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*More for Less: “Yield Spread” Mortgage Broker
Compensation and the Subprime Foreclosure Crisis*

The Subprime Housing Crisis: Interdisciplinary Policy Perspectives

Forkenbrock Series on Public Policy

University of Iowa, Iowa City – October 10, 2008

Chris Peterson, Professor of Law



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*Subprime Mortgage Securitization, Foreclosure, and
the U.S. Capital Market Crisis*

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U.S. Subprime Lending Crisis

- As many as eight million families are facing foreclosure
- The decline in housing values associated with foreclosure has put our economy on the brink of a depression
- Events have forced the most comprehensive change in the structure of the mortgage market since the Great Depression



Why have so many Americans suddenly become unable to pay for their shelter?

Traditional explanations of insolvency:

- Advocates of disclosure law: Inadequate contract formation.
- Advocates of debtor amnesty: Health care expenses, divorce, job loss, etc.
- Advocates of cultural change: Decline in thrift and the stigma of bankruptcy

Why have so many Americans suddenly become unable to pay for their shelter?

- One additional part of the puzzle:
 - Structural incentives associated with the U.S. loan origination and funding system.

Overview

- 1) Summary of the development and use of private label residential mortgage securitization
- 2) An explanation and critique of the law governing home mortgage lending and securitization
- 3) Some recommendations for reform

Historical Background

Three periods in the history of the U.S. secondary mortgage market:

- 1. Two party mortgage market
- 2. Three party mortgage market
- 3. Private securitization secondary market

Figure A -- Subprime Home Mortgage Securitization Structure

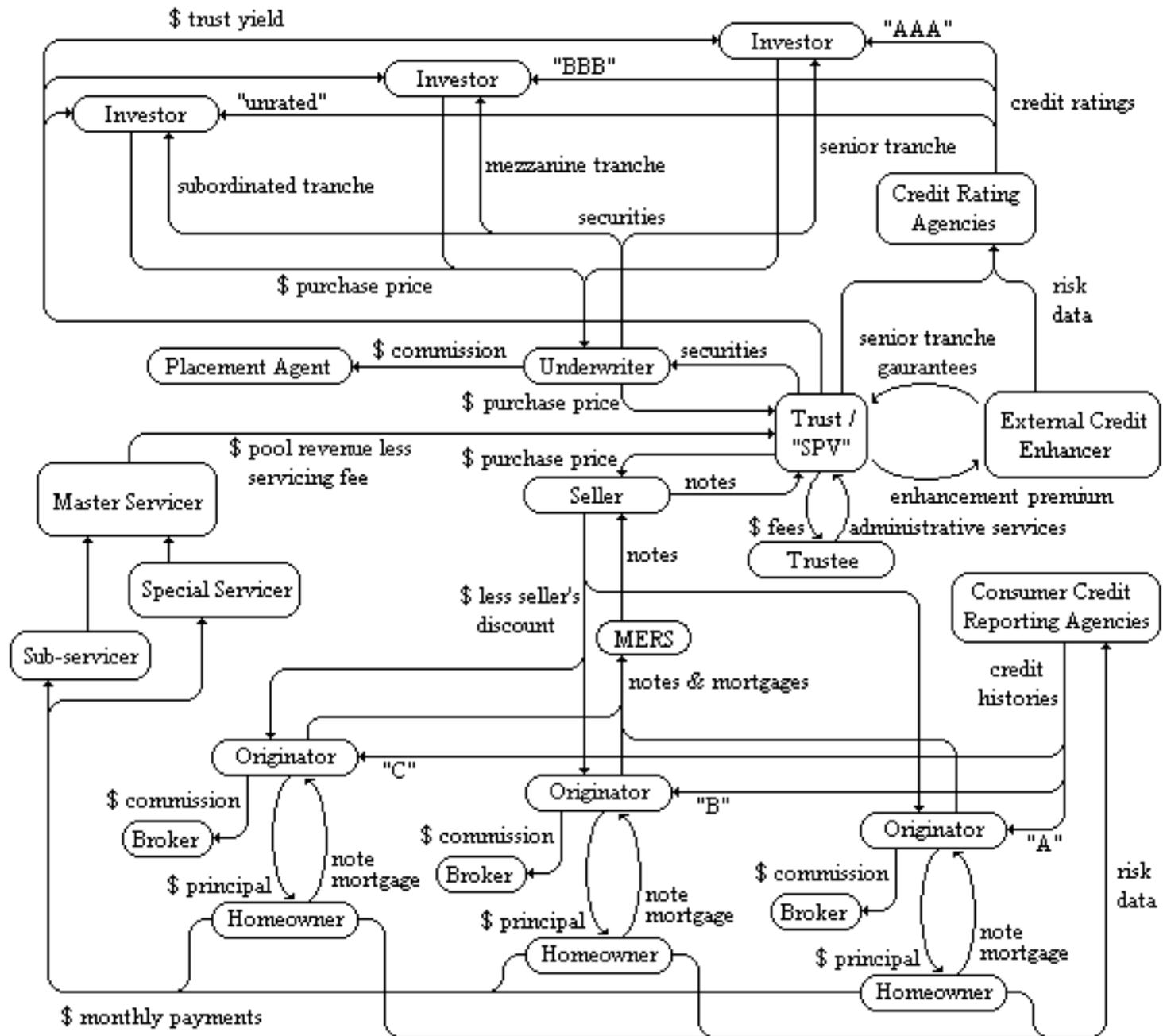
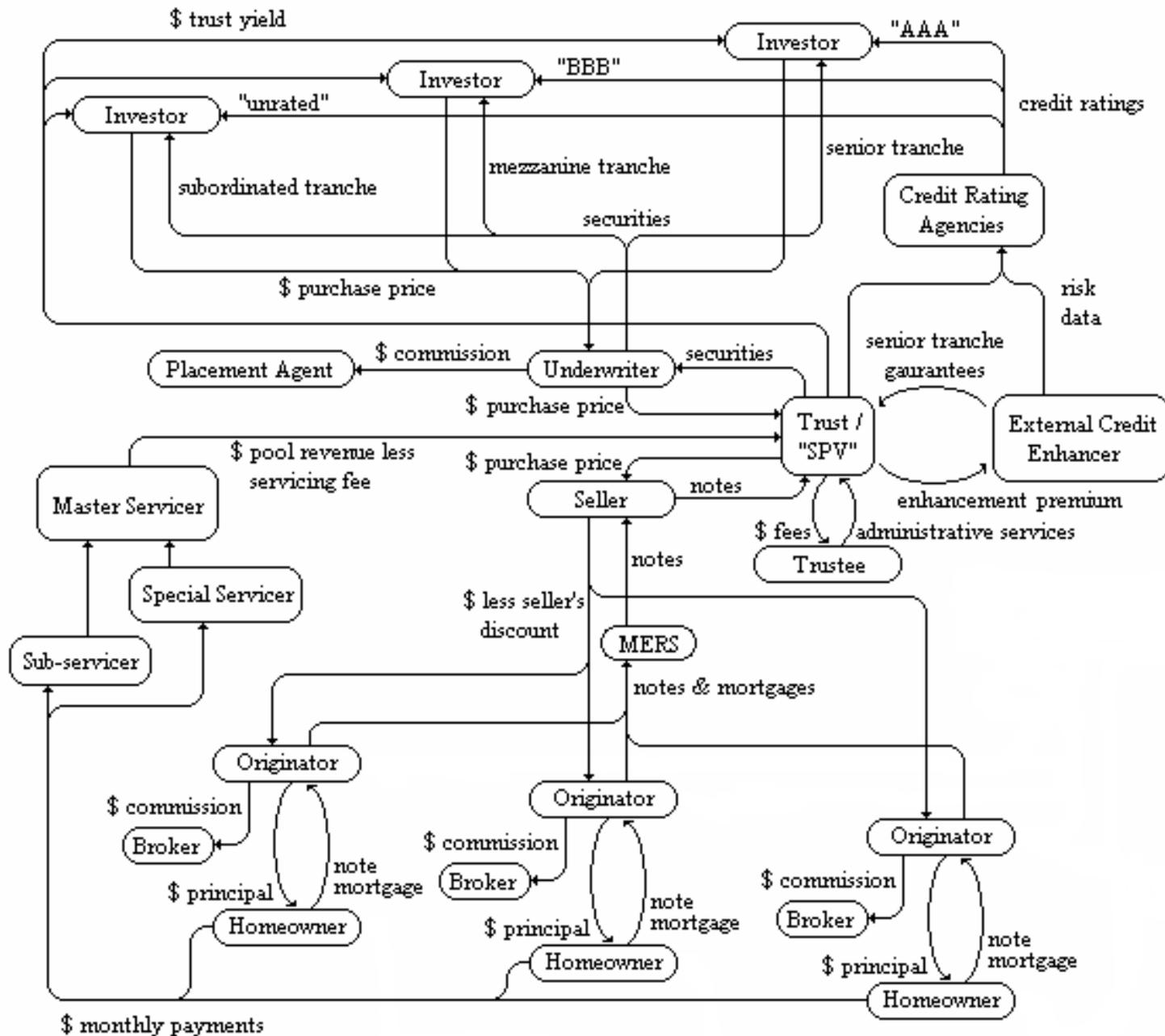
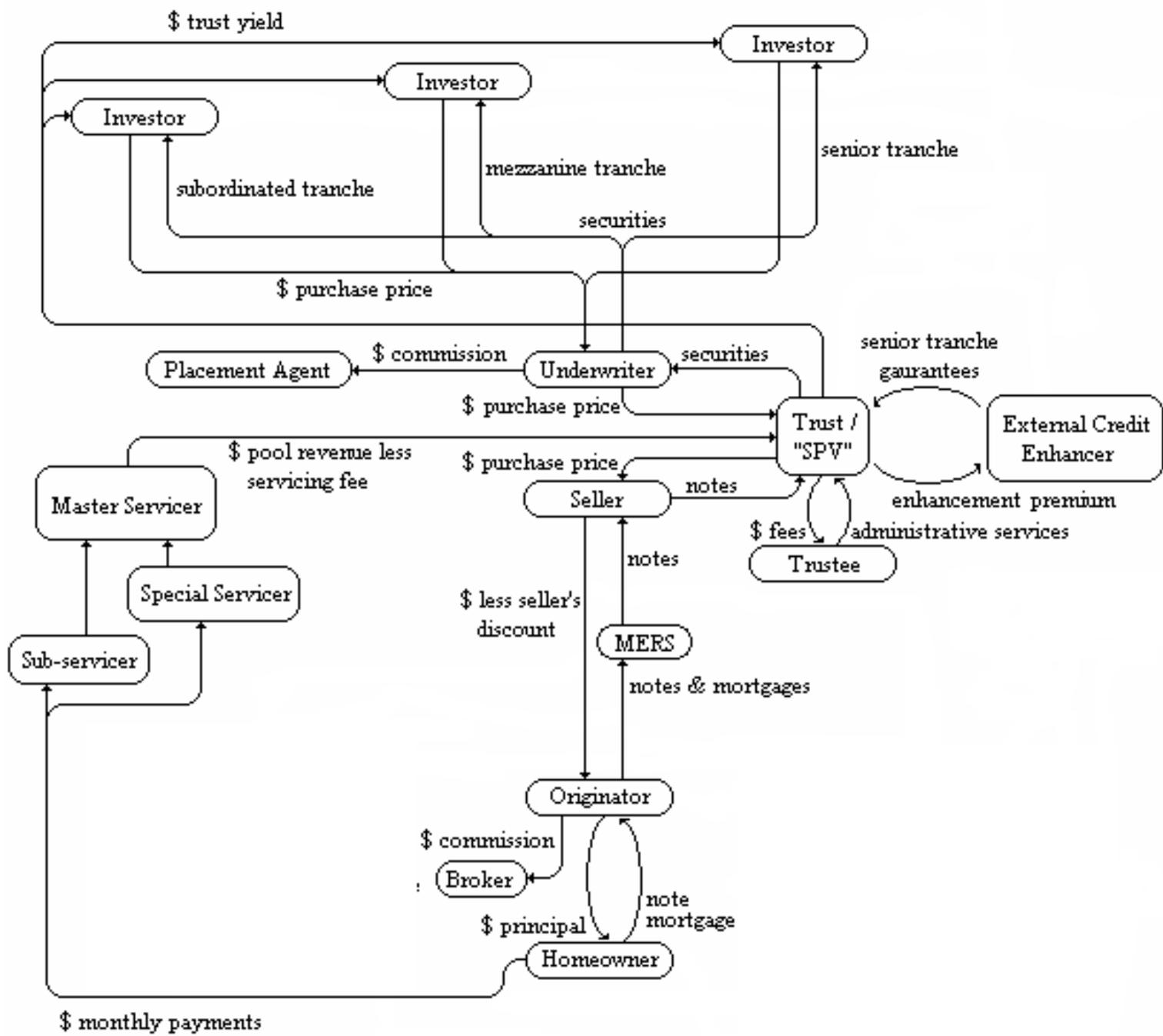
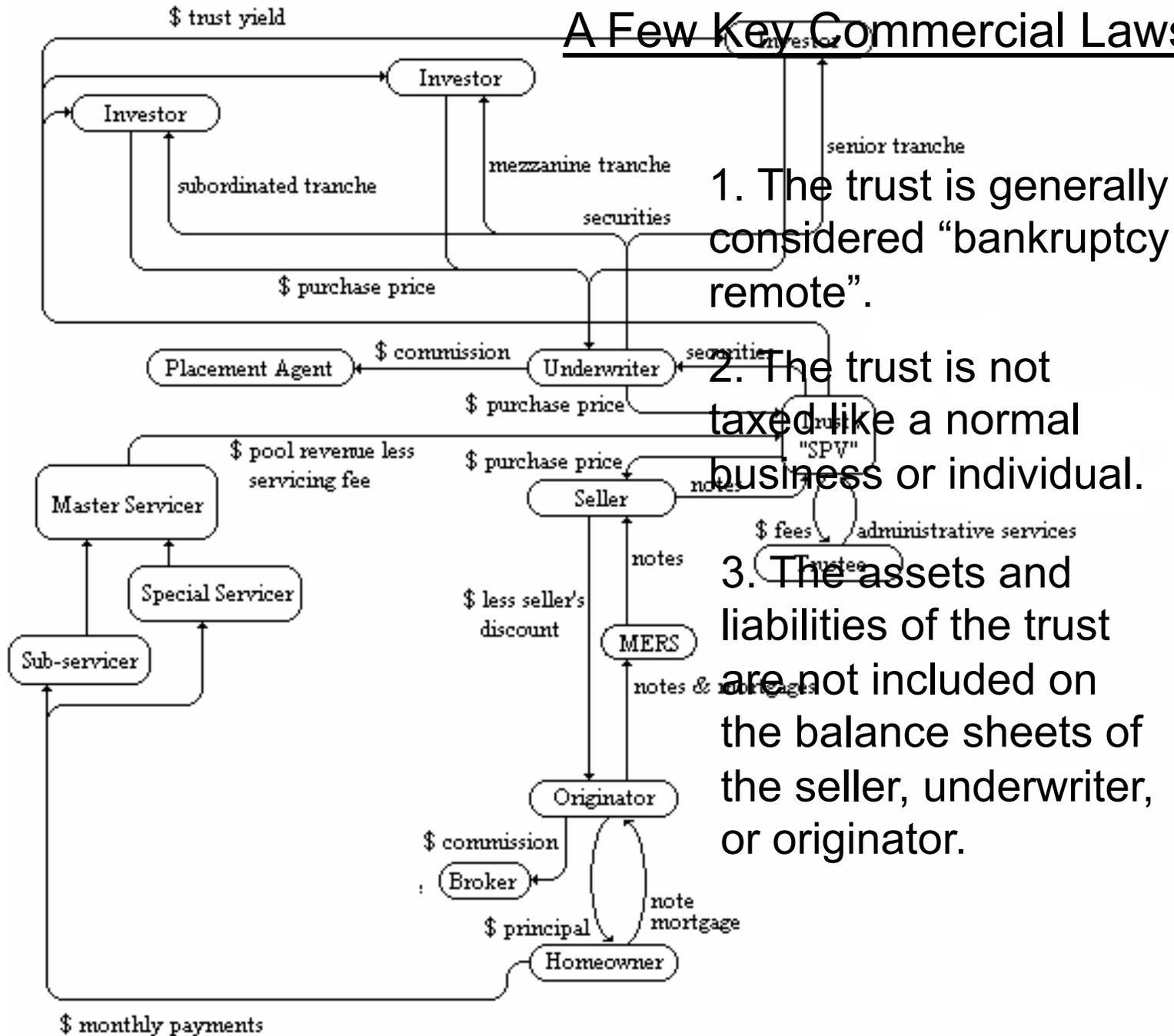


Figure A -- Subprime Home Mortgage Securitization Structure





A Few Key Commercial Laws...

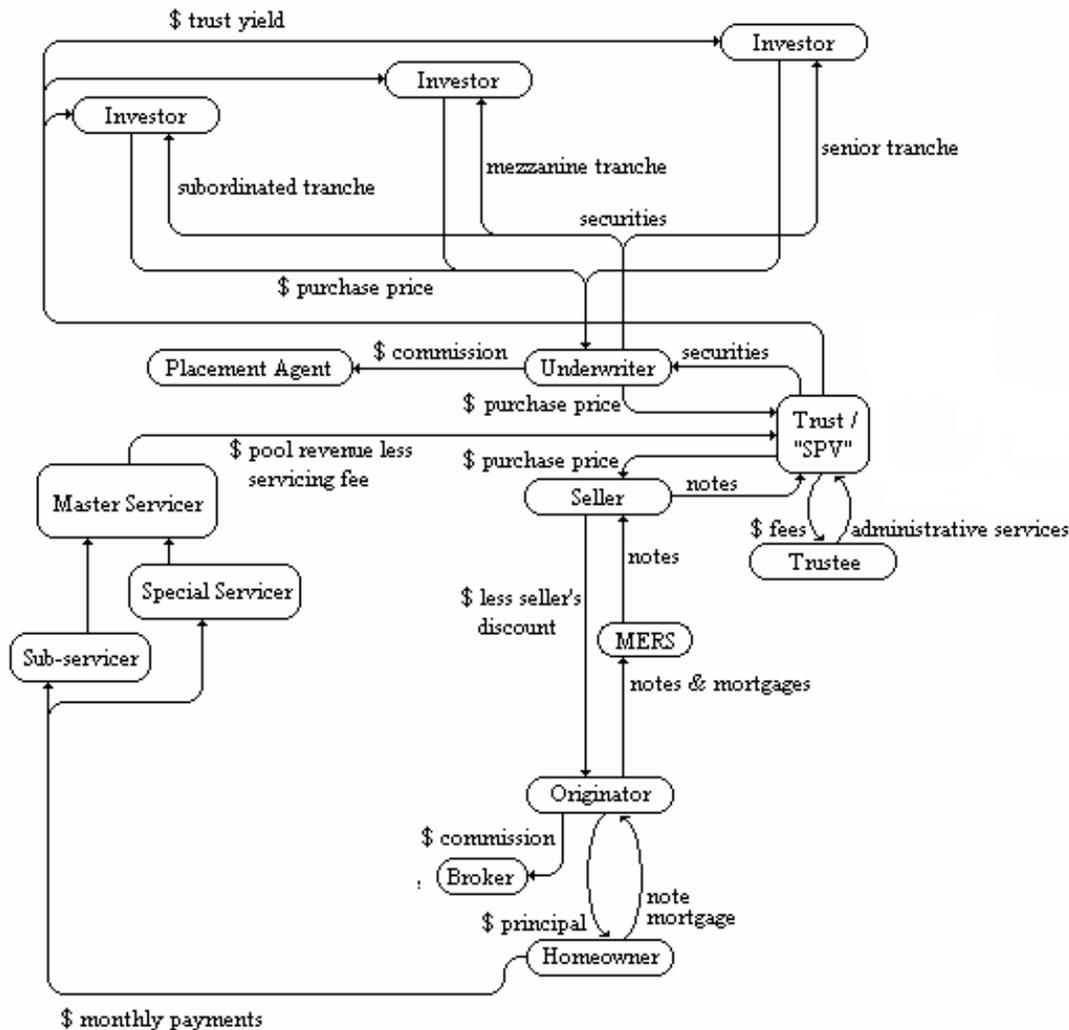


1. The trust is generally considered "bankruptcy remote".

2. The trust is not taxed like a normal business or individual.

3. The assets and liabilities of the trust are not included on the balance sheets of the seller, underwriter, or originator.

A few key consumer protection laws...



1. Common law fraud
2. Truth-in-Lending Act
3. Home Ownership and Equity Protection Act
4. Real Estate Settlement Procedures Act
5. Fair Debt Collection Practices Act
6. State Foreclosure Procedures
7. Bankruptcy

Why has the system broken down?

1. Ambiguity: Consumer protection laws assume an antiquated model of mortgage finance.
2. Opacity: Enforcing consumer protection laws has become much more expensive for consumers and regulators.
3. Immunity: Securitization shelters assets from lawsuits enforcing consumer protection laws.
4. Dishonesty: We have become tolerant of commercial fictions and outright deception.

Why has the system broken down?

- fraud, misleading terms, false estimates, and inadequate disclosure
- excessive rates and fees
- Teaser rates without an underwriting-based justification
- broker commissions for loans that exceed a risk adjusted price
- high pressure sales
- inclusion of overpriced or unnecessary insurance
- unnecessarily harsh prepayment penalties
- inflated appraisals, forgery
- collusion with disreputable home improvement contractors or other vendors
- targeting of vulnerable groups, including racial minorities, immigrants, the elderly, persons with visual impairment, or persons with mental impairment
- distorting loan structure to avoid the application of consumer statutes
- allocating insufficient time to review documents at closing
- mark ups on third party services
- repeated refinancing of loans over a short period of time to capture closing costs
- extending credit without regard to the borrower's ability to repay
- engineering servicing systems that encourage late payment to generate fee revenue
- incorrect calculation of interest and other charges
- ignoring correspondence, telephone calls, and otherwise refusing to provide account information
- abusive or harassing collections
- excessive and unnecessary attorney fees to borrowers in arrears
- engineering servicing systems that encourage foreclosure to generate fee revenue
- failure to properly maintain tax and insurance escrow accounts
- delay and obstruction of judicial, administrative, and consumer investigations and discovery
- unfair arbitration terms

Why has the system broken down?

Predatory Lending

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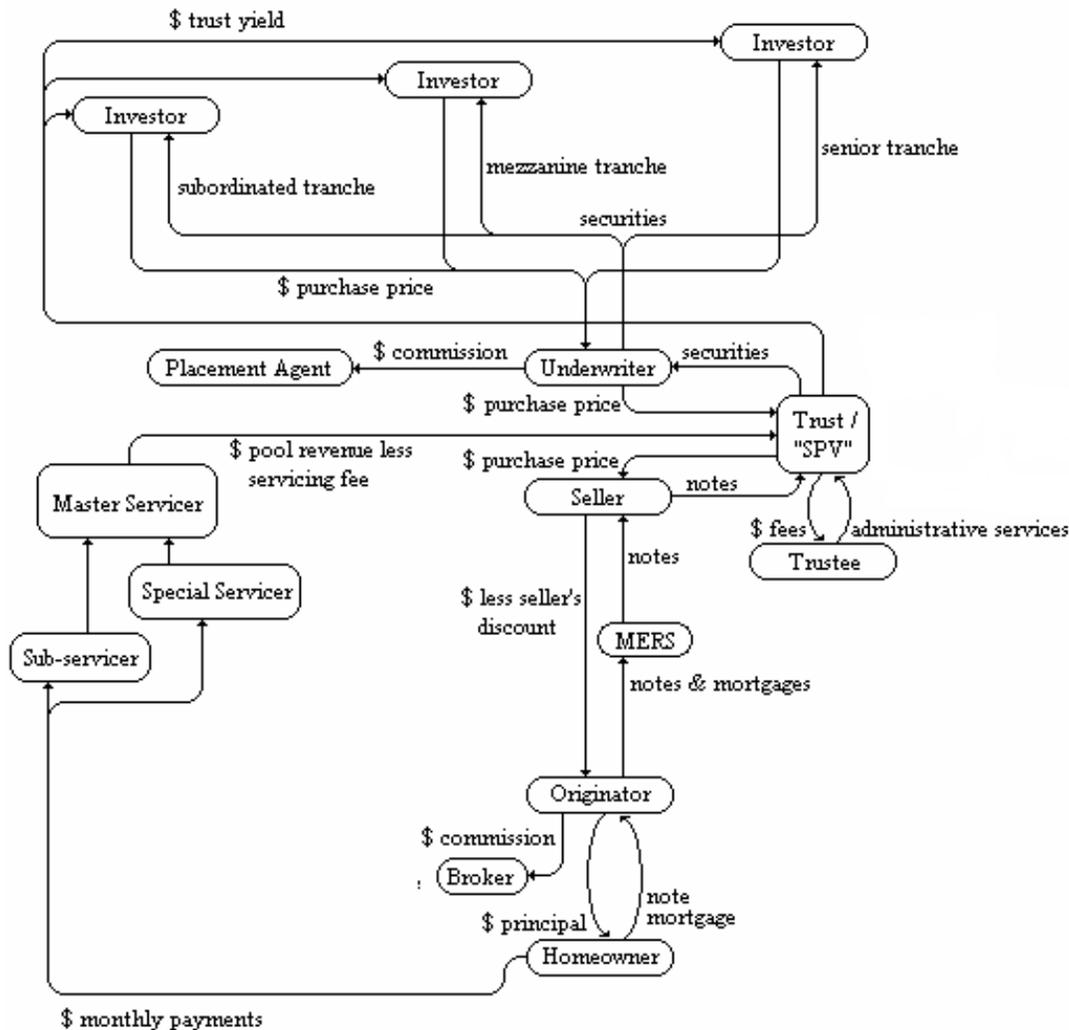
Predatory Lending

Predatory Structured Finance

Comprehensive Reform

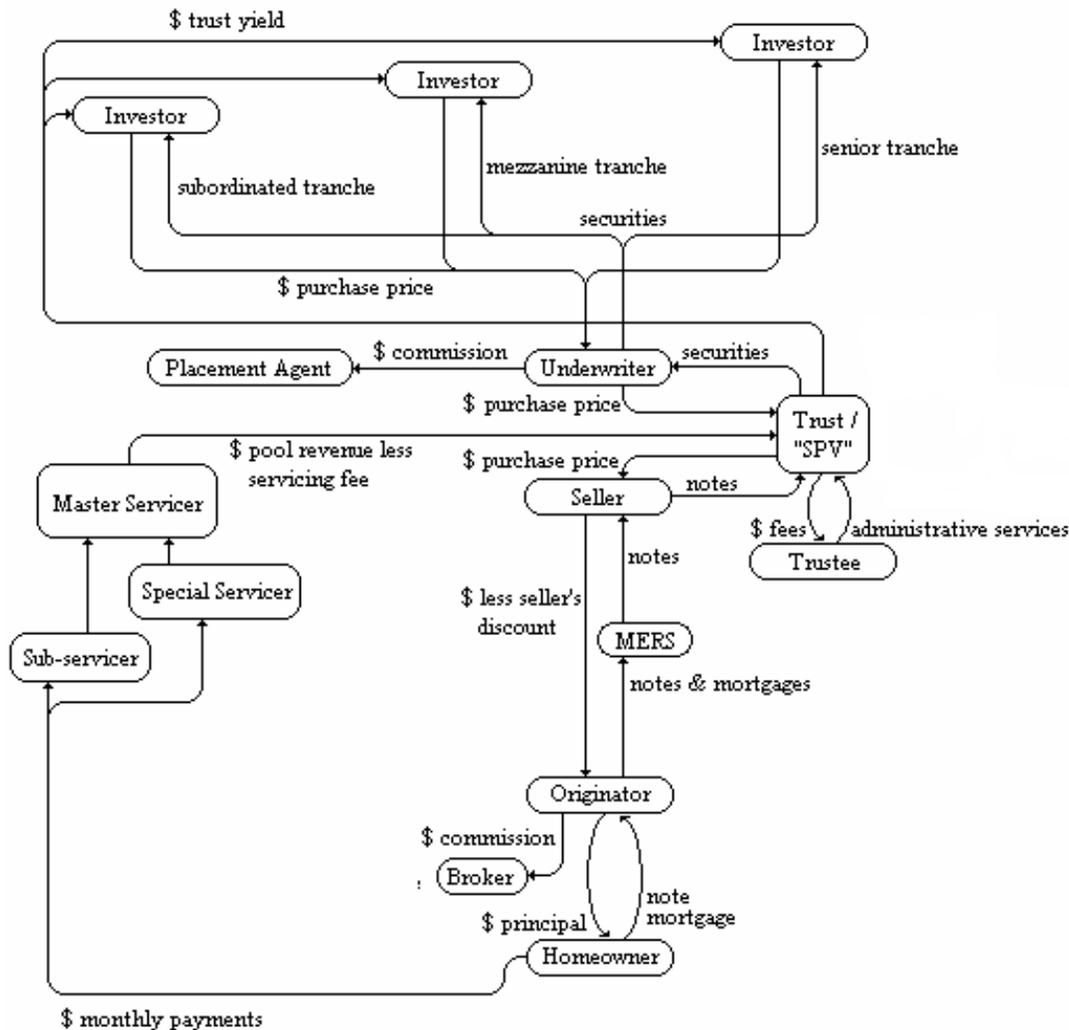
1. Origination
2. Underwriting
3. Servicing and foreclosure
4. Bankruptcy
5. Accountability

Underwriting Reform



1. Require underwriting at a fully adjusted "post-teaser" interest rate.
2. Impose a fiduciary duty on home appraisers in favor of investors.

Servicing, Foreclosure, & Bankruptcy Reform



1. Prevent MERS from bringing foreclosure actions.
2. Amend the Fair Debt Collection Practices Act to apply to all mortgage servicers
3. Amend the bankruptcy code to allow mortgage loan modification.

Accountability Reform...

Concluding Remarks

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ABC Interview, September 12, 2008. Charles Gibson interview with
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Accountability Reform...

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Accountability Reform...

Concluding Remarks

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Palin: **We have got to make sure that we reform the oversight also of the agencies including the quasi-government like Freddie and Fannie. Those things that have created an atmosphere here in America where people are fearful of losing their homes; people are looking at job loss; people are looking at unaffordable health care for their families. We have got to reform the oversight of these agencies that have such control over Americans' pocketbooks.**