Continental Law and the Global Financial Crisis

World Bank, Washington, DC

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Round table 1 - 9:00 a.m.

How to Best Reduce the Risk in the Mortgage Market

The U.S. Approach

We start by accepting in relation to consumer type of mortgages, the dichotomy proposed by Me Rochelois between responsible and irresponsible mortgages. However the idea of freedom to negotiate a contract may prevent acceptance in the USA of the over-regulation of private mortgages that seems to be inherent in the French approach. Instead, the approach in the US is to emphasize two basic concepts:

a. The recognition of a fiduciary relationship between financial entities, mainly commercial banks, its depositors and investors. The repeal of the Glass-Steagall Act by the Gramm-Leach-Bliley Act), obviated the distinction between investment banking and commercial banking by allowing an entity to engage in both activities. In fact many of the major investment banks have elected to be treated as commercial banks enabling a steady supply of deposits to assist them in both banking activities; and

b. The requirement that financial entities must comply with rules and regulations of their respective regulatory authorities. The primary concept here is that these financial entities comply with the net capital rules imposed by the relevant regulatory agency under which they operate, foremost are rules that advances made by such entities be adequately collateralized. In some areas existing variances in rules and regulations imposed by the Federal Reserve Board, the Office of the Comptroller of the Currency or by the FDIC. has led to a massive "forum shopping," for example, by banks seeking to be regulated by an agency having the least restrictive rules.

The Issue

The recent actions of mortgage originators in making economically disastrous, if not legally improper, financial decisions related to the granting of mortgages and the general effect such decisions have had on the financial markets, indicates inadequate transparency preventing an assessment of the quality of derivatives thereof, such as asset backed securities, traded in securities market. Me Rochelois has raised issues relating to the individual mortgage applicant. I would like to look at this problem from the approach needed in the capital market, especially since capital markets rely on rating authorities to indicate the quality of debt securities (note: whether the total assets of a debtor can be deemed to stand behind the debtor's mortgage debt is doubtful in the context of the US Constitution, see the Thirteenth Amendment).

Basic to the efficiency of the capital markets trading mortgages asset backed securities of mortgage derivatives are the activities of the mortgage originator. It is mortgage originator that produces the asset by advancing credit in connection with a mortgage and it is the agreement between the mortgage originator and the financial bundellers, i.e., the originator-to-distribute, that gives rise to the securitized mortgage to be traded in the financial markets. In many instances, the lack of a direct relationship between the originator-to-distribute and the individual seeking a mortgage, [the debtor] requires that reliance with regard to the quality of the securitized mortgage depends on the activity of the mortgage originator. It should be noted, however, that in many instances the mortgage originator creates an entity to act as an originator-to-distribute, i.e., an issuer of participation in securitized mortgages. The mortgage originator, a large financial entity, does this by creating a Special Purpose Vehicle [SPV] to distribute the asset securitized investments, i.e., creates an originator-to-distribute.

US laws and regulations do not get involved in the financial quality of the mortgages underlying asset [mortgage] backed securities, provided that there is adequate disclosure to enable an investor to make a judgment as to quality. Yet the failure of mortgage originators to exercise a reasonable business judgment in granting advances secured by a mortgage on real estate is one of the causes of the collapse of financial entities during the present crisis. An extreme example of a failure to exercise reasonable business judgment was granting a loan to an applicant with inadequate financial resources to service the mortgage. In one case an applicant with an annual income of $ 50 K was granted a mortgage in excess of $ 1.5M. It was offered to the applicant on the basis that for the first seven years only interest payments were

demanded. An expectation that the mortgage would then be refinanced was based on an expectation of an increased market value in the house.

A mortgage originator and a financial entity that creates mortgage backed securities to distribute must comply with the requirements of the Securities Act of 1933 and Securities & Exchange Commission Rules and Regulations when attempting to raise capital for themselves. Such capital rising normally takes the form of a distribution of securities. A sale of securities to an accredited investor, i.e., a sophisticated investors who has knowledge of the entity raising capital and has the sophistication to evaluate the facts involved, as well as the financial means to undertake the risk involved, does not require compliance with the strict approach governing a sale to the public, i.e., a publication of a registration statement/prospectus. Any statement made to an accredited investor, of course, is subject to review in any legal proceeding to show that there was neither a false statement nor a misrepresentation in communications with an ac credited investor. To determine the status of an accredited investor the issue is whether such entity would actually have the information a registration statement/prospectus would elicit. Once the security is offered to the public, however, there must be disclosure in the formal method of a registration statement/prospectus. The foremost requirement of securities laws and regulations is "transparency."

The sale of securities to capitalize a mortgage originator as well as a sale by an originator-to-distribute of participation in a pool of mortgage backed securities requires disclosure of the risk factors such an investment involves. This would include disclosure of the adequacy of the capital of such entities and of facts illustrating the risk involved in vesting in the securities offered, i.e., the quality of the securities to be sold. In the case of a sale of mortgage backed securities, one risk factor would be based on the number of defaults by mortgagors to meet their obligations under the mortgage loan obtained by them.

Recommendations

1. Appraisal

As I have indicated it is the mortgage originator who is in close contact with an applicant for a loan to be secured by a real estate mortgage. Such mortgage originator is best able to determine the economic ability of the applicant and the quality of the collateral, the real estate. In many instances the value of the real estate is based on an appraisal by a professional appraiser. However, to assure that the appraiser is independent of the mortgage originator both, Fannie Mae and Freddie Mac are contemplating a policy

[GSE] not to accept the value placed on the real estate by an appraiser selected by the loan officer or by a mortgage broker involved in the transaction. There have been too many assets appraised that were over the assertainable market value to the detriment of investors in the asset backed security they purchased This proposal is violently opposed by the Industry.

2. Secondary Liability of Mortgage Originators

A tool that has not been properly explored is one that an originator-to-distribute can easily apply not only to induce the mortgage originator to properly investigate the economic ability of the mortgagor, but also it would act to improve the quality of mortgages in its issue of mortgage backed securities. That tool arises when the mortgage originator seeks to discount the mortgage collateralized debt to an originator-to-distribute. In the US, attached to each mortgage is a promissory note, a negotiable instrument. Such promissory note will be negotiated to the originator-to-distribute by means of an endorsement and delivery. This will enable the originator-to-distribute to claim holder in due course status [in civil law: bona fide purchaser status]. Unless the endorsement is "without recourse," as it may be when the transfer/negotiation is between a mortgage originator and a SPV set up by it, the endorsement will create a secondary liability in the transferor/endorser so as to enable the originator-to-distribute to enforce the obligation to pay the obligation under the promissory note should the mortgagor fail to do so.

A promissory note endorsed "without recourse" carries with it a greater risk of default and would thereby indicate a lack of quality. The note so endorsed does not have the financial backing of the mortgage originator and would be of lower quality and financial worth. An originator-to-distribute, i.e., the issuer of mortgage backed securities, will have to evaluate the economic value of such mortgage note endorsed over to it. The effect of insisting on the secondary liability in the endorser, will force the mortgage originator/endorser to take care that the financial ability of the mortgagor is adequate to support the cost of servicing the mortgage. In addition a rating authority will consider the absence of such secondary liability when considering its rating of the securities to be issued. Rating authorities have been rather liberal in granting high ratings to debt securities, leading to the conclusion that a rating of "investment grade" is often not adequate to be relied upon. Rating authorities are now subject to the Credit Rating Authority Act of 2006 which may restore some of the confidence investors had on the rating by such commercial entities. Where the mortgages are sold to a self created SPV difficulties may arise when attempting to rate the SPV issued asset backed securities. The quality of the such securities will be closely linked to the financial condition of the mortgage originator. Especially where it may be possible to show that the originator-to-distribute is merely an alter ego [agent] of the mortgage originator. Sales of

mortgages to self created SPVs may occur "without recourse" and may attract a very low rating from rating authorities. This itself will act as a deterrent to purchase such securities unless an investor has a very high risk tolerance.
The proposed Mortgage Reform Bill [HR 1728} proposes to limit the amount of mortgages that a mortgage originator can discount with a originator-to-distribute. The proposal will require the mortgage originator to retain five percent of the mortgages in its own portfolio. An attempt to shield the general public from highly leveraged mortgages in such asset backed securities.

3. Independent Analysis of Economic Viability

Since originators-to-distribute do not have a direct relationship with the mortgagor, they have to rely on the mortgage originators or a service company to service the mortgages, i.e., to collect payments from the mortgagors, inspect the premises and otherwise see that there is compliance with the terms of the mortgage. This service is required to maintain the value of each constituent mortgage in the bundle of securitized mortgages. Protection of investors, including the issuer of these mortgage backed securities, [i.e., the originator-to-distribute], requires an analysis of the economic viability of the mortgage originator. It would be preferable that such service activities not be undertaken by the mortgage originator but by an independent service organization. This would assure that the mortgage originators would not be exposed to any conflict of interest charges. The requirement to supervise the mortgagor also emphasizes the need that the originators-to-distribute assure themselves that mortgage originators sell to them their produce subject to recourse. The use of an independent service company will enable the originator-to-distribute and any rating authority to rely on the economic viability of the mortgage originator which would, if it is a publicly held corporation, have to make quarterly reports to the SEC disclosing its contingent secondary liability on the mortgagors' promissory notes. [An entity having at least five hundred shareholders and a capital of at least $ 10m must make quarterly reports of its financial condition]

4. Increased Role of the SEC- Disclosure of the Risks Involved in the Purchase of Asset Backed Securities

In the sale/distribution of asset backed securities the originator-to-distribute would have to indicate the risk factors of such investment. The registration statement/prospectus would have to disclose the nature of the risks involved in such investment and to provide for full transparency to potential investors. Thus the issuer would have to disclose (a) the percentage of the mortgages in the issue of mortgage backed

securities it is selling that are subject to recourse or not subject to recourse; (b) what is the credit rating of the mortgage originator; (c) what is the ratio are the ratings represented in the basket of mortgages securitized and (d) whether there is a service organization engaged or whether the mortgage originator is acting as the service organization policing the mortgagor.

Since the distribution of mortgage backed securities in a public offering requires the filing of a registration statement, and the distribution of a prospectus, any misrepresentation in such documents would trigger liability under Sections 11 and Section 12 of the Securities Act of 1933. Both, the SEC and an investor may also be able to sue for a violation by virtue of SEC Rule 10b-5. Should the SEC take a more active role in examining attempts to distribute mortgage backed securities, such approach would involve a change of direction by Congress and by the SEC. Although the approach recommended here is based on existing securities laws, Congress has repeatedly followed a laissez faire approach to new developments in the securities markets which have developed more complex forms of investments, notably in relation to derivatives and hedging devices. In many instances this complexity has led to non-informative disclosures often making it impossible for even sophisticated individuals to comprehend the risks involved in such investments. This is most apparent in relation to new derivatives such as options and futures on options. The former are clearly within the purview of the SEC while the CFTC oversees future trading. On the other hand, Congress has even gone so far as to prohibit the SEC and the CFTC from requiring traders in hedging devices, such as credit default swaps, to register as such and to impose upon them, the reporting requirements required from traders in securities and in commodities. These hedging devices are left expressly to the jurisdiction of the Federal Reserve Board, which has so far not considered any regulations relating to this form of hedging to be necessary. See Commodities Futures Modernization Act of 2000.

5. Assessment of Agency Involvement

The need for a complete review of the present approaches to financing the mortgage credit market requires governmental agencies involved in regulating this market to examine their approaches to the parties involved in this market. It is no longer possible for any one agency to argue that it should not be involved in regulating these parties because it could not understand the complexity of the new investment vehicles that are being developed by market participants. At the same time what has to be realized is that the involvements of too many agencies will lead to uncertainty and also to forum shopping by members of the industry seeking the least invasive agency's approach to its problems. Thus, the SEC and the CFTC will have to be combined when it comes to securities and futures on securities, since one influence the

other in price determination. With regard to credit default swaps, where the credit "seller" agrees, in exchange for the payment of a fee by the credit "buyer," to assume the credit risk of a debt obligation of a specified debtor if a default, such as insolvency or bankruptcy, were to occur. With in regard to the debtor, the credit seller undertakes to pay to the credit buyer the post default value of the debt, or the full value of the debt as they may have agreed upon. Trading in these derivatives, i.e., hedging devices, may not qualify as trading in securities nor could it be argued that these derivatives are not commodities. Congress by deciding that security based swaps cannot be required to be subject to the registration and reporting requirements of the SEC., See '34 Act Section 3A(b), nor of the CTFC, turned to the Federal Reserve Board to deal with this type of hedge. The rational for this present dichotomy is difficult to accept as it leads to uncertainty and has led the Federal Reserve Board to abstain from acting as a regulatory authority. See Guttman: The Futures Trading Act of 1978: Reaffirmation of Coordinated CFTC/SEC Jurisdiction Over Commodity/Securities.

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