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LEGAL WINNERS AND LOSERS IN THE MORTGAGE CRISIS

SHAUN P. MARTIN

I. INTRODUCTION

Trillions of dollars were lost when the mortgage and housing bubble burst in the late 2000s. Some of those losses fell squarely on lenders who otherwise had made good loans. But billions of dollars were also lost as a result of mortgage fraud, often the result of borrowers who allegedly made material misstatements on their loan applications. Not surprisingly, after the meltdown, banks and others sought to recoup those losses through civil and ancillary criminal proceedings against these borrowers. Courts have generally been sympathetic to such efforts. Borrowers adjudged guilty of mortgage fraud are often ordered to pay millions of dollars in criminal restitution payments to the banks to which they submitted fraudulent mortgage applications.

However, these restitution orders are not only typically unwarranted, but reward active participants in fraudulent conduct who have already handsomely profited from the underlying fraud. Given the presence of widespread mortgage securitization during the relevant period, lenders rarely lost money from even blatantly fraudulent mortgages. Instead, these lenders originated the underlying mortgages and promptly sold them to other market participants. Some downstream purchasers lost money when the housing market collapsed and the fraudulent mortgages went unpaid; but the restitution orders entered by courts invariably fail to direct restitution payments to the actual losers. Instead, such orders improperly award restitution to lenders who made – rather than lost – money from the fraud.

This Article explores the pervasive securitization of mortgages during the relevant period and argues that in light of this practice, courts should not award civil or criminal restitution absent evidentiary proof of direct losses by the actual lender itself. In the overwhelming majority of cases, no such evidence exists.

II. DIRECT MORTGAGE LENDING: HISTORY AND INCENTIVES

The traditional view of the mortgage industry is a simple one. It is also one that resonates with the lay public, since it accurately characterizes a portion of the way in which banks make some of their loans.

In this model, banks make loans to borrowers and then retain these loans (and the repayment thereof) as a means of making money.¹ There may be intermediaries in such settings; for example, a particular company that “services” the loan by performing the day-to-day function of communicating with the borrower and making sure payments are made on time and to the correct entity. However, in the end the lender is the entity that makes the loan, and the borrower’s repayments of that loan are given to the lender.

When the bank is a direct lender, as the mortgage originator, it traditionally has substantial incentives to be diligent in the information it obtains, verifies, and relies upon in deciding which mortgages it funds.² Those incentives exist because the bank, as a direct lender, incurs the losses resulting from any fraud.³ In the traditional mortgage transaction, a bank obtains capital from depositors (e.g., its customers), directly lends funds to residential borrowers, is the beneficial holder of the resulting mortgages on the properties, and profits when these mortgages are repaid (or loses money

¹ See generally Janet Berry-Johnson, *How Does a Mortgage Work?*, LENDINGTREE (Nov. 12, 2017), <https://www.lendingtree.com/home/mortgage/how-does-a-mortgage-work/>.

² See generally FDIC Law, Regulations, Related Acts, FDIC (April 20, 2014), <https://www.fdic.gov/regulations/laws/rules/5000-5150.html>.

³ See generally Ben Hallman, *Bank of America Mortgage Fraud: Feds Sue For Over \$1 Billion Alleging Multi-Year Scheme*, HUFFINGTON POST (Oct. 25, 2012), http://www.huffingtonpost.com/2012/10/24/bank-of-america-mortgage-fraud_n_2009791.html.

if the borrowers default).⁴ This traditional structure generally gave banks substantial reason to ask relevant inquiries of potential borrowers and to confirm the truth of those answers, as the financial consequences of an unpaid mortgage would fall directly on the bank.⁵

It nonetheless bears mention that a lender's economic self-interest in diligently seeking and verifying relevant information was somewhat diminished even in this traditional mortgage setting during periods in which home prices consistently increased.⁶ Traditional incentives waned because lenders typically expected to make money even on those loans that were obtained based on applications that contained factual misstatements. The factual misstatements did not negatively impact the lenders, due in part to the appreciation in the value of the home during the period between the issuance of the mortgage and the subsequent sale (and/or repossession) of the property.⁷ For example, if a home buyer overstated his income on a mortgage application in order to qualify for the purchase of a \$300,000 property in 2005 and was subsequently unable to make his required mortgage payments in 2006, the direct lender would still profit on this loan because the home, when repossessed or refinanced in 2006, was worth \$350,000 as a result of appreciation in the overall housing market. A lender in such an economic environment would not suffer adverse consequences as a result of the misstatements in the application since the resulting increased equity in the home would be sufficient to repay the mortgage. In fact, direct lenders often made substantial additional profits in

⁴ See Navid Vazire, *Smoke and Mirrors: Predatory Lending and the Subprime Mortgage Loan Securitization Pyramid Scheme*, 30 PACE L. REV. 41, 47 (2009).

⁵ *Id.*

⁶ Jann Swanson, *Market Shifts May Lead to More Mortgage Fraud*, MORTGAGE NEWS DAILY (Mar. 1, 2017), http://www.mortgagenewsdaily.com/03012017_mortgage_fraud.asp.

⁷ See generally Annika Mengisen, *Straight From the Foreclosure Expert's Mouth*, FREAKONOMICS (May 1, 2009, 10:09 AM), <http://freakonomics.com/2009/05/01/power-question/>.

such settings as a result of late fees and other charges associated with the failure to pay and/or refinancing of the mortgage.⁸

In short, during an era in which home prices were appreciating or expected to appreciate, all lenders in the mortgage industry – even those who retained their own loans – profited from loans that were funded based on radically inaccurate loan application statements.⁹ This expectation of profit dramatically affected the standards applied by those lenders in deciding which statements in a loan application were material. When lenders expected that housing prices would appreciate, the specific information in any particular loan application would not solely affect their rationale for lending. Rather, their decisions were based on market conditions. It was that anticipated appreciation – not anything in the loan application itself, nor information about the borrower – that swayed lenders throughout the industry in deciding whether to fund any particular mortgage.¹⁰

The first half-decade of the twenty-first century was an appreciating market.¹¹ From 2000 to 2006 home prices rose dramatically and consistently before leveling out and abruptly declining in 2008.¹² Even when expressed in nominal terms – and, to be clear, lenders in this industry cared only about actual values, not inflation-adjusted values – even subprime lenders during this period saw ever-increasing home prices as a substantial bulwark against losses from even fraudulently obtained

⁸ Jane Quinn, *Foreclosure Fraud: How You Can Be Driven to Default Even If You Pay On Time*, CBS NEWS MONEYWATCH (Oct. 13, 2010, 2:06 PM), <https://www.cbsnews.com/news/foreclosure-fraud-how-you-can-be-driven-to-default-even-if-you-pay-on-time/>.

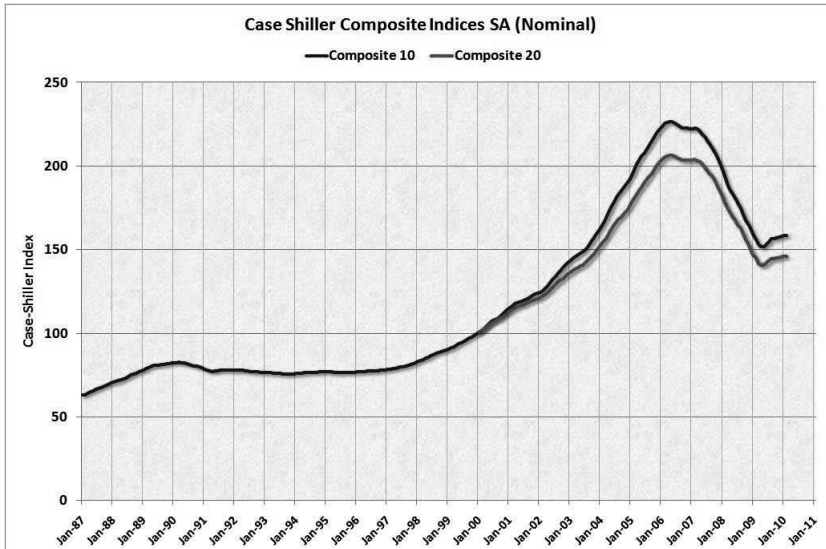
⁹ *Id.*

¹⁰ See generally Ronald Utt, *The Subprime Mortgage Market Collapse: A Primer on the Causes and Possible Solutions*, THE HERITAGE FOUNDATION (Apr. 22, 2008), <http://www.heritage.org/report/the-subprime-mortgage-market-collapse-primer-the-causes-and-possible-solutions>.

¹¹ See Raymond Lombra, *The Rise and Fall of the U.S. Housing Market Past, Present, and Future*, JUNIOR ACHIEVEMENT, 3, <https://www.juniorachievement.org/documents/20009/36541/Housing-Market-paper.pdf/63e03a3a-9561-4532-be0a-4311141ddb67>.

¹² *Id.*

mortgages.¹³ The dominant market appreciation, as well as the subsequent crash in housing prices, is evident from the following chart:



This price appreciation was even more pronounced (and anticipated) in particular mortgage markets.¹⁴ For example, between the fourth quarter of 2003 and the fourth quarter of 2004, the median sales price for a home in the Sacramento, California area increased a whopping 31.5%, and several other metropolitan areas saw even larger year-on-year appreciation.¹⁵ Traditional mortgage loans made and held by direct lenders created a facial incentive to avoid (or at least not actively participate) in

¹³ See William N. Goetzmann, Liang Peng & Jacqueline Yen, *The Subprime Crisis and House Price Appreciation*, 44 J. REAL EST. & FIN. ECON. 33, 57, 60 (2012).

¹⁴ See PUBLIC POLICY INSTITUTE OF CALIFORNIA, *THE CALIFORNIA ECONOMY: CRISIS IN THE HOUSING MARKET* (2008), http://www.ppic.org/content/pubs/jtf/JTF_HousingMarketJTF.pdf.

¹⁵ See Sara Max, *Hot Housing Markets*, CNN MONEY (Feb. 15 2005 11:40 AM EST), http://money.cnn.com/2005/02/15/real_estate/metromarkets/.

mortgage fraud, but even those incentives were generally overwhelmed by anticipated market appreciation.¹⁶

III. THE RISE OF SECURITIZATION

Direct residential lending was the dominant norm for most of our nation's history, with individual banks directly making loans to individual borrowers and the banks themselves holding the resulting mortgages for repayment.¹⁷ The United States experimented with two brief departures from this precedent before the 1980s with both episodes ending badly.¹⁸

In the late 1800s, due to insufficient capital in local rural banks and a desire to geographically diversify, farm mortgages were sometimes financed through a process called "mortgage brokerage," in which western borrowers were connected with northeastern and European investors through mortgage brokers in rural areas.¹⁹ The investors who purchased these farm mortgages reviewed and could accept or reject each individual loan. As a result, there was substantial (albeit imperfect) quality control.²⁰ Ultimately, the rural mortgage brokerage industry collapsed after many of the western mortgage companies were devastated by financial crises in the 1890s, and traditional mortgage lending returned to the rural west.²¹

Quasi-securitization of private mortgages briefly returned in the 1910s and 1920s, this time in cities. Here, northeastern title insurance

¹⁶ See Neil Fligstein & Alexander Roehrkasse, Dep't. Soc. U.C. Berkeley, *All the Incentives Were Wrong: Opportunism and the Financial Crisis* at 18, Address at Yale Law School: Law and Ethics Conference (Feb. 15-16, 2013).

¹⁷ See generally Michele Lerner, *The mortgage market is now dominated by non-bank lenders*, THE WASHINGTON POST, (Feb. 23, 2017), https://www.washingtonpost.com/realestate/the-mortgage-market-is-now-dominated-by-nonbank-lenders/2017/02/22/9c6bf5fc-d1f5-11e6-a783-cd3fa950f2fd_story.html?utm_term=.afe87c5136a8.

¹⁸ See Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 IND. L. J. 213, 217 (2013).

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 218.

companies insured private mortgages, pooled them into trusts, and sold investors “participation certificates” backed by these insured mortgage pools.²² The inadequate capitalization of the insurance companies, combined with endemic fraud, engendered the collapse of this fledgling market as well.²³

As a result, direct bank lending again became the unchallenged norm. This was especially the case once the federal government began insuring mortgages through programs sponsored by the Federal Housing Administration (“FHA”) (established in 1934), the Department of Veterans Affairs (“VA”) (established in 1944), and the Farmers Home Administration (“FmHA”) (established in 1946). This custom was further normalized once the Federal National Mortgage Association (“Fannie Mae”) began buying mortgages in 1938.²⁴

In the 1980s, however, large-scale private mortgage securitization reemerged; this time becoming the overwhelmingly dominant means through which banks allocated default risks.²⁵ Significantly, and relatedly, this allocation of default risk radically altered which statements in a mortgage application would be material to lenders in that industry; i.e., which statements the lenders would actually (or even tend to) rely upon in deciding whether to fund any particular mortgage.²⁶

²² See generally *Housing Finance Reform: Should There Be a Government Guarantee? Hearing Before the Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 54-55 (2011).

²³ *Id.*

²⁴ See Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 *Ind. L.J.* 213 (2013).

²⁵ *Id.* at 24; see also Neil Fligstein & Adam Goldstein, *The Transformation of Mortgage Finance and the Industrial Roots of the Mortgage Meltdown*, UC BERKELEY WORKING PAPER SERIES (Oct. 2012), <https://escholarship.org/uc/item/2zx8r7fb>.

²⁶ See Elena Carletti, *Competition and Regulation in Banking*, in *HANDBOOK OF FINANCIAL INTERMEDIATION AND BANKING* 441, 450–51 (Anjan V. Thakor & Arnoud W. A. Boot eds., 2008) (noting that an increase in the number of competitors undermines bank screening tests for borrower creditworthiness).

In its most basic form, mortgage securitization involves selling a bundle of loans, or specific pieces of that bundle to outside investors.²⁷ When mortgages are securitized, the bank that originated the mortgage no longer loses money if the homeowner defaults on the mortgage. Instead, only the outside investors (or some of them) bear the burden of this default.²⁸ In contrast, the bank that initially funded the mortgage has already sold its interest in the loan at a profit, and is not injured by the subsequent default.

The process of mortgage securitization involves four steps.²⁹ First, an institution – typically a bank – “originates” a loan by making a mortgage to an individual homeowner.³⁰ Second, either the originating institution or a different entity “services” the mortgage by collecting and recording payments made by the borrower.³¹ Third, another financial entity creates a “securitization” package by buying large numbers of individual loans from originators and then packages these loans into products that can be sold to outside investors.³² Finally, individual investors and institutions (e.g., money market mutual funds and pension funds) purchase these securitized loans – generally called “mortgage backed securities” (“MBS”) – from securitizers and stand to gain or lose money depending on whether specific portions of the securitized loans are eventually repaid by the borrowers.³³

Starting in the 1980s, but particularly in the 1990s and thereafter, participants in the mortgage origination industry began to recognize that they could exponentially increase their profits were they to securitize the

²⁷ See Simkovic, *supra* note 24, at 214.

²⁸ See generally Edward L. Glaeser, *Debating the Securitization of Mortgages*, N.Y. TIMES, July 27, 2010, <https://economix.blogs.nytimes.com/2010/07/27/debating-the-securitization-of-mortgages>.

²⁹ See generally *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (March 2008) <https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf>.

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

mortgages they made rather than holding them.³⁴ Three attributes of the securitization process facilitated the availability of these increased revenues.

First, originators discovered that outside investors would pay more for privately originated loans than the expected value of those loans to the originator. Sometimes outside investors had lower costs of capital, or lesser regulatory burdens than the originating banks.³⁵ Other times outside investors could diversify better than a regional (or even national) bank.³⁶ Outside investors were also often willing to pay more for a package of loans than what that package was objectively (at least to the originator) worth.³⁷ With outside investors willing to pay more for mortgages than banks thought they were worth, banks quickly discovered that there was money to be made by securitizing these loans.³⁸

Second, originating banks and more sophisticated financial institutions (e.g., brokers) quickly discovered that the profits from securitization could be multiplied even further by dividing the mortgage backed securities into “tranches” – by splitting up these bundled mortgages into various pieces – and selling each of these pieces separately.³⁹ For example, a bundle of mortgages might be split into ten different tranches, each representing the right to specific payments on the underlying set of mortgage loans.⁴⁰ Accordingly, the first (highest-quality) tranche of the MBS might represent the right by the investor to be paid the first ten

³⁴ Martin Neil Baily et al., *The Origins of the Financial Crisis*, in PAPER 3 FIXING FINANCE SERIES, BROOKINGS 1, 27 (2008).

³⁵ Navid Vazier, *Smoke and Mirrors: Predatory Lending and the Subprime Mortgage Loan Securitization Pyramid Scheme*, 30 PACE L. REV. 41, 45-46. (2009).

³⁶ *Id.* at 46.

³⁷ See Gretchen Morgenson, *Inside the Countrywide Lending Spree*, THE NEW YORK TIMES at A4 (Aug. 26 2007) (<http://www.nytimes.com/2007/08/26/business/yourmoney/26country.html>).

³⁸ *Id.*

³⁹ See generally, FIN. CRISIS INQUIRY COMM'N, *The Financial Crisis Inquiry Report, The CDO Machine* (Jan. 2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

⁴⁰ *Id.* at 128.

percent of payments received by the mortgage pool. For a MBS representing \$100 million in bundled mortgages, an investor who purchased the first tranche of the MBS would obtain the right to the first \$10 million in payments received from borrowers. This tranche would be considered an extremely “high quality” tranche because the only way the investor would lose money would be if over ninety percent of borrowers – an unprecedented number – defaulted on their mortgages; otherwise, the first-tranche investor would be paid in full. Similarly, the second tranche of the MBS might represent the right to be paid the next ten percent of payments received by the pool. This too would be a high-quality tranche, since the investor would make money so long as twenty percent of borrowers repaid or refinanced their loans.

Because these high-quality tranches had very little risk, they were sold by the originator at a lower premium but could still be sold at a profit.⁴¹ Moreover, because of the low default risk, rating agencies typically rated these high-quality tranches as AAA investments, and outside investors would rely on these ratings as a signal that the underlying investment was essentially risk-free; an attribute for which investors were willing to pay a premium.⁴² Subsequent lower-quality tranches of the MBS (often called “mezzanine” tranches) would involve higher risks but would simultaneously offer higher returns.⁴³ These too could be sold by the originating bank and the securitizer at a profit, often obtaining an AA (or A) rating by the rating agencies despite the heightened risk of default.⁴⁴

The lowest tranche of the MBS – e.g., the right to receive only the final ten percent of payments on the mortgages – would necessarily involve the highest default risk for the outside investor since a default by any borrower would directly impact returns for this MBS tranche. This lowest tranche – often called the “equity,” “residual,” or “first-loss” tranche –

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

would normally be rated the lowest by the rating agencies and would offer the highest return as compensation for this increased risk.⁴⁵

Banks and other financial institutions quickly discovered that they could successfully “bundle” and sell MBS tranches just as they successfully done so with residential mortgages.⁴⁶ Moreover, these same institutions also discovered that by doing so, they could enhance their profits as well as distort public perception of risk. Institutions accordingly began selling collateralized debt obligations (“CDO”) that consisted of low-quality tranches from a variety of different mortgage-backed securities that the broker would originate and offload to investors.⁴⁷ These CDO consisted of the riskiest portions of multiple mortgage-backed securities and accordingly entailed a substantial risk of default.⁴⁸

Participants in the mortgage industry also discovered that they were able to hide these default risks, as well as further enhance their profits, by tranching CDO in the same way they had tranced the underlying MBS. For example, the first tranche of a CDO might correspond to the first ten percent of payments on the CDO, the second tranche the next ten percent, and so on. Financial institutions and brokers in the mortgage industry would then sell these CDO tranches to investors, just as they sold MBS tranches.⁴⁹

Because CDO almost exclusively consisted of the lowest-quality tranches of the underlying MBSs – i.e., the portions of the MBS that were least likely to be repaid – the entire CDO entailed substantial default risk. Through creative packaging and machinations, however, participants in the mortgage industry that created and sold these financial products were able to obtain high ratings (e.g., AAA) for many CDO tranches, thereby hiding this default risk from investors and maximizing the profits flowing to the securitizing entities.⁵⁰

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

Finally, these same institutions and market participants also found a way to maximize their profits and hide the risk of even the lowest tranches of the CDO – i.e., the most at risk portion of a collection of the riskiest residential mortgages – by yet again repackaging these low-quality CDO tranches into another bundled product, the “CDO-squared,” which would again be sold to outside investors at a profit.⁵¹

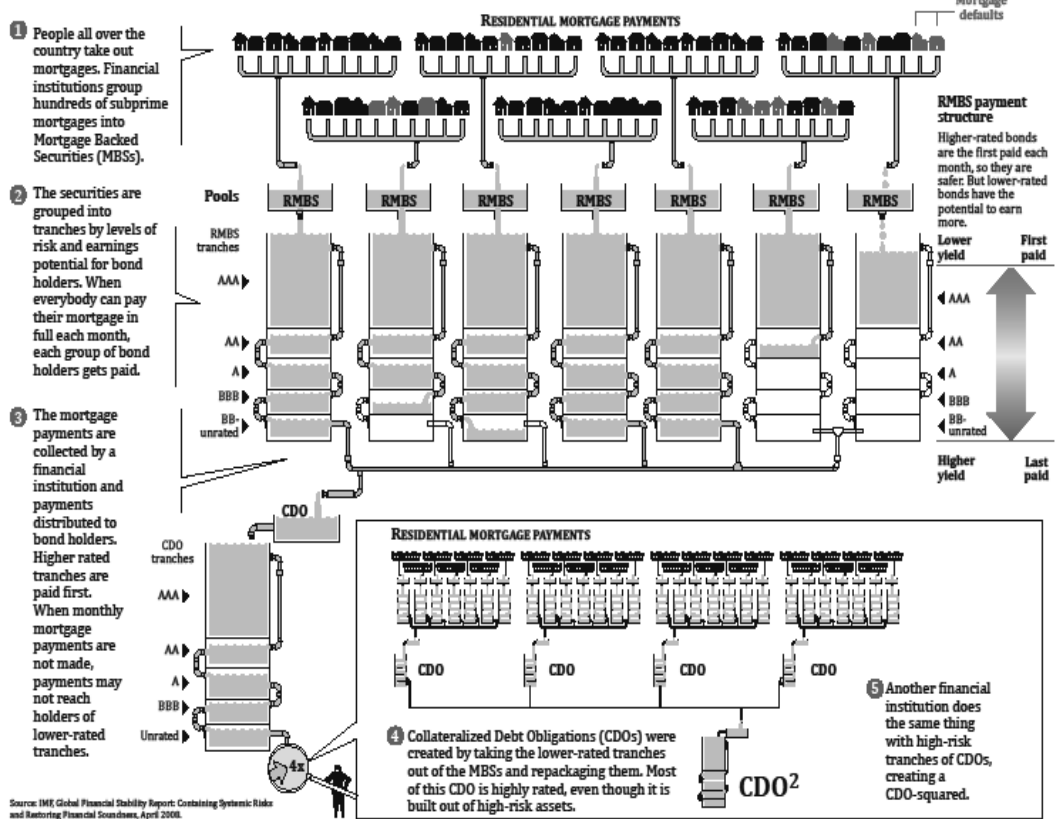
The final product of this financial manipulation of residential mortgages, the typical practice throughout the relevant period, can be graphically displayed as follows:

⁵¹ See Raghuram Rajan, *A View of the Liquidity Crisis*, CHICAGO BOOTH (Feb.2008), <https://faculty.chicagobooth.edu/raghuram.rajan/research/papers/A%20view%20of%20the%20liquidity%20crisis.pdf>.

THE THEORY OF HOW THE FINANCIAL SYSTEM CREATED AAA-RATED ASSETS OUT OF SUBPRIME MORTGAGES

In the financial system, AAA-rated assets are the most valuable because they are the safest for investors and the easiest to sell. Financial institutions packaged and re-packaged securities built on high-risk subprime mortgages to create AAA-rated assets. The system

worked as long as mortgages all over the country and of all different characteristics didn't default all at once. When homeowners all over the country defaulted, there was not enough money to pay off all the mortgage-related securities.



As the National Commission on the Causes of the Financial and Economic Crisis in the United States concluded in *The Financial Crisis Inquiry Report*, “[s]ecuritization was designed to benefit lenders, investment bankers, and investors. Lenders earned fees for originating and selling loans. Investment banks earned fees for issuing mortgage-backed securities.... Purchasers of the safer tranches got a higher rate of return than

ultra-safe Treasury notes without much extra risk – at least in theory.”⁵² That last caveat proved to be exceptionally significant, because while lenders and investment bankers in the mortgage industry indeed profited from the resulting explosion in mortgage-backed securitization, these profits came at the direct expense of investors and resulted directly from the deliberate misconduct of these entities.

IV. THE DOMINANCE OF SECURITIZATION

Starting in 2000 (and in occasional years before then), a growing majority of residential mortgages originated in the United States were securitized, and the rate of securitization during this period increased virtually every year.⁵³ By the late 2000s, the vast majority of residential mortgages were securitized rather than held by the originating lender, and this rate was exacerbated for originators whose business model relied upon securitization.⁵⁴ Securitization was exceptionally dominant in the “subprime” portion of the mortgage industry, the particular portion of the industry most relevant to the mortgages at issue in the majority of criminal and civil prosecutions. Securitization levels peaked at roughly ninety percent of originated mortgages before the housing (and securitization) market crashed in 2008 and 2009.⁵⁵

Further, during this period virtually every mortgage originator in the United States designated Mortgage Electronic Registration Systems, Inc. (“MERS”) as the beneficial nominee on its mortgages in order to facilitate the easy transfer and securitization of the resulting mortgages, without the requirement that these transfers be recorded or publicly available.⁵⁶ Typically, mortgages in this industry were securitized almost

⁵² THE CDO MACHINE, *supra* note 39.

⁵³ See Fligstein & Roehrkasse, *supra* note 16 at 20.

⁵⁴ See Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 11–13 (2011).

⁵⁵ See Fligstein & Roehrkasse, *supra* note 16 at 20.

⁵⁶ See Ellen Brown, *Homeowners' Rebellion: Could 62 Million Homes be Foreclosure-Proof?*, YES! MAG., (Aug. 18, 2010), <http://www.yesmagaz>

immediately after origination. The lenders were eager to obtain their profits from the brokers who bundled and securitized these mortgages, while the brokers were desperate for additional mortgages to bundle, and investors were hungry to purchase new securitized packages.⁵⁷

As a result of these innovations, the extent of securitization was massive. For example, in 2006 alone, over \$1.15 *trillion* in mortgage-backed securities were issued.⁵⁸ Moreover, the majority (seventy-one percent) of the assets in these MBS products consisted of subprime or Alt-A (“liar loan”) mortgages.⁵⁹ Subprime and liar loan mortgages were; (a) typically made to lower-quality borrowers; (b) often made through “lite doc,” “stated income,” and/or stated (or no) asset mortgage programs; and, (c) generally made at higher interest rates. This portion of the mortgage industry consisted of the riskiest – yet most profitable – loans.⁶⁰ Furthermore, those loans were almost invariably securitized, and because they offered the highest interest rates (and yet could be bundled or tranced with AAA ratings), were the ones most sought after by both lenders and other participants in the mortgage industry (e.g., brokers and investors).⁶¹

ine.org/new-economy/homeowners-rebellion-could-62-million-homes-beforeclosure-proof.

⁵⁷ See generally Miguel Segoviano Basurto, Bradley Jones, Peter Lindner & Johannes Blankenheim, *Securitization: Lessons Learned and the Road Ahead* 38 (Int’l. Monetary Fund Working Paper No. 13/255, Nov. 2013), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2381853 (choose to either download the paper or open pdf in browser).

⁵⁸ See THE CDO MACHINE, *supra* note 39, at 102.

⁵⁹ *Id.*

⁶⁰ See generally Bill Black, *Only Lying Lenders Made “Liar’s” Loans*, BUS. INSIDER (Mar. 28, 2011, 3:04 PM), <http://www.businessinsider.com/only-lying-lenders-made-liars-loans-2011-3>.

⁶¹ See Michael LaCour-Little & Jing Yang, *Taking the Lie Out of Liar Loans: The Effect of Reduced Documentation on the Performance and Pricing of Alt-A and Subprime Mortgages*, 35 J. REAL EST. RES. 507, 508 (2013); Richard Greenberg & Chris Hansen, *If you had a pulse, we gave you a loan*, DATELINE NBC (Mar. 22, 2009, 7:32:49 PM), http://www.nbcnews.com/id/29827248/ns/dateline_nbc-the_hansen_files_with_chris_hansen/t/if-you-had-pulse-we-gave-you-loan/#.WaNOatMrK34.

V. MORTGAGE FRAUD AND THE MARKET

Lenders of these types of loans during the relevant period did not generally make mortgages with any hope or expectation that the bank would make money when, or if these loans were repaid.⁶² These entities instead originated these loans exclusively in the expectation that they would immediately bundle and sell them to outside investors, keeping fees and making profits for the banks regardless of whether the loans were actually repaid. This was the routine and nearly uniform practice in the mortgage origination industry during the relevant period. Because lenders promptly bundled and sold these mortgages, in pieces, they did not face any risk of loss and instead obtained substantial profits even when loans were entirely unpaid and foreclosed on. This persisted even when real estate prices declined.⁶³

This was true even with respect to mortgages obtained through fraudulent means. Throughout the 2000s, mortgage fraud was rampant across the United States.⁶⁴ The details of any particular fraud scheme varied. Generally speaking, individuals would buy (or assist others in buying) residential properties by making false statements about their income, assets, intentions for the property, sale prices, or other facts in connection with the transactions.⁶⁵ These individuals would then retain proceeds from the resulting residential mortgages.⁶⁶ After the subsequent burst of the housing bubble, the properties would often go into foreclosure,

⁶² See Fligstein & Roehrkasse, *supra* note 16, at 18.

⁶³ *Id.*

⁶⁴ L. Randall Wray, *The Mortgage Fraud Scandal Is the Biggest in Human History*, BUS. INSIDER (Oct. 14, 2010, 9:30 PM), <http://www.buinessinsider.com/mortgage-fraud-scandal-2010-10>).

⁶⁵ See Nicole Stowell, Carl Pacini, Martina Schmidt & Kathryn Keller, *Mortgage Fraud: Schemes, Red Flags, and Responses*, 6 J. OF FORENSIC & INVESTIGATIVE ACCT. 225, 229 (2014), http://web.nacva.com/JFIA/Issues/JFIA-2014-2_7.pdf.

⁶⁶ *Id.*

in which case the lenders would repossess and then sell the mortgaged properties, often at a substantial loss.⁶⁷

When a direct lender originates and holds a mortgage, it is the originating bank that stands to make money if the mortgage is fully repaid, or, lose money if it is not. By contrast, once a loan is securitized, the allocation of benefits and losses dramatically changes. Banks that originate and then securitize their loans make money merely by originating the loan, and do not stand to gain or lose money based on whether the mortgage is repaid. Instead, banks profit by collecting mortgage origination and other fees (including “junk” fees) associated with the mortgage, as well as additional proceeds based upon the “spread” between the stated interest rate on the mortgage and prevailing market interest rates.⁶⁸ In other words, once the bank securitizes the loan, it no longer cares whether it is repaid. Instead, its only concern is that the loans are generated, since the bank made its money through loan origination rather than repayment.⁶⁹

The economic realities engendered by securitization were reflected in the loan products offered to borrowers by the banks. As the insatiable demand for securitized mortgages continued to grow, banks developed and originated high-interest “stated income/stated asset” mortgages that required no documentation and relied upon the borrower’s own (almost invariably misstated) representations about his income and assets to underwrite the loan. From 2000 to 2007, low-and-no-documentation mortgages more than quadrupled, from less than two percent to roughly nine percent of all outstanding loans. Similarly, alt-A originations increased from less than \$20 billion in 2000 to more than \$300 billion in 2005.

⁶⁷ *Id.*

⁶⁸ See Peter Eavis, *With Rates Low, Banks Increase Mortgage Profit*, N.Y. TIMES, Aug. 8, 2012, at A5. Spread fees are profits paid to the mortgage originator when the interest rate on a mortgage is higher than market rates; e.g., when the interest rate on a loan is eight percent but the typical interest rate is only six percent. *Id.*

⁶⁹ See Fligstein & Roehrkasse, *supra* note 16.

Eighty percent of all subprime mortgages that were securitized in 2006 had limited or no documentation.⁷⁰

The inherent risk of these loans did not deter the banks from making them. As the National Commission explained, with securitization, “[t]he mortgages would be packaged, sliced, repackaged, insured, and sold as incomprehensibly complicated debt securities to an assortment of hungry investors. Now even the worst loans could find a buyer. More loan sales meant higher profits for everyone in the chain.”⁷¹

Those buyers were, in turn, as desperate to buy mortgage-backed securities as the mortgage industry was to package and sell them. An MBS with a AAA rating would facially deliver high interest rates and was backed by a concrete asset – a residential property, typically in a rapidly-appreciating market. Additionally, particular tranches of an MBS would often facially promise exceptionally high returns. Investors knew little about the underlying risks of these securities, but they knew how much they paid, and how hot the underlying real estate market was. That was all that mattered. As long as the housing market continued to appreciate, everyone would make money.

VI. THE PROFITS AND LOSSES OF FRAUDULENT MORTGAGES

But, of course, all good things invariably come to an end. The housing bubble eventually collapsed. Borrowers stopped making their mortgage payments, and individuals and entities that held residential mortgages were often forced to foreclose on the property. When properties were eventually foreclosed upon, the sales price of the property was often a small fraction of the amount of the mortgage. Losses were huge. But not for the bank.

The bank that originated and funded the loan rarely held the foreclosed-upon mortgage. Rather, that mortgage had typically long ago been bundled and sold to outside investors. The originating lender rarely

⁷⁰ See THE CDO MACHINE, *supra* note 39.

⁷¹ *Id.* at 7.

lost money from even the most blatant mortgage fraud scheme. Instead, those mortgages generated hefty fees for the originating lender, and the fact that those loans later failed did not affect the lender, who had long ago departed the scene.

As a result of routine securitization, these entities benefitted, rather than lost money, as a result of the pervasive securitization and the fraudulent mortgages with which they were associated. They sold these mortgages to others for a profit. They made money from origination and underwriting fees. They did not bear the risk of default, which they instead transferred to others through the securitization of these loans.

When the banks securitized the underlying mortgages, they were bundled with a plethora of other mortgages and sold, in pieces, to others. The beneficial owners of these pieces were the ones who bore the risk of the resulting default upon the fraudulent mortgages, not the originating and investment banks. Moreover, when borrowers defaulted on these mortgages, typically, no particular person or entity – and, in any event certainly not the originating bank – owned the entirety of a single one of these loans. Rather, as the National Commission explained in its Financial Crisis Inquiry Report, by the time a single mortgage was foreclosed, “a mortgage on a home in south Florida might become parts of dozens of securities owned by hundreds of investors – or parts of bets being made by hundreds more.”⁷²

Thus, the beneficial owners of the mortgage-backed securities within which the underlying mortgages were bundled were the only ones who could gain or lose money as a result of the repayment or failure to repay the loan. Despite this, courts in mortgage fraud cases have almost uniformly entered criminal restitution orders that ignore this basic fact. Instead, these orders portray the originating banks as the entities that have shouldered the financial consequences of the fraud. As a result, such orders require individuals found guilty of mortgage fraud to pay those banks all losses from the underlying loans; typically, millions of dollars.⁷³

⁷² *Id.* at 8.

⁷³ *See, e.g.,* *Roberts v. U.S.*, 134 S. Ct. 1854, 1856-59 (2014) (affirming \$220,000 restitution order); *U.S. v. Beecroft*, 825 F.3d 991, 995-97 (9th Cir.

As has been stressed, the banks were not the ones who lost money. Rather, the ones who lost were the beneficial owners, typically consisting of mutual funds that had purchased an MBS, CDO, or MBS/CDO tranche, pension funds that had made a similar investment, hedge funds, governmental entities (e.g., municipalities), and on the rare occasion high net worth individuals looking for increased yields. Moreover, not only did these individuals and entities not own a particular mortgage or even a particular piece of any mortgage; they almost always only owned a specified piece of a bundle of loans; i.e., the tranche associated with their purchase. Finally, even the entities that formally owned a particular tranche of a given MBS containing a fraudulent mortgage were *still* generally not the ones who gained or lost money from a default. Rather, it was the beneficial owners of those overlying securities – e.g., the individuals who owned shares in the mutual fund – who were the ones who actually stood to gain or lose from the return generated by the piece of an MBS or CDO tranche owned by the distributing entity.

For an allegedly fraudulent mortgage, then, the people who were actually at risk for losing money as a result of any subsequent default typically numbered in the tens or hundreds of thousands, or even millions. For example, a given mortgage might be securitized by a lender, bundled and sold in various MBS tranches, and a tiny slice of one of those particular tranches then purchased by a particular mutual fund (e.g., Vanguard), which then sells to investors a mutual fund of which this tiny slice of an MBS tranche is in turn a tiny portion of the fund. As a result, every individual investor who owned that particular Vanguard fund would be someone who might have lost money as a result of the default on the underlying mortgage.

2016) (affirming \$2.2 million restitution order); U.S. v. Cross, 273 F.App'x. 557 (7th Cir. 2008) (affirming \$4.3 million restitution order); U.S. v. Powell, 509 F.App'x. 958 (11th Cir. 2013) (affirming \$843,000 restitution order). Courts do not appear to have considered the dominant presence of securitization in assessing the propriety of these restitution orders, nor does there appear to have been any evidence submitted in the underlying restitution hearings regarding this market practice.

But even *these* individuals were likely not materially harmed by any particular mortgage fraud (or series of fraud). Rather, to determine whether any person suffered any identifiable injury, one would first have to ascertain whether the level of defaults of other (totally unrelated) mortgages in the particular MBS rose to the level of the particular tranche of the MBS purchased by the mutual fund (or other entity). If not, then the investor in that fund would not lose even a penny notwithstanding his or her beneficial ownership of a piece of the defaulted mortgage. And even if one could conclude that a particular tranche was, in fact, affected, one would then have to assess whether this tranche was insured, either by the government or private entities, as many MBS tranches were; if so, the mutual fund investor would again lose no money as a result of the default.

Finally, even if one could identify with certainty that an individual beneficial investor owned some tiny portion of a mutual fund that in turn owned a tiny piece of an uninsured tranche of an MBS containing a particular fraudulent loan, and one was then somehow able to calculate with precision the degree of this individual investor's exposure to any particular fraudulent mortgage, in truth, such an investor would not, in fact, have lost even a penny as a result the default. Any individual's alleged "loss" from any such default would instead be, quite literally, a rounding error, and would not in fact affect at all the investor's actual return. Even in the worst of all possible worlds, an investor who has purchased, say, \$100,000 worth of mutual fund shares in the \$200 billion Vanguard 500 fund, which in turn invested a fraction of its assets in a tiny piece of a particular billion-dollar MBS, which in turn experienced even a million-dollar default in one of those mortgages, would find that the net asset value of that fund would change not even a penny – or even a fraction of a fraction of a penny – as a result of this default. It would not matter. Even the \$100,000 investor would not fear, nor would any such investor in fact typically incur, the loss of even a penny as a result of the default of a particular fraudulently obtained mortgage, even if there was a default on

that mortgage and the underlying property sold for a mere fraction of that mortgage.⁷⁴

But it gets worse. Even if these beneficial owners had incurred actual losses as a result of the default of a particular fraudulent mortgage, the restitution orders typically entered by courts do absolutely nothing to remedy these losses. These restitution orders do not compel the individual convicted of fraud to identify and reimburse the investors who actually (allegedly) incurred a loss from the underlying mortgage. Instead, these orders compel the defendant to pay these losses to the originating banks.

To reiterate: the banks made, rather than lost, money on these securitized mortgages. Providing money to these banks in restitution in no way remediates the harm to any beneficial owners of the fraudulent mortgages allegedly injured by the defaults. The originating lenders have no continuing relationship with the investors who (hypothetically) would

⁷⁴ There are additional reasons not to worry about potential restitution to particular MBS investors as well. When individuals or entities purchased an MBS or CDO, these actors were neither participating as direct lenders nor funding an individual mortgage. Instead, by purchasing a selected “tranche” of a huge bundle of mortgages, rather than funding a particular loan, they were essentially placing a bet on the overall real estate market. Investors in an MBS tranche invariably thought that real estate prices would continue to rise, and hence that their tranche would be repaid either as borrowers refinanced or (if necessary) when the bank repossessed and sold the appreciated residence. These investors were not betting on an individual loan or mortgage. They were instead betting on the overall market. If the overall market went up, their bundle would go up, and they would make money. If the overall market went down, their bundle would go down, and they would lose money.

This is, in fact, why investors purchased residential-backed mortgage securities. Investors who thought that the real estate market was a bubble did not buy them. Those who thought that real estate would continue to appreciate did. Whether an individual mortgage was unsound, or unwise, or even fraudulent, was not the bet they made, and would not materially affect the value of their security. What mattered was simply the overall direction of the underlying real estate market.

have been the ones financially harmed by the defaulted mortgages. Any restitution paid to these banks simply constitutes a windfall to them.

These restitution payments do not go to anyone who actually incurred any losses (even if they could be identified) as a result of the underlying fraudulent loans. Rather, these restitution payments simply become the assets of the relevant bank – a bank that, unlike the investor, actually gained, rather than lost, money as a result of the fraud.

The prevailing judicial restitution orders thus essentially rob Peter (the defendant) to pay Paul (the originating banks). And this robbery typically occurs when Peter's already in prison, and Paul not only didn't lose any money, but actually made money from – and often participated in – the underlying fraud. When the underlying mortgage has been securitized, the typical restitution order entered in favor of the originating bank is not only improper, but inequitable.

It is certainly true that lenders and others suffered mightily as a result of the collapse of the housing market and the burst of the real estate bubble. Banks failed, lenders went out of business, and billions of dollars in real estate valuations disappeared in the historical blink of an eye. Moreover, it is also true that some small fraction of those losses were infected with fraud, and resulted from mortgage loans made to individuals who were neither forthright nor fully truthful in their underlying mortgage applications.

But these businesses failed because the market collapsed, not because they lost money on the underlying loans. When the housing market crashed, investors were no longer confident in future real estate appreciation, and without such anticipated appreciation, no longer wanted to buy mortgage-backed securities. That is what destroyed the banks and lenders, not losses from any underlying frauds. Without demand from investors, there was no demand for securitization, and without securitization, lenders could not originate loans. The market dried up, and those lenders who participated in that market went bankrupt or disappeared.

That was not the fault of any individual who engaged in mortgage fraud. It was the result of the crash of the overall housing market, for reasons having nothing to do with fraud and everything to do with the

irrational exuberance of both purchasers of and investors in real estate. Lenders surely lost money, but, with the exception of the minority of direct make-and-hold originators, not from fraud.

VII. CONCLUSION

The dominant presence of mortgage securitization during the relevant period critically affects the propriety of civil and criminal restitution orders. Courts continue to enter such orders based upon a simplistic and outdated understanding of mortgage lending that does not reflect the dominant market in this century. The restitution orders entered by courts almost invariably fail to direct restitution payments to the actual losers, and instead improperly award restitution to lenders who made – rather than lost – money from the underlying fraud.

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