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Tamar Frankel, *The Problems of Securitizing Sub-Prime Loans* , *in* 1 Asian Business Lawyer 20 (2008).
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Citations:

Bluebook 21st ed.
Tamar Frankel, The Problems of Securitizing Sub-Prime Loans, 1 Asian Bus. LAW. 20 (2008).

ALWD 7th ed.
Tamar Frankel, The Problems of Securitizing Sub-Prime Loans, 1 Asian Bus. Law. 20 (2008).

APA 7th ed.
Frankel, T. (2008). The Problems of Securitizing Sub-Prime Loans. Asian Business Lawyer, 1, 20-31.

Chicago 17th ed.
Tamar Frankel, "The Problems of Securitizing Sub-Prime Loans," Asian Business Lawyer 1 (2008): 20-31

McGill Guide 9th ed.
Tamar Frankel, "The Problems of Securitizing Sub-Prime Loans" (2008) 1 Asian Bus Law 20.

AGLC 4th ed.
Tamar Frankel, 'The Problems of Securitizing Sub-Prime Loans' (2008) 1 Asian Business Lawyer 20

MLA 9th ed.
Frankel, Tamar. "The Problems of Securitizing Sub-Prime Loans." Asian Business Lawyer, 1, 2008, pp. 20-31. HeinOnline.

OSCOLA 4th ed.
Tamar Frankel, 'The Problems of Securitizing Sub-Prime Loans' (2008) 1 Asian Bus Law 20

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THE PROBLEMS OF SECURITIZING SUB-PRIME LOANS

*Tamar Frankel**

I. INTRODUCTION

In October 2007, the board of directors of Merrill-Lynch, Smith & Fenner, one of the largest if not the largest brokerage houses in the United States, accepted the request for early retirement of its Chief Executive Officer. The brokerage firm disclosed that it has lost over $8 billion on its investments in sub-prime mortgage loans.[1] Merrill Lynch was not the only financial giant to sustain enormous losses. The losses caused market liquidity to dry up. The U.S. government took steps to ease the pressure.[2] But the high leverage of the system is still unravelling. The effect of these events spread abroad, and foreign regulators accused U.S. regulators of laxity — a drastic change from the usual complaints about U.S. strict regulation. More importantly, the scepter of a recession and even a depression has risen.[3] It is still

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The research on which this Article is based was performed entirely by Sofia Tsachouridou, Δικηγόρος (Greek attorney), M.L.E.; L.L.M. Scholar (Boston University School of Law), doctoral candidate (Universität Hannover). The quality of her work and her professional commitment are exceptional, for which I am grateful.

1 Kai Ryssdal, *Merrill Lynch's subprime losses pile up*, Oct. 24, 2007, *available at* http://marketplace.publicradio.org/display/web/2007/10/24/merrill_lynch/

2 Barry Grey, *US government brokers scheme to bail out Wall Street banks*, Oct. 18, 2007, *available at* http://www.wsws.org/articles/2007/oct2007/bank-o18.shtml; *see also* John R. Price, *Viewpoint: FHLBs' Critical Role in Restoring Liquidity*, Oct. 19, 2007, *available at* http://www.americanbanker.com/article.html?id=200710185QH9T3MG&queryid=1433601750&hitnum=1

3 For the debate whether U.S. economy needs a depression *see Does America need a recession?* Aug. 23, 2007, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=9687245; *see also* John Stepek, *Do we need a recession?* Sept. 28, 2007, http://money.uk.msn.com/Investing/Insight/Special_Features/Moneyweek/article.aspx?cp-documentid=6252186; *see also* Samuel Brittan, *Why the US needs a recession*, FT, March 29, 2001, *available at* http://www.samuelbrittan.co.uk/text73_p.html

clouding the horizon.

The crisis was triggered by securitized sub-prime mortgage loans. Like all good things securitization involves not only benefits but also business and legal risks to participants and sometimes to the financial system. The risks of securitization are reduced by strong market and cultural constrains, by the lawyers' designs[4] and by law. But occasionally these protective mechanisms fail. This Article discusses the securitization of sub-prime mortgage loans: an example of securitization gone wrong.

II. DEFINITIONS OF SUB-PRIME LOANS

"Mortgage loans" are loans secured by mortgages on real estate. In the United States these loans are often secured by mortgages on private homes. Mortgage loans are considered relatively secure loans, because real estate collateral is relatively secure; the usual borrowers are expected to make every effort to meet the loan payments rather than lose their homes. In addition, the amounts of the loans are usually lower than the value of the real estate collateral when the loans are made. The collateral of real estate homes is not risk free, however. The cost of selling occupied-homes can be very high, real estate is relatively illiquid and the occupants are protected by legal foreclosure and eviction rules.[5]

The meaning "prime interest rate" is ambiguous. The term used to mean "interest rate charged by most banks to their most credit worthy, low-risk — "prime borrowers." Later, the uniform meaning of prime rate became far more flexible.[6]

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4 *See* Tamar Frankel, *The Law of Cross-Border Securitization: Lex Juris*, 12 DUKE J.COMP. & INT'L L., 475 (2002).

5 *See* Andreas Lehnert and Karen M. Pence, *The Price of Protection: Foreclosure Law and House Prices*, Dec. 20, 2003, *available at* http://andreas.marginalq.com/Research/Foreclosure/fhp.pdf; *Contra* Jeremy B. Fox, *Foreclosure protection not always the deal it seems*, WAS. BUS. J., April 12, 2002, *available at* http://www.bizjournals.com/washington/stories/2002/04/15/focus14.html?page=2

6 *Lum v. Bank of Am., et al.*, 361 F.3d 217 (3d Cir. 2004). The prime rate has been described as "murky, ill-defined term that rarely reflects the lowest rates available to corporate customers." *See* Staff of House Comm. On Banking, Finance and Urban Affairs, 97th Cong., 1st Sess., An Analysis of Prime Rate Lending Practices of the Ten Largest United States Banks 3 (Comm. Print 1981). Decisions supporting the lack of precision in the term "prime rate": *Blount Fin. Serv. Inc. v. Walter E. Heller and Co.*, 819 F.2d 151, 152-53 (6th Cir. 1987); *Wilcox v. First Interstate Bank of Oregon*, 815 F.2d 522, 527-28 (9th Cir. 1987) considering prime rate to mean the average cost of a loan; *Center Cadillac, Inc.*

The meaning of "sub-prime rate" is even more ambiguous than the term "prime rate" and may be somewhat misleading. The term could indicate to borrowers that they pay less than the prime rate, and suggest to lenders that the borrowers pose a lower risk than prime rate borrowers. In fact sub-prime mortgages triggered far higher interest rates (after a grace period) and their borrowers posed far greater risk than prime rate borrowers.

Sub-prime loans posed high risk for both borrowers and lenders. To attract borrowers, sub-prime mortgages carried below prime interest rates —*for a limited period*[7] but then carried very higher interest rates.[8] The borrowers of sub-prime mortgages were high-risk borrowers. They included borrowers who could not, or did not want to, prove their income and/or cash flow,[9] or "2/28 or 3/27 loans" with only an initial 2- or 3- year period of fixed interest, or loans of larger amounts than the value of the real estate collateral.[10] The borrowers and lenders hoped that real estate prices would continue to rise.[11] Thus, names can mislead.[12]

III. SECURITIZING LOANS

Securitization is a process by which contract loans are converted into

v. Bank Leumi Trust Co. of New York, 859 F. Supp. 97, 103 (S.D.N.Y. 1994), aff'd, 99 F.3d 401 (2d Cir. 1995); *Lum v. Bank of America, et al.*, 361 F.3d 217 (3d Cir. 2004).

7 LexisNexis. *Subprime Lending: An Update of the Issues and Approaches*, Aug. 2007; *see also Doyle v. Trinity Savings & Loan Association*, 869 F.2d 558 (lOth Cir. 1989) footnote 2.

8 *Id.*

9 *McCloskey v. NovaStar Mortg., Inc.*, 2007 U.S. Dist. LEXIS 62297 (E.D. Pa. Aug. 21, 2007); *In re Marriage of Chakko*, 115 Cal. App. 4th 104, 8 Cal. Rptr. 3d 699, 2004 Cal. App. LEXIS 80, 2004 Cal. Daily Op. Service 585, 2004 D.A.R. 761 (Cal. App. 2d Dist. 2004).

10 *In re Cmty. Bank of N. Va. & Guar. Nat'l Bank of Tallahassee Second Mortg. Loan Litig.*, 418 F.3d 277, 303 (3d Cir. 2005) 277, 2005 U.S. App. LEXIS 17471 (3d Cir. Pa. 2005).

11 For the historical evolution of the prime rate especially in ARMs *see ARM Indexes: Prime Rate, 2000-present, available at* http://www.hsh.com/indices/prime00s.html#explanation (last visited Dec. 02, 2007); *see also* Carie Lee, "*Slice of the System*" *Product Applicable Interest Rates for Delinquent Bills and Annual True-Up Adjustment*, Nov. 6, 2007, *available at* http://www.bpa.gov/power/psp/products/slice/interest_rates.shtml

12 Martin Wolf, *Life could yet follow death for the idea of securitization*, FT, Oct. 3, 2007 at 9.

marketable securities. The process involves a number of steps. A lender makes loans. The lender sells the loans to an Originator, or serves as the Originator. The Originator pools and transfers the loans to an entity, be it a trust or a corporation or any other recognized entity. The entity issues securities to investors, representing the payments from the pool of loans. The investors' payments for the securities are then paid to the Originator who pays the lender. The pooled loans produce income for the investors as well as the repayment of the capital. Usually, the lender or Originator continues to service the loans, collecting the payments from the borrowers, and transferring the payments due to the investors.[13]

Securitization helps reduce the lenders' risk by providing liquidity, and transfering and spreading risk. By selling the mortgage loans to an entity, the Originator transfers to the buyers the borrowers' default-risk, the risk that the value of the collateral will fall, and the market risk of interest rate fluctuations. Selling the loans provides the Originator-lender with funds for further lending or investing. The buying investors benefit from what seems to be relatively lower (diversified) risk-high return investments as compared to traditional secure investments such as government bonds and liquidity. Many intermediaries benefit from fees.

IV. LEGAL ISSUES: EXISTING AND FAILING PROTECTIONS OF THE PARTICIPANTS AND THE SYSTEM

Historically regulated banks and thrifts were the main originators of mortgage loans,[14] but later unregulated mortgage bankers have become involved as lenders and Originators.[15] Also, regulated banks financed unregulated Originators of the securitization process. Banks may be regulated with respect to the loans they make but not with respect to the loans that their borrowers make.

The next step in the securitization process is a transfer of the loans

13 *See generally* Tamar Frankel, *Securitization – Structured Financing, Financial Assets Pools, and Asset-Backed Securities* §8.1 (2d. ed. 2006).

14 *Id.* §7.1.

15 *Id.* Operating corporations and holders of receivables securitize loans as well and especially financial intermediaries, interested in expanding their primary business and entering new businesses. These include securities brokers that acquire financial assets, such as mortgages, for sale.

an entity, Special Purpose Vehicle (SPV). In most cases, the loan documents (including the borrowers' note) remain in the seller's possession, and the seller or another party continues to service the loans. Furthermore, the notes accompanying the loan are rarely indorsed to the buyer. The final step in securitization is the issuance of securities by the SPV, either to a small group of sophisticated investors or to the public.

For investors, the process involves a number of concerns. One concern relates to the possible bankruptcy of the transferor of loans to SPVs.[16] If the transferor becomes bankrupt, its creditors might claim the assets of the SPV as the property of the transferor. In such a case the investors in the SPV's securities might stand in line as unsecured creditors, even though they paid fully for the SPV's assets. Therefore lawyers take great pains to ensure that the transfer of the loans to the SPV is a "true sale."[17]

Another potential loss to the investors is the possible consolidation of the SPV with the bankrupt transferor. The result is that the assets of the SPV will be viewed as the assets of the bankrupt transferor. To protect the investors, the contacts of the SPV with the transferor of the loans must be severed. SPVs are designed to be independent of the lender or transferor of the loans in order to shelter the SPV and its investors from the claim of the lender's or transferor's creditors.[18]

A further concern to investors is the absence of clear information about the value of the securities. Securitization is based on the assumption that the risk of securitized financial assets can be evaluated and quantified. For as long as the risk (mainly default and prepayment risk)[19] can be predicted, and the securitized loans have similar qualities,

16 *Id.* §10.6.

17 Steven L. Schwarcz, *Structured Finance* 28 (2nd edition 1993); *see also Id.* footnote 62 about the objections of the SEC observer concerning the recognition of transfer of receivables as sales during the meeting of the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EIRF).

18 The existence of an SPV is essentially what differentiates Securitization from Factoring, where an already existing financial company buys the receivables at a discount from the Originator with the purpose to reduce the default risk by gathering and handling numerous obligations; *see* Steven L. Schwarcz, *Feature: The Alchemy of Asset Securitization*, STAN. J.L. BUS. & FIN. 133 (1994); Lawrence R. Ahern III, "*Workouts*" *Under Revised Article 9: A Review of Changes and Proposal for Study*, 9 AM. BANKR. INST. L. REV. 115 (2001).

19 The prepayment risk refers to the strategy of borrowers to re-finance in order to prepay loans with a higher interest rate. That would leave investors with a lower interest rate than they expected, and might expose them to a higher risk for those borrowers who could not

the securitized loans can be priced.[20]

The concern involves both investors and the financial system that supports securitized loans. If the cost of verifying the value of these securities and the trustworthiness of the involved financial intermediaries becomes too high, investors would refrain from buying these securities, or they may demand a far higher price for them.[21] If originators' cost of producing convincing evidence of the value of the securities and their own trustworthiness are too high, they would refrain from offering assets backed securities. In such a case the law reduces the costs of both parties and encourages their interaction.[22]

Securitized loans and the probability of their failure are very difficult to evaluate. Therefore, investors in securitized loans trust the transferors and the rating agencies to set the right price for the securities. If the valuation and pricing prove wrong, investors are likely to sell their securities and depress the market price. In the liquid market of mortgage backed securities doubts about the value of the securities can lead to a "run" and to drying up liquidity.[23]

Rating agencies are assumed to use a reliable rating scale to make their analysis.[24] Rating analyses cover both securities and organizations.[25] After dividing the pool of loans into classes (tranches), a rating agency evaluates and rates each tranche according to the risk attached to it. The first tranche, for example, might be entitled to receive a high percentage of the repaid principal, whereas each of the following tranches will be entitled to a lower percentage of the repaid principal, and as a result will be pose a higher risk.[26]

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refinance because of deteriorating financial conditions.

20 Steven L. Schwarcz, *Structured Finance* 7 (2nd ed. 1993).

21 *See* Tamar Frankel, *Trust and Honesty America's Business Culture at a Crossroad* (2006), at 52 discussing the market for lemons.

22 *Id.*

23 Martin Wolf, *Life could yet follow death for the idea of securitization*, FT, Oct. 3, 2007 at 9.

24 SEC: *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, at 9, *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf

25 Manggi Habir, *The Role of Credit Rating Agencies*, Nov. 22, 2004, *available at* http://www.adbi.org/conf-seminar-papers/2006/04/03/1760.credit.rating.agencies/; *see also* Kara Scannell and Deborah Solomon, *Unraveling the Subprime Mess*, WALL ST. J., Sept. 4, 2007, at A6.

26 John Mauldin, *The Panic of 2007*, 18. Aug., 2007, *available at* http://www.realclearpolitics.com/articles/2007/08/the_panic_of_2007.html; *See also* Lore G. Kenneth and

V. WHAT CIRCUMSTANCES LED TO THE SUB-PRIME LOANS CRISIS?

At the beginning of the year 2000, interest rates soared in the U.S.[27] Consequently, the number of borrowers and loan securitizations fell,[28] yet investors' demand for loan products has not diminished. Loan Originators sought new ways to market loan products and satisfy the demand in the secondary market.[29] These pressures drove to making riskier loans. According to Freddie Mac only about 15% of the borrowers of sub-prime loans would have qualified for traditional loans, according to their credit score.[30] The rest would not have qualified.

The environment during the years 2000 to 2004 was conducive to hopeful speculation and risk taking. Real estate prices were rising, in part driven by easier financing and in part by generous and optimistic appraisals. Borrowers bought houses they could not afford,[31] in the belief that real estate market prices would continue to rise.[32] Sub-prime mortgage borrowers believed that they could always sell their property for more than the amount of the loan, no matter how high the loans were, and that interest rates would remain stable and the variable rates, which they would have to pay in the future, would not rise. That in combination with a perpetual appreciation of the home values made a very attractive, though risky move. Even borrowers who recognized the

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Cameron L. Cowan, *Mortgage-Backed Securities; Developments and Trends in the Secondary Market* IV, § 1:18 (2001) "An investment grade rating from one of the nationally recognized rating agencies is critical to the successful marketing of most large mortgage-backed securities issues."

27 *Id.*

28 For the rise in demand of securities *see* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J., *available at* http://ssrn.com/abstract=7589 or DOI: 10.2139/ssrn.7589 *citing*: Fred Vogelstein, *Credit Cards Fuel Asset-Backed Issues*, WALL ST. J., Oct. 30, 1995.

29 About the rise in demand of securities see LoPucki, Lynn M., "*The Death of Liability*", YALE L.J., October 1996, *available at* http://ssrn.com/abstract=7589 *citing*: Fred Vogelstein, *Credit Cards Fuel Asset-Backed Issues*, WALL ST. J., Oct. 30, 1995.

30 Kimberly Blanton, *Dark side of subprime loans*, BOSTON GLOBE, Aug. 3, 2007, *available at* http://www.boston.com/business/personalfinance/articles/2005/08/03/dark_side_of_subprime_loans/

31 Martin Wolf, *Questions and answers on a sadly predictable debt crisis*, FT, Sept. 5, 2007 at 11.

32 About the course of the mortgage interest rates from 1995 until 2006 and foreclosure activity *see* James P. Gaines, *The Value of Subprimes*, Tierra Grande, July 3, 2007, *available at* http://recenter.tamu.edu/tgrande/vol14-3/1824.htmli

possible problems failed to realize their full extent.[33]

However, some of the sub-prime loans that started with low or fixed interest rate for a period converted into higher rates for the rest of the loan period,[34] which some borrowers could not pay. As borrowers attempted to sell their homes they could not find buyers at the prices they demanded. Higher supply and unrealistic price demands drove real estate prices down.[35] The terms of the borrowers' loans made re-financing almost impossible (because of high penalty requirements). Foreclosure rates rose to a record high.[36] Rising defaults and deteriorating real estate prices fed each other.

As the sub-prime loan crisis developed, rating agencies were criticized for unreliable ratings and conflicts of interest.[37] Their close contact to the issuers of the rated securities may have become too close. Paying issuers that are the source of information are likely to influence the rating of their securities.[38]

In sum, historically, rating agencies were considered the authority on the value of mortgage backed securities, and their judgment was

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33 Scott Applewhite, *Greenspan: I saw loan dangers too late*, BOSTON GLOBE, Sept. 14, 2007 at C2. *See also* Martin Wolf, *Questions and answers on a sadly predictable debt crisis*, FT, Sept. 5, 2007 at 11.

34 Martin Feldstein, *Liquidity now!*, WALL ST. J. Sep. 14, 2007, *available at* http://www.nber.org/feldstein/Wall St. J.091207.html; *see also* Jesse J. Holland, *Mortgage woes spur ideas but no plan*, BOSTON GLOBE, Sept. 4, 2007 at C1, according to the Senator Christopher Dodd 1 to 3 million people could lose their homes just because of their onerous mortgage.

35 Home building has fallen 20% at the lowest level of the decade. House prices have fallen 3.4% from the last 12 months. *See* Martin Feldstein, *Liquidity now!*, WALL ST. J., Sep. 14, 2007, *available at* http://www.nber.org/feldstein/Wall St. J.091207.html

36 Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, *available at* http://www.bis.org/publ/bcbs128.pdfi

37 SEC: *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, at 19, *available at* www.sec.gov/news/studies/credratingreport0103.pdf (voicing similar criticisms in connection with the Enron and WorldCom scandals); SEC: *The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, Nov. 15 and 21, 2002, *available at* www.sec.gov/news/studies/credratingreport0103.pdf

38 In addition, this information could increase market volatility and promote a lack of transparency in the market. *See* SEC: *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, footnotes 90-92, *available at* www.sec.gov/news/studies/credratingreport0103.pdf

accepted without questions. In fact, no issuance of debt securities was possible without rating. But in the early 2000s, it was recognized that there might be a need to better understand the agencies' methods and possibly impose on them stricter disclosure requirements of their practices and conflicts of interest. Market discipline in this case was not fully effective. We are likely to see court cases against rating agencies in the near future.[39]

A similar failure has appeared in relation to real estate appraisals, which are crucial to a healthy sub-prime loan-securitization, and any mortgage-backed securities. These appraisals determine the value of the loans' collateral. The Attorney General of the State of New York has recently sued First American Corporation and First American eAppraiseIT.[40] The Attorney General of New York asserted, appraisers were greatly pressured to provide ever-higher appraisals. Thus, securities backed by these loans and collateral were fraudulently over-priced.

The sub-prime mortgage loan crisis has affected underwriters and broker-dealers. As noted, these transactions caused the Merrill-Lynch brokerage firm to lose over $ 8 billion. The brokerage firm did not buy the securities; it sold them. However, to induce buyers, the brokerage firm promised the buyers to buy the securities back, if they so demanded. In short, the brokerage firm sold the securities with a "put." When the buyers required the brokerage firm to buy back the securities, it had little choice. However, it could not resell the securities at the same price and had to post the losses on its balance sheet. It did not, however, post the obligations to buy back the securities as a guarantee, and its balance sheet did not reflect these obligations.

The legal issue in this case is unclear and may depend on the facts as they develop. After all, brokerage firms are also dealers. Dealers provide clients with liquidity by buying the clients' securities and then

39 Raphael Nach, et al. v. Linda Huber, et al., 07-CV-4071, *available at* http://securities.stanford.edu/1038/MCO_01/2007719_f01c_074071.pdf

40 *See* press release of the New York State Attorney General (Nov. 1, 2007), *available at* http://www.oag.state.ny.us/press/2007/nov/nov1a_07.html; Ben White, *Big real estate group accused of home price fraud with WaMu*, FT, Nov. 2, 2007, at 1; *See also* Dow Jones, *Suit Claims Washington Mutual Pressed Appraisers*, American Banker, Nov. 6, 2007, *available at* http://www.americanbanker.com/article.html?id=2007110572PK7TE8&queryid=1746634224&hitnum=20; see also Jody Shenn and Sharon L.Crenson, *New York Subpoenas First American Appraisal Unit*, May 22, 2007, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=ayO8AMw7nMPc&refer=home

turning around and selling the securities. Merrill Lynch could argue that did not have a duty to disclose the obligations it made on its balance sheet because everyone knew that it is a dealer as well as a broker. The answer maybe that Merrill Lynch bought the securities at higher than the market price — that is, it provided a guarantee. That type of obligation should have been disclosed to the public and to its board of directors. Merrill Lynch could respond that if it did not buy back the securities, as dealers would do, its reputation would suffer significantly and it might lose more business than its losses now indicate. This is an interesting aspect of the mortgage backed securities markets that must await further developments.

Furthermore, a recent study concluded that hedge funds trading amounts to about 30% of all bond-trading in the United States.[41] Arguably, hedge funds had substantially increased their leverage and their risks because they purchased and traded in significantly under-priced financial assets,[42] including sub-prime mortgage loans.

VI. PROPOSED REGULATORY CHANGES

Regulating agencies are investigating the entire system of sub-prime loans' securitization.[43] So is the Bush administration[44] offering plans for borrowers' relief[45] although the extent of the problem may be greater.[46] There are proposals to require hedge funds and private equity funds to

41 *See* Craig Karmin, *Hedge Funds Do About 30% Of Bond Trading, Study Says*, WALL ST. J., Aug. 30, 2007, at C3 (suggesting that mortgage backed securities were initially developed for highly sophisticated investors, such as the hedge funds but later expanded to less sophisticated investors such as pension funds). This suggestion is questionable.

42 Martin Feldstein, *Liquidity now!*, WALL ST. J., Sept. 14, 2007, *available at* http://www.nber.org/feldstein/Wall St. J.091207.html

43 Jeremy Grant, *SEC sets up enforcement groups*, FT, Sept. 12, 2007, at 17 (Barack Obama has joined the demand for tighter regulation combined with fines to "irresponsible" lenders).

44 *President Bush Discusses Homeownership Financing*, speech in the Rose Garden, Aug. 31, 2007, *available at* http://www.whitehouse.gov/news/releases/2007/08/20070831-5.html

45 Jan Hatzius and Michael Fletcher, *Fed Chief, Bush Give Hope to Wall Street*, WASHINGTON POST, Aug. 31, 2007, at A01; *See also President Bush Discusses Homeownership Financing*, speech in the Rose Garden, Aug. 31, 2007, *available at* http://www.whitehouse.gov/news/releases/2007/08/20070831-5.html

46 Michael A. Fletcher, *Bush Responds With Restraint To Questions About Economy*, WASHINGTON POST, Aug. 19, 2007 at A7.

increase disclosure and transparency,[47] whether or not they are otherwise regulated.[48] It is recognized that the problems were caused not by the highly regulated institutions but mainly by the unregulated independent mortgage lenders and brokers, and that disclosure of sophisticated complex innovative products is not effective.[49] Yet, regulation does not help predict risk on a daily basis, and imposing regulation would reduce market effectiveness.[50] There are also legislative proposals in the states.[51] Because the problem of the sub-prime mortgage market has expanded very quickly to the global markets, there is a movement for internationally coordinated regulation and avoidance of international competition on regulation, as well as regulation of the banks.

In Europe, the solutions to the problem vary. The Swiss International Bank increased the interest rate (perhaps against possible inflation). At the same time when the European Central Bank and the Fed were cutting the rates (perhaps to maintain sufficient liquidity).[52] The Bank of England seemed to follow the European Central Bank's practice — refusing initially to cut rates. "However, it increased the banks' reserve requirement range and "provided additional reserves through its weekly open-market operation."[53]

VII. CONCLUSION

In the United States, it is generally recognized that the financial markets and market solutions to excesses cannot be solved by the markets and must be addressed by governments. America believes in market freedom. Market freedom brings innovations and provides prosperity and should not be hampered by government interference.

47 Poul Nyrup Rasmussen, *Subprime crisis highlights case for greater disclosure*, FT, Sept. 4, 2007.

48 Barney Frank, *Lessons of the subprime crisis*, BOSTON GLOBE, Sept. 14, 2007 at A11.

49 *Id.*

50 Stephen Cecchetti, *A better way to organize securities markets*, FT, Oct. 5, 2007 at 11 (similar issue, after the 1998 fall of Long-Term Capital Management, which lacked interference by an organized exchange. Cecchetti proposes the intervention of a clearing-house for stability, enforcement of the parties' obligation, and standardization of the securities, facilitating valuation).

51 H.R. 1852, *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.1852

52 WALL ST. J.: *Europe's Central Banks on Different Paths*, Sept. 14, 2007, at A2.

53 *Id.*

However, innovations can bring excesses, which the markets do not always restrain in time. If excess is not controlled, market discipline might come too late, and market reaction can harm not only individuals and organizations but also to the entire financial system. At that stage, the damage of excesses from market freedom may be greater than the damage of restrain by legal or other government intervention.

Market freedom and regulated market are not easy to balance. Arguably, the driving force to the cub-prime loans was the rise in interested rates. Therefore, the line is very hard to draw, and it may differ in different situation and times. But in certain situations governments must intervene. This must happen once it is clear that excesses have occurred, that the market has not limited the excesses but allowed them to continue to a stage, which results in great harm to the financial system. This is the stage at which the United States as well as other countries, intervene. In the future we might see different solutions in different countries, including international regulation. Hopefully the suffering of those who are blameless will be reduced and the benefits of those who are to blame, will be reduced as well, without eliminating the spirit of innovations and risk taking that the financial system can withstand.

KEYWORDS

sub-prime loans, mortgage loans, loan-securitization, sub-prime mortgage market, Special Purpose Vehicle(SPV)