Securitization – A Primer

Most people have heard the term "securitization" in media reports about the Housing Crisis. Some even know that securitization involved the selling of mortgage loans to Wall Street. But beyond that, most people have no clue as to what Securitization really is.

Securitization is the process whereby loans were sold to Wall Street and then sold to investors as bonds. It is a process that is complicated, and filled with legal issues. This article will attempt to simplify the understanding of this process. It is outside the scope of the writing to describe Securitization in complex detail, the "ins and outs", and the myriad details involved. It would only serve to confuse the layman, and to create misunderstandings. Those who understand the process, please keep this in mind. I only want this to serve as a basic Primer.

History

Securitization has been involved in mortgage loans for decades. It started in rudimentary form in 1938 with the creation of Fannie Mae, to help with the Housing Crisis in the Depression and to stimulate home purchasing. At that time, government funds were used, and Fannie Mae was kept on the government "balance sheet".

By 1968, Fannie Mae was becoming a large budgetary item. The Johnson Administration took Fannie Mae and turned it into a "shareholder-owned" company, which removed it from the Federal Budget. Freddie Mac was created at this same time to be competitive with Fannie Mae.

By the 1980's, Fannie and Freddie had become major players in the mortgage industry. Other entities had taken notice and in 1990, Long Beach Savings introduced the first "privately securitized" deal for $70 million, executed through Greenwich Capital. It was so successful that other lenders took immediate interest.

In 1993, Fannie Mae, Freddie Mac, Bank of America and numerous other lenders "commissioned" a study to determine if private securitization could be effectively accomplished and the best methods to pursue for effectiveness. In 1995, the study was completed, which laid out the road map, and at the same time, identified a method for controlling costs associated with recordings and assignments and for identifying ownership of the loans. Thus was born MERS, the Mortgage Electronic Registration Systems. By the end of 1996, MERS was fully up and running, but not in systemic use.

In 1997, Long Beach Savings “split” apart and the key players went off in different directions. Ameriquest/Argent was the direct result of this split. Later, other entities like New Century and Option One were born from the former Long Beach Savings personnel.

By 1998, Private Securitization was beginning to gain popularity, but the collapse of Long Term Capital in Sep 2008 saw the securitization effort delayed, due to a “mini-financing” crisis. However, the repeal of Glass Steagall in 1999 restarted the efforts. (Glass Steagall prevented Commercial Banks and Investment Banks from conducting the same types of business. The repeal allowed commercial banks to also conduct investment banking and vice versa.)

Countrywide, Indymac and other commercial banks began to create investment operations for the purpose of Securitization, while the Wall Street investment banks undertook actions in reverse. This led to the” Securitization Boom” starting in 2000 and peaking in 2005-2006.

In 2000, the “Dot Com Bubble” burst as well. The people who made money from this boom had already taken their money out and had it sitting in banks and mutual fund investments. When 9-11 occurred, the Fed started dropping interest rates, directly affecting these assets. Wall Street came to the “rescue” offering Mortgage Backed Securities with what was promoted to be great “Return on Investments” with little risk This led the way to the current crisis. (There is much more to this part of the story, but for the sake of simplicity, I shall not cover that in this article.)

The Process

The actual process of securitizing a loan involved the following steps. To keep it simple, we shall assume that a Warehouse Line of Credit provided by a Wall Street firm was used to fund the loan.

- The Wall Street entity “pre-sold” the loans. This meant that parties were found who would buy the loans, and usually fronted the money to the Wall Street firm, though often, the firm would use their “own” money.

- Wall Street would then contract lenders to find the loans and fund them through a Warehouse Line of Credit.

- The borrower needed a loan and went to a broker. The broker did the paperwork and took the loan to the lender who approved the loan.

• The lender funded that loan and many others, through the Warehouse Line of Credit. Other lenders with Warehouse Lines would do the same.

• A “Sponsor” was named for the securitization transaction. The Sponsor would “collect” all the necessary loans and “bundle” them together in one large pool of loans. The loans would then be “sold” to the “Depositor”.

• The purpose of the Depositor was to “deposit” the loans into the “Issuing Entity” or “Trust”, after “segmenting” the loans into various “tranches” or slices of loans, which would make up the different parts of the pool. During this period of time, the loan tranches would be “rated” for quality, and ratings such as AAA were assigned each tranche.

• Once the “Issuing Entity” or “Trust” took possession of the loans which were now segmented into the tranches, the loans were ready to “sell” to the different entities that had already spoken for them. The loans were sold as “Certificates” or “Bonds” known as Mortgage Backed Securities. These were then resold to Investors.

• Incredibly, these Certificates and Bonds were often again “broken up” and resold in smaller portions in values. These were known as Credit Default Obligations. Sometimes, these were broken up again and sold in smaller amounts.

The purpose of the Sponsor and the Depositor was to comply with REMIC and other Tax Code provisions. To achieve certain Tax Benefits, there had to be at least “Two True Sales” of each loan to another entity before the Notes were sold as Certificates. The “True Sales” were supposed to be to the Sponsor, and then the Depositor. Arguably, the Sponsor and Depositor corporations were nothing more than “sham” corporations, to assist in “sham” sales.

For a “true sale”, there must be an offer and acceptance, with the transfer of the Deed and Note and consideration. When the Notes are sold, first to the Sponsor, and next to the Depositor, there is no evidence of any actual money changing hands. Nor were the Note and Deed transferred between these parties by recordings or any other method. One could reasonably argue that these were “sham sales”.

(Note: This is a VERY simplified version of the process, but it gives the general idea. Depending upon the originating lender, it could change to some degree. The purpose of such a convoluted process was so that the entities selling the bonds could become a “bankruptcy remote” vehicle, protecting lenders and Wall Street from harm, and also creating a “Tax

Favorable" investment entity known as an REIMC. An explanation of this process would be cumbersome at this time.)

MERS

As described, each Securitized Loan has purportedly been transferred two to three times at a minimum. However, no Assignment of Beneficiary was ever recorded when the transfers took place. That was the purpose of MERS.

The Deeds would be kept in the name of MERS as "Nominee for the Beneficiary". This allowed MERS to "pretend" to be the Beneficiary and avoid the expenses of recording Assignments at each transfer, usually about $30 per recording. MERS "hid" these transactions behind a "steel curtain" that would have made the 70's Pittsburgh Steelers proud. Even today, it is virtually impossible for most people to find out who the "Issuing Entity" is for a Note and loan that was purportedly placed into a Trust.

Prior to MERS, any transfer of a Note and Deed needed to be recorded in the County of the property as a public record. This was to allow notice of true ownership and to establish a "priority of liens". MERS circumvented this procedure and obscured the ability of anyone to determine the legal owner of a property.

MERS records are confidential and limited to viewing only by "members" of MERS. To further worsen the situation, MERS "restricts" membership to only "approved parties". A person or firm can only become a member after a lengthy application, and an "interview". Unless you are a lender, servicer, or other party that MERS will accept, your application will be turned down because MERS does not want you to have access to this information for litigation purposes.

Pooling and Servicing Agreement and Document Delivery

The Pooling and Servicing Agreement and other related documents for securitization cover all aspects of the transaction. It identifies the parties involved, how the loans are obtained, payment distributions, credit enhancements and other issues. For our purposes, we shall just review the issues regarding the delivery of the documents. The following is from a Goldman Sachs Agreement for GSAMP Trust 2007-NC1. This was a group of New Century loans that were securitized through Goldman Sachs.

From the Agreement:

Delivery of Mortgage Loan Documents

In connection with the sale, transfer and assignment of each mortgage loan to the issuing entity, the depositor will cause to be delivered to the custodian, on or before the closing date, the following documents with respect to each mortgage loan, which documents constitute the mortgage file:

(a) the original mortgage note, endorsed without recourse in blank by the last endorsee, including all intervening endorsements showing a complete chain of endorsement from the originator to the last endorsee (except for no more than 1.00% of the mortgage loans for which there is a lost note affidavit and a copy of the mortgage note);

(d) the originals of any intervening mortgage assignment(s), showing a complete chain of assignment from the originator of the related mortgage loan to the last endorsee or, in certain limited circumstances, (i) a copy of the intervening mortgage assignment together with an officer's certificate of the responsible party (or certified by the title company, escrow agent or closing attorney) stating that of such intervening mortgage assignment has been dispatched for recordation and the original intervening mortgage assignment or a copy of such intervening mortgage assignment certified by the appropriate public recording office will be promptly delivered upon receipt by responsible party, or (ii) a copy of the intervening mortgage assignment certified by the appropriate public recording office to be a true and complete copy of the recorded original;

(e) the original mortgage assignment in recordable form, which, if acceptable for recording in the relevant jurisdiction, may be included in a blanket assignment or assignments, of each mortgage from the last endorsee in blank;

The Problem

If one reviews sections (a), (d) and (e) with care, an important issue stands out. The Agreement calls for a complete "Chain of Assignment" of the Deed, and a complete "Chain of Endorsement" of the Note. Furthermore, section (e) suggests that there might be mortgage assignments that have not been recorded. This is a problem that litigators are beginning to address so as to argue "Legal Standing".

There is no recorded and perfected Chain of Assignments, nor is there a Chain of Endorsements in any Securitized Loan, no assignment history that goes from the lender, to the Sponsor, to the Depositor, and lastly, to the Trust, as required by the PSA. Any Assignment of the Deed to the Trust will almost always occur after a Notice of Default is filed and the Assignment is made from the lender or MERS to the Trust. This is done to “establish” Beneficiary Rights in the mind of the Trust. It also tries to unite the Note and the Deed for Legal Standing to foreclosure.

Since the Assignment has occurred AFTER the Notice of Default, and the Assignment is from the originating lender or MERS, there is an unperfected Chain of Assignment. Can this make the Notice of Default lawful? Some attorneys in California are arguing that it is not lawful, and the results of such arguments are mixed, dependent upon the Court and the judge’s perspective. Most often, the Court will rule that since the Non-Judicial Foreclosure Statutes are “exhaustive”, the assignment issues are immaterial. Some Bankruptcy Court judges are beginning to consider this a ‘defect” in legal standing and are reacting accordingly.

The Note has been endorsed in blank, usually with only one endorsement on the Note, or an Allonge, and there is no Chain of Endorsement representing the different entities involved. This turns the Note into a “Bearer Note”. Anyone in possession is arguably entitled to payment under Commercial Code. But if the Deed is not perfected, can the Note Holder foreclose without turning to Judicial Foreclosure methods? This will be the next area that Courts in California will have to consider. Likely, it will occur in the Bankruptcy Courts, and then slowly come into the Trial Courts, after appeals are heard.

The Allonge could present another issue. Under different Statutes and case law, an Allonge must be permanently attached to the Note. This usually means that the Allonge is stapled to the Note, or affixed in some other manner. If the Allonge is not permanently affixed, it poses issues regarding Legal Standing and the ability to foreclose as well.

When preparing to argue Allonge and Note endorsement issues, you are not likely to have access to originals of either document. Courts have tended to rule that the originals are not necessary to prove Legal Standing, especially in California. However, a copy of the Note, especially if it shows only one endorsement when there should be two or more endorsements may offer some Legal Standing questions. An Allonge that is not attached could offer the same. This has been shown, at least to the satisfaction of one Bankruptcy Court, by the copies provided showing no evidence of staple marks in the copy.

Summary

Hopefully, this article has served to explain in relatively simply detail the history of Securitization, the process, and how it was instrumental in events leading up to the Mortgage Crisis. It has also tried to present in limited detail some issues regarding Legal Standing so that the non-attorney can begin to understand the legal issues that may be present with regards to Securitization.

There is much more to Securitization than what I have presented. Much is immaterial to the layman attempting to understand the process. Some aspects as the payment streams to the different buyers of the Certificates and Bonds are so complex that years from now, people will still be trying to make sense of it.

The Underwriters of the Tranches, I have deliberately avoided writing about. It was not necessary to present for an understanding of how the loans were securitized. Underwriting would be more applicable to the understanding of how the Certificates and Bonds were presented to Investors for purchase. These topics would likely not be of use in present homeowner litigation, but will attain importance in Investor lawsuits.

My next writing will pertain to the Pooling and Servicing Agreement and other related documents, and will reveal why this document needs to be presented in litigation, beyond just proving legal standing. The PSA will tie the complete loan transaction, from origination to funding to Securitization, into a concise understanding of why these loans were doomed to fail, and the Housing Crisis becoming inevitable.

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