldstein & Kevin G. Hall, *Private Sector Loans, Not Fannie or Freddie, Triggered Crisis*, MCCLATCHY NEWSPAPERS, Oct. 12, 2008, <http://www.mcclatchydc.com/251/story/53802.html>. This article also appears in print at McClatchy Newspapers, *Data Prove Push for Affordable Housing Did Not Instigate Crisis*, AUGUSTA CHRON., Oct. 12, 2008, at A4.

26. Goldstein & Hall, *supra* note 25.

27. “I believe that the economic difficulties we face are primarily the result of a lack of adequate regulation of key aspects of our financial system . . . including non-bank mortgage originators and unregulated dealers in [private-label MBS].” Letter from Congressman Barney Frank to Constituents About the Economic Crisis (Oct. 11, 2008), *available at* <http://www.house.gov/frank/docs/08-11-08-economic-crisis-letter.html> [hereinafter Frank Letter to Constituents]. Congressman Frank further argues that “[t]he problem is this, their failure to regulate sensibly has so endangered the economy and so burdened it with bad stuff that it’s become very vulnerable.” Beth Healy, *Frank: Lack of Government Regulation Led to Troubles Plaguing Wall Street*, BOSTON GLOBE, Sept. 18, 2008, at E1. The current administration is echoing Frank’s calls for greater regulation, making clear that “financial instruments now mostly unsupervised [e.g., private-label MBS] must be swept back under a larger regulatory umbrella, [and the White House will likely have] the SEC become more involved in supervising the underwriting standards of securities that are backed by mortgages.” Stephen Labaton, *Obama Plans Fast Action to Tighten Financial Rules*, N.Y. TIMES, Jan. 25, 2009, at A1. President Obama stated on March 6, 2009, that “the credit crisis . . . began when some banks bundled and sold mortgages in complex ways to hide risk and avoid responsibility.” President Barack Obama, Remarks to Small Business Owners, Community Leaders, and Members of Congress at the East Room of the White House (Mar. 16, 2009). “[S]ecuritization . . . is important [and] multipl[ies] our use of money.” Press Release, Congressman Barney Frank, Chairman Frank Holds News Conference to Discuss the Committee Agenda and Priorities for the Coming Year (Feb. 3, 2009), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/press020309.shtml. Some have argued that by attacking private-label MBS, Congressman Frank is able to strengthen GSE MBS over which he has control:

its Chairman, greater regulation of private-label MBS is needed. The Committee, instrumental in the formulation and passage of the regulatory behemoth, the 2002 Sarbanes-Oxley Act (Sarbanes-Oxley), will play a central role in any decisions to further regulate private-label MBS.²⁸ The Financial Services Committee may take several approaches to greater regulation of private-label MBS, including legislatively weakening the 1984 Secondary Mortgage Market Enhancement Act (SMMEA).²⁹ SMMEA exempted private-label MBS from certain securities laws, and thus “enable[d] private issuers of mortgage securities to compete more effectively with government-related agencies . . . by removing some of the legal impediments to issuing private mortgage-backed securities.”³⁰ However, greater regulation of private-label MBS is not the answer.

This Article defends private-label MBS against calls for greater regulation.³¹ Part II provides a primer on private label MBS. Part III

In January of last year, Mr. Frank also noted one reason he liked Fannie [Mae] and Freddie [Mac] so much: They were subject to his political direction. Contrasting Fannie and Freddie with private-sector mortgage financiers, he noted, “I can ask Fannie Mae and Freddie Mac to show forbearance” in a housing crisis. That is to say, because Fannie and Freddie are political creatures, Mr. Frank believed they would do his bidding.

Editorial, *Fannie Mae’s Patron Saint*, WALL ST. J., Sept. 9, 2008, at A24; see also Editorial, *Barney’s Rubble*, WALL ST. J., Sept. 17, 2008, at A26; Kara Scannell, *Frank Backs Regulator for Systemic Risk*, WALL ST. J., Feb. 4, 2009, at C3. Barney Frank, *Why America Needs a Little Less Laissez-Faire*, FIN. TIMES, Jan. 14, 2008, at 11.

28. See Brent J. Horton, *How Corporate Lawyers Escaped Sarbanes Oxley: Disparate Treatment in the Legislative Process*, 60 S.C. L. REV. 149, 170–75 (2008).

29. The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984). In addition, any attack on SMMEA would have to address also the companion Real Estate Mortgage Investment Conduit provisions of the 1986 Tax Reform Act [hereinafter REMIC provisions of the Tax Code], Pub. L. No. 99-514, §§ 671–675, 100 Stat. 2085, 2308–20 (1986). (For purposes of simplicity, SMMEA and REMIC provisions of the Tax Code will occasionally be referred to collectively as the “Reagan era legislation.”) This can be accomplished via a “salami slicing” approach; that is to say, several pieces of regulation slowly chipping away at SMMEA and REMIC. The term “salami-slicing” appears to have been coined by *Time Magazine* in 1968, talking about legislative assistant to Lyndon Johnson, Wilbur Cohen:

Short (5 ft. 6 in.) and portly, Cohen has a keen sense of the possible. With an eye on the generation ahead, he has always been willing, if necessary, to sacrifice cherished legislative objectives so long as he gets at least a small piece of what he wants. This morsel, Cohen believes, can be fattened a little year by year until eventually the legislation resembles what he wanted in the first place. An aide calls his technique “salami slicing.” One slice does not amount to much, but eventually there is enough for a sandwich.

The Salami Slicer, TIME, Apr. 5, 1968.

30. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1385 (1991).

31. Curiously, despite the prominence of private-label MBS in the national debate over how best to recover from the present economic crisis, private-label MBS is a topic rarely discussed in academic literature. For articles with the most comprehensive discussions of MBS, see generally

compares GSE MBS. Part IV asks whether lack of regulation of private-label MBS encouraged risky decision-making that pushed home prices above values, resulting in an unsustainable housing bubble,³²—as claimed by some politicians. Part IV concludes that lack of regulation of private-label MBS was not to blame. In fact, the 1984 removal of regulatory impediments to the issuance of private-label MBS did not encourage risky decision-making, but did “enable private issuers of mortgage securities to compete more effectively with government-related agencies.”³³ Moreover, greater regulation of private-label MBS will not solve the problem, and will likely be counter-productive.

This Article next argues at Part V that the government-imposed monopoly on the securitization of less risky conforming loans by Fannie Mae and Freddie Mac (government sponsored entities or GSEs) “forced”³⁴ private-label issuers to securitize risky non-conforming loans.³⁵

Andrew R. Berman, “Once a Mortgage, Always a Mortgage”—*The Use (and Misuse) of Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76 (2005); Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497 (1989); John C. Cody, Comment, *The Dysfunctional “Family Resemblance” Test: After Reves v. Ernst & Young, When are Mortgage Notes “Securities?”*, 42 BUFF. L. REV. 761 (1994); Susan M. Golden, Comment, *Collateralized Mortgage Obligations: Probing The Limits of National Bank Powers Under the Glass-Steagall Act*, 36 CATH. U.L. REV. 1025 (1987). For articles with more tangential discussions of MBS, see generally Ann M. Burkhart, *Real Estate Practice in the Twenty-First Century*, 72 MO. L. REV. 1031 (2007); Richard S. Millerick, *Federal Income Tax Aspects of Stripped Mortgage-Backed Securities*, 12 VA. TAX REV. 219 (1992); 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); Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77 (2008); Judah Skoff, *Developments In Banking And Financial Law*, 25 ANN. REV. BANKING & FIN. L. 146 (2006).

32. See Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 803 (2002) (stating that excessive risk-taking pushes prices above values and results in price bubbles); Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 410 (2005) (stating that effective legislation must combat “irrational actions such as investors engaging in herd behavior”); Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling? – Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 997–99 (1992) (stating that effective legislation must combat irrational actions).

33. Shenker & Colletta, *supra* note 30.

34. I say “forced” because private-label MBS issuers are “not in a position to compete head on with GSEs.” David Reiss, *The Federal Government’s Implied Guarantee of Fannie Mae And Freddie Mac’s Obligations: Uncle Sam Will Pick up the Tab*, 42 GA. L. REV. 1019, 1033 (2008).

35. Non-conforming mortgages are sometimes confused with subprime mortgages. While they share many characteristics, subprime mortgages means loans with characteristics such as high payment-to-income or loan-to-value ratios. Raymond Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271, 287 (2008). There are other characteristics that can be taken into account. The term “subprime borrower” can refer to those “who do not qualify for prime interest rates because they exhibit one or more of the

Compounding this government-imposed risk-taking was the Community Reinvestment Act (CRA)³⁶ and federal housing policy that pressured private lenders to make risky loans.³⁷ For too long the CRA provided private-label issuers with “the excuse and the regulatory cover” to make risk-laden decisions.³⁸ As argued by Professors Jonathan R. Macey and Geoffrey Miller, the effect of the CRA is to “reduce depository institution safety and soundness,” encourage “‘more flexible’ lending criteria when making CRA loans,” and “encourage ‘high loan-to-value-ratio’ mortgage loans in local communities, which means nothing other than that the depository institution should incur greater risks.”³⁹ Offering and securitizing these risky mortgages helped create the unsustainable housing bubble. However, it was not because of a lack of regulation, but rather too much government regulation. Therefore, given Congress’ track record of regulating private-label MBS, this Article concludes in Part VII that the worst approach is more government management of private industry through greater regulation—ironically, the approach currently being encouraged by Congress, and taken by the Treasury.

II. MORTGAGE SECURITIZATION

A. *Types of Private-Label MBS*⁴⁰

A mortgage is a loan that finances the purchase of a home.⁴¹ “The lender holds the mortgage note in which the borrower agrees to repay the loan with the real estate serving as security.”⁴² As discussed previously, the

following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios.” *Id.* (quoting *Mortgage Market Turmoil: Causes and Consequences: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. 2 (2007) (testimony of Roger T. Cole, Director, Division of Banking Supervision and Regulation)).

36. 12 U.S.C.A. §§ 2901–08 (West 2009).

37. Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.

38. *See infra* Part V.B.

39. Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 320 (1993) (quoting Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act, 54 Fed. Reg. 13,742, 13,744 (1989)).

40. Part II is limited to a discussion of private-label MBS. GSE MBS are discussed in Part III.

41. 12 U.S.C.A. § 1451(d) (West 2009). The “mortgagor” is the “borrower,” and this Article will use “mortgagor” and “borrower” interchangeably. BLACK’S LAW DICTIONARY 1034 (8th ed. 2004). Likewise, the terms “mortgagee” and “lender” are synonymous and will be used interchangeably. *Id.*

42. Cody, *supra* note 31, at 763–64 (citing FRANK J. FABOZZI & FRANCO MODIGLIANI, MORTGAGE AND MORTGAGE-BACKED SECURITIES MARKETS 41–44 (1992)). This Article will use a basic definition of mortgage, based upon the fixed-rate thirty-year mortgage. However, it should be noted that there are variations on the traditional model, such as the adjustable rate mortgage, or mortgages with a large “balloon” payment at the end of the mortgage term. Austan Goolsbee, “Irresponsible” Mortgages Have Opened Doors to Many of the Excluded, N.Y. TIMES, Mar. 29,

lender may simply keep the mortgage as is and collect the payments as they come due.⁴³ Alternatively, the lender may decide to securitize the mortgage or sell it to a third party that specializes in securitizations.⁴⁴

There is no one way to securitize a mortgage. Part I mentions the simplest kind of private-label MBS, a mortgage pass-through.⁴⁵ In a mortgage pass-through, the lender packages an individual mortgage with others into a pool, and offers coupons that entitle each investor to a share in the payments of principal and interest from the underlying mortgages.⁴⁶ In this simple case, the originator of the mortgages and the issuer of the private-label MBS are one and the same.⁴⁷ However, some private-label MBS issuers do not originate the underlying mortgages, but rather they securitize mortgages originated by others.⁴⁸ These non-originators or “private conduit[s] specialize in acquiring a large ‘warehouse’ of mortgages and then selecting mortgages from that inventory to pool together into securities offerings.”⁴⁹ The prevalence of conduits increased following the passage of legislation providing them with favorable tax treatment.⁵⁰ A large inventory of mortgages—either under an originator or a conduit—allows for more complex private-label MBS known as collateralized mortgage obligations (CMO).⁵¹ The difference between a pass-through and a CMO is best described as follows:

[CMO] arrangements are similar to pass-through arrangements in that the economic substance of both types of

2007, at C3.

43. *See infra* note 45.

44. *See infra* note 45.

45. This simple securitization is called a “pass-through”—for obvious reasons—monthly payments are passed through the lender, from mortgagor to investor. JOSEPH HU, BASICS OF MORTGAGE BACKED SECURITIES 15 (1997). Distinguishable from pass-throughs are mortgage-backed bonds:

Mortgage-backed bonds, like corporate bonds, are general obligations of the issuer, but they are collateralized by mortgages or mortgage securities. Unlike mortgage pass-through securities, however, in which investors receive payments of principal and interest on a monthly basis as it is paid by the mortgagors, a mortgage-backed bond will typically pay interest to investors semi-annually from the issuer’s general funds, and pay principal at maturity.

Pittman, *supra* note 31, at 500.

46. *See supra* note 18 and accompanying text; *see also* Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1, 19 (2008) (citing S. REP. NO. 98-293, at 4 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2809, 2810).

47. *Anchor Sav. Bank*, 81 Fed. Cl. at 20.

48. *Id.* (stating that the originator may sell the mortgage to a private conduit).

49. *Id.*; *see also* FRANK J. FABOZZI & DAVID YUEN, MANAGING MBS PORTFOLIOS 45 (1998).

50. *See infra* Part IV.C.

51. Rebecca Curnin, Note, *The NASD’s Fair Sales Practice Rules: An Argument for Their Application to Government Securities Transactions, and for the Consideration of Some New Rules in the Mortgage Market*, 1993 COLUM. BUS. L. REV. 191, 200 (1993).

securitizations is the sale of cash flows from assets to investors. However, since a [CMO] arrangement involves separate debt obligations of an issuer, the cash flows from assets can be carved up in much more sophisticated and creative ways. In a pass-through trust arrangement, investors must generally share the cash flows pro rata.⁵²

To create a CMO “issuers take the interest and principal payments from underlying collateral and reallocate them into any number of separate bonds, [each having] its own coupon, maturity and particular risk characteristics.”⁵³ Each of these individual bonds is known as a tranche.⁵⁴ Tranche is French for slice, or “a division or portion of a pool or whole.” In the private-label MBS context, tranche refers to an “issue of bonds derived from a pooling of like obligations.”⁵⁵ The purpose of a tranche is to mitigate risk.⁵⁶ For private-label MBS, one form of risk is prepayment risk, or uncertainty about “how long the security would be outstanding.”⁵⁷ Unlike a non-callable bond, a private-label MBS can be paid off at any time.⁵⁸ An example of prepayment risk is as follows:

[An] investor in a \$100,000, 8.125% 30-year FHA-insured mortgage knows . . . that as long as the loan is outstanding,

52. Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests*, 2 FLA. TAX REV. 149, 154–55 (1994).

53. Curnin, *supra* note 51, at 200. There is a difference between GSE and private-label CMOs. An agency CMO is formed from pools of pass-through securities. FABOZZI & YUEN, *supra* note 49, at 84–85. The first agency CMO was issued by the Federal Home Loan Mortgage Corporation in 1983 and consisted of three sequential maturity classes. *Id.* In contrast, a private-label CMO is a MBS pooled from a warehouse of mortgages that have not been securitized as pass-throughs. *Id.*

54. Curnin, *supra* note 51, at 200.

55. Merriam-Webster.com, Definition of Tranche, <http://www.merriam-webster.com/dictionary/tranche> (last visited July 10, 2009).

56. FABOZZI & YUEN, *supra* note 49, at 2.

57. *Id.*

58. *Anchor Sav. Bank, FSB v. United States*, 81 Fed. Cl. 1, 17 n.13. There is generally no question that a mortgage can be prepaid. However, there is a question whether the lender can charge a prepayment penalty. The answer is quite complicated and depends upon whether the lender is federally chartered or state chartered, and whether the loan is fixed, has a variable rate, or includes a balloon payment. *See, e.g., Glukowsky v. Equity One, Inc.*, 848 A.2d 747 (N.J. 2004) (holding that prior regulation by the Office of Thrift Supervision authorizing state housing lenders to charge prepayment penalties in alternative mortgage transactions did not exceed authority delegated by Congress in Alternative Mortgage Transaction Parity Act and that the regulation preempted state laws). 12 C.F.R. § 560.34 (1994) states that:

Any prepayment on a real estate loan must be applied directly to reduce the principal balance on the loan unless the loan contract or the borrower specifies otherwise. Subject to the terms of the loan contract, a Federal savings association may impose a fee for any prepayment of a loan.

interest will be received [at 8.125%] and the principal will be repaid at the scheduled date each month; then at the end of the 30 years, the investor would have received \$100,000 in principal payments. What the investor does not know—the uncertainty—is for how long the loan will be outstanding⁵⁹

If the interest rates drop and the underlying mortgages refinance, the mortgages are prepaid.⁶⁰ The investor receives her principal back but loses her future eight percent interest payments. In other words, “[w]hen homeowners prepay on their loans and principal is returned early, the investment effectively dries up (much like a corporate bond that has been “called” by the issuer), [and the] investor must then reinvest in the prevailing lower interest rate environment, therefore realizing a relatively lower total return.”⁶¹ This problem is solved by investing in a tranche that has “seniority or priority relative to the other tranches in the CMO structure [because] [t]he priority level can determine the timing of the receipt of cash flow from the collateral.”⁶² The first tranche is entitled to be paid off first, then the second tranche, and so on.⁶³

B. Are Private-Label MBS Really Securities?

Are private-label MBS really securities?⁶⁴ To answer this question, one must distinguish the holder of a simple mortgage from an investor who holds a private-label MBS entitling her to cash flows from hundreds of mortgages. Section 2(1) of the 1933 Securities Act⁶⁵ defines a “security” as

59. FABOZZI & YUEN, *supra* note 49, at 14.

60. *Id.* at 109.

61. Curnin, *supra* note 51, at 202.

62. *Id.* at 200.

63. FABOZZI & YUEN, *supra* note 49, at 45 (“The basic principal is that redirecting cash flows (interest and principal) to different bond classes, called *tranches*, mitigates different forms of prepayment risk.”); Kathleen C. Engel & Patricia A. McCoy, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2047 (2007) (“In a feature known as a ‘waterfall,’ the senior tranche is paid off before any other tranche. Once the senior tranche is paid off, the next tranche moves to the head of the line for principal payments until all of the tranches are retired.”). Of course, the lower tranches are compensated for the greater risk via higher coupon rates. *In re Countrywide Fin. Corp. Secs. Litig.*, 588 F. Supp. 2d 1132, 1152 (C.D. Cal. 2008); *see also In re Oakwood Homes*, 449 F.3d 588, 613 (3d Cir 2006).

The tranches are paid in descending order—with each subsequent tranche yielding higher interest to compensate for the increased risk that the last dollar will be taken by a higher tranche. Thus, the lowest tranche (the “residual interest”) takes the first loss, the next level takes the next loss, and so on until the highest tranche (the “supersenior tranche”) takes the last loss.

In re Countrywide Fin. Corp. Secs. Litig., 588 F. Supp. 2d at 1152.

64. *See generally* Cody, *supra* note 31 (asking when a mortgage note is a security).

65. 15 U.S.C. § 77 (2006). The impetus for the Securities Act was the Wall Street excesses of

follows:

When used in this [title], *unless the context otherwise requires*—[the] term “security” means any note, stock, treasury stock, security future, *bond*, debenture, *evidence of indebtedness*, certificate of interest or participation in any profit-sharing agreement, *collateral-trust certificate*, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, *or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in*, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, *any of the foregoing*.⁶⁶

Emphasized are those portions relevant to the discussion of private-label MBS.⁶⁷ However, the foregoing is a broad definition, and applying it to determine if a private-label MBS is a security can be difficult.⁶⁸ As a starting point, a mortgage note is like any other promissory note, and a plain reading of Securities Act § 2(1) would include a private-label MBS as a “certificate of interest or participation in” a note.⁶⁹ But, § 2(1) also contains troublesome language: “unless the context otherwise requires.”⁷⁰ Tackling this language, the Supreme Court in *Reves v. Ernst & Young* analyzed “whether certain demand notes issued by the Farmers Cooperative of Arkansas and Oklahoma (Co-Op) are ‘securities’ within the meaning of § 3(a)(10) of the Securities Exchange Act of 1934.”⁷¹ The Co-

the 1920s causing the Great Depression. James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1960). I am always amused by the story that the Securities Act was written by Felix Frankfurter and others over a weekend and a case of scotch. See Horton, *supra* note 28, at 183 (citing Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1227 (1999)).

66. 15 U.S.C. § 77b(a)(1) (2006) (emphasis added).

67. KENNETH G. LORE, MORTGAGE-BACKED SECURITIES 4-2 (1985).

68. See *Zolfaghari v. Sheikholeslami*, 943 F.2d 451, 454–55 (4th Cir. 1991) (discussing whether an MBS is a security).

69. 15 U.S.C. § 77b(a)(1); see *Exch. Nat’l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138–39 (2d Cir. 1976) (holding that in certain instances, notes are securities within the provisions of federal securities law).

70. 15 U.S.C. § 77b(a) (2006).

71. *Reves v. Ernst & Young*, 494 U.S. 56, 58 (1990). “We have consistently held that “[t]he definition of a security in § 3(a)(10) of the 1934 Act, . . . is virtually identical [to the definition in the Securities Act of 1933] and, for present purposes, the coverage of the two Acts may be

Op was an agricultural cooperative that raised money to support its general business operations via promissory notes payable on demand by the holder.⁷² The Co-Op had gone bankrupt, and more than 1,600 people held notes worth \$10 million.⁷³ If the demand notes were deemed securities, then the investors could seek monetary damages under the antifraud provisions of the securities laws against Ernst & Young, the firm that had audited the Co-Op's financial statements.⁷⁴

The Court found that the demand notes were securities,⁷⁵ observing that “Congress painted with a broad brush” when defining securities, and recognizing “the virtually limitless scope of human ingenuity, especially in the creation of countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”⁷⁶ As such, the Court set down the following test, “[a] note is *presumed* to be a ‘security,’ and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument [that are notes, but not securities].”⁷⁷ Those categories include the notes delivered in consumer financing, the short-term notes secured by a lien on small business assets, the short-term notes secured by an assignment of accounts receivable, and important for our purposes, the *notes secured by a mortgage on a home*.⁷⁸ As such, the Court—at least in dicta—found that a note secured by a mortgage on a home is not a security.⁷⁹

However, a private-label MBS is more than a note secured by a

considered the same.” *Id.* at 61 n.1 (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975)).

72. *Id.* at 58.

73. *Id.* at 59.

74. *Id.* Petitioners alleged, *inter alia*, that Arthur Young had intentionally failed to follow generally accepted accounting principles in its audit, specifically with respect to the valuation of one of the Co-Op's major assets, a gasohol plant. Petitioners claimed that Arthur Young violated these principles in an effort to inflate the assets and net worth of the Co-Op. Petitioners maintained that, had Arthur Young properly treated the plant in its audits, they would not have purchased demand notes because the Co-Op's insolvency would have been apparent. On the basis of these allegations, petitioners claimed that Arthur Young had violated the antifraud provisions of the 1934 Act. *Id.*

75. *Id.* at 70.

76. *Id.* at 60–61 (internal quotation marks omitted).

77. *Id.* at 67 (emphasis added).

78. *Id.* at 65.

79. In holding that the demand notes in question were securities, the Court observed that demand notes are not like any of the enumerated categories of instrument and thus fell back upon the traditional factors set forth in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946): “[t]he Co-Op sold the notes in an effort to raise capital for its general business operations, and purchasers bought them in order to earn a profit;” there was “a plan of distribution, the Co-Op offered the notes over an extended period to its 23,000 members, as well as to nonmembers, and more than 1,600 people held notes when the Co-Op filed for bankruptcy;” further “advertisements for the notes here characterized them as ‘investments;’” and finally, “there were no risk-reducing factor to suggest that these instruments are not in fact securities. . . the notes are uncollateralized and uninsured.” *Reves*, 494 U.S. at 61.

mortgage.⁸⁰ The subsequent pooling and selling of participation interests in the mortgage convert the note into a security subject to federal law because it is fundamentally an investment vehicle.⁸¹ In *Zolfaghari v. Sheikholeslami*,⁸² the Fourth Circuit overturned the lower court's finding that private-label MBS were not securities, stating:

A note secured by a mortgage on a single home is typically not a security because the return on investment therefrom is not derived from the entrepreneurial or managerial efforts of others. However, participation interests in a managed pool of mortgage notes are securities Such interests in amalgamated mortgage notes are securities because any profits realized are derived from the managerial efforts of those who run the pool and make such decisions as determining which mortgages shall be in the pool, how the individual notes will be serviced and managed, and other fund decisions.⁸³

Likewise, a mortgage pass-through is a security. For example:

[A] two-year note an insurance company receives for its \$10 million loan to a corporation is almost certainly not a security. But, if the insurance company then causes the \$10 million note to be divided into 10,000 notes each of \$1,000 face value which are sold to the public, those 10,000 notes are just as certainly securities. Indeed, the \$10 million note would be a security when owned by the insurance company if the insurance company had, at the time the insurance company was irrevocably committed to make the loan, intended to distribute the 10,000 notes to the public.⁸⁴

Thus, to answer the question first posed: are private-label MBS really

80. LORE, *supra* note 67, at 4–3.

81. *Id.* at 4–10.

82. 943 F.2d 451 (4th Cir. 1991).

83. *Id.* at 455 (citations omitted).

84. ARNOLD S. JACOBS, 5B LITIGATION AND PRACTICE UNDER RULE 10B-5 § 38.03[dd][ii] at 2-386 (release # 26, 6/1991), *cited in* *Realtex Indus., Inc. v. Nomura Secs.*, 939 F. Supp. 572, 580–81 (N.D. Ohio 1996). The *Realtex* court notes:

Interestingly, at least two courts have held that under certain circumstances, a fractional undivided equity interest in a pool of mortgages—which is what the participation certificates were intended to be—is *not* a security for purposes of Section 10(b)/Rule 10b-5 claims. . . . Without question, however, the leading legal experts concur that mortgage-backed “securitized” instruments sold as investments should be regarded as “securities,” which fall under the protection of the federal securities acts.

Realtex Indus., 939 F. Supp. at 581 n.6 (citations omitted).

securities? Yes, because they are more than notes secured by mortgage; they are a participation interest in the cash flows from a pool of such notes, the profitability of which is made possible by the efforts of others.⁸⁵

C. *Why Securitize Mortgages?*

Some argue that the MBS is “the supreme postwar financial innovation on Wall Street.”⁸⁶ Certainly it dominated the past decade, allowing a stream of mortgage payments to be pooled with other mortgage payments, and allowing bankers to sell slices of that “cash flow to investors who provide fresh funds for still more mortgage lending.”⁸⁷

Before the advent of private-label MBS, as persons deposited cash in a bank, the bank used that cash to originate mortgages, and held those mortgages as an investment (the “originate and hold” model).⁸⁸ Thus, a bank would use deposits from Aaron, Bruce, Cynthia, and Dave (A, B, C, and D, respectively) to provide a mortgage to Zed as follows:

A, B, C, and D each deposit \$10,000. The bank now has \$40,000. The bank receives a request from Zed (Z) for a mortgage, and given Z’s outstanding credit record, the bank agrees. The bank provides Z with a \$40,000 mortgage at eight percent (8%) per annum over thirty years. Over the course of the loan, the bank is repaid the principal and earns \$65,662.10 in interest.

The problem under the originate and hold model was that the deposits limited the amount of mortgages that could be originated by the bank.⁸⁹ In the above example, just one mortgage to Z could be originated. Other contenders—Zachary, Zara, Zena, and Zuzu (Z¹, Z², Z³, and Z⁴, respectively)—each of whom had less stellar credit, were out of luck. Today, lenders have the option to securitize the mortgages that they originated and sell private-label MBS on the secondary market, which provides the bank with more liquidity (cash on hand) to facilitate the origination of still more mortgages.⁹⁰ Thus, in the example above, the bank could use the deposits of A, B, C, and D to offer mortgages to Z, as well as Z¹, Z², Z³, Z⁴ . . . the only limit is demand.⁹¹ In short, the primary

85. *Zolfaghari*, 943 F.2d at 455.

86. Christopher Farrell et al., *How Wall Street Is Driving the Mortgage Market*, BUS. WK., May 4, 1987, at 108.

87. *Id.*

88. *The Housing Decline: The Extent of the Problem and Potential Remedies*, Hearing Before the S. Comm. on Fin., 109th Cong. (2007) (testimony of Michael Decker, Senior Managing Dir., Research & Pub. Policy, Secs. Indus. & Fin. Markets Assn.) [hereinafter Decker Statement].

89. *Id.*

90. *Id.*

91. As such, the mortgage business has evolved from individual local banks making loans

advantage of mortgage securitization is an influx of liquidity to lenders from those purchasing the private-label MBS, thus, allowing lenders to originate more mortgages.⁹² Securitization is responsible for “pumping trillions of dollars into the mortgage market,”⁹³ and “supplying more mortgage credit . . . than would have ever been possible under the old ‘originate and hold’ model.”⁹⁴

III. THE DEVELOPMENT OF GSE MBS

Part II.C described the principal advantages of mortgage securitization: it provides greater liquidity and allows lenders to originate more mortgages and by extension, creates more homeownership. Indeed, one of the goals of every president since Franklin Delano Roosevelt has been to increase homeownership.⁹⁵ For example, “President Franklin Roosevelt, in his address to the United States Savings and Loan League in 1942 stated, ‘[A] nation of home owners, of people who own a real share in their own land, is unconquerable.’”⁹⁶ President Ronald Reagan stated, “I firmly believe that the opportunity to own a home is part of the American dream,” and went on to quote Walt Whitman: “the final culmination of this vast and varied republic will be the production and perennial establishment of millions of comfortable city homesteads . . . healthy and independent, single separate ownership, fee simple, life in them complete but cheap, within reach of all.”⁹⁷ A decade later, George H.W. Bush stated, “I believe that those on welfare, what they really want is a piece of the American dream: homeownership, a good job, opportunities for their children, and strong, loving families.”⁹⁸ And thereafter, Bill Clinton stated that home ownership is “an essential part of the American dream we’re working hard

from its customers’ deposits to one “dominated by securitization.” *Id.*

92. *Id.*

93. Zachary A. Goldfarb & Alec Klein, *The Bubble: How Homeowners’ Missed Mortgage Payments Set off Widespread Problems and Woke up the Fed*, WASH. POST, June 16, 2008, at A1.

94. Decker Statement, *supra* note 88.

95. See Leon H. Keyserling, *The Minimum Wage and the Wagner Act*, in *THE MAKING OF THE NEW DEAL 195, 199* (Katie Louchheim ed., 1983) (noting that the Housing Act of 1949 determined it to be the “right of every family to [have] a decent home”). The government “encourage[s] home ownership on the theory that the man who owns a home is a better citizen than one who does not.” Henry E. Hoagland, *The Relation of the Work of the Federal Home Loan Bank Board to Home Security and Betterment*, 16 *PROC. OF THE ACAD. OF POL. SCI.* 45, 46 (1935); see also Michael J. Lea, *Housing and the Capital Markets*, in *BUILDING FOUNDATIONS: HOUSING AND FEDERAL POLICY* 188 (1990).

96. Forrester, *supra* note 20, at 374 n.1 (quoting N.Y. TIMES, Nov. 17, 1942, at 35).

97. President Ronald Reagan, Remarks at the Midyear Meeting of the National Association of Realtors (May 10, 1984), available at <http://www.reagan.utexas.edu/archives/speeches/1984/51084d.htm> (last visited July 10, 2009).

98. Remarks on Arrival in Appleton, Wisconsin, 1992–93 *PUB. PAPERS* 1188, 1188 (July 27, 1992).

to restore.”⁹⁹

The only variation from administration to administration is the plan for reaching the goal.¹⁰⁰ In the aftermath of the Great Depression—during the New Deal—the government took on a greater role in encouraging home ownership through the creation of federal agencies.¹⁰¹ In 1934, the National Housing Act (NHA) was passed,¹⁰² establishing the Federal Housing Administration (FHA).¹⁰³ In 1938, the FHA chartered the Federal National Mortgage Association (FNMA or Fannie Mae).¹⁰⁴ “to help bolster the mortgage market under Roosevelt’s New Deal.”¹⁰⁵ Congress tasked Fannie Mae with:

[E]stablish[ing] secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible,

99. Radio Address to the Nation on the Economic Plan, 29 WEEKLY COMP. PRES. DOC. 331, 332 (Feb. 27, 1993).

100. Lea, *supra* note 95, at 188.

101. *Id.* The evolution to encouraging home ownership sprung from the more pressing goal of preventing home foreclosures; during the Great Depression, the concern was with preventing those Americans that owned homes from losing them. *See* Hoagland, *supra* note 95, at 46 (“As soon, therefore, as large numbers of people actually suffered the loss of their homes and far larger numbers saw the specter of foreclosure in every contact with their heavy burdens of debt, the federal government began to consider ways and means of saving the American home.”). Many homeowners had very little—if any—equity, and correspondingly high mortgage payments. *See id.* at 45. Further, many homeowners were unemployed and unable to make those mortgage payments. *See id.* at 46. The solution was for the government to purchase the mortgages from the lending institutions holding them. *See id.* “The Home Owners’ Loan Act passed in June 1933 allowed creditors to exchange mortgages they were owed for government bonds instead of foreclosing.” Keyserling, *supra* note 95, at 197 n.1.

102. National Housing Act of 1934, codified as amended at 12 U.S.C. §§ 1701–1735 (West 2009). As one commentator stated:

It was the National Housing Act of 1934, . . . that offered an acceptable formula for an immediate expansion of private mortgage credit. In the congressional hearings on the act, it was made plain enough that the major participants in the program were expected to be, not the savings and loan associations, but the banks and mortgage and insurance companies. . . . Safer lending policies would be achieved, not by subjecting mortgage institutions to direct federal control, but by attaching requirements to the offer of government insurance of new commitments. Since private capital lacked sufficient confidence to seek investment unaided, a sufficient public offer of underwriting could expect, at least for the time being, to bring a substantial part of new investment within the reach of public control.

David M. French, *The Contest for a National System of Home-Mortgage Finance*, 35 AM. POL. SCI. REV. 53, 62 (1941) (internal citation omitted).

103. 12 U.S.C. § 1702 (2006). Power over the Federal Housing Administration was delegated from the president to the Secretary of Housing and Urban Development. 42 U.S.C. § 3534 (2006) (“[T]here are hereby transferred to and vested in the Secretary all of the functions, powers, and duties . . . of the Federal Housing Administration.”).

104. 12 U.S.C. § 1716 (2006); *see* Cody, *supra* note 31, at 765–66.

105. Andrew Ross Sorkin, *And They Could Call It Frannie*, N.Y. TIMES, Sept. 2, 2008, at C1.

and to authorize such facilities to (1) provide stability in the secondary market for residential mortgages; [by] provid[ing] ongoing assistance . . . by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing¹⁰⁶

Originally, the primary goal of Fannie Mae was to purchase on the secondary market recently-issued mortgages, and provide originating banks with liquidity (cash on hand) to make further mortgages.¹⁰⁷ At first, the mortgages purchased by Fannie Mae were held for its own account, not securitized and sold.¹⁰⁸ But when the Housing and Urban Development (HUD) Act of 1968 spun Fannie Mae into a federally sponsored quasi-governmental corporation,¹⁰⁹ the new “quasi-governmental”¹¹⁰ Fannie Mae had a new power: issuing GSE MBS. Section 1719(d) of the HUD Act provides Fannie Mae with this power:

(d) To provide a greater degree of liquidity to the mortgage investment market and an additional means of financing its operations under this section, the corporation is authorized to set aside any mortgages held by it under this section, and, upon approval of the Secretary of the Treasury, *to issue and sell securities based upon the mortgages so set aside*. Securities issued under this subsection may be in the form of debt obligations or trust certificates of beneficial interest, or both. Securities issued under this subsection shall have such maturities and bear such rate or rates of interest as may be determined by the corporation with the approval of the Secretary of the Treasury.¹¹¹

Thus, Fannie Mae could purchase “mortgages from banks, thrifts, insurance companies and mortgage banking companies, [package them into pools], and sell[] securities issued in its own name backed by these mortgage pools.”¹¹² In 1981, Fannie Mae issued its first GSE MBS.¹¹³ By

106. 12 U.S.C. § 1716 (2006).

107. HU, *supra* note 45, at 21.

108. LORE, *supra* note 67, at 2–15.

109. 12 U.S.C. § 1716b (2006). The portion of the corporation that remained within HUD was the Government National Mortgage Association (GNMA or “Ginnie Mae”). *Id.* GNMA guarantees interests in pools of mortgages issued by the FHA, VA, and Farmers’ Home Administration, as to timely payment of interest and principal. *See* Cody, *supra* note 31, at 766–67. This guarantee is backed by the full faith and credit of the United States. *See id.*

110. “Despite the widespread perception of FNMA as a ‘federal’ agency, FNMA [traditionally] received no government subsidy or appropriation, is owned by its stockholders, and pays taxes at the full corporate rate.” LORE, *supra* note 67, at 2–13. As such FNMA issued MBS are not guaranteed by the full faith and credit of the United States Government. *See id.* However, they generally receive AAA ratings. *See id.*

111. 12 U.S.C. § 1719(d) (2006) (emphasis added).

112. Cody, *supra* note 31, at 766.

2007 Fannie Mae was annually issuing \$563 billion in GSE MBS.¹¹⁴

Fannie was soon joined by Freddie. The Emergency Home Finance Act of 1970 created the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac).¹¹⁵ Like Fannie Mae, Freddie Mac was tasked with providing a secondary mortgage market for conventional mortgages.¹¹⁶

FHLMC was authorized to purchase and make commitments to purchase first-lien, fixed-rate conventional residential mortgage loans and participations from any [FDIC insured financial institution]. The corporation then resells those loans as guaranteed securities, primarily Mortgage Participation Certificates [i.e., mortgage pass-throughs]. . . . Funds to purchase these mortgages are generated principally by the sale of mortgage-related securities. FHLMC thus operates as an intermediary between primary mortgage originators and the capital markets.¹¹⁷

Whether Fannie Mae or Freddie Mac, the formulation remains the same: “They purchase mortgages that conform to standard criteria from lenders, package them into [GSE MBS] enhanced with credit guarantees, and then sell them in the market.”¹¹⁸ As such, with the inception of the FHA in 1938 and the creation of Fannie Mae and Freddie Mac, the federal government created a monopoly over mortgage securitization.¹¹⁹ That is to say, the federal government, via GSE MBS, was the primary actor in funding mortgages prior to the 1980s.¹²⁰

IV. THE DEVELOPMENT OF PRIVATE-LABEL MBS

In the 1980s the Reagan Revolution was under way centered on the premise that the federal government was not the answer to all of America’s problems.¹²¹ According to Reagan, “[t]he nine most terrifying words in the English language are: “I’m from the government and I’m here to help.””¹²²

113. *Fannie Mae Marks 25 Years as a Public Firm*, NAT’L MORTGAGE NEWS, Sept. 27, 1993, at 2.

114. Fannie Mae, 2007 Annual Report (Form 10-K), at 45 (Mar. 21, 2008).

115. 12 U.S.C. §§ 1451–1459 (2006).

116. *Id.* § 1454.

117. LORE, *supra* note 67, at 2–24.

118. Paul Mills, *What Next for Fannie and Freddie?*, IMF SURV. MAG., Oct. 3, 2008.

119. *See infra* Part V.

120. *Id.*

121. *See* Letter from Ronald Reagan to Captain Wayne P. Spiegel (circa 1975), in REAGAN: A LIFE IN LETTERS, at 267 (Kiron Skinner, Annelise Anderson & Martin Anderson eds., 2003). Reagan wrote: “We have turned to government more and more (for answers that could better be provided in the marketplace) until we have shackled business and industry with so many restrictions, nitpicking regulations and punitive taxes we can no longer compete in the world market.” *Id.*

122. JULIA VITULLO-MARTIN & J. ROBERT MOSKIN, THE EXECUTIVE’S BOOK OF QUOTATION 130 (1994) (quoting Ronald Reagan on assistance to farmers in his press conference in Chicago on

President Reagan endeavored to provide private alternatives to government programs including funding mortgages for Americans.¹²³ President Reagan stated in an address to the Presidents Commission on Privatization: “presently, the Federal Government is the Nation’s largest lender, with \$252 billion in direct loans, \$450 billion in loan guarantees, and \$453 billion in government-sponsored loans. We will be taking a close look at these assets to determine which loans can be better handled by the private sector.”¹²⁴

As it turns out, President Reagan’s plan was simple: private citizens, rather than Fannie Mae or Freddie Mac, would provide cash to banks in return for a coupon that entitled those citizens (now investors) to receive regular payments from the principal and interest of the mortgages the banks were issuing.¹²⁵ As discussed in Part II, the coupons and the rights associated with them are called pass-throughs.¹²⁶ The fact that these pass-throughs are issued by private financial institutions—as opposed to GSEs—distinguishes them from GSE MBS.¹²⁷

Luckily for President Reagan, the Senate’s needs aligned with his in the early 1980s, when the United States was working its way out of a deep recession and more Americans were looking to purchase homes.¹²⁸ The consensus in the Senate was that Fannie and Freddie “by themselves could no longer provide the required credit for the housing market.”¹²⁹ A Senate report stated that “[d]ue to the projected demand for mortgage credit, the existing Federal agencies simply will not be able to provide all of the liquidity for mortgages that will be required For the consumer, this scarcity would mean that mortgages would cost more and be more cumbersome to obtain.”¹³⁰

It was time for the private sector to “assume a more significant role” in funding mortgages.¹³¹ To accomplish this, private-label MBS needed to be exempted from burdensome securities laws (e.g., registration requirements, prohibitions on forward trading, state blue sky laws) and tax code provisions (e.g., double taxation for certain entities) that made it cost prohibitive for the private sector to pool mortgages and issue their own

August 2, 1986); *see also* Helen Thomas, *Washington Window*, THE BRYAN TIMES, Aug. 21, 1986, at 4 (quoting Ronald Reagan, 40th president of United States (1911–2004)).

123. *See* LORE, *supra* note 67, at 1–11 to 1–12; *see also* Golden, *supra* note 31, at 1028.

124. President Ronald Reagan, Remarks on Federal Loan Asset Sales to the President’s Commission on Privatization in the Roosevelt Room at the White House (Sept. 30, 1987), *available at* <http://www.reagan.utexas.edu/archives/speeches/1987/093087a.htm> (last visited July 10, 2009).

125. *See* LORE, *supra* note 67, at 1–11 to 1–12.

126. *See supra* Part II.

127. *See* LORE, *supra* note 67, at 1–11 to 1–12.

128. Abelman, *supra* note 18, at 138–39.

129. *Id.* at 139.

130. *Id.* at 140 (quoting S. REP. NO. 293, at 2 (1983)).

131. Abelman, *supra* note 18, at 140 (quoting S. REP. NO. 293, at 2 (1983)).

private-label MBS.¹³² Private-label MBS issuers needed an even playing field with the GSEs, Fannie Mae and Freddie Mac, which did not face such burdens.¹³³ And despite recent claims from some politicians, the ensuing deregulation of private-label MBS did not increase risky decision-making and cannot be said to be the cause of the unsustainable housing bubble.

A. *Secondary Mortgage Market Enhancement Act of 1984*

Congress sought to expand private sector participation in the secondary mortgage market by passing the SMMEA.¹³⁴ “SMMEA was designed to enable private issuers of mortgage securities to compete more effectively with the market dominant government-related agencies by removing some of the legal impediments to issuing private mortgage-backed securities.”¹³⁵

132. *Id.* at 138, 141.

133. *Id.* at 138.

134. Pub. L. No. 98-440, 98 Stat. 1689. When Senator Tower introduced SMMEA, he explained:

New sources for mortgage money must be found as more and more demands are placed on the credit market and mortgage lenders. Due to the magnitude of the demand for mortgage credit, the existing Federal agencies simply will be unable to provide all of the liquidity for mortgages that will be required during the coming decade.

Cassandra Jones Havard, “Goin’ Round in Circles” . . . and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation, 86 NEB. L. REV. 737, 746 n.34 (2008) (statement of Sen. John Tower) (quoting *Secondary Mortgage Market Enhancement Act: Hearing before the S. Subcomm. on Hous. & Urban Affairs of the S. Comm. on Banking, Hous., & Urban Affairs*, 98th Cong. 1 (1983)).

135. Shenker & Colletta, *supra* note 30, at 1385; see Lois R. Lupica, *Asset Securitization: The Unsecured Creditor’s Perspective*, 76 TEX. L. REV. 595, 601 n.21 (1998) (“In 1984, the federal government once again supported and encouraged active trading in the secondary mortgage market by enacting the Secondary Mortgage Market Enhancement Act (SMMEA).”); see also *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 299–300 (S.D.N.Y. 1998) (noting that the Secondary Mortgage Market Enhancement Act in 1984 was enacted for the purpose of “encouraging the ‘broadening of the market for mortgage-backed securities by encourag[ing] more extensive involvement of the private sector’”) (quoting S. REP. NO. 98-293, at 3 (1984)); *Hearing on H.R. 833, Bankruptcy Reform Act, Before the H. Subcomm. on Commercial & Admin. Law of the H. Judiciary Comm.*, 106th Cong. (1999) (remarks of Rep. James A. Leach, Chairman, House Banking & Fin. Servs. Comm.), available at <http://judiciary.house.gov/legacy/leac317.htm> (last visited July 10, 2009):

Securitization has received legislative review, and approval, since the 1980s. In 1984, Congress adopted the Secondary Mortgage Market Enhancement Act that provided for the exemption of highly rated mortgage-backed securities from the registration requirements of most state securities laws and made them eligible for investment by certain regulated entities. In 1994, Congress amended the Secondary Mortgage Market Enhancement Act to provide an exemption from state securities laws for highly rated securities backed by certain lease receivable and small business loans similar to the exemption already enjoyed by mortgage-backed securities. Then, as part of the Tax Reform Act of 1986, Congress enacted new tax legislation permitting the creation of real estate mortgage investment conduits—called “REMICs”—facilitating the issuance of multiclass, pass-through securities.

SMMEA removed restrictions on forward trading of private-label MBS (by exempting them from Exchange Act § 7(c) and Regulation T),¹³⁶ exempted private-label MBS from state blue sky laws,¹³⁷ and allowed FDIC banks to invest in them (by exempting private-label MBS from the Glass-Steagall Act).¹³⁸ Below, I discuss each change, and reach similar conclusions for all: the exemptions provided by SMMEA did little, if anything, to increase the risky decision-making that inflated the unsustainable housing bubble. Rather, each change played a role in putting private-label MBS on a level playing field with GSE MBS.¹³⁹

1. Allowing Forward Trading Of Private-Label MBS

In the Roaring Twenties that preceded the Great Depression, many investors were not content with merely doubling their money; they wanted to trade on margin,¹⁴⁰ or forward trading,¹⁴¹ where the investor purchases part of the stock in cash and the remainder through a loan from the broker transacting the purchase (the loan is secured by the stock purchased).¹⁴² In this way, forward trading is akin to taking out a loan to buy a car where the loan is secured by the car purchased.¹⁴³ To illustrate:

Radio Corporation of America [RCA] . . . leaped from 85 to 420 during 1928. . . . Suppose a buyer purchased on margin a share of the aforementioned RCA stock at the beginning of 1928, putting up \$10 and borrowing the remaining \$75 from his broker. At the end of the year he could have sold it for \$420. The stock itself had appreciated by 394 percent, which wasn't bad; but Mr. X saw his \$10 investment bring him \$341.25 (\$420 less \$75 and 5 percent interest owed to the

See id.

136. SMMEA, Pub. L. No. 98-440, § 102, 98 Stat. 1689 (codified at 15 U.S.C. § 78(g)) (2006).

137. *Id.* § 106 (codified at 15 U.S.C. § 77r-1) (2006).

138. *Id.* § 105 (codified at 12 U.S.C. § 1464(c)(1)) (2006); *id.* § 107 (codified at 12 U.S.C. § 1757) (2006); *see* Abelman, *supra* note 18, at 142–43; *see also* HOUSING AND THE NEW FINANCIAL MARKETS 344–45 (Richard L. Florida ed., 1986).

139. Abelman, *supra* note 18, at 141.

140. In early 1929 the conventional wisdom was that it was easy to get rich buying stock, holding it for a short time, and selling it. *See* MCELVAINE, *supra* note 16, at 44. “Stocks, once bought principally on the basis of their earning power, came to be purchased only for resale after their price had risen. . . . The quality of a stock was largely immaterial, as long as prices continued to rise.” *Id.* And rise they did. In just the period from early 1928 to September 1929 the Dow doubled, rising from 191 to 381. *Id.*

141. Abelman, *supra* note 18, at 141.

142. “Margin Transaction,” BLACK’S LAW DICTIONARY 966 (6th ed. 1990). “The purchase of a stock or commodity with payment in part in cash (called the margin) and in part by a loan. Usually the loan is made by the broker effecting the purchase.” LORE, *supra* note 67, at 4–53.

143. MCELVAINE, *supra* note 16, at 44.

broker). His profit for the year was over 3400 percent.¹⁴⁴

How is this risky? Because when prices fall, Mr. X's profit depreciates just as rapidly.¹⁴⁵ As prices fall, the value of the collateral—the stock—falls.¹⁴⁶ The trader is forced to sell stock to make up the difference.¹⁴⁷ The increased supply of stock on the market reduces prices further, and the process repeats itself.¹⁴⁸ Consider the following example:

[A]n investment fund [buys bonds] by borrowing 85% of the purchase price, using its own equity for only 15%. The fund's leverage can be expressed as 85/15, meaning the power of its own investment has been magnified 5.7 times by leverage. Now suppose that the securities owned by the fund fall in value by 5%. This isn't a very large decline, but it reduces the fund's equity to 10%, and its leverage jumps to 85/10 or 10.5 times. Because the fund agreed when it borrowed money from a broker-dealer to maintain at least 15% equity, it receives a notice known as a margin call, requiring it to either put up more cash or sell as much of the portfolio as necessary to get back to the agreed margin. Most funds are reluctant to put up more cash, particularly in a declining market, so they take the second option and sell . . . Now consider what happens when there are many such funds and all receive margin calls . . . at the same time. The wave of forced selling drives prices for [bonds] . . . sharply lower, further exacerbating investors' collective problems.¹⁴⁹

Thus, “the host of margin buyers could be wiped out quickly,”¹⁵⁰ and “even a modest decline . . . can provoke a rout.”¹⁵¹ A series of such routs contributed to the stock market crash of 1939.¹⁵² In response, the Exchange

144. *Id.* It can also work in the opposite direction:

Short sellers borrow securities to make delivery of what they sell and subsequently purchase securities to repay the loan. They profit if prices fall between the time they sell and the time they cover, and lose if prices rise. Professor Loss has observed that ‘legislators in different ages and different lands [have shared the feeling] that the very idea of a person’s selling something he does not own, in the hope of buying it back later at a lower price, is essentially immoral.’

Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 427 (1991).

145. MCELVAINE, *supra* note 16, at 44.

146. *Id.* at 47.

147. *Id.*

148. *Id.*

149. ZANDI, *supra* note 17, at 183, 84.

150. MCELVAINE, *supra* note 16, at 44–45.

151. ZANDI, *supra* note 17, at 84.

152. MCELVAINE, *supra* note 16, at 47.

Act § 7(c)¹⁵³ “prohibits a broker-dealer from extending or arranging for the extension of credit to a customer.”¹⁵⁴ Pursuant to § 7(c), the Board of Governors promulgated Regulation T.¹⁵⁵ Under Regulation T, brokers cannot extend credit in excess of 50% of the purchased securities’ value.¹⁵⁶

Exchange Act § 7(c) and Regulation T, while well intentioned, served as impediments to the issuance of private-label MBS.¹⁵⁷ Issuers of private-label MBS require promises from investors to purchase the security before they originate the mortgages and package them into pools—a process [called] forward trading.¹⁵⁸ As one commentator succinctly explained:

[M]ortgage pass-through securities frequently are sold through advance commitments and traded on a forward delivery basis. Both the investor and the issuer of the forward contract are contractually bound to purchase and sell the securities, respectively. The investor typically will pay a small commitment fee and maintain margin with a broker-dealer to reflect any fluctuations in the value of the commitment prior to delivery. Because the contractual commitment affords the investor the rights and benefits of ownership of the underlying mortgage security, but does not require full payment, there was concern that broker-dealers participating in the transactions would be viewed as extending or arranging for the extension of credit in violation of sections 7(c) and

153. Exchange Act § 7(c) (codified at 15 U.S.C. § 78g (2006)).

154. Pittman, *supra* note 31, at 535. It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer . . . on any security . . . in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System (hereafter in this section referred to as the “Board”) shall prescribe. Exchange Act § 7(c) (codified at 15 U.S.C. § 78g (2006)).

155. 12 C.F.R. § 220.1; see Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45, 76 n.56 (1999) (“Since the 1930s, securities credit has been regulated by the Federal Reserve Board’s so-called ‘margin rules,’ . . . [that] comprehensively regulate credit extended by brokers (Regulation T).”).

156. 12 C.F.R. § 220.1; see Lynn Stout, *Why the Law Hates Speculators*, 48 DUKE L.J. 701, 730 (1999) (“Thus section 7 of the SEA directs the Federal Reserve Board to limit stock traders’ ability to borrow money from banks or brokers to fund their speculations. Under present rules, investors can borrow no more than 50% of the funds they [use] to purchase corporate equities.”). Further, “[i]f an entity that is both a broker and a dealer participates in the distribution of a new issue of securities, section 11(d)(1) prohibits it from extending or arranging for the extension of credit on the securities for a period of thirty days following the broker-dealer’s participation in the offering.” Pittman, *supra* note 31, at 535.

157. LORE, *supra* note 67, at 4–54 (noting this was an impediment that did not apply to agency issue MBS). “Since Agency securities generally are not subject to sections 7(c) or 11(d)(1), these provisions had not inhibited the development of a forward trading market for the securities.” Pittman, *supra* note 31, at 536.

158. Abelman, *supra* note 18, at 141.

11(d)(1) of the Exchange Act.¹⁵⁹

To encourage the issuance of private-label MBS, Congress provided private-label issuers with an exemption for “Mortgage Related Securities,” that is to say, a security representing an ownership interest in a mortgage or pool of mortgages.¹⁶⁰ As such, private-label MBS issuers can have a commitment before they go ahead and originate and pool mortgages into securities.¹⁶¹ The exemption provides that settlements that occur up to 180 days before actual delivery of the security do not violate Exchange Act §§ 7 or 11.¹⁶²

159. Pittman, *supra* note 31, at 536; *see* Abelman, *supra* note 18, at 141–42.

160. Exchange Act § 3(a)(41) (codified at 15 U.S.C. § 78c (2006)) states:

The term “mortgage related security” means a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization, and either:

- A. represents ownership of one or more promissory notes or certificates of interest or participation in such notes (including any rights designed to assure servicing of, or the receipt or timeliness of receipt by the holders of such notes, certificates, or participations of amounts payable under, such notes, certificates, or participations), which notes:
 - i. are directly secured by a first lien on a single parcel of real estate . . . ; and
 - ii. were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 1709 and 1715b of Title 12 . . . ; or
- B. is secured by one or more promissory notes or certificates of interest or participations in such notes (with or without recourse to the issuer thereof) and, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the requirements of subparagraphs (A)(i) and (ii) or certificates of interest or participations in promissory notes meeting such requirements.

161. Abelman, *supra* note 18, at 142.

162. Abelman, *supra* note 18, at 142. Exchange Act § 7 was amended by adding the following subsection at the end thereof:

- (g) Effect of bona fide agreement for delayed delivery of mortgage related security. Subject to such rules and regulations as the Board of Governors of the Federal Reserve System may adopt in the public interest and for the protection of investors, no member of a national securities exchange or broker or dealer shall be deemed to have extended or maintained credit or arranged for the extension or maintenance of credit for the purpose of purchasing a security, within the meaning of this section, by reason of a bona fide agreement for delayed delivery of a mortgage related security or a small business related security against full payment of the purchase price thereof upon such delivery within one hundred and eighty days after the purchase, or within such shorter period as the Board of Governors of the Federal Reserve System may prescribe by rule or regulation.

Of all the changes made by SMMEA, exemption of private-label MBS from Exchange Act § 7(c) and Regulation T arguably threatened the greatest increase in risky decision-making, because the exemption allowed for forward trading, which had catastrophic effects in 1929. However, any such risk was mitigated in two ways. First, the exception is narrowly tailored to 180 days, “coincid[ing] with the production period for single family housing and was intended to facilitate the creation of Mortgage Related Securities.”¹⁶³ Second, “payment delays unrelated to the creation of the security [i.e., those that result from speculation] are not included in the exemption.”¹⁶⁴

Nor can it be said that the exemption encourages risky decision-making compared to GSE MBS.¹⁶⁵ This is because Fannie Mae and Freddie Mac were already exempted from Section 7(c) of the Exchange Act and Regulation T.¹⁶⁶ If allowing forward trading for private-label MBS under the limited circumstances discussed above is truly that risky, Congress could have removed the disparity between GSE MBS and private-label MBS by “subjecting government issues to the provisions of the 1934 Act. Instead, however, Congress chose to provide private issuers with an exemption similar to that which benefits Ginnie Mae, Fannie Mae, and Freddie Mac.”¹⁶⁷

2. Exempting Private-Label MBS from State Blue Sky Laws

State blue sky laws¹⁶⁸ were a major economic barrier to issuance of private-label MBS, in that “an issuer typically [paid] between \$30,000 and \$40,000 in state filing fees on a \$100 million issue.”¹⁶⁹ Further, the delay

SMMEA § 102 (codified at 15 U.S.C. § 78g (2006)). Exchange Act § 11 was amended by providing “[t]hat credit shall not be deemed extended by reason of a bona fide delayed delivery of . . .

- (ii) any mortgage related security or any small business related security against full payment of the entire purchase price thereof upon such delivery within one hundred and eighty days after such purchase, or within such shorter period as the Commission may prescribe by rule or regulation.

SMMEA § 104 (codified at 15 U.S.C § 78k (2006)).

163. Pittman, *supra* note 31, at 537.

164. *Id.*

165. Abelman, *supra* note 18, at 141.

166. *Id.*

167. *Id.*

168. Generally speaking, state blue sky laws supplement federal law by also regulating the offer and sale of securities. *See* LORE, *supra* note 67, at 4–132 to 4–136. “A typical state blue sky statute requires the registration of nonexempt securities sold within the state and of persons involved in the securities industry, and also prohibits fraud in connection with the offer and sale of the security.” Michael S. Gambro & Scott Leichtner, *Selected Legal Issues Affecting Securitization*, 1 N.C. BANKING INST. 131, 154 (1997).

169. Abelman, *supra* note 18, at 144.

caused by compliance with state blue sky laws was a major deterrent.¹⁷⁰ SMMEA solved the problem by exempting private-label MBS from state blue sky laws.¹⁷¹ While states were free to opt out, only “ten states (Arizona, Arkansas, Indiana, Louisiana, Maryland, Minnesota, New Mexico, Oklahoma, South Dakota, and Utah) overrode the preemption.”¹⁷²

Exempting private-label MBS from state blue sky laws did not increase risky decision-making; instead, it simply reduced the costs associated with offering private-label MBS.¹⁷³ This is because state blue sky laws are generally accepted as overriding federal securities laws.¹⁷⁴ As one commentator argued:

[S]tate securities regulation (or “blue-sky” laws) preceded federal securities regulation. This . . . was recognized when the first federal securities law, the Securities Act of 1933 . . . was passed and when the Securities Exchange Act of 1934 . . . was adopted the following year creating the SEC. The federal-state . . . system of securities regulation involved conflicting philosophies and considerable overlap and duplication.¹⁷⁵

As such, there was no appreciable increase of risk to investors with SMMEA’s preemption of state blue sky laws.

3. Allowing National Banks to Invest in Private-Label MBS

The Glass-Steagall Act restricted the ability of national banks to purchase securities from a single issuer.¹⁷⁶ Glass-Steagall stated in relevant part:

170. *Id.*

171. 15 U.S.C. § 77r-1(c) (2000). (c) Registration and qualification requirements; exemption; subsequent enactment by State. Any securities that are offered and sold pursuant to section 77d(5) of this title, that are mortgage related securities (as that term is defined in section 78c(a)(53) of this title) . . . shall be exempt from any law of any State with respect to or requiring registration or qualification of securities or real estate to the same extent as any obligation issued by or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof. Any State may, prior to the expiration of seven years after October 3, 1984, enact a statute that specifically refers to this section and requires registration or qualification of any such security on terms that differ from those applicable to any obligation issued by the United States.

172. Gambro & Leichtner, *supra* note 168, at 154; see Michael H. Schill, *Uniformity Or Diversity: Residential Real Estate Finance Law In The 1990s And The Implications Of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1284 n.128 (1991).

173. Abelman, *supra* note 18, at 144.

174. Roberta S. Karmel, *Appropriateness Of Regulation At The Federal Or State Level: Reconciling Federal And State Interests In Securities Regulation In The United States And Europe*, 28 BROOK. J. INT’L L. 495, 497 (2003).

175. *Id.*

176. Glass-Steagall Act § 16, 12 U.S.C. § 24, Par. Seventh (2000); Abelman, *supra* note 18, at 142–43.

The business of dealing in securities and stock . . . [by a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account *Provided* [a national bank] *may purchase for its own account investment securities* under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. *In no event shall the total amount of the investment securities of any one obligor or maker, held by the [national bank] for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund.*¹⁷⁷

The 10% restriction on the purchase of investment securities for the national bank's own account was a major impediment to the proliferation of private-label MBS.¹⁷⁸ SMMEA solved this problem by exempting private-label MBS from Glass-Steagall, allowing FDIC financial institutions to invest in private-label MBS, stating:

[Glass-Steagall] is amended by adding at the end of paragraph Seventh the following: 'the limitations and restrictions contained in this paragraph as to an association purchasing for its own account investment securities shall not apply to securities that . . . (C) are mortgage related securities'¹⁷⁹

The amendment had no effect on the ability of national banks to purchase GSE MBS issued by Fannie Mae or Freddie Mac because, at that time, banks could already invest in Fannie Mae or Freddie Mac-issued GSE MBS.¹⁸⁰ Instead, it put private-label MBS on a competitive playing

177. Glass-Steagall Act § 16, 12 U.S.C. § 24, Par. Seventh (2000) (emphasis added).

178. Abelman, *supra* note 18, at 142–43.

179. Glass-Steagall Act § 16, 12 U.S.C. § 24, Par. Seventh (2000); *see* Abelman, *supra* note 18, at 142–43.

180. “[S]ection 16 of the [Glass-Steagall Act] explicitly authorizes a national bank to . . . purchase for its own account obligations of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corporation (FHLMC).” Golden, *supra* note 31, at 1026–27.

It is important to note that the SMMEA did not grant national banks authority to underwrite and deal in MBSs. A national bank's authority to issue MBS was addressed by the Gramm-Leach-Bliley Act. *See* Golden, *supra* note 31, at 1051–52; *see also* Keith R. Fisher, *Orphan of Invention: Why the Gramm-Leach-Bliley Act Was Unnecessary*, 80 OR. L. REV. 1301, 1338–51 (2001) (arguing that Gramm-Leach-Bliley also reversed Glass Steagall's restriction on a national bank issuing securities). Senator Gramm defended Gramm-Leach-Bliley as follows:

The principal alternative to the politicization of mortgage lending and bad monetary policy as causes of the financial crisis is deregulation. How deregulation caused the crisis has never been specifically explained. Nevertheless, two laws are

field with GSE MBS,¹⁸¹ opening up a large market for private-label MBS.¹⁸² How this change makes an investor more prone to risky decision-making is difficult to imagine.

B. Rule 415 Shelf Registration

“The Secondary Mortgage Market Enhancement Act of 1984 . . . would have required the [SEC] to provide a permanent shelf registration procedure for mortgage-backed securities, but that [SMMEA provision] was eliminated as a result of the adoption of rule 415 on a permanent basis.”¹⁸³ Securities Act Rule 415, finalized in 1983, authorizes shelf registration of private-label MBS, stating:

Securities may be registered for an offering to be made on a continuous or delayed basis in the future, *Provided, That:* The registration statement pertains only to: . . . (vii) *Mortgage related securities*, including such securities as mortgage backed debt and mortgage participation or pass through certificates.¹⁸⁴

Absent shelf registration, an issuer of private-label MBS had to file with the SEC a separate registration statement for each new offering.¹⁸⁵

most often blamed: the Gramm-Leach-Bliley (GLB) Act of 1999 and the Commodity Futures Modernization Act of 2000.

GLB repealed part of the Great Depression era Glass-Steagall Act, and allowed banks, securities companies and insurance companies to affiliate under a Financial Services Holding Company. It seems clear that if GLB was the problem, the crisis would have been expected to have originated in Europe where they never had Glass-Steagall requirements to begin with. Also, the financial firms that failed in this crisis, like Lehman, were the least diversified and the ones that survived, like J.P. Morgan, were the most diversified.

Moreover, GLB didn't deregulate anything. It established the Federal Reserve as a superregulator, overseeing all Financial Services Holding Companies. All activities of financial institutions continued to be regulated on a functional basis by the regulators that had regulated those activities prior to GLB.

When no evidence was ever presented to link GLB to the financial crisis—and when former President Bill Clinton gave a spirited defense of this law, which he signed—proponents of the deregulation thesis turned [dropped it as an issue].

Gramm, *supra* note 37.

181. Abelman, *supra* note 18, at 142–43.

182. *Id.*

183. Thomas Harmon, *Emerging Alternatives To Mutual Funds: Unit Investment Trusts And Other Fixed Portfolio Investment Vehicles*, 1987 DUKE L.J. 1045, 1092 n.263 (1987).

184. 17 CFR § 230.415(a)(1)(vii) (2008) (second emphasis added); see Harmon, *supra* note 183, at 1092 n.263.

185. Andrew Seth Bogen, *The Impact Of The SEC's Shelf Registration Rule On Underwriters' Due-Diligence Investigations*, 51 GEO. WASH. L. REV. 767, 767 (1983) (citing Securities Act,

Rule 415 “permits an issuer’s filing of a single registration statement to satisfy reporting requirements for several offerings if the issuer periodically supplements that statement with certain new information.”¹⁸⁶ The principal advantage of shelf-registration is cost savings, because the issuer can time the offering “to avail itself of the most advantageous market conditions.”¹⁸⁷ Cost savings also result from reduced legal and accounting costs.¹⁸⁸

Disclosure via registration is important because it helps “market participants to determine prices for securities that accurately reflect all available information. Disclosure can contribute to informational efficiency (and ultimately to social welfare) by enabling traders to gather information, and reflect that new information in prices, at a reduced cost compared to a world without disclosure.”¹⁸⁹ Simply put, disclosure is important because “publicity is justly commended as a remedy for industrial diseases [and] sunlight is said to be the best of disinfectants.”¹⁹⁰ However, the principal complaint about shelf registration is that it results in inadequate disclosure, in that the information provided becomes stale during the life of the security.¹⁹¹ However, this overlooks the fact that the private-label issuer still must periodically supplement that statement with certain new information.¹⁹² In short, allowing shelf registration adds little, if any, risk to private-label MBS.

C. REMIC Provisions of the Tax Reform Act of 1986

The final piece of Reagan-era legislation designed to free private-label MBS from stifling regulation was the REMIC provisions in the Tax Reform Act of 1986.¹⁹³ Prior to the REMIC provisions of the Tax Code, private-label MBS were generally offered through grantor trusts to avoid double taxation.¹⁹⁴ However, using grantors trust was problematic because

§ 6(a).

186. *Id.*

187. Shelf Registration, Securities Act Release No. 33-6499, Exchange Act Release No. 34-20384 (Nov. 17, 1983).

188. *Id.* at 1.

189. Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1047–48 (1995).

190. L. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKER’S USE IT* 62 (1967).

191. Shelf Registration, Securities Act Release No. 33-6499, Exchange Act Release No. 34-20384, at *1–5, 17 CFR Part 20 (Nov. 17, 1983); *see* Bogen, *supra* note 185, at 775 (arguing that Rule 415 renders underwriters less able to verify registration information).

192. Bogen, *supra* note 185, at 775.

193. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 671–675, 100 Stat. 2085, 2308–20.

194. Pittman, *supra* note 31, at 503. Pittman states:

Historically, pools of mortgages were placed in a trust for tax reasons. If the trust was characterized as a “grantor trust” for tax purposes, its existence was ignored and investors were treated as owners of proportionate interests in the underlying pool of mortgages. If the pool did not fall within the grantor trust provisions of the Internal Revenue Code, it could have been classified by the Internal Revenue

each grantor trust contained:

- (1) a prohibition against creating a power under the trust agreement to vary the investment of the certificate holders; and (2) a prohibition against multiple classes of ownership interests in a single trust unless the multiple classes are incidental to facilitating direct investment in the assets of the trust.¹⁹⁵

Under these prohibitions, issuers were generally prevented from issuing CMOs with multiple “tranches.” The Tax Reform Act, however, “improve[d] the efficiency of . . . mortgage security issues”¹⁹⁶ by allowing for REMICs.¹⁹⁷ As one commentator stated, “the legislation allows issuers to avoid dual taxation . . . regardless of the business structure used (i.e., owner trust, partnership, corporation, or even segregated asset pool).”¹⁹⁸ Thus, allowing for REMICs is simply another way of removing prohibitive costs—double taxation—from private-label MBS issuances without any appreciable increase in the chance of risky decision-making.

To conclude, Reagan-era legislation did not increase risky decision-making and cannot be said to be the cause of the unsustainable housing bubble. Instead, each change—whether SMMEA, Rule 415, or REMIC provisions of the Tax Code—simply was an attempt to put private-label MBS on a competitive playing field with GSE MBS. It follows from this conclusion that reinstating the regulatory impediments to issuing private mortgage-backed securities (by repealing or weakening Reagan-era legislation) will not address the root cause of the excessive risk-taking that fostered the market bubble and will be “counterproductive regulations,

Service (“IRS”) as a taxable association. . . . the interest income passed through to investors would be taxed at the entity level, in the same fashion as a corporation, so that investors effectively would have been taxed twice on profits.

Id.

195. Am. Bar Ass’n Section of Taxation Comm. on Fin. Transactions Subcommittee on Asset Securitization, *Legislative Proposal to Expand the REMIC Provisions of the Code to Include Nonmortgage Assets*, 46 TAX L. REV. 299, 313 (Spring 1991) (citing Treas. Reg. § 301.7701-4(c) (2009)) [hereinafter *Legislative Proposal*]; see Pittman, *supra* note 31, at 503 (“In order to maintain the desired status as a grantor trust, the trustee had to be essentially passive, so that it would not be viewed as being engaged in a business. Consequently, the trustee could not have any power to substitute mortgage loans, allocate principal and interest payments, or reinvest prepayments from the mortgages for the benefit of investors.”).

196. Thomas Kasper & Les Parker, *Understanding Collateralized Mortgage Obligations*, 1987 COLUM. BUS. L. REV. 139, 145 (1987).

197. 26 U.S.C. §§ 860A–860G (2009); see Van Brunt, *supra* note 52, at 155.

198. Pittman, *supra* note 31, at 508–09; see also Michael Hirschfeld & Thomas A. Humphreys, *Tax Reform Brings New Certainty to Mortgage-Backed Securities*, J. TAX’N, 280 (1987); Rudnick & Praise, *Real Estate Mortgage Investment Conduits: An Introduction*, 4 J. TAX’N INVS. 238 (1987).

[which limits] the human freedom upon which prosperity depends.”¹⁹⁹

V. GOVERNMENT INTERFERENCE WITH PRIVATE-LABEL MBS

A. *GSEs Relegate Private-Label MBS Issuers to Securitizing Risky Mortgages*

Part IV absolves Reagan era legislation (SMMEA, Rule 415, and REMIC) as the culprit for the risky decision making associated with the issuance of private-label MBS. This section builds on that conclusion by arguing that instead of lack of regulation, it was instead *too much* government interference that caused the unsustainable housing bubble. Case in point is the federal government’s support of the GSEs, which “enjoy significant competitive advantages due to their quasi-public status.”²⁰⁰ For example, GSEs “are allowed access to Treasury funds at a discounted rate . . . are for the most part exempt from [securities] laws, and they are not subject to state or local income taxes.”²⁰¹ Further, their “obligations are generally regarded to carry an implicit [federal government] guarantee, on the assumption that Congress would not allow them to default in their obligations,”²⁰² which means that they are not required to provide credit enhancements to earn an AAA rating (compared to private-label issuers who have to purchase pool or bond insurance).²⁰³ In short, GSE MBS are cheaper to issue. This means that GSEs have a de facto monopoly in any segment of the market in which they choose to operate.²⁰⁴ Important for our analysis, GSEs choose to operate by

199. James L. Huffman, *The Impact of Regulation on Small and Emerging Business*, 4 J. SMALL & EMERGING BUS. L. 307, 308 (2000).

200. Amy C. Bushaw, *Small Business Loan Pools: Testing the Waters*, 2 J. SMALL & EMERGING BUS. L. 197, 252–53 (1998).

201. *Id.*

202. *Id.* As to the guarantee by the federal government, see generally Reiss, *supra* note 34, at 1033.

203. See Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783, 803 (2004).

204. Reiss, *supra* note 31, at 1012. Indeed, some have expressed concern that the GSEs are—or were prior to the current economic crisis—expanding to offer mortgages to less credit worthy borrowers, squeezing private-label issuers out of that market as well:

The fact that private-label firms cannot compete with GSEs is of key importance in the subprime market, because Fannie Mae and Freddie Mac are beginning to enter it. Freddie Mac began purchasing subprime loans in 1997, and Fannie Mae began in 1999. Both “have moved slowly and have limited their purchases to the most creditworthy segment of the subprime market with the most creditworth[iness].” They are believed to own a relatively small portion of outstanding subprime securities. Nonetheless, GSEs have had and will have an extraordinary impact on the subprime secondary market as they become more comfortable operating in the subprime market.

Id. at 1011–12 (quoting U.S. GEN. ACCOUNTING OFFICE, CONSUMER PROTECTION: FEDERAL AND

securitizing less risky conforming mortgages.²⁰⁵

The GSEs' charters restrict the mortgages they may buy. In general, they may only buy mortgages with loan-to-value ratios of 80% or less unless the mortgage carries mortgage insurance or other credit support, and they may not buy mortgages with principal amounts greater than an amount set each year. Loans that comply with the restrictions placed on Fannie Mae and Freddie Mac are known as "conforming" loans. Those that do not comply with either of these restrictions are known as "nonconforming" loans, and may not be purchased by Fannie Mae or Freddie Mac.²⁰⁶

The result is that private-label issuers may originate conforming mortgages, but they sell them to the GSEs to securitize while keeping and securitizing the more risky non-conforming mortgages.²⁰⁷ Non-conforming mortgages are those with: (1) high payment-to-income ratios, measuring a borrower's capacity to make monthly payments; (2) high loan-to-value ratios, measuring the amount of the mortgage loan vis-à-vis the appraised property value; and (3) high (jumbo) loan amounts.²⁰⁸ Each category is discussed in turn below. I conclude that the federal government created market conditions that relegated private-label MBS issuers to securitizing risky non-conforming mortgages.²⁰⁹ Thus, if private-label issuers wanted to

STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 74 (2004), available at <http://www.gao.gov/new.items/d04280.pdf>.)

205. Edmund L. Andrews, *White House Scales Back a Mortgage Relief Plan*, N.Y. TIMES, Nov. 12, 2008, at B1. Indeed—as required by statute—GSEs securitize only conforming mortgages. See 12 U.S.C. §§ 1451(h), 1454 (2008). The maximum loan limit was amended upward by Title XII, § 1202 of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 225 (2009).

206. Reiss, *supra* note 34, at 1033.

207. *Id.* at n.58 (citing ERIC BRUSKIN ET AL., NONAGENCY MORTGAGE MARKET: BACKGROUND AND OVERVIEW, in THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES 5, 6–7 (Frank J. Fabozzi et al. eds., 2d ed. 2000) (identifying major categories of nonconforming loans as jumbos and B/C quality, which includes subprime low-doc and no-doc loans)); Wayne Passmore et al., *GSEs, Mortgage Rates, and the Long-Run Effects of Mortgage Securitization*, 25 J. REAL EST. FIN. & ECON. 215, 218 (2002) ("Most private-sector securitizations are backed by jumbo mortgages or mortgages held by 'sub-prime' borrowers, the bulk of which have blemished credit histories but adequate assets or income to support a mortgage.").

208. *Anchor Sav. Bank v. United States*, 81 Fed. Cl. 1, 17 (Fed. Cl. 2008). However, "[b]y virtue of the GSEs operating in only a portion of the secondary mortgage market—that of conforming loans—there remained a need for a sophisticated secondary market for nonconforming loans that did not meet the GSEs' strict underwriting criteria." *Id.*

209. See HU, *supra* note 45, at 23 (noting that if a mortgage fails to be conforming for any of the three above reasons, non-agency lenders can still package such mortgages—jumbo, subprime, no documentation—and issue private-label pass-throughs (distinguished from agency pass-throughs)); see also FRANK J. FABOZZI, REAL ESTATE BACKED SECURITIES 12 (2001) (These non conforming loans may also be packaged by non-agency lenders and issued as private-label pass-

realize the profits that came with securitization, they were forced to use risky non-conforming mortgages.

1. Payment-to-Income and Loan-to-Value Ratios

As stated above, a mortgage is non-conforming where the payments exceed a certain portion of the borrower's income.²¹⁰ Freddie Mac, for example, will not underwrite loans where "the monthly debt payment-to-income ratio [is] greater than 33% to 36% of the Borrower's stable monthly income"²¹¹ because a high payment-to-income ratio increases the chance of default and reduces the borrower's cash cushion. Even a slight decrease in income (or increase in expenses, e.g., unexpected health care costs) can have a catastrophic effect.²¹² Despite this danger, at the height of the housing bubble many private-label issuers were originating or purchasing mortgages with payment-to-income ratios in the low 40% range,²¹³ and some at 50% or higher.²¹⁴ Amazingly, other private lenders did not bother to confirm the borrower's income at all.²¹⁵ By 2006, over half of subprime loans were so-called "stated income" or "liar" loans; the borrower simply stated an income, and the lender believed that income without supporting documentation.²¹⁶

The second criterion, loan-to-value ratio, historically was 65%.²¹⁷ To illustrate the effect of this criterion, prior to the housing bubble, for a

throughs).

210. *Anchor Sav. Bank*, 81 Fed. Cl. at 17.

211. FREDDIE MAC SINGLE-FAMILY SELLER/SERVICER GUIDE § 37.16.

212. SHANE SHERLUND, FED. RESERVE BD., *THE PAST, PRESENT, AND FUTURE OF SUBPRIME MORTGAGES 20* (2008), available at, <http://www.federalreserve.gov/pubs/feds/2008/200863/200863pap.pdf> (discussing the role of household cash flow shocks on sub-prime mortgages) see Mary Ellen Slayter, *It's More Than a Mortgage*, WASH. POST, Sept. 6, 2008, at F1 ("When you're a homeowner, not only do you have to make those very predictable monthly expenses, but you have to be prepared to protect that investment.").

213. SHERLUND, *supra* note 212, at 20.

214. Liz Pulliam Weston, *60 Percent Mortgage Requires Great Credit*, L.A. TIMES, June 14, 2006.

215. ZANDI, *supra* note 17, at 40.

216. *Id.* Less nefarious, a loan may lack documentation because the individual is self employed or owners of businesses where the amount reported in tax returns or paid as income would not meet the required payment-to-income ratio. See FRANK J. FABOZZI, *REAL ESTATE BACKED SECURITIES 65* (2001). One additional problem with "low-doc" or "no-doc" loans is they are ripe for fraud. One insider commented:

As his team analyzed the individual loan files, [he] said he was struck by evidence of fraud, such as doctored bank statements. "Fraudulent loans were a big part of the subprime mess," he said. Mortgage brokers forged borrowers' signatures and pumped up their income, he said. People seeking to buy and sell a home for a quick profit lied that they were going to live in the home—qualifying for a lower interest rate.

Goldfarb & Klein, *supra* note 93, at A1.

217. ZANDI, *supra* note 17, at 39–40.

\$100,000 home the outstanding mortgage was \$65,000.²¹⁸ In the event of default, the lender could foreclose on the home and collect its principal (and costs of foreclosure) and still have some cash to return to the homeowner.²¹⁹ However, during the housing boom, many lenders, eager to originate mortgages to securitize, were offering mortgages with loan-to-value ratios of 95%.²²⁰ That was tremendously risky for the lender.²²¹ If home values fell as little as 6%, the outstanding principal would be more than the value of the home.²²² For example, consider that “the median price in January [2009] was down 26% from its peak of \$230,100 in July 2006.”²²³ Thus, even if a mortgage lender did foreclose, it could not collect its principal, let alone the interest due under the contract or the costs of foreclosure. These are the loans that private-label MBS issuers were securitizing. These are the loans that Fannie Mae and Freddie Mac would not touch.

2. Jumbo Mortgages

The other category of non-conforming mortgages, “jumbo mortgages,” is mortgages that exceed the maximum dollar amount that the agency will underwrite.²²⁴ These mortgages generally have a face value of greater than \$417,000,²²⁵ averaging about \$750,000 and running as high as \$5 million or more.²²⁶ Jumbo mortgages may be pooled and securitized by companies that originate them, or purchased on the secondary market by companies with conduits specialized to pool and securitize jumbo mortgages.²²⁷ Like the non-conforming mortgages discussed above, securities backed by jumbo mortgages are riskier than those issued by GSEs. As of January 2009, about 7% of “jumbo” loans were at least ninety days delinquent, compared to 2% for “non-jumbo prime loans that qualify for backing by

218. *See generally id.* (discussing historical requirement that home purchasers pay a significant amount of the purchase price up-front).

219. *See generally id.* (same).

220. *Id.* at 40. Further, those loans with a high loan-to-value ratio arise where there is a very small down payment. A traditional means of judging a mortgagor’s ability to pay their mortgage was the following question: where they able to save enough cash for a substantial down payment? *See id.* at 39. A 20% down payment “was large enough to convince lenders that a new owner was truly committed and would not risk losing the investment.” *Id.* However, during the housing boom, the required down payment shrank to 10% or 5%, and in some cases nothing at all. *Id.*

221. *Id.*

222. *See generally id.*

223. Jack Healy, *Home Sales and Prices Continue to Plummet*, N.Y. TIMES, Feb. 26, 2009, at B4.

224. *See HU, supra* note 45, at 23.

225. *See id.* The dollar limit is as of January 2008. *See* Fannie Mae: Loan Limits, <http://www.fanniemae.com/aboutfm/loanlimits.jhtml> (last visited July 10, 2009). Some high cost housing markets have limits as high as \$625,000. Timiraos, *supra* note 20.

226. Timiraos, *supra* note 20.

227. *See infra* Part VI.A.

government agencies.”²²⁸ Such a delinquency ratio meant big losses for banks that held jumbo private-label MBS for investment, and for investors who “snapped up jumbo loans packaged into mortgage-backed securities.”²²⁹

B. *Impact of the Community Reinvestment Act*

Exacerbating the problem, the Community Reinvestment Act (CRA)²³⁰ forced private-label issuers to securitize non-conforming mortgages in greater numbers. When the CRA was signed into law in 1977, its stated purpose was to “require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, [and] to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.”²³¹

As such, the admirable goal of the CRA was to ensure access to credit in low- and moderate-income communities.²³² In the beginning, the CRA reasonably focused on the process, “i.e. the efforts and methods used to assess and meet credit needs.”²³³ In 1995, however, this policy was revised to focus “on performance-based standards.”²³⁴ In other words, the test for compliance was changed from evaluating the process used to make loans to counting the number of mortgage loans made.²³⁵

228. Timiraos, *supra* note 20.

229. *Id.* Credit reporting agencies have downgraded hundreds of CMO tranches of MBS backed by jumbo loans. *Id.*

230. 12 U.S.C. § 2901 (2006). In the 1970s concerns over discrimination in mortgage lending led to the Community Reinvestment Act (CRA). *See, e.g.*, Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act And Its Critics*, 80 N.Y.U.L. REV. 513 (May 2005); Forrester, *supra* note 20, at 373.

231. 12 U.S.C. § 2901(b) (2006).

232. *See* Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463, 1465 (1994). *See generally* Barr, *supra* note 230, at 515 (discussing the evolution of the CRA).

233. Vincent M. Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility In The New Millennium*, 71 U. COLO. L. REV. 51, 96 (2000).

234. *Id.*

235. 12 C.F.R. § 25.22 (2009). 25.22—Lending test.

- (a) *Scope of test.* (1) The lending test evaluates a bank’s record of helping to meet the credit needs of its assessment area(s) through its lending activities by considering a bank’s home mortgage. . . . lending.
- (b) *Performance criteria.* The OCC evaluates a bank’s lending performance pursuant to the following criteria:
 - (1) *Lending activity.* The number and amount of the bank’s home mortgage . . . loans . . . in the bank’s assessment area(s);
 - (2) *Geographic distribution.* The geographic distribution of the bank’s home

Measuring compliance based on the number and dollar amount of mortgages in low- and moderate-income neighborhoods substantially tied a bank's hands as to risk determinations.²³⁶ While the Office of the Comptroller of the Currency (OCC) claims that it does not use a quota system to determine CRA compliance, a review of its Community Reinvestment Act Examination Procedures indicates that it uses a point system based on loans made in determining whether a bank's CRA rating is outstanding, high satisfactory, satisfactory, needs to improve, or exhibits substantial noncompliance.²³⁷ CRA ratings have serious implications. A low CRA rating could prevent a lender from receiving approval from the OCC for the "the establishment of a domestic branch; [t]he relocation of the main office or a branch . . . the merger or consolidation with or the acquisition of assets or assumption of liabilities of an insured depository institution; and [t]he conversion of an insured depository institution to a national bank charter."²³⁸ Any applicant seeking a charter must set forth a

mortgage . . . loans . . . on the loan location, including:

- (i) The proportion of the bank's lending in the bank's assessment area(s);
 - (ii) The dispersion of lending in the bank's assessment area(s); and
 - (iii) The number and amount of loans in low-, moderate-, middle-, and upper-income geographies in the bank's assessment area(s);
- (3) *Borrower characteristics.* The distribution, particularly in the bank's assessment area(s), of the bank's home mortgage . . . loans . . . based on borrower characteristics, including the number and amount of:
- (i) Home mortgage loans to low-, moderate-, middle-, and upper-income individuals . . .

236. Barr, *supra* note 230, at 525 n.46 (citing 12 C.F.R. § 25.22 (2009)); see Gramm, *supra* note 37 ("The 1992 Housing Bill set quotas or 'targets.'"). Newt Gingrich stated:

When you put someone in a house they cannot afford, you have not done them a favor; you have established the basis for their bankruptcy. When you put enough people in houses they can't afford, you threaten to bankrupt the institution that was stupid enough to do it. *And when you have the government imposing on the institution the obligation to be stupid, you then have a perfect cycle of self destruction.*

Newt Gingrich, former speaker of the House of Representatives, Keynote Address at the Indiana Chamber of Commerce: Our Economic Crisis—History Repeated?: The Historic Cycle of Manias, Panic and Crashes (Nov. 7, 2008). Not surprisingly, some commentators point not to private-label MBS as the cause of the current economic problems, but to the unreasonable requirements placed on private-label MBS by the federal government. See Gramm, *supra* note 37 (noting the increasing politicalization of mortgage lending "led regulators to foster looser underwriting and encouraged the making of more and more marginal loans."); see also Terence Corcoran, *Quantum Of Failures; Forget The Markets: Massive Government Failure Is Behind World Financial Chaos*, THE FINANCIAL POST (CANADA), Oct. 25, 2008, at FP18.

237. COMMUNITY REINVESTMENT ACT EXAMINATION PROCEDURES, COMPTROLLER'S HANDBOOK 48, 51–52 (1997).

238. 12 C.F.R. § 25.29 (2009); see Lee v. FDIC, No. 95 Civ. 7963(LMM), 1997 WL 570545, at *2–3 (S.D.N.Y. Sept. 12, 1997) (challenging mergers based on CRA non-compliance).

plan as to how it will meet CRA requirements.²³⁹ In the worst case scenario, the failure to make a loan could result in lawsuits.²⁴⁰ While private suits are generally dismissed for lack of standing,²⁴¹ victory is little consolation, where the stigma associated with such a suit can be ruinous. Consequently, lenders erred on the side of making risky loans even if the loan was against their best business judgment.

In an obvious attempt to preemptively deflate criticism that the CRA promotes risky decision-making, the regulations state that “the CRA do[es] not require a bank to make loans or investments or to provide services that are inconsistent with safe and sound operations.”²⁴² But as one CRA critic argued, [R]egulators award extra CRA points to institutions that utilize “more flexible” lending criteria when making CRA loans. Although the applicable regulation quickly recites that such “flexible” loans must be “consistent with safe and sound practices,” it is difficult to imagine what “more flexible” could mean, if not risky²⁴³

The federal government relegated private-label issuers to securitizing risky non-conforming mortgages, and then forced them to securitize even more via the CRA. It is no surprise that private-label MBS plummeted in value, dragged down by defaults on the risky mortgages that backed them. Under such circumstances more government regulation is not the answer.

VI. A CASE STUDY: GMAC MORTGAGE

A. *The Impact of SMMEA and REMIC on GMAC*

The passage of SMMEA in 1984 sent shockwaves of innovation throughout the finance industry.²⁴⁴ GMAC immediately diversified its lending business from auto loans to include mortgages.²⁴⁵ At the time, a GMAC spokesman stated: “[I]t’s a natural area to build [on] GMAC’s traditional strengths. It’s an extension of what we’ve been doing

239. 12 C.F.R. § 25.29 (2009).

240. *See Powell v. Am. Gen. Fin., Inc.*, 310 F. Supp. 2d 481, 483 (N.D.N.Y. 2004).

241. *See, e.g., Lee*, 1997 WL 570545 (dismissing case for lack of standing).

242. 12 C.F.R. § 25.21 (2009).

243. Macey & Miller, *supra* note 39, at 320. Likewise, the actual experience of one affected entity—General Motors Acceptance Corporation (GMAC)—shows what can happen where a lender is held captive by CRA requirements. *See infra* Part VI.

244. L. Michael Cacace, *New Giants Entered the Mortgage Servicing Industry This Year*, AM. BANKER, Oct. 26, 1986, at 2 (GMAC acquired the fourth and ninth largest servicers in the field: Norwest Mortgage Inc., and Colonial Mortgage Service Co.). GMAC was formed in 1919 to provide financing for the purchase of automobiles and continues to do so. *See About GMAC*, <http://www.gmacfs.com/us/en/about/who/index.html> (last visited July 10, 2009).

245. Cacace, *supra* note 244, at 2.

successfully for the past 67 years. We've been looking at and evaluating loans, granting credit and servicing credit. While the product may be different, the process is very similar."²⁴⁶ GMAC immediately began originating its own mortgages under the name GMAC Mortgage.²⁴⁷ Soon thereafter, it began a history of securitization that spans the legislative timeline of MBS discussed above.²⁴⁸ For that reason, GMAC makes an

246. Caroline E. Mayer, *GM Aims to Be King of Hill in Mortgage Field*, WASH. POST, May 13, 1986, at D1.

247. Robert M. Garsson, '86 in Washington: Banking Industry Has Had Better Years in the Capital, AM. BANKER, Feb. 4, 1987, at 1 ("General Motors Acceptance Corp. was already the second largest servicer of mortgage portfolios, and last year it began moving into mortgage origination as well.").

248. See *supra* Parts III–V. The history of GMAC Mortgage is set forth in detail at http://www.gmacmortgage.com/About_Us/Company_Info/History.html:

- 1985: GMAC acquires Colonial Mortgage Service Company as well as the loan administration and servicing portfolio of Norwest Mortgage and becomes GMAC Mortgage.
- 1990: GMAC Mortgage acquires Residential Funding Corporation
- 1998: Purchased first mortgage servicing rights from Wells Fargo
- 1998: GMAC Mortgage announces formation of GMAC Home Services and acquisition of Better Homes and Gardens Real Estate Service
- 1998: Purchased 400,000 conforming loans from Capstead making it the largest servicing-only acquisition in the company's history.
- 1999: Acquired primarily all the assets of DiTech Funding Corp. (now known as ditech.com, LLC) to increase the company's e-commerce presence on the Internet.
- 2000: GMAC Residential was given conditional approval to form GMAC Bank.
- 2003: GMAC Mortgage announces the formation of CalDirect, the premiere mortgage lender for California homeowners.
- 2004: GMAC Mortgage converts servicing to single platform (DSU), acquires Pacific Republic Mortgage to grow business in the West, and achieves second best earnings ever with \$262 million and \$89 billion in lending production.
- 2005: GMAC Residential celebrates its 20th year with GMAC. GMAC also announced the official launch and initial funding of its new parent holding company, Residential Capital, or ResCap, a global real estate finance business created from the combined strength and experience of GMAC Residential and GMAC-RFC.
- 2006: GMAC Residential and GMAC-RFC continue the integration process and form the Residential Finance Group (RFG) under GMAC ResCap.

excellent case study to review the impact of the various legislative initiatives discussed above.

While GMAC Mortgage could not compete with the GSEs in the securitization of conforming mortgages, it utilized SMMEA's reforms to securitize non-conforming mortgages (e.g., jumbo mortgages).²⁴⁹ In addition, GMAC Mortgage used the REMIC provisions of the Tax Code to serve as a conduit for the securitization of non-conforming mortgages originated by others:

[GMAC was] one of the first mortgage conduits to focus on buying and securitizing single-family mortgages, with loan balances above the purchasing authority of the government-sponsored enterprises (jumbo mortgages). [GMAC] purchased loans in the secondary market from a variety of originators (for example, mortgage bankers) and sold them as mortgage-backed securities (MBS) to fixed-income institutional investors.²⁵⁰

GMAC Mortgage became a leader in the private-label MBS field²⁵¹ and was viewed by analyst and competitor alike as “the ultimate step in the integration of the mortgage origination process and the world capital markets.”²⁵²

B. *The Impact of CRA on GMAC*

The impact of the CRA can also be viewed through the lense of GMAC's experience with private-label MBS. Forty-four percent of the

2007: The home offices of GMAC Mortgage and GMAC Bank relocate from its Horsham, Pa. headquarters to a brand new GMAC facility in Fort Washington, PA.

249. Phil Roosevelt, *GMAC Will Issue Bonds Backed by Jumbo Mortgages*, AM. BANKER, Aug. 27, 1987, at 3 (noting that, at that time, jumbo mortgages made up 10% of its originations). The aggregate principal amount of jumbo mortgage loans securitized by GMAC Mortgage in 2005 was \$3.4 billion. *See* GMAC Mortgage Corp., GMACM Mortgage Pass-Through Certificates, Series (Prospectus), at S-27 (Mar. 27, 2006). As to subprime mortgage production, in March 1990, GMAC acquired Residential Funding Corporation (RFC) from Anchor Savings Bank, and expanded RFC into subprime lending. *Anchor Sav. Bank v. United States*, 81 Fed. Cl. 1, 107 (Fed. Cl. 2008). The aggregate principal amount of these non-conforming loans securitized by GMAC Mortgage reached \$700 million by 2005. *See* GMAC Mortgage Corp., GMACM Mortgage Pass-Through Certificates, *supra*.

250. GMAC ResCap, Our History, <https://www.gmacrfc.com/about/history.asp> (last visited June 7, 2009); *see Anchor Sav. Bank*, 81 Fed. Cl. at 107 (discussing GMAC RFC becoming the largest warehouse lender in the nation); *see also* Fred R. Bleakley, *Mortgage Banking's Allure*, N.Y. TIMES, Mar. 27, 1985, at D1.

251. Andrea R. Priest, *GMAC Uses Owners' Trust Structure To Market \$155 Million CMO Issue*, THE BOND BUYER, July 9, 1986, at 3.

252. *Id.*

mortgage loans that GMAC Mortgage securitized were originated by an affiliate entity, GMAC Bank.²⁵³ GMAC Bank is subject to CRA regulations, including requirements on loan originations to low- and moderate-income borrowers.²⁵⁴ Giving GMAC Bank a CRA rating of “outstanding,” the Department of the Treasury stated:

GMAC Bank established nationwide dollar volume and income distribution performance requirements as a condition to the institution’s charter. The institution significantly exceeded those requirements in lending to low- and moderate-income borrowers and/or geographic areas.²⁵⁵

A review of the Evaluation reveals that following promulgation of the CRA regulations, mortgage loans originated by GMAC Bank to low- to moderate-income borrowers increased from 5%–30%.²⁵⁶ As such, GMAC Bank “cloaked itself in righteousness and silenced any troubled regulator.”²⁵⁷ However, the result was a six-fold increase in very risky mortgage assets that it securitized.²⁵⁸

C. The Fall of GMAC

Despite the securitization of some very risky mortgages, all went well at GMAC Mortgage as long as the housing bubble continued to inflate.²⁵⁹ In fact, GMAC Mortgage had record quarters in late 2003 and early 2004, causing executives to worry that poor performance at GMAC Automotive would harm GMAC Mortgage.²⁶⁰ In 2005, in order to protect GMAC Mortgage from losses arising at GMAC Automotive, executives restructured GMAC Mortgage under a new holding company, Residential

253. GMACM Mortgage Loan Trust 2006-AR2, Prospectus (Form 424B5), at S-25 (Mar. 29, 2006).

254. Some argue that “[t]he CRA could not have led to financial Armageddon, because the overwhelming share of subprime mortgages came from lenders that were not banks and not regulated by the CRA.” This ignores the fact that, “[n]early 4 in 10 subprime loans between 2004 and 2007 were made by CRA-covered banks such as Washington Mutual and IndyMac. And that doesn’t include loans made by subprime lenders owned by banks, which were in effect covered by the CRA.” IBD Editorial Board, *Stop Covering Up and Kill the CRA*, INVESTOR’S BUS. DAILY, Nov. 28, 2008.

255. OFFICE OF THRIFT SUPERVISION, COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION, GMAC BANK 2 (Nov. 4, 2003), available at <http://www.dcrac.org/GMAC%202003.pdf> [hereinafter GMAC Rating].

256. *Id.*

257. Gramm, *supra* note 37.

258. GMAC Rating, *supra* note 255.

259. See GMAC Rating, *supra* note 255, at 2.

260. John Porretto, *GM Earns \$1.3 Billion in First Quarter*, ASSOCIATED PRESS, Apr. 20, 2004.

Capital, LLC (ResCap).²⁶¹

GMAC Mortgage's success lasted well into 2006.²⁶² In 2006, GMAC Mortgage was the third largest non-agency mortgage lender.²⁶³ However, in late 2006 it became clear that the housing bubble had burst. GMAC Mortgage's net income, which was \$857 million in 2003, \$968 million in 2004, \$1,021 million in 2005, and \$705 million in 2006,²⁶⁴ fell to negative \$4,346 million in 2007, and GMAC Mortgage lost \$5,611 million in 2008.²⁶⁵ GMAC Mortgage losses for the first quarter of 2009 total \$125 million.²⁶⁶

What went wrong at GMAC Mortgage? When the housing bubble burst, many of the first delinquencies were among those mortgages that GMAC Mortgage securitized: those non-conforming loans (loans too risky for the GSEs) and risky loans made pursuant to CRA mandate.²⁶⁷ These delinquencies negatively affected GMAC Mortgage in a number of ways. First, some of the private-label MBS issued by GMAC Mortgage allowed for recourse against GMAC Mortgage in the event of nonpayment.²⁶⁸ A

261. Aparajita Saha-Bubna, *GMAC Has a Buffer from ResCap Woes*, WALL ST. J., Nov. 10, 2008, at B2. GMAC Mortgage was placed under ResCap. *See generally* GMAC LLC & Residential Capital, LLC, 2007 Investor Forum (Mar. 28, 2007), available at <https://www.rescapholdings.com/investor/docs/2007%20Presentations/GMAC%20and%20ResCap%20Investor%20Forum%20Web%20cast%20Transcript.pdf> [hereinafter GMAC Investor Forum] (recapping investor forum). The deal was reported as follows:

GMAC in 2005 restructured ResCap's business model to establish the mortgage lender as a distinct entity. At the time, ResCap was GMAC's crown jewel, raking in profit at the height of the residential real estate bubble. The idea had been to protect ResCap from declining credit ratings at GM and GMAC so ResCap's access to cheap funding [would not] be restricted. The agreement also isolated ResCap and GMAC from any bankruptcy filings by the other. That clause provides some relief to GMAC now. It could also allow the finance arm to cut itself loose from ResCap if the mortgage unit files for bankruptcy protection.

Saha-Bubna, *supra*.

262. Aleksanders Rozens, *The Race to Save ResCap*, INVESTMENT DEALERS DIG., June 16, 2008.

263. *Id.*; see Ari Levy, *ResCap Debt Sinks on Scrapped Plan to Buy Bad Assets*, BLOOMBERG, Nov. 12, 2008 (noting GMAC Mortgage was the twelfth largest issuer of agency and non-agency subprime mortgages with \$71.1 billion in outstanding MBS).

264. Ken Fischbach, Managing Dir., Investor Relations, GMAC Financial Services, ResCap: 2007 Investor Forum 9 (2007), available at http://media.corporate-ir.net/media_files/irol/13/139684/rescappresentation0307.pdf.

265. Residential Capital, LLC, Annual Report (Form 10-K) at 119 (Dec. 31, 2008); see Levy, *supra* note 263 (ResCap lost 1.9 billion in the third quarter of 2008).

266. *GMAC Financial Services Reports Preliminary First Quarter 2009 Financial Results*, PR NEWswire, May 5, 2009.

267. Joe Bel Bruno, *Subprime Pressure Drives GMAC Profit Down 63%*, ASSOCIATED PRESS, July 31, 2007 (discussing "increased amount of default and delinquencies"). Even conventional homeowners fell behind on mortgage payments. See Levy, *supra* note 263 (loans no longer collecting interest jumped to 22% of related receivables from 13% the year before).

268. Residential Capital, LLC, Quarterly Report (Form 10-Q) (Sept. 30, 2007).

typical GMAC Mortgage's prospectus reads: "Payment of principal, interest and premium, if any, on the senior debt securities will be unconditionally guaranteed by [GMAC Mortgage in the event of default]."²⁶⁹ As a result, GMAC Mortgage was forced to pay senior stakeholders' balances when enough of the underlying mortgagors stopped making payments.²⁷⁰ Second, even if the private-label MBS contracts did not allow for recourse against GMAC Mortgage in the event of non-payment—but instead provided for recourse against collateral mortgages only—GMAC Mortgage still was liable for breaching various representations and warranties as to the quality of the underlying collateral (the mortgages) and had to repurchase a certain number of previously issued securities.²⁷¹

Third, the market for private-label MBS dried up, causing those selling to do so at a distressed price.²⁷² GMAC Mortgage found itself stuck with a large inventory of held-for-sale MBS that it could not unload on the market.²⁷³ Additionally, GMAC Mortgage had a large inventory of held-for-investment MBS that were quickly losing value.²⁷⁴ These assets were quickly losing value not because of valuation of the underlying mortgages' cash flows (most will be paid), but rather because pursuant to mark-to-market regulations, GMAC Mortgage was forced to mark the value of the private-label MBS to market.²⁷⁵ If there is no market for private-label MBS, their marked value is zero.²⁷⁶

269. Residential Capital Corp., Registration Statement (Form S-3) 5 (Oct. 20, 2005). In turn, "event of default" is defined as: "(1) our failure to pay principal or premium on any of the senior debt securities of such series when due; or (2) our failure to pay any interest on any of the senior debt securities of such series when due, which failure continues for 30 days." *Id.* at 6.

270. *See id.*

271. Residential Capital, LLC, Quarterly Report (Form 10-Q) 61 (Sept. 30, 2007).

272. *Id.* at 64 (discussing illiquid market for MBS); GMAC Investor Forum, *supra* note 261 ("Severe illiquidity in the market, no legitimate bids for certain assets . . . and . . . significant downward mark-to-market adjustments that weighted heavily on earnings.").

273. GMAC Investor Forum, *supra* note 261. On the other hand, mortgages or MBS are characterized as "held for sale" when the decision has been made to sell the mortgage or MBS. 2 D.R. CARMICHAEL & PAUL H. ROSENFELD, ACCOUNTANTS HANDBOOK, SPECIAL INDUSTRIES AND SPECIAL TOPICS (11th ed. 2007). These are the mortgage banker's "inventory." *See id.*

274. GMAC Investor Forum, *supra* note 261. Private-label MBS are characterized as "held for investment" where the mortgage banker decides to hold the loans to maturity, or where "the loans [are] transferred into a mortgage banker's 'loans held for investment' category from a 'loans held for sale' category after it is determined that the loan is unsalable." CARMICHAEL & ROSENFELD, *supra* note 273. A mass transfer from the "held for sale" to the "held for investment" category is exactly what happened at ResCap when the market for its MBS dried up and ResCap was stuck with a large inventory of MBS that it could not sell. *See* GMAC Investor Forum, *supra* note 261.

275. *See infra* Part VI.D.

276. *See infra* Part VI.D.

D. *The Impact of Mark-To-Market*

Mark-to-market regulations rendered GMAC Mortgage's private-label MBS, whether held-for-sale or held-for-investment, worthless.²⁷⁷ If a bank simply originates and holds a mortgage (without securitizing it) it can carry the asset on its books at its face value indefinitely.²⁷⁸ On the other hand, when it is pooled into a private-label MBS a mortgage becomes a security²⁷⁹ subject to SEC accounting standards.²⁸⁰ Although authorized by the Securities Laws to promulgate its own standards, the SEC has traditionally relied upon the private sector to do so, specifically, the Financial Accounting Standards Board (FASB).²⁸¹ The FASB pronounced that any private-label MBS held for sale must be valued at fair market value, based upon published mortgage-backed securities' yields.²⁸² The impact of this valuation method is not to be understated:

[L]ets say an investment bank has securitized \$50 million worth of mortgages into an MBS bundle. If 10% of those loans become non-performing loans, and nobody wants to buy

277. ZANDI, *supra* note 17, at 237–38.

278. Robert F. Kornegay, Jr., *Bank Loans As Securities: A Legal and Financial Economic Analysis of the Treatment of Marketable Bank Assets Under the Securities Acts*, 40 UCLA L. REV. 799, 802 (1993).

279. *See supra* Part II.B.

280. Kornegay, *supra* note 278, at 802.

281. *See* Financial Accounting Standards Board, Facts About FASB, <http://www.fasb.org/facts/> (last visited July 10, 2009).

282. FASB Statement 65 § 9 states:

The market value of mortgage loans and mortgage backed securities held for sale shall be determined by type of loan. At a minimum, separate determinations of market value for residential (one- to four-family dwellings) and commercial mortgage loans shall be made. Either the aggregate or individual loan basis may be used in determining the lower of cost or Market value for each type of loan. Market value for loans subject to investor purchase commitments (committed loans) and loans held on a speculative basis (uncommitted loans) shall be determined separately as follows:

...

- c. *Uncommitted Mortgage-Backed Securities.* Market value for uncommitted mortgage-backed securities that are collateralized by a mortgage banking enterprise's own loans ordinarily shall be based on the Market value of the securities. If the trust holding the loans may be readily terminated and the loans sold directly, Market value for the securities shall be based on the Market value of the loans or the securities, depending on the mortgage banking enterprise's sales intent. Market value for other uncommitted mortgage-backed securities shall be based on published mortgage-backed securities yields.

Financial Accounting Standards Board, Statement No. 65: Accounting for Certain Mortgage Banking Activities § 9 (1982), *available at* <http://www.fasb.org/pdf/FAS65.pdf> (footnote omitted).

that MBS bundle, the value of the whole bundle would be written down to, technically \$0; and the bank has to write off \$50 million in investment. This is the case, despite the fact that 90% of those loans are still receiving payments. Last year, banks and financial firms around the globe [took] write downs topping \$500 billion.²⁸³

As another commentator stated bluntly, “[The private-label MBS] must be written down to their current market value. Unfortunately, the current market stinks. In fact, it’s practically nonexistent. So while anticipated credit losses are much smaller, the mark-to-market values make things look far worse than they are.”²⁸⁴ Thus, GMAC was forced to state that its assets were worth less than they actually were.²⁸⁵

E. Systemic Financial Meltdown

By the time GMAC Mortgage realized that its portfolio over relied on private-label MBS, it was too late. GMAC Mortgage’s net income fell to negative \$4,346 million in 2007.²⁸⁶ At the time, some feared that GMAC Mortgage’s over exuberant investment of time and money in private-label MBS would lead to its bankruptcy.²⁸⁷ Tragically, GMAC Mortgage’s experience was repeating itself across many financial institutions in 2007.²⁸⁸ At another mortgage securitization company things were equally bad:

The mortgage executives who gathered in a blond-wood conference room in Southern California studied their internal reports with growing alarm. More and more borrowers were falling behind on their monthly payments almost as soon as they moved into their new homes, indicating that some of them never really had the money to begin with. “Nobody had models for that,” said David E. Zimmer, then one of the

283. Sonny Coloma, *In The End, It Will Be Calm*, BUS.WORLD, Oct. 10, 2008, at S1/4.

284. Michael K. Guttai, *Home Loan Banks Can Absorb Any MBS Pain*, AM.BANKER, Jan. 30, 2009, at 10; see Schwarcz, *supra* note 12, at 396 (arguing that mark-to-market requirements can have “‘perverse effects on systemic stability’ during times of market turbulence, when forcing sales of assets to meet margin calls can depress asset prices, requiring more forced sales (which, in turn, will depress asset prices even more), causing a downward spiral.”).

285. *But see* Henry M. Paulson Jr., U.S. Sec’y of Treasury, Address at Ronald Reagan Presidential Library (Nov. 20, 2008) (“We must address those aspects of our system that reinforce rather than counterbalance cycles; regulators and ratings agencies often take actions after a problem emerges that exacerbates the cycle. For example, mark-to-market accounting is clearly pro-cyclical. Yet I know of no better accounting method, and welcome the steps to review and modify its implementation during severe market stress.”).

286. Residential Capital, LLC, Annual Report (Form 10-K), at 119 (Dec. 31, 2008).

287. Bankruptcy for GMAC is looking more and more likely. Neil King, Jr. & John D. Stoll, *Task Force Visits Detroit as Deadline Looms on Aid*, WALL ST. J., Mar. 9, 2009, at B1.

288. See ZANDI, *supra* note 17, at 177.

executives at People's Choice, a subprime lender based in Irvine. "Nobody had predicted people going into default in their first three mortgage payments." The housing boom had powered the U.S. economy for five years. Now, in early 2006, signs of weakness within the subprime industry were harder to ignore. People with less-than-stellar credit who had bought homes with adjustable-rate mortgages saw sharp spikes in their monthly payments as their low initial teaser rates expired. As a result, more lost their homes; data showed that 70 percent more people faced foreclosure in 2005 than the year before. Housing developers who had raced to build with subprime borrowers in mind now had fewer takers, leaving tens of thousands of homes unsold.²⁸⁹

Big players reported losses at alarming rates: Chase Mortgage Financial Company,²⁹⁰ Citicorp Mortgage Securities, Inc.,²⁹¹ HSBC's MBS trading unit,²⁹² New Century Financial Corporation,²⁹³ People's Choice Mortgage,²⁹⁴ Bank of America,²⁹⁵ Wells Fargo & Co.,²⁹⁶ and Prudential Home Mortgage Securities.²⁹⁷ Nevertheless, GMAC Mortgage did not go bankrupt. Instead GMAC, and some of the other above listed mortgage companies, received a bailout in the form of Troubled Asset Relief Program (TARP) funds on December 29, 2008, in return for preferred stock.²⁹⁸ Further, GMAC Mortgage received an additional influx of cash

289. Goldfarb & Klein, *supra* note 93.

290. Floyd Norris, *Belated Withdrawal From Risk*, N.Y. TIMES, Aug. 15, 2008, at C1 (Chase announced to SEC that it expected a lot more losses before the mortgage situation stabilized).

291. Kevin Dobbs, *3Q Earnings: Subtractions Still on Citi's Agenda: So Are Additions*, AM. BANKER, Oct. 17, 2008, at 1 (stating that Citi was "[b]adly bruised by losses on mortgage-related securities"); *see also* David Enrich, *Citi's Hits: 15 Times \$100 Million*, WALL ST. J., Feb. 26, 2008, at C2 ("\$20 billion in mortgage-related write-downs [taken] last year"). "J.P. Morgan [Chase & Co.] disclosed that it had \$34.4 billion in jumbo mortgages [held for investment]." Timiraos, *supra* note 20. Its "Chief Executive James Dimon acknowledged that [J.P. Morgan Chase] expanded too aggressively into the market in 2007, particularly in places such as California, where home prices later collapsed. 'We were wrong,' Mr. Dimon says. 'We obviously wish we had not done it.'" *Id.*

292. Goldfarb & Klein, *supra* note 93 ("HSBC, a 142-year-old London-based bank that was one of the largest subprime lenders, says it must set aside \$10.6 billion to cover expected losses.").

293. *Id.*

294. *Id.*

295. Timiraos, *supra* note 20.

296. *Id.*

297. Richard Newman, *Prudential Posts \$108 M Loss in Quarter*, THE RECORD, Oct. 30, 2008, at B3 ("Like some other insurers, Prudential has invested in financial instruments, such as securities backed by subprime mortgages, that have plummeted in value.").

298. *See* Jennifer Niemela, *ResCap's Owner, GMAC Receives \$5B in TARP Funds*, MINNEAPOLIS/ST. PAUL BUSINESS JOURNAL, Dec. 30, 2008, available at <http://www.bizjournals.com/twincities/stories/2008/12/29/daily6.html> (last visited July 10, 2009) ("GMAC Financial Services received a \$5 billion investment from the Treasury as part of the Troubled Assets Relief Program, the company announced Monday. That could be a lifeline for

via the Home Affordable Modification Program (HAMP) funds on March 13, 2009.²⁹⁹

VII. WHERE DO WE GO FROM HERE?

What can we do now? Finally, I present several courses of action that Congress could take regarding private-label MBS and evaluate them in light of the foregoing historical review of private-label MBS development. I conclude that the worst approach is the one currently underway—greater regulatory interference in private-label MBS. Too much government interference was the true cause of the unsustainable housing bubble vis-à-vis selective competition from GSEs in the MBS marketplace coupled with misguided federal housing policy, including the CRA. Therefore, reducing that counterproductive regulatory interference is the proper course of action.

A. *Rolling Back the Privatization of MBS*

Reagan-era encouragement of private-label MBS did not increase the risky decision-making that lead to an unsustainable housing bubble and economic crisis.³⁰⁰ As such, repealing or weakening SMMEA, Rule 415, and REMIC provisions of the Tax Code would be a mistake. Such an action will seriously restrict mortgage credit. It was not until Reagan-era privatization that “the private mortgage securities market rapidly expanded . . . increase[ing] sevenfold [from \$10 billion] to more than \$71 billion.”³⁰¹ It was only then that home ownership rose from 64% to 70%.³⁰² This was no small feat considering the sizable portion of the population who will always choose to rent.³⁰³ While rolling back Reagan-era

ResCap, the residential real estate lending arm of the company, which GMAC had said in November might not survive if it didn't receive the government investment.”); *see also* Edmund Andrews, *Treasury Department Is Said to Plan Second Bailout for GMAC*, N.Y. TIMES, May 21, 2009, at B4; Brian Collins, *GMAC Gets \$5B TARP Funds*, NAT'L MORTGAGE NEWS, Jan. 5, 2009, at 1.

299. *See* Brian Collins, *Servicers to Get \$15B for Loan Mods*, MORTGAGE SERVICING NEWS, June 2009, at 1; *see also* UNITED STATES DEP'T OF THE TREASURY, SECTION 105(A) TROUBLED ASSET RELIEF PROGRAM REPORT TO CONG. FOR THE PERIOD APR. 1, 2009 TO APR. 30, 2009, *available at*, http://www.financialstability.gov/docs/105CongressionalReports/105aReport_042009.pdf. HAMP is discussed in detail in the next Part VII.

300. *See supra* Part IV.

301. Ann M. Burkhardt, *Lenders and Land*, 64 MO. L. REV. 249, 275 (1999) (citing Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 497 (1989)).

302. U.S. CENSUS BUREAU, HOUSING VACANCIES AND OWNERSHIP, ANNUAL STATISTICS: 2007, at tbl. 12, *available at* <http://www.census.gov/hhes/www/housing/hvs/annual07/ann07ind.html>. For rates prior to 1960, *see* WENDELL COX & DR. RONALD D. UTT, SMART GROWTH, HOUSING COSTS, AND HOMEOWNERSHIP (2001), *available at* http://www.heritage.org/research/smartgrowth/upload/9423_1.pdf.

303. David Varady & Barbara Lipman, *What Are Renters Really Like: Results from a National*

privatization would not spell an absolute end to private-label MBS, experience tells us that far fewer private-label MBS would be issued. For example, the first private-label MBS were issued by Bank of America in 1977,³⁰⁴ and thereafter only a very small number of private institutions issued private-label MBS prior to SMMEA.³⁰⁵ Therefore, most financial institutions would be forced to return to the originate-and-hold model rather than subjecting their companies to stifling restrictions on forward trading, state blue sky laws, investor restrictions, increased registration requirements, and double taxation.

Rather than a noisy repeal of SMMEA, it appears that the 111th Congress is acquiescing to a Treasury power grab to regulate private-label MBS. Consider the following: the Senate version of the 2009 American Recovery and Reinvestment Act (Recovery Act) authorized the Treasury to “pay” lenders to modify the underlying mortgages, without the consent of those who hold the private-label MBS in question,³⁰⁶ at a rate of \$2,000 for each modified mortgage.³⁰⁷ However, following significant opposition, the Recovery Act as passed did not contain the mortgage modification provisions.³⁰⁸ There were serious objections to the Treasury paying financial institutions to conform their mortgages to the Treasury’s idea of fairness.

Failure of the Senate version to pass did not stop the Treasury. It simply fell back to arguing that it could force such modifications pursuant to the older Emergency Economic Stabilization Act of 2008 (Stabilization Act).³⁰⁹ As such, the Treasury began the Home Affordable Modification

Survey, 5 Hous. Pol’y Debate 491, 501 (1994) (stating 32% of renters say they will always rent).

304. *Legislative Proposal*, *supra* note 195, at 303–04, 304 n.11 (“In 1977, Bank of America issued the first major nonagency guaranteed mortgage pass-through certificates. Subsequently, numerous nonagency guaranteed pass-through certificates have been issued.”).

305. Kerry D. Vandell, *Multifamily Finance: Pathway to Housing Goals, Bridge to Mortgage Market Efficiency*, 11 J. OF HOUSING RESEARCH 319 (2000) (“[W]ith the quasi privatization of Fannie Mae and the creation of Freddie Mac in 1970, came the creation of a new secondary market facility for conventional loans. The volume of purchase was relatively low at first, but the program provided experience for the future.”).

306. American Recovery and Reinvestment Act, H.R. 1 (as passed by House of Representatives Feb. 10, 2009) [hereinafter “Senate Version”], *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1pp.txt.pdf.

307. Senate Version § 8003. And the holders are stripped of any right to enforce the servicer’s duty to maximize shareholder value, as the Act provides that the servicer “shall be deemed to act in the best interest of all such investors and parties if the servicer agrees to implements a modification, workout, or other loss mitigation plan.” *Id.*

308. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

309. 12 U.S.C. § 5221, et. seq. Such belief is based on Sections 101 and 109 of the Stabilization Act. *See* FED. NAT’L MORTGAGE ASS’N, COMMITMENT TO PURCHASE FINANCIAL INSTRUMENT AND SERVICER PARTICIPATION AGREEMENT FOR THE HOME AFFORDABLE MODIFICATION PROGRAM UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008, *available at* <https://www.hmpadmin.com/portal/docs/servicerparticipationagreement.pdf>.

Program (HAMP) and is currently paying lenders to modify mortgages to fit the Treasury's idea of fairness.³¹⁰ The problem is that the Treasury's idea of fairness is often reflective of special interest pressure, not sound business practices.³¹¹ Case in point is the CRA previously discussed in Part V.B. Further, ACORN has already put the Treasury on notice that it is watching to make sure mortgage modifications are implemented in a "fair" manner.³¹² That is to say, failure to modify a loan could result in lawsuits, and while fair lending suits are generally dismissed for lack of standing,³¹³ victory is little consolation, because the stigma associated with such a suit may be ruinous. This will likely cause lenders to err on the side of modifying loans that should be allowed to enter foreclosure.

B. *Legislating Aversion to Risk—A Risky Proposition*

Congress could conclude, as argued in this Article, that the Reagan-era legislation encouraging private-label MBS did not increase the risky decision-making that led to the unsustainable housing bubble and economic crisis. Even then, Congress still may pass legislation designed to discourage risk-taking by those that deal in private-label MBS. Indeed, Congress has demonstrated its favor for such "ethics" legislation recently by passing Sarbanes-Oxley.³¹⁴ However, such efforts can be counterproductive where they purport to define ethical business decisions.³¹⁵ To illustrate:

The contract states in relevant part:

WHEREAS, the U.S. Department of the Treasury (the "Treasury") has established a Home Affordable Modification Program (the "Program") pursuant to section 101 and 109 of the Emergency Economic Stabilization Act of 2008 (the "Act"), as section 109 of the Act has been amended by section 7002 of the American Recovery and Reinvestment Act of 2009. . . .

Id. Sections 101 and 109 of the Stabilization Act do not authorize such payments. They simply allow for the Treasury to purchase toxic assets, not pay banks to modify mortgages.

310. See *GMAC Mortgage Formalizes Participation in Home Affordable Modification Program*, REUTERS, Apr. 15, 2009.

311. See Letter from ACORN to Timothy Geithner (Mar. 29, 2009), available at <http://www.consumerlaw.org/issues/foreclosure/content/SummersgeithnerMarch09.pdf>. The letter reminds the Treasury must collect information about "homeowner characteristics, including race and national origin, which is essential for monitoring fair lending compliance. These data must be made publicly available so that the public can have confidence that loan modifications are being offered in a fair and nondiscriminatory manner." *Id.*

312. See *id.*

313. See *Powell v. Am. Gen. Fin., Inc.*, 310 F. Supp. 2d 481, 485-86 (N.D.N.Y. 2004).

314. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); see Horton, *supra* note 28, at 182-83 (arguing that Sarbanes-Oxley was an arbitrary piece of legislation and that the text of which was derived more from campaign contributions than from policy considerations).

315. I concede that legislation may create conditions where good business decisions are encouraged. See Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation:*

Adam is vice president in charge of XYZ, Inc.'s mortgage division. The division originates and packages mortgages, and offers either pass-through securities or CMO. Traditionally, they have only securitized jumbo mortgages. There is a question as to whether they should begin to originate and securitize subprime mortgages—a more risky proposition.

In deciding whether to originate and securitize subprime mortgages, Adam is faced with two distinct considerations: the first, a business decision (what is ethical business behavior?), and the second a legal decision (what is legal?). The former decision is Adam's to make alone, and is indeed difficult, pitting Adam's self interest against the interests of the shareholder. For example, originating and securitizing more mortgages may increase Adam's bonus if it is calculated on the basis of originations and securitizations; on the other hand, it will expose shareholders to greater risk.³¹⁶

If Adam decides to go forward with the originations and securitizations, he may justify his decision by pointing out that his actions are technically legal. He may exclaim, "My attorney handled the securitization."³¹⁷ Adam

An Inquiry into the Causes of Corporate Immorality, 73 TEX. L. REV. 477, 532 n.252 (1995) (citing Aristotle's *Nicomachean Ethics*, which argued that because it is difficult for individuals to become virtuous without any moral guidance, laws are needed to legislate morality and to prescribe acceptable methods of behavior, deviation from which must be sanctioned by corrective treatments and penalties); see also David Hess, *A Business Ethics Perspective On Sarbanes-Oxley And The Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1784 (2007) (arguing that Sarbanes-Oxley creates such positive conditions). However, such legislation is rare. See Milton Friedman, Commentary, *Woof! Woof! This Cat Just Won't Bark*, WALL ST. J., May 16, 1995, at A18. I would certainly disagree with Mr. Hess as to Sarbanes-Oxley.

316. A good illustration of managers placing self-interest over the interests of shareholders is in the context of hostile takeovers. Resisting hostile takeovers via a poison pill is legal, but often not in the best interest of shareholders. See Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 278–79, 291–92 (1984). Awarding bonuses based on production of mortgages is legal, but may not be in the best interest of shareholders if there is a high likelihood that those mortgages will fail. But see Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 69 (1992) ("[A] shareholder may be eager for the corporation to take on risk, but the executive with performance-based bonuses may have powerful incentives to avoid risk taking. Even though incentive compensation is designed to align shareholder and executive interests, when it comes to risk taking, those interests radically diverge.").

317. Beyond the fact that what is merely legal may not rise to good business, there is another reason why Adam should not be able to displace his business decision onto his attorney: The lawyer's Rules of Professional Responsibility often *prevent* a lawyer from advising as to what is ethical—or in this case, good business. For example, a central tenant as to professional responsibility is that the "client is entitled to zealous representation—the most aggressive business structure that the law supports." Horton, *supra* note 28, at 157. A lawyer is required to go beyond what is ethical, up to the line of what is legal, and if that line is grey, to go beyond. See William H. Simon, *After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer*, 75 FORDHAM L. REV. 1453, 1455–57 (2006) (discussing the formalist and anti-formalist debate on legal advice regarding business decisions); see also Julie Hilden, *Scummy Judgment: Why Enron's Sleazy Lawyers Walked while Their Accountants Fried*, SLATE, June 21, 2002, available at

may even cite compliance with congressional legislation that purports to define ethical business behavior (i.e., Sarbanes-Oxley).³¹⁸ Adam can “give up entirely on trying to figure out what is ethical and . . . instead us[e] what’s legal as [his] standard for decision-making. [However,] the result is moral bankruptcy.”³¹⁹ Ironically, a classic example of decision makers using what is legal as a guide for what is ethical already arises in the private-label MBS context.³²⁰ The CRA provides regulatory cover for risky decision-making:

As Mr. Greenspan testified last October at a hearing of the House Committee on Oversight and Government Reform, “It’s instructive to go back to the early stages of the subprime market, which has essentially emerged out of CRA.” It was not just that CRA and federal housing policy pressured lenders to make risky loans—but *that they gave lenders the excuse and the regulatory cover.*³²¹

Furthermore,

Countrywide Financial Corp. cloaked itself in righteousness and silenced any troubled regulator by being the first

<http://www.slate.com/id/2067206/pagenum/all/> (last visited July 10, 2009) (“The ethical obligation to vigorously represent the client marches right up to the very brink of what is legal, although it does not go beyond it.”). Lawyers are not equipped to, and therefore, should not make business determinations for a corporation.

318. See e.g., David Reilly, *Bank of America’s Lewis Loses His Mind to Lawyers*, BLOOMBERG, June 17, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601039&sid=aYs7S5OKuSSg> (last visited July 10, 2009). According to Reilly, Kenneth Lewis at Bank of America (BoFA) was asked by a congressional committee on June 11, 2009 why he kept BoFA’s “shareholders in the dark for almost a month about gaping losses at Merrill Lynch & Co. (Merrill)” at a time when BoFA was set to acquire Merrill. See *id.* Lewis responded that he felt “comfortable that [he] followed the law.” *Id.* When pressed that this is information that shareholders would want to know, he passed the buck to BoFA’s lawyers, stating, “[w]e take disclosure very, very seriously. If anybody in our legal group had suggested we do anything of that nature, we would have done it.” William Cohan, *Did Ken Lewis Mislead Shareholders?*, FORTUNE, June 29, 2009, available at http://money.cnn.com/2009/06/25/news/companies/lewis.fortune/index.htm?section=magazines_fortune (last visited July 10, 2009).

319. JOHN MAXWELL, *THERE’S NO SUCH THING AS BUSINESS ETHICS* 12 (2003). Indeed, there is ample anecdotal evidence that officers and directors rely on what is legal as their standard for decision-making, allowing it to trump good business behavior. See *Howard v. SEC*, 376 F.3d 1136, 1146-48 (D.C. Cir. 2004) (relying on advice of counsel defense in securities fraud action); *SEC v. Leffers*, 289 F. App’x 449, 451(2d Cir., 2008) (relying on advice of counsel defense in securities fraud action); *SEC v. Snyder*, 292 F. App’x 391, 404-07 (5th Cir. 2008) (relying on advice of accountant in securities case). In each case the defendants claim believing that their actions were legal because their attorney or accountant advised them so. Beyond believing the actions to be legal, did they also believe them to be ethical?

320. Gramm, *supra* note 37.

321. *Id.* (emphasis added).

mortgage lender to sign a HUD “Declaration of Fair Lending Principles and Practices.” Given privileged status by Fannie Mae as a reward for “the most flexible underwriting criteria,” it became the world’s largest mortgage lender—until it became the first major casualty of the financial crisis.³²²

The cloak of regulatory cover can be intoxicating, causing decision makers to abandon their own notion of right and wrong for a set of “ethics” provided by the law.³²³

C. *The Way Forward*

This same goal of preventing risky behavior can be accomplished by non-legislative means. In fact, encouraging more prudent decision-making is likely already accomplished because decision makers’ lightened wallets will make them think twice before embracing risk once again.³²⁴ Consider the response of GMAC Mortgage.³²⁵ GMAC Mortgage executives

322. *Id.*

323. Take for example the 1974 experiments of Stanley Milgram. See STANLEY MILGRAM, *OBEDIENCE TO AUTHORITY, AN EXPERIMENTAL VIEW* (1974). Milgram asked a subject to administer electric shocks to victims—a clearly unethical endeavor. *Id.* The subject was more likely to comply where they were told that administering the shocks is acceptable. *Id.* Likewise, our hypothetical vice-president, Adam, is more likely to engage in bad business decisions (e.g., originating and securitizing sub-prime mortgages) where a corporate lawyer tells him that doing so is legal. Adam may do more than transfer responsibility for decision-making to his attorney, he may actually subordinate his opinion to that of his attorney. As pointed out by the literature, the incidence of bad business decisions increases where the decision-maker views himself as subordinate to a person that labels the activity is acceptable. See Andrew Pearlman, *Unethical Obedience by Subordinate Attorneys: Lessons from Social Psychology*, 36 HOFSTRA L. REV. 451, 452, 459–62 (2008). A corporate officer may well believe himself subordinate to his lawyer on moral determinations, because he equates morality with law. *Id.*; see also David Hess, *A Business Ethics Perspective On Sarbanes-Oxley and The Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1785 (2007) (stating that social pressure plays an important role in ethical decision-making as “a subjective norm refers to the social pressure a person feels from important others to perform or refrain from performing the behavior and to the person’s motivation to comply with those pressures”).

324. Alan J. Heavens, *Mortgage Lenders Lower Their Risk*, PHILA. INQUIRER, Sept. 28, 2008, at E1.

325. GMAC is not alone in its new “conservative” risk-adverse approach. Wells-Fargo is aggressively moving to refinance mortgages “to achieve sustainable and affordable mortgage payments generally targeting a 38 percent mortgage payment-to-income ratio.” *Wells Fargo Merger Gives 478,000 Wachovia Customers Access to New Wells Fargo Solutions if Their Mortgage Payments Become At-Risk; Wells Fargo Expands Leading the Way Home Program to Stabilize Hard-Hit Communities*, ENP NEWSWIRE, Jan. 27, 2009, available at FACTIVA, Document ENPNEW0020090127e51r0005o. As discussed in Part V.A., a high payment-to-income ratio is a leading indicator that a borrower will have trouble making payments. The above described market-driven reduction of risk on the part of private-label MBS issuers is coupled with the federal government buying certain toxic MBS assets from those issuers, further reducing their exposure.

admitted at an Investor Forum held in early 2007 that they had invested too heavily in risky subprime private-label MBS, stating that the “Held for Investment . . . portfolio is predominantly subprime, and that’s why we got hit very, very hard in the fourth quarter [of 2006].”³²⁶ That was an understatement: risky subprime mortgages accounted for 62% of GMAC Mortgage’s held-for-investment portfolio as of September 30, 2007.³²⁷ There was a real attempt to reduce some of that exposure by reducing subprime production by 15% that year.³²⁸ The company moved to reduce its risk further by selling off much of its subprime held-for-investment MBS.³²⁹ Despite these defensive measures, “[t]he extent of Rescap’s exposure to the subprime-mortgage sector remain[ed] an issue of uncertainty.”³³⁰ GMAC Mortgage may not survive, but such is the natural result of poor decision-making, and in this case, poor decision-making brought on by excessive government regulation.³³¹

A good amount of risky decision-making can be averted by removing the cloak of regulatory cover for risky decision-makers by repealing the CRA. Indeed, “repeal of the CRA” is the resounding call from those who recognize the value of private-label MBS.

According to an *Investors Business Daily*’s editorial, “The CRA should be abolished, along with the government-sponsored enterprises that fueled the secondary market for subprimes.”³³² Further, according to Senator Phil Gramm’s opinion piece in the *Wall Street Journal*, “It was not just that CRA and federal housing policy pressured lenders to make risky loans—but that they gave lenders the excuse and the regulatory cover.”³³³

In addition to editorial calls, there were legislative calls to repeal the CRA.³³⁴ In response to a growing perception that the CRA forced risky decision-making, House Bill 7264 was introduced on October 3, 2008.³³⁵ It would have expressly repealed the CRA.³³⁶ House Bill 7264 was referred

Brad Kelly, *Fed Refills Tool Kit Amid Growing Signs Of Long Downturn*, INVESTOR’S BUS. DAILY, Jan. 7, 2009, at A1.

326. GMAC Investor Forum, *supra* note 261, at 60.

327. Lingling Wei & John D. Stoll, *Buyers Shun ResCap Bonds*, WALL ST. J., Nov. 17, 2007, at B5.

328. GMAC Investor Forum, *supra* note 261, at 65, 66 (stating, in addition to an overall reduction in its held for investment portfolio, “[ResCap] stopped the growth of [its] Held for Investment [portfolio,] and [said investments] actually came down throughout [2006]”).

329. Wei & Stoll, *supra* note 327 (“[T]he company says . . . it has sold off into securities a large portion of subprime loans.”).

330. *Id.*

331. *Id.*

332. IBD Editorial Board, *supra* note 254.

333. Gramm, *supra* note 37.

334. Reliable Economic Stabilization, Capital Utilization, and Enterprise Reform Act of 2008, H.R. 7264, 110th Cong. § 105 (2008).

335. *Id.*

336. *Id.*

to the House Committee on Financial Services where it was to be “marked up” by those representatives with expertise in the subject matter and then returned to the entire House of Representatives for an up or down vote.³³⁷ There, opponents allowed it to languish, “known as wielding the ‘blocking power’—if committee members disfavor the bill for any reason they can do nothing and allow the bill to languish in committee.”³³⁸

VIII. CONCLUSION

What caused the unsustainable housing bubble that peaked in mid-2006, and by extension, the current economic crisis? The answer to this question is essential “because the reforms implemented by Congress will be profoundly affected by what people believe caused the crisis.”³³⁹ Private-label MBS growth truly began with the Reagan-era legislation, including SMMEA (1984) and the REMIC provisions of the Tax Code (1986), that freed it from burdensome securities regulation. But recently, in a rush to be seen as doing something to combat the current economic crisis, Congress (and others in a position to fashion domestic economic policy) have identified lack of regulation of private-label MBS as the “root cause” of the problem³⁴⁰ and lamented the “lack of adequate regulation of key aspects of our financial system . . . including non-bank mortgage originators and unregulated dealers in exotic financial instruments.”³⁴¹ The call for greater regulation and the impulse to blame the private sector apparently arises from a congressional belief that risky decision-making arises only in the absence of regulation.

However, this Article has demonstrated that the unsustainable housing bubble was not a result of “enabl[ing] private issuers of mortgage securities to compete more effectively with government-related agencies.”³⁴² To the contrary, and with no lack of irony, it was congressional tinkering in the form of federal housing policy and the CRA that caused private-label MBS issuers to engage in risky decision-making that inflated the housing bubble. Given its track record, Congress’ inaction, i.e., letting the free market take its course, is the best approach. Just as in the aftermath of the Great Depression, private-label MBS issuance will diminish.³⁴³ In fact, one

337. *Id.*; Judy Schneider, Congressional Research Service, House Committee Organization and Process: A Brief Overview (2005), available at <http://www.rules.house.gov/archives/RS20465.pdf> (describing the mark-up process).

338. Horton, *supra* note 28, at 183 (citing KENNETH A. SHEPSLE & MARK S. BONCHEK, ANALYZING POLITICS 338 (1997)).

339. Gramm, *supra* note 37.

340. Press Release, United States Treasury, Paulson Statement on Financial Markets Update (Oct. 8, 2008), available at <http://www.treas.gov/press/releases/hp1189.htm> (last visited July 10, 2009).

341. Frank Letter to Constituents, *supra* note 27.

342. Shenker & Colletta, *supra* note 30, at 1385.

343. LORE, *supra* note 67, at 1–13, 1–14 (writing about MBS after the great depression).

commentator, writing of MBS and the Great Depression writes:

[A] significant experiment in pooled mortgages took place in the 1920s. That effort disappeared in the collapse of the real estate market across the country in the 1930s. As an aftermath of that debacle, many states passed emergency legislation to salvage billions of dollars of mortgage participations and syndications. For successive decades that experience clouded the reputation of mortgage related securities with much of the investment community—individual investors and financial houses alike.³⁴⁴

Private-label MBS will and should rise again—as it did over the past twenty years—and maybe it will do so free of the chains of government’s counterproductive regulation.

344. *Id.*