Why People Are So Angry At Lenders and Servicers

(Part One)

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Although some may disagree, the origins of the current housing and credit crisis can be traced directly back to the explosion of the securitization industry in the early years of this decade. For those interested in an enlightening expose' of this issue, watch the recent Oscar-winning documentary, Inside Job.

Although securitization of mortgages had been going on for several years, the process reached a fever pitch during the easy credit days, i.e. 2005 – 2007. Securitization is a fancy word for what Fannie and Freddie had been doing for years in the secondary market, i.e. purchasing mortgage loans, pooling them, turning them into investment grade securities, and selling them to large investors, such as pension funds. For years the process was basically sound, in large part because these two Government Sponsored Enterprises placed strict limits on the loans they would purchase – these were known as "conforming loans," which meant that they conformed to Fannie's and Freddie's institutionalized standards.

But the big lenders and Wall Street decided that they wanted to create a market for "non-conforming" loans, so they created the "private label" secondary market. Once the process got rolling, the banks' business model did an abrupt left turn from what the marketplace had previously seen, since there was now a market for non-conforming, high risk loans. The result was that lenders began making much riskier loans (i.e. low or non-existent underwriting standards) such as the infamous, "No-Doc" or "Stated Income" loans.

"No money? No job? No problem. We'll finance 100% of your loan with 80% and 20% piggy-back loans. You won't even have to pay private mortgage insurance! Can't make the monthly principal and interest payments? No problem. We'll let you pay interest-only or even less than interest-only! And if you find you really can't afford it, you can just refinance or resell, since market appreciation will continue to make your home more and more valuable."

There have been many studies and commentaries on why the credit and housing markets crashed. We heard new terms being thrown around such as "moral hazard" [the elimination of risk to borrowers] and "no skin in the game" [banks securitizing the mortgages retained no risk of the loans later going bad]. However, in its simplest terms, what happened was simply too much of a good thing. As long as interest rates remained low, credit and housing would continue to flourish. This was the era of – in Alan Greenspan's words, "irrational exuberance." Why none of these very bright people never saw this coming – or if they did, why they remained quiet – is a mystery. One explanation may be that there was no political stock in being a naysayer.

Another lesser-known factor that was an essential part of the securitization boom, was the complicity of the ratings agencies, such as Moody's and others. Although they were fully aware of the risks inherent in packaging and securitizing high-risk loans, they assumed that these toxic cocktails could be diluted by adding lower risk loans into the mix. Armed with algorithms and historical data, they were able to teach the investment houses how to engage in alchemy, spinning straw into gold. And, ignoring the blatant conflict of interest, after charging the investment houses to teach them how to achieve investment grade status, the ratings agencies then charged them again, for giving investment grade ratings. Now the toxic loan pools could be marketed to large investors as "safe." Unfortunately, no amount of "historical data" could predict the disaster that was to occur, since lender underwriting had never before been so compromised. Banks no longer cared about their borrowers' credit, since the loans they were about to make would be entirely sold off as securities, for others to worry about. In technical terms, there was no "risk retention," an issue of some debate today, due to the Dodd-Frank financial law.

The other essential player in the securitization boom was MERS®, which stands for "Mortgage Electronic Registration System, Inc." It is little more than a massive, online database, where member banks "register" their multiple transfers of mortgages between themselves. They go to great lengths to say that they are merely *"…acting solely as a nominee for Lender and Lender's successors and assigns."* Their registered trademark includes the phrase: *"Process loans, not paperwork."*

MERS®' website describes its business model as follows: *"MERS® was created by the mortgage banking industry to streamline the mortgage process by using electronic commerce to eliminate paper. Our mission is to register every mortgage loan in the United States on the MERS® System. Beneficiaries of MERS® include mortgage originators, servicers, warehouse lenders, wholesale lenders, retail lenders, document custodians, settlement agents, title companies, insurers, investors, county recorders and consumers. "* Elsewhere on their site, they are more specific about their mission: *"To eliminate the need for assignments and to realize the greatest savings, lenders should close loans using standard security instruments containing language approved by Fannie Mae and Freddie Mac which name MERS® as Original Mortgagee (MOM)."* For a more in-depth discussion of MERS®, go to my posts, here and here.

To the outsider, this model may not seem unusual for a large industry providing a product registration service to its members. However, what isn't readily apparent to the layperson is that the intent of MERS® and its members was to substitute its registration model for the public recording requirements of states such as Oregon. ORS 86.735(1)requires that each time a lender assigns their mortgage, the transfer document, an "Assignment" must be publicly recorded. When borrowers pay off their mortgages (known as "trust deeds" in Oregon) this lack of recording the intervening assignment is of little consequence, as the public record clearly shows the debt has been satisfied and the lien removed from borrower's title. But when the loan goes into foreclosure, the industry's failure to record their Assignments has resulted in a new crisis – the foreclosure crisis.

In Part Two we'll discuss how and why the MER® model has ushered in a foreclosure crisis the likes of which we've never seen before – and never could have imagined. We will also discuss why bank servicers provide a terrible disservice to distressed homeowners.