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Too Conflicted to be Transparent: Giving Affordable Financing its 'Good Name' Back

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TOO CONFLICTED TO BE TRANSPARENT: GIVING AFFORDABLE FINANCING ITS 'GOOD NAME' BACK

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Securitization, the process of pooling loans for re-sale on the secondary market, is an important part of mortgage financing. It creates more capital for mortgages and makes home pricing affordable, which is beneficial to borrowers. The subprime crisis exposed intrinsic structural flaws in the mortgage securitization process. Chief among them is the "issuer-pays" model of credit ratings. Issuers, who bundle loans for sale on the securities market, are required to have an independent analysis from a credit rating agency or a Nationally Recognized Statistical Rating Organization (NRSRO) prior to the sale of the securities to investors. This rating is not only a certification of the creditworthiness of the securities, but also a signal to investors that the securities will perform as predicted. Prior to the subprime crisis, the ratings provided for subprime loans were inflated, causing investors, who relied on the ratings, to leave the private-label mortgage market. Restoring confidence in this market is critical to having robust, sustainable mortgage financing.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") made significant changes in the financial services industry designed to protect borrowers and investors. Although the amended law required the Securities and Exchange Commission (SEC) to assume more authority over credit rating agencies, the SEC did not abandon the issuer-pays model of credit ratings. This Article fills a void in credit rating agency reform. It proposes that credit rating agencies independently verify and substantiate the information provided by issuers to ensure the accuracy of the information inputted into the business models they use. Rules tightening loan quality standards are now in place, but independent review of the quality of loan manufacturing remains elusive. This Article also argues that borrowers, who have a vested interest in both a sustainable mortgage and an unbiased, fair, transparent rating, are indirect beneficiaries of the rating process. Regulating the market by requiring credit rating agencies to conduct due diligence incorporates quality standards into the ratings process and deters abuse. Given the failure of the credit rating agency reforms to address the inherent structural flaw in the current model, this Article argues the proposal will ensure the needed accountability, transparency, and oversight that can better protect borrowers and investors.

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INTRODUCTION

Securitization, the process of pooling loans for re-sale on the secondary market, is an important part of mortgage financing.[1] It creates

1. Structured finance, a highly complex financial transaction, makes illiquid assets liquid, freeing up capital on the originating lender's balance sheet. Firms use the products when a conventional financial product, such as a loan, will not meet the firm's financing needs. Structured finance products have been a major segment in the financial industry since the mid-1980s. Examples of structured finance products include collateralized bond obligations (CBOs), collateralized debt obligations (CDOs), syndicated loans, and synthetic financial instruments. *See* TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES § 1.1 (2d ed. 1991); *see also* Elizabeth Laderman, *Subprime Mortgage*

more capital for mortgages and makes home pricing affordable, which is beneficial to borrowers.[2] The subprime crisis exposed intrinsic structural flaws in the mortgage securitization process. Chief among them is the issuer-pays model of credit ratings. Issuers, who bundle loans for sale on the securities market, are required to have an independent analysis from a credit rating agency or a Nationally Recognized Statistical Rating Organization (NRSRO) prior to the sale of the securities to investors.[3] This rating is not only a certification of the creditworthiness of the securities, but also a signal to investors that the securities should perform as predicted. Prior to the financial crisis, the ratings provided for subprime loans were inflated, causing investors, who relied on the ratings, to leave the private-label mortgage market.

This Article fills a void in credit rating agency reform by proposing credit rating agency due diligence. Although the Securities and Exchange Commission (SEC), charged with the supervision of credit rating agencies, assumed more authority over credit rating agencies after the financial crisis, it did not abandon the issuer-pays model for credit ratings.[4] Rules tightening loan quality standards are now in place, but independent review of loan manufacturing quality remains elusive.[5] Given the failure of the reforms to address that structural

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Lending and the Capital Markets, FED. RES. BANK S.F. ECON. LETTER (Dec. 28, 2001), http://www.frbsf.org/economic-research/publications/economic-letter/2001/december/subprime-mortgage-lending-and-the-capital-markets/.

2. Securitization weakens lenders' screening incentives. *See* discussion *infra* note 93 and accompanying text; *see generally* Surnit Agarwal et al., *Adverse Selection in Mortgage Securitization*, 105 J. FIN. ECON. 640 (2012); Nicola Cetorelli & Stavros Peristiani, *The Role of Banks in Asset Securitization,* FED. RES. BANK N.Y. ECON. POL'Y REV. 47–63 (July 2012).

3. Issuer-pays model of credit ratings involves the issuer of the securities stock offering paying the rating agency for the initial rating of a security, as well as ongoing ratings. Only one of the Nationally Recognized Statistical Rating Organizations (NRSRO), Egan Jones, uses the subscriber-pays model, in which investors pay for the ratings. During the financial crisis, credit rating agencies used inaccurate modeling and produced inflated ratings. *See* discussion *infra* Part III.

4. The Securities and Exchange Commission (SEC) now requires disclosure of models and assumptions. See INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING THE FINANCIAL CHALLENGES AHEAD 82 (2009), http://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/~/media/Websites/IMF/imported-flagship-issues/external/pubs/ft/GFSR/2009/02/pdf/_textpdf.ashx. Specifically, the rules require stronger conflicts of interest and governance controls and enhanced transparency. *See generally* U.S. SEC. & EXCH. COMM'N, REPORT TO CONGRESS: CREDIT RATING STANDARDIZATION STUDY (2012), https://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.

5. Under SEC rules, credit rating agencies must disclose any certifications from providers of third-party due diligence services with respect to mortgage-backed securities. *See* 17 C.F.R. § 240.17g-10 (2015) ("Rule 17g-10"); *id.* § 249b.500 (2014) ("Form ABS Due Diligence-15E").

flaw, full transparency and quality control measures are needed in credit ratings.

These quality control measures would have been beneficial to homeowners, such as individuals in Detroit, Michigan, who were victims of subprime loan abuse and lost their homes due to foreclosure. [6] The affected homeowners brought a lawsuit against the investment bank Morgan Stanley, claiming that it had adopted mortgage securitization policies that caused predatory lending and violated consumer laws and African Americans' civil rights.[7] Although the court dismissed this class action lawsuit because the prospective class could not be certified, the crux of the claims was that racial discrimination precipitated the securitization of mortgage-backed securities.[8] Specifically, plaintiffs alleged that New Century Mortgage Company, a now-defunct loan originator, targeted minority neighborhoods and minority borrowers to sell loans with unjustifiably high costs and risk of foreclosure.[9] Morgan Stanley allegedly provided the up-front funding, set loan volume goals, established the criteria for the mortgage terms, and thus was claimed to be responsible for the disparate impacts of New Century's lending practices.[10]

Securitization was beneficial to financial institutions, such as New Century, because it allowed them to transfer credit risks of loans it originated from their balance sheets to investments banks, such as Morgan Stanley, which purchased them.[11] It was initially beneficial to homeowners like plaintiff Beverly Adkins, but eventually ruinous to

6. Ronald D. Utt, Heritage Found., *The Subprime Mortgage Market Collapse: A Primer on the Causes and Possible Solutions* 13 (2008) (discussing how the lack of transparency in the pooled mortgages makes it difficult to assess the risks).

7. *See* Complaint, Adkins v. Morgan Stanley, 2012 WL 4856708 (S.D.N.Y. 2012) (No. 12CIV7667). New Century Mortgage Co., a non-bank mortgage company, regularly made subprime loans based on questionable underwriting and then sold those loans to investment banks and other secondary market purchasers, including Morgan Stanley, which securitized them. The Complaint alleged that Morgan Stanley had a significant impact on New Century's practices, including an early funding program in which Morgan Stanley wanted future commitments from New Century for unfunded loans. *Id.* at ¶67. In July 2013, the court dismissed Morgan Stanley's motion to deny the discrimination claims asserted under the Fair Housing Act and granted the motion to dismiss the claims asserted under the Equal Credit Opportunity Act and the Michigan Elliott-Larsen Civil Rights Act. *See* Adkins v. Morgan Stanley, 307 F.R.D. 119, 120 (S.D.N.Y. 2015).

8. The class-action lawsuit sought to certify a class of all African-American homeowners in Detroit, but certification was denied due to a lack of commonality among the purported class. Adkins v. Morgan Stanley, 307 F.R.D. 119, 120 (2015).

9. Complaint at ¶ 55–60, Adkins v. Morgan Stanley, 2012 WL 4856708.

10. *See id.* at ¶ 76–81.

11. *See* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 Wash. U. L.Q. 1061, 1086–1103 (1996).

these same homeowners and neighborhoods because issuers pooled those loans into mortgage-backed securities for investors to purchase. Issuers systematically disregarded basic guidelines for fair lending, purchasing loans that put borrowers at high risks of foreclosure and incentivizing loan originators to favor predatory loans. Moreover, credit rating agencies routinely failed to independently verify information from issuers regarding securitized loan pools and rated the securitized loans as "investment" grade when, in reality, they were of poor quality.[12]

The subprime mortgage, a product established after the deregulation of the financial industry in the 1980s, developed robustly between 2002 and 2006.[13] It dramatically increased mortgage credit availability to borrowers who might otherwise not have obtained a loan, albeit at a higher interest rate.[14] Mortgage securitization is unique because it bundles as collateral small mortgage loans from diverse geographic locations that are difficult to monitor and verify.[15] Despite these hidden risks, subprime securitization, with its higher rates of return, attracted substantial private investments because of the underwriting restrictions on government-sponsored secondary market entities.[16] The

12. *See* Susan E. Hauser, *Predatory Lending, Passive Judicial Activism, and the Duty to Decide*, 86 N.C. L. REV. 1501, 1514–16 (2008).

13. Subprime mortgages, available to buyers with less than perfect credit, were not new products, but were niche products usually offered to upscale borrowers with particular cash flow needs or to borrowers who were expecting to remain in their homes for a short time. *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing on the Issues Surrounding Non-Traditional Mortgages and their Possible Implications for Consumers, Financial Institutions, and the Economy Before the Subcomm. on Hous. & Transport. and the Subcom. on Econ. Pol'y of the S. Comm. on Banking, Hous. & Urban Affairs*, 109th Cong. 7–9, (2006) (statement of Allen J. Fishbein, Director of Housing Policy, Consumer Federation of America) (showing an increase in the origination of riskier loans from 2002 to 2006); CHRISTOPHER L. FOOTE ET AL., FED. RESERVE BANK OF BOS., WHY DID SO MANY PEOPLE MAKE SO MANY EX POST BAD DECISIONS? THE CAUSES OF THE FORECLOSURE CRISIS. 49–50 (2012) (discussing flaws in twelve myths about the foreclosure crisis).

14. Subprime borrowers pay higher interest rates on their mortgages due to the increased risk of default making these loans particularly attractive to investors. *The Financial Crisis and the Great Recession*, *in* NEVA GOODWIN ET AL., MACROECONOMICS IN CONTEXT 343 (2d ed. 2014).

15. See Gary Gorton, The Panic of 2007, at 3 (Yale Sch. of Mgmt. & Nat'l Bureau of Econ. Research, Working Paper No. 08-24, 2008), http://ssrn.com/abstract=1255362 (discussing the varying investment risk in subprime lending).

16. Although Fannie Mae and Freddie Mac, both government-sponsored entities, originally had conforming limits set by Congress that affected their ability to make certain loans, some of these restrictions were lifted and Fannie Mae and Freddie Mac purchased subprime loans. *See* Kimberly Amadeo, *Did Fannie and Freddie Cause the Mortgage Crisis?*, THE BALANCE (Aug. 11, 2016), https://www.thebalance.com/did-fannie-and-freddie-cause-the-mortgage-crisis-3305659.

securities, partitioned into tranches according to risk, allowed investors to make purchases according to their speculation tolerance. However, partitioned securitization created some securities that were riskier than the original mortgages and made it more difficult to establish the values of various tranches.[17]

Credit rating agencies, and arguably regulators and investors, understood how extensive the structural failure that resulted in the subprime crisis could be. Investors, who are expected to conduct their own assessments, rely on investment grade labeling when they make purchases.[18] Credit rating agencies intended to fill in informational gaps created by securitization by rating the underlying assets according to its risks.[19] However, the financial crisis exposed intrinsic structural flaws in the credit ratings used in the mortgage securitization process.[20] One such flaw was that credit rating agencies failed to con-

17. Subprime loans were securitized into mortgage-backed securities and collateralized debt obligations (CDOs). Many of these were adjustable-rate mortgages, requiring borrowers to re-finance within a specified time, on the assumption was that real estate values would continue to appreciate, making the loan more affordable. Donald MacKenzie, *The Credit Crisis as a Problem in The Sociology of Knowledge*, 116 AM. J. OF SOC. 1778, 1779 (2011).

18. Numerous scholars argue that investor over-reliance on credit ratings was one of the causes of the financial crisis. *See* TECH. COMM. INT'L ORG. SECS. COMM'NS, THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS (2008) [hereinafter IOSCO CRA REPORT], http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf (updating the Code after the 2008 financial crisis to cover the rating of structured finance products and related transactions); Jan De Bruyne, *How the Threat of Holding Credit Rating Agencies Liable Might Increase the Accuracy of Their Ratings*, 52 WILLAMETTE L. REV. 173, 208 (2015) (discussing negligence claims against CRAs); Allana M. Grinshteyn, *Horseshoes and Hand Grenades: The Dodd-Frank Act's (Almost) Attack on Credit Rating Agencies*, 39 HOFSTRA L. REV. 937, 957 (2011) (discussing Dodd-Frank's new cause of action for credit rating agency liability).

19. Credit rating agencies such as Moody's, Standard & Poor's, and Fitch, provide ratings based on their assessments of whether the issuer will pay the promised interest or principal payments. *See generally* GARY SHORTER & MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., R40613, CREDIT RATING AGENCIES AND THEIR REGULATION (2009).

20. "This crisis could not have happened without the rating agencies." FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xxv (2011), http:// www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; *see also The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 110th Cong. 47 (2007) [hereinafter *Role of Credit Rating Agency Hearings*] (statement of H. Sean Mathis) (investigating the role of credit rating agencies in engineering and grading structured finance products). Congress enacted The Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-

duct their own due diligence on the quality of the securities.[21] The crisis brought into clearer focus the dual purpose of credit ratings—to serve as a check on the originators' securitization policies and practices as well as to predict whether the securities would yield the expected returns. This duality led to the result that borrowers who want to purchase affordable loans with fair terms indirectly rely on credit ratings to the same extent as investors do.

The conflict of interest presented by the issuer-pays credit rating model requires an analysis of its effects from the perspective of borrowers and investors who have a vested interest in credit ratings.[22] Multiple stages in the securitization process create the problem of information asymmetry, meaning one party in the transaction has superior knowledge compared to the other.[23] A purportedly objective, neutral credit rating would eliminate the loan originators' informational advantage over investors and borrowers. However, the structural flaw in the issuer-pays model prevented credit rating agencies from achieving such a goal.

Designed to protect borrowers and investors, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") made significant changes to the financial services industry.[24] Although Dodd-Frank required the SEC to assume more authority over credit

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Frank], in response to the global financial crisis. Dodd-Frank was the most significant reform of the financial industry since the Great Depression.

21. Professor Steven Schwarcz identifies three causes of the subprime crisis: conflicts, complacency, and complexity. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 404 (2008) (positing that the securities issued were so complex that the disclosures issued by the credit rating agencies were insufficient for investors to assess risk); *see also* Miguel Segoviano et al., *Securitization: Lessons Learned and the Road Ahead*, 14 (Int'l Monetary Fund, WP/13/255, 2013), https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf (discussing the significant negative impact that the misaligned incentives had on the borrower and the investor).

22. *See* Troy S. Brown, *Legal Political Moral Hazard: Does the Dodd-Frank Act End Too Big to Fail?*, 3 ALA. C.R. & C.L.L. REV. 1, 37–52 (2012).

23. Eight different parties participate in a mortgage-backed security transaction: the loan originator, the securitizer, a Special Purpose Vehicle (SPV), underwriters, rating agencies, trustees, servicers, and ultimately investors. *See* Yuliya Guseva, *Evolutionary Developments in Mortgage Securitization: Financial Law Reforms, Putative Beneficiaries, and Archetypal Economic Risks*, 21 TRANSNAT'L L. & CONTEMP. PROBS. 395, 406–16 (2012); *cf.* FOOTE ET AL., *supra* note 13, at 35–38 (arguing that the changed regulations are insufficient to address the underlying causes of the crisis because the housing bubble was sustained by the mistaken belief of borrowers and investors that housing prices would rise rapidly and could never fall).

24. Congress enacted Dodd-Frank in response to the global financial crisis. Dodd-Frank resulted in the most significant reform of the financial industry since the Great Depression. *See supra* note 20.

rating agencies, the SEC did not abandon the issuer-pays model of credit ratings.[25]

This Article proposes to address this structural flaw by requiring credit rating agencies to conduct due diligence by independently verifying and substantiating information provided by issuers. Due diligence incorporates quality standards into the rating process and deters issuers' abuse of information, which in turn ensures the accuracy of information going into the business models that produce credit ratings.

Part I discusses the credit rating process and the role that credit rating agencies play in risk assessments of structured finance products, and argues that these private companies perform a regulatory function for the public benefit. Part II examines the failed economic and legal principles underlying securitization and the regulatory structure that facilitated it. Part II also argues that the combination of deregulation, vertical integration of banking companies, and opportunistic securitization harms borrowers and investors alike. Part III contends that due diligence from credit rating agencies is needed to restore investor confidence in the private-label mortgage securitization market. It posits that Dodd-Frank's reforms on loan origination, borrower creditworthiness, and credit rating disclosures do not adequately protect the interests of borrowers and investors, given the conflict of interest inherent in the issuer-pays structure. These changes will meaningfully address the conflict of interest and the information asymmetry in the mortgage securitization process, ensure that mortgage-backed securities are sustainable and profit-maximizing, and enhance the transparency of credit ratings to better protect both borrowers and investors.

I.
Financial Information and the Public Good

Securitization, at its best, relies on market discipline and accurate information to prevail.[26] Credit rating agencies play an important role in the system by serving as informational intermediaries between bor-

25. The SEC now requires disclosure of models and assumptions. Under section 15E(s), "Transparency of Credit Rating Methodologies and Information Reviewed," the ratings agencies must disclose information on the quality of data reviewed. They must also disclose information that might affect the uncertainty of the rating, any third-party due diligence services used, and a description of their findings or conclusions. Dodd-Frank § 932(a)(8).

26. *See generally* Frank Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 673 (1984); *see also* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 717, 747 (1984).

rowers and investors.[27] They help to direct capital to efficient use by assessing the accuracy of the information that borrowers provide, weighing and pricing risks, testing the assumptions underlying issuers' projections, and evaluating performance under stress scenarios.[28]

A. *The Credit Rating Process*

Credit rating agencies provide an assessment of the issuer's ability to pay its financial obligation. Investors then use these credit ratings to evaluate the quality of the debt and to measure the probability of default. Internal committees at individual rating agencies determine credit ratings by reviewing and approving the alphanumeric rating categories that are assigned to debt securities.[29] These ratings are based on a variety of quantitative and qualitative factors weighed by the committees.[30]

Mortgage securitization ratings are relatively new.[31] Traditional corporate finance ratings are based on a routine financial analysis of a firm's financial risks based on balance sheets, liquidity, cash generation, and its credit risks based on the firm's priority debt instruments and the value of the firm in default.[32] In contrast, structured finance focuses on the legal and financial structure of a debt security as well as the quality of assets on which the security is based. Ratings evaluate how defaults in the underlying pool of mortgages or other assets will affect the risk of default to each level or tranche of a security.[33]

27. *See* Onnig H. Dombalagian, *Regulating Informational Intermediation*, 1 AM. U. BUS. L. REV. 59, 68 (2012).

28. Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1288 (2009) (discussing SEC's efforts to improve transparency of the credit rating process for the benefit of investors).

29. SEC OFFICE OF INV'R EDUC. & ADVOCACY, INVESTOR BULLETIN: THE ABCS OF CREDIT RATINGS 3, https://www.sec.gov/investor/alerts/ib_creditratings.pdf.

30. *See, e.g.*, MOODY'S INV'RS SERV., RATINGS SYMBOLS AND DEFINITIONS 32 (2013), https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

31. Because it involved "highly complex structured products," mortgage securitization ratings were unlike the corporate ratings that the rating agencies traditionally performed. *See* Segoviano et al., *supra* note 21, at 20.

32. In general, the qualitative factors evaluate the market potential of the customers and management controls and the quantitative factors evaluate the balance sheet and external ratings. *See*, *e.g*., HERWIG M. LANGOHR & PATRICIA LANGOHR, THE RATING AGENCIES AND THEIR CREDIT RATINGS: WHAT THEY ARE, HOW THEY WORK, AND WHY THEY ARE RELEVANT 257–63 (2008).

33. Prior to the financial crisis, structured finance debt ratings primarily used mathematical models. The historical rates of default and losses were based on mortgages made between 1994–2000. Kia Dennis, *The Ratings Game: Explaining Rating Agency*

B. Credit Ratings as Public Information

Credit ratings, when accurate, shift transaction costs from originators to issuers.[34] However, credit rating agencies perform optimally only if they have adequate information from issuers. By transforming raw data into useful information, the agencies provide market participants with information that they often would not be able to amass on their own.[35] Issuers, in turn, shift transaction costs to investors. Investors rely on ratings analysis to understand the offerings' market and economic circumstances, and to determine whether issuers will meet their financial and contractual obligations. As a part of the SEC disclosure process, ratings that are accurate indicators of market risk can make markets more transparent.[36] Investors can then expect that the germane characteristics about securities are fully and fairly revealed, and thus they have a sufficient opportunity to independently assess the value of the offering.[37]

Because ratings are required in the securities market, credit rating agencies indirectly facilitate market development.[38] Although credit ratings do not assess market liquidity or volatility, they embody accumulated knowledge about past and present market performance, efficacy of financial innovations, and market trends.[39] Projecting the performance of a new security in essence provides an assessment of

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Failures in the Build Up to the Financial Crisis, 63 U. MIAMI L. REV. 1111, 1124–1126 (2009).

34. Disclosure rules exist to provide investors with the critical information needed to assess profitability and performance. A popular phrase in this context is "sunlight is the best disinfectant." THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2[3] (7th ed. 2017).

35. *See* Dombalagian, *supra* note 27, at 63 (analyzing alternative regulatory regimes for credit rating agencies).

36. While credit rating agencies are not auditors, there are serious questions about whether those agencies should have reassessed the quality of their methodologies and underlying assumptions when rating subprime structured finance instruments in light of credible information regarding housing market bubbles in the United States, the lack of incentives for mortgage lenders to conduct proper due diligence, and a possible increase in mortgage fraud, among other things. Floyd Norris, *Regulators Struggle with Conflicts in Credit Ratings and Audits*, N.Y. TIMES, Aug. 21, 2014, at B1.

37. *But see* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 65 n.110 (2004) (noting that the most sophisticated investors arguably do not rely on credit rating agencies given their consistently poor performance).

38. Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 36 (2009).

39. Brown, *supra* note 22, at 50 ("[T]he credit rating agencies were tasked with rating new financial innovations for which there was no historical track record."); Peter H. Hamner, *The Credit Crisis and Subprime Litigation: How Fraud Without Motive "Makes Little Economic Sense,"* 1 U. P.R. BUS. L.J. 103, 110–11 (2010) (discussing the primary financial and economic reasons for securitization).

market demand for that security. Credit rating agencies' role in facilitating market development is even more critical in new and evolving markets because projections of these markets require nuance and precision.[40] Therefore, the objectivity of the ratings process should serve as a foil to financial innovation and engineering, which is neither safe nor sound, and neutral credit rating procedures should identify flaws in the design of financial instruments.

Innovative financial engineering created products that completely changed the mortgage securitization market.[41] The uniqueness of the products required some form of credibility to substantiate them as viable investment vehicles. Credit ratings—supposedly neutral, objective evaluations—served that function. Investors presumed that the information embedded in the ratings was a reliable indicator of creditworthiness. Credit rating agencies were instrumental in developing the subprime market and attracting investors to it because they provided integral information for would-be investors.

In addition to investors, issuers also relied on the ratings. The growth and competitiveness of the subprime securitization market depended on access to information embedded in the ratings. But issuers were also faced with the dominance and fundamental nature of the oligarchical credit ratings industry. The supremacy of the largest ratings agencies' abilities to control the manner and mode of the ratings process subjected issuers to adhere to the credit rating agencies' established standards. The credit ratings structure is so unique and complex that it cannot be feasibly replicated from an outside source without complete knowledge about the methodologies and assumptions.[42] In

40. One of the significant errors credit rating agencies made in subprime mortgage securitization assessments was evaluating them in the same way as prime conforming mortgages, which are less complex. As one witness in a Congressional hearing explained:

> The NRSROs, however, overlooked the crucial and well-known characteristics of collateral risk and heterogeneity and supported the rapidly growing sector by rating complex and lucrative security structures for subprime mortgages as if the collateral were typical prime conforming mortgages.

Role of Credit Rating Agencies Hearings, *supra* note 20, at 2 (statement of Dr. Joseph R. Mason, Lebow College of Business, Drexel University).

41. Often issuers told originators what products they wanted developed and the rating company complied. Claire A. Hill, *Why Didn't Subprime Investors Demand A (Much Larger) Lemons Premium?*, 74 LAW & CONTEMP. PROBS. 47, 55 (2011) ("Rating agencies worked with the issuers and their lawyers to craft instruments the agencies could rate highly.").

42. *See* Guseva, *supra* note 23, at 401 (arguing that structural securitization increases costs and risks because of its complexity); Bianca Mostacatto, *Eliminating Regulatory Reliance on Credit Ratings: Restoring the Strength of Reputational Concerns*, 24 STAN. L. & POL'Y REV. 99, 138–140 (2013) (positing that replacing ratings-

this way, the credit rating agencies created both an information market that issuers were bound to participate in and a market that could not operate without the expected and required ratings.

The financial information that credit ratings provide serves a regulatory function, which is for the public good.[43] Charged with regulating capital markets, the SEC uses credit ratings to safeguard the adequacy of financial institutions' capital.[44] The credit rating of a securities offering is a proxy for government approval and signals that the offering meets basic valuations and risk requirements, ensuring its capital adequacy.[45] Credit rating agencies distinguish investment grade securities from those that are less liquid and more volatile,[46] and allow investors to further evaluate the data and make informed choices. Investors' evaluation of financial instruments is presumed to simply supplement the SEC's merit review of securities offerings.[47]

Investors, who wanted to participate in the subprime securities market, needed access to the aggregated data provided exclusively by the oligarchical ratings information market.[48] Given the complexity of subprime mortgage-backed securities, whether investors could accu-

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based regulation with reputation mechanism produces ratings that are more accurate and beneficial to the capital markets).

43. *See* Panayotis Gavras, *Ratings Game*, 49 FIN. & DEV. 34, 36 (2012) (arguing that there is an over-reliance on private credit rating agencies to assess risk).

44. *See* Brown, *supra* note 22, at 49 (discussing the "countercyclical" capital requirements of Dodd-Frank's Volcker Rule).

45. *See Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, BASEL COMMITTEE ON BANKING SUPERVISION 23 (Nov. 2005) [hereinafter BASEL COMMITTEE] http://www.bis.org/publ/bcbs118.pdf.

46. As one industry executive explained, "[w]hile the SEC clearly equated the term 'investment-grade' with liquidity, that fact was never memorialized in legislation, process, or definition." *Role of Credit Rating Agencies Hearings*, *supra* note 20, at 2 (statement of H. Sean Mathis, Miller Mathis & Co., LLC).

47. The present model assumes that the credit rating agencies are "gatekeepers of risk." This assumption is criticized because the rating agencies are not accountable and do not seem to have an incentive to perform well. *See generally* Rachel Jones, *The Need for A Negligence Standard of Care for Credit Rating Agencies*, 1 WM. & MARY BUS. L. REV. 201, 231 (2010) (arguing that it is inappropriate to apply First Amendment protections to financial information because credit rating agencies, unlike journalists, are not independent); Jefferey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1059–65 (2009) (advocating that creditors should finance the ratings through an SEC-administered user fee system).

48. For example, from 2000–2007, Moody's rated 42,625 residential mortgages "AAA." In 2006, $869 billion worth of mortgage securities were AAA-rated by Moody's, eighty-three percent of which were later downgraded. *See Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission*, 111th Cong. 10 (2010) [hereinafter CRA June 2010 Hearing] (statement of Phil Angelides, Chairman).

rately assess risks in these securities is open for debate.[49] Investors also rely on credit ratings because of the difficulty of assessing information and the distance between investors and borrowers.[50] The variance in mortgage terms and obligations makes this particular sector too heavily reliant on credit ratings to attract investors without credit ratings.

Investors face significant barriers in evaluating mortgage securities. Insufficient information in the market about exotic mortgage securities, such as credit default swaps (CDSs) and collateralized debt obligations (CDOs)[51], and the opacity of these instruments made it difficult to gauge and price risks.[52] In addition, the complexity of offerings made investors more dependent on the credit ratings. Ratings provided a basis for investors to conclude that novel financial products were standard and safe, even though these products' structures were actually very new and complex, and the underlying assets were too volatile to be modeled properly.[53] Thus, investors' duty to independently review the risks of mortgage securities was effectively abrogated.[54]

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49. In particular, there are serious questions about whether institutional investors, either through ignorance or lax internal governance and risk management, relied excessively on credit ratings, with little regard for the underlying risks of the financial instruments they bought. Schwarcz, *supra* note 21, at 381; *see generally* Brent J. Horton, *Toward A More Perfect Substitute: How Pressure on the Issuers of Private-Label Mortgage-Backed Securities Can Improve the Accuracy of Ratings*, 93 B.U. L. REV. 1905 (2013) (proposing that the SEC require rating agencies to have an ongoing monitoring duty that includes verifying loan-level data and regularly updating macroeconomic trend data).

50. Credit rating agency reforms under Dodd-Frank are designed to lessen the dependence of investors on agency ratings. *See* discussion *infra* Part III.

51. *The CDO is a "bond that is backed by the cash flows on underlying pools of debt or debt-like instruments, such as corporate loans, other asset-backed securities, or credit default swap (CDS) contracts." Zachary J. Gubler*, The Financial Innovation Process: Theory and Application, 36 DEL. J. CORP. L. 55, 66 (2011).

52. Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1113–14 (explaining that the cost-benefit of independent assessments in complex transactions might yield false results because there are tangible costs but intangible benefits).

53. The standard practice at the time was to use "methodologies [that are] rigorous [and] systematic . . . subject to some form of validation based on historical experience." IOSCO CRA REPORT, *supra* note 18, at 2. The faulty assumption was that the newly engineered financial products comprised of subprime mortgages had a low credit risk. The rating agencies were virtual prerequisites for most debt issuances, and yet had no accountability or incentive to provide accurate information and mitigate risk. *Id.*

54. Subprime mortgages were compartmentalized into tranches, according to risk. Investors in the highest tranches were the most protected from loss and effectively were "free riders" who had less incentive to conduct due diligence. John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Sub-*

As discussed below, the securitization of subprime mortgages turned predatory and failed to satisfy economic and legal principles. These failures in fact underscore the opaqueness of the information and support the proposals set forth in Part III to modify the intermediation functions of mortgage securitization.

II.
The Economic and Regulatory Complications of Securitization

A. *The Economic Principles of Securitization*

Financial innovation presents unique opportunities for capital development. With adverse incentives and an inadequate regulatory framework, financial innovation can result in systemic risks. This Part first introduces the benefits and complications of securitization and then discusses the role of capital requirements in mitigating moral hazard and regulatory arbitrage. This Part concludes with a discussion of the risk retention provision in Dodd-Frank and why it is ineffectual in addressing moral hazard.

1. *The Value of Mortgage Securitization*

Securitization is attractive because it achieves economic efficiency through diversification and liquidity, transfers risks to reduce the costs of capital, and makes credit more freely available. Investor partition in the market reduces the costs of capital, keeps regulatory capital low, and also increases the availability of credit. Subprime securitization, which flourished in an era of deregulation, juxtaposed efficiency against profit maximization, affordable financing against poor-quality lending, and credit availability against loan volume.[55] The complexity of subprime securitization, operating in an unregulated market, undermined securitization's underlying economic and legal principles.

Securitization is an alternative funding mechanism that allows lenders to raise cash by converting long-term obligations on balance

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prime Mortgage Markets, 5 (Int'l Monetary Fund, WP/07/188, 2007), https://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2007/_wp07188.ashx.

55. Timothy A. Canova, *Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to A New Keynesian Regulatory Model*, 3 Harv. L. & Pol'y Rev. 369, 377–380 (2009) (discussing the confluence of deregulation of depository interest rates and the Federal Reserve's credit controls incentivizing securitization of subprime loans).

sheets into securities.[56] Mortgage securitization is the process of disaggregating a borrower from the mortgage loan. It involves bundling mortgages into pools, separating securities into risk tranches, rating future credit performance of the securities, and selling securities to investors.[57]

The mortgage securitization process involves several stages. The originator, who made the initial loans to borrowers, selects a group of assets to sell to a special purpose vehicle (SPV), a stand-alone bankrupt-remote entity, which becomes the securities issuer.[58] The issuer, who may or may not be the originator, hires a credit rating agency to assess the creditworthiness of the securities.[59] After receiving a favorable rating, the SPV issues interest-bearing securities. Investors then purchase the securities and are paid cash flows generated by the asset pool over the life of the loan. Cash generated from these purchases of securities goes back to the originator.[60]

a. Diversification and Liquidity

Securitization diversifies risks: a lender can choose to share risks by moving loans off of its balance sheet.[61] This mixture of on- and off-balance sheet lending reduces the lender's exposure to loans defaults. By spreading the risks, securitization mitigates the impacts of bank funding shocks on the availability of residential mortgages.[62]

Securitization also enables lenders to hold fewer liquid assets and expand lending capacity; expanded lending capacity leads to increased profitability.[63] Lenders convert a present right to future payments into

56. *See* Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655 (2004).

57. Donald J. Kochan, *Certainty of Title: Perspectives After the Mortgage Foreclosure Crisis on the Essential Role of Effective Recording Systems*, 66 ARK. L. REV. 267 (2013).

58. Ryan E. Scharar, *The Limits of Securitization: Why Bankruptcy Courts Should Substantively Consolidate Predatory Sub-Prime Mortgage Originators and Their Special Purpose Entities*, 2008 MICH. ST. L. REV. 913, 913 n.7 (2008).

59. F. Phillip Hosp, *Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies*, 79 MISS. L.J. 531, 548 (2010).

60. Special investment vehicles were advantageous for banks to use because they allowed an off-balance sheet transaction for low-quality loans, allowing banks to avoid capital and leverage requirements. *See* Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 171 (2011).

61. *See* Brown, *supra* note 22, at 79.

62. Elena Loutskina & Philip E. Strahan, *Securitization and the Declining Impact of Bank Finance on Loan Supply: Evidence from Mortgage Originations*, 64 J. FIN. 861 (2009).

63. Elena Loutskina, *The Role of Securitization in Bank Liquidity and Funding Management*, 100 J. FIN. ECON. 663, 663–83 (2011).

lump sum cash payments, which, in turn, are used to fund current projects. Along with increased cash flow, lenders reduce their debts without negatively impacting their financial status.[64] After selling the loans onto the secondary market, lenders re-cycle the cash to make new loans.

Allowing asset classification by level of risk also increases the value of the securitized assets on the lender's balance sheet. The issuer or securitizer classifies assets according to the level of risk and sells them in "tranches" to investors, according to value, costs, rights, and privileges.[65] Securitizing assets presents a significant advantage when the originator has an unfavorable credit rating. The securitized assets pool, as well as the tranches within the pool, receive a credit rating separate from the originator. As a result, financing rates correlate to the quality of the underlying assets, rather than the institution's creditworthiness.[66] Thus, the originator is able to borrow funds more cheaply.[67]

b. Reduction of Regulatory Capital

Prior to the financial crisis, favorable regulatory capital rules encouraged securitization. As heavily-regulated financial institutions, banks must maintain a certain minimum regulatory capital ratio; in other words, banks must hold onto a certain amount of solvent assets. Securitization of assets moves debts off-balance sheet and improves the bank's regulatory capital.[68]

The regulatory capital ratio measures risk. It is a ratio of a financial institution's capital to the risk sensitivity of its assets. On- and off-balance sheet assets are measured against the institution's equity to determine the financial institution's capital adequacy.[69] An inadequate

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64. Securitization allows banks to sell off risks while simultaneously generating a profit. *See, e.g.*, Michel G. Crouhy et al., *The Subprime Credit Crisis of 2007*, 16.1 J. DERIVATIVES 81, 103 (2008).

65. Issuers of the structured product often decide beforehand what rating each tranche will have and then assign mortgages and then structure the tranches accordingly. *See* Lisbeth Freeman, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 VT. L. REV. 585, 602 (2009).

66. Harald Hau, Sam Langfield, & David Marques-Ibanez, *Bank Ratings What Determines Their Quality?* 11–12 (European Cent. Bank, Working Paper Series No. 1484, 2012).

67. Andreas Jobst, *Back to Basics: What is Securitization*, 45 FIN. & DEV. 48 (2008), http://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/fd0908.pdf.

68. *See* BASEL COMMITTEE, *supra* note 45.

69. 12 C.F.R. § 522.1 (2014).

capital status subjects a financial institution to regulatory restrictions and sanctions.[70]

The burden of meeting regulatory capital guidelines is eased when banks securitize assets. To the extent that a revenue-generating asset can be securitized, it reduces the amount of regulatory capital a financial institution must maintain.[71] Off-balance sheet assets receive reduced regulatory capital as compared to on-balance sheet holdings.[72] Arguably, banks securitizing assets sought both efficiency in mortgage financing and a reduction in capital requirements. Given the market perceptions of mortgage risks, bankers generally viewed securitized subprime mortgages as safe.[73]

In general, regulatory costs in the form of capital requirements created an incentive for banks to shrink their balance sheets by securitizing loans. The industry consensus has consistently held that regulatory capital requirements for the traditionally stable mortgage loan category were too high. Lenders considered mortgage loans to be "good assets" because the bank's risk level remained the same.[74] The regulatory costs provided a disincentive for banks to hold these loans on their balance sheets. Instead, it was more profitable for banks to securitize any stable assets and to produce revenues from origination and other services.[75]

Finally, bank managers followed accounting conventions to control regulatory capital requirements.[76] Favorable accounting rules re-

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70. *Id.* § 522.3 (2014).

71. *See* discussion of regulatory arbitrage *infra* note 115 and accompanying text.

72. 12 C.F.R. § 522.2 (2014).

73. *See* Basel Committee, *supra* note 45.

74. Private investors usually fund subprime mortgages, which provides more flexibility in interest rates and underwriting for borrowers. Philip Ashton, *An Appetite for Yield: The Anatomy of the Subprime Mortgage Crisis*, 41 Env't & Planning 1420, 1428 (2009).

75. The total amount of subprime originations increased from $34 billion in 1994 to $213 billion in 2002. U.S. Comptroller of the Currency, Economic Issues in Predatory Lending 5 (Adm'r of Nat'l Banks Working Paper 2003). Lenders took advantage of the capital and accounting rules to increase short term liquidity, using the cash they generated to make loans. The fees and profits that they accrued on the front-end of the transaction were used up quickly when they made more loans, requiring them to keep repeating the cycle. With the fast rate of sales, lenders focused more on the quantity of the loans, rather than their quality. *See infra* note 192 and accompanying text.

76. This is an especially common tactic when a bank's assets have become impaired. Securitizing banks exercised discretion in choosing which assets to move off balance sheets and which to retain. In addition, if the transactions did not receive off-balance sheet treatment, the benefit to financial institutions was reduced. *See generally* Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 Del. J. Corp. L. 141, 167 (1997).

garding securitized assets created more balance sheet flexibility.[77] Under those rules, gains on securitization sales were recognized on the front-end of a transaction;[78] de-recognition of assets and a sale of securitized assets generated profits and artificially improved capital adequacy, while securitizing or selling off assets removed assets from the financial institution's balance sheet.[79] This created cash on the institutions' balance sheets that could be recorded at the present value of the expected cash flow reduced by the net assets—an accounting convention which allowed liabilities to remain unchanged.[80]

Although banks retained some subprime mortgages on balance assets, the banks' dual function of originating *and* managing securities was very beneficial.[81] Banks made more credit available by managing balance sheets in a way that optimized product risk and return. Align-

77. The accounting rules gave sales treatment to securitized assets, which encouraged the originators to distribute loans for securitization. Accounting rules allowed the recognition of gains on sales at the front-end of securitization. Financial institutions reported the cash from sales as profits, although it was difficult to calculate the exact amount of the gains. Sale of the assets could be timed to achieve the most profitable gains, which also inflated balance sheets. *See generally* S.P. Kothari & Rebecca Lester, *The Role of Accounting in the Financial Crisis: Lessons for the Future,* 26 ACCT. HORIZONS 335, 351 (2012).

78. *See* Robert F. Hugi et al., *U.S. Adoption of Basel II and the Basel II Securitization Framework*, 12 N.C. BANKING INST. 45, 76 (2008) (explaining securitization exposure on interest-only subordinated strips).

79. The originator does not have to wait to receive payment of the receivables (or, in a "future flow" securitization, until it even generates them) to obtain funds to continue its business and generate new receivables. In many cases this is essential and a role otherwise filled by more traditional methods of financing, including factoring. This is more significant when the receivables are relatively long-term, such as with real property mortgages, auto loans, or student loans, and not as significant with short-term receivables, such as trade and credit card receivables. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140: ACCOUNTING TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, 10(C) 140-12, (2000), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124871&acceptedDisclaimer=true.

80. Thus, companies received the benefit of selling off their "event risks" and simultaneously generating capital without negatively impacting their financial statements. *See* Peter J. Lahny IV, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815, 827–28 (2001).

81. Retained on-balance sheet assets required equity capital, which is determined based on the riskiness of the assets. Banks had the discretion to determine how to meet those requirements. Senior tranches require less capital and can be mixed with junior tranches that require more capital lowering the amount of capital that must be held for all of the securities. In the industry, the lowest tranches were referred to as "toxic waste," indicating the significant portability that those security holders would not receive a return. *See* Günter Franke & Jan P. Krahnen, *The Future of Securitization* (Ctr. for Fin. Studies, Working Paper No. 2008/31, 2008); Olaf Clemens, Accounting Discretion, Securitization, and the Subprime Crisis: An Accounting-based Analysis of the Subprime Market 33 (Jan. 15, 2010) (unpublished manuscript) (on file

ing risks in this way is arguably an efficient use of regulatory capital. However, the manipulation of regulatory capital exposes the FDIC to insolvency.[82]

c. *Affordable Financing*

Securitization allows lenders to reduce costs of lending. As the mortgage markets become more liquid, more affordable financing is available to borrowers. Spreading the risks of borrowing eventually leads to lower interest rates on home mortgages.[83] Through the process of securitization, the risk of default is transferred from a single lender to investors. Mortgage securities are then priced based on the potential of loss, allowing investors to select a preferred risk tolerance.[84] Investors choose between safer securities, which pay lower interest rates, and riskier securities, which generate higher interest rates. By differentiating the securities' risks, the market becomes attractive to a wider group of investors and thus becomes more liquid. As more investors participate in the market, more loan funds become available and interest rates decline.[85]

2. *The Disadvantages of Subprime Securitization*

Impaired subprime securitization created substantial risks in the financial system. The vulnerabilities included excessive credit growth, asset price bubbles, looser lending standards, the emergence of finan-

with author) (discussing the controversies surrounding fair value accounting in the subprime crisis).

82. *See* Clemens, *supra* note 80, at 37–38 (describing the off-balance sheet vehicles used in the subprime crisis as "inglorious").

83. Manuel B. Aalbers, *The Financialization of Home and The Mortgage Market Crisis*, 12 COMPETITION & CHANGE 148, 150–53 (2008).

84. The securities issued in the securitization are more highly rated by participating rating agencies (because of the isolation of the receivables in a "bankruptcy-remote" entity), thus reducing the cost of funds to the originator when compared to traditional forms of financing. In instances when the receivables earn interest, there is usually a significant spread between the interest paid on the securities and the interest earned on the receivables. Ultimately, the originator receives the benefit of the spread. In addition, the originator usually acts as servicer and receives a fee for its services. *See* Lahny IV, *supra* note 79, at 827–28.

85. Santiago Carbó Valverde et al., *Securitization, Bank Lending, and Credit Quality: The Case of Spain* 1329 (European Cent. Bank., Working Paper Series No. 8, 2011) (finding a positive correlation between securitization and lower rates of interest for home loans, suggesting that the savings enjoyed by lenders are passed on to borrowers).

cial engineering, and perverse investment incentives, resulting in a general decline in collateral standards and lending.[86]

a. Excessive Increases in Credit Growth and Asset Prices

The flow of credit in the regulated banking and shadow banking[87] sectors increased with increased securitization. Bank portfolios very quickly expanded with poorer quality loans. Along with the credit expansion, asset prices persistently increased, but were followed by rapid reversals.[88] With no limits on asset concentration or credit growth, the market grew to accompany the demand, resulting in systemic risks and financial instability.[89]

b. Asymmetric Information

The participation of credit rating agencies in the securitization process also caused agency problems. The combined effects of information asymmetry and agency problems existed in various stages.[90] When the monitoring system is improper, one party acts in its own interests and ignores the interests of others.[91] Each party in the securitization chain forewent the duty to adequately monitor the preceding party's transaction. Originators acted as agents for issuers by controlling the quality of borrowers, issuers acted as agents for warehouse lenders and investors by controlling the quality of loans in the securities pool, and credit rating agencies acted as agents for issuers by controlling the assessments of the loan pool. However, many investors

86. Andrea Heuson et al., *Credit Scoring and Mortgage Securitization: Implications for Mortgage Rates and Credit Availability*, 23 J. REAL EST. FIN. & ECON. 337 (2001).

87. Shadow banks, which rely on short-term debt, do not accept deposits like a depository bank and therefore are not subject to the same regulations. *See* Kathryn Judge, *Information Gaps and Shadow Banking*, 103 VA. L. REV. 411, 420 (2017) ("The shadow banking system is an intermediation regime that resides in the capital markets while serving many of the economic functions traditionally fulfilled by banks.").

88. *See generally* Miroslav Misina & Greg Tkacz, *Credit, Asset Prices, and Financial Stress*, 5 INT'L J. CENT. BANKING 95 (2009) (concluding that domestic credit growth is the best predictor of a financial crisis in developed countries).

89. GIOVANNI DELL'ARICCIA ET AL., INT'L MONETARY FUND, POLICIES FOR MACROFINANCIAL STABILITY: DEALING WITH CREDIT BOOMS AND BUSTS 2 (2012), http://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/sdn/2012/_sdn1206.ashx (critiquing the appropriate policy response to credit booms).

90. *When It Goes Wrong . . .*, ECONOMIST (Sept. 20, 2007), http://www.economist.com/node/9830765; *see also* Clemens, *supra* note 80 (discussing the inherent weaknesses in the accounting standards and the subprime crisis).

91. *Gubler*, *supra* note 51, at 60 (discussing the failure of credit rating agencies to detect the informational asymmetries in financial innovation products).

incorrectly assumed that credit rating agencies acted on behalf of investors.

Even though originators were most knowledgeable of the trustworthiness of borrowers, the asymmetric information theory of loan origination presupposes that originators lack the incentive to properly screen out risky loans.[92] Consequently, moral hazard and adverse selection resulted in excessive borrowing and lending.[93] At least two aspects of securitized mortgage transactions allowed originators to gain an efficiency advantage: First, securitization lowered the costs of funds and thus made it profitable for an originator to sell all of the securitized loans. Second, originators were aware that issuers did not independently verify borrowers' creditworthiness. Originators could generate an essentially infinite amount of low-quality loans without closely screening borrowers, and passed the effects of the laxity onto the next party.[94]

Borrowers with relatively bad credit transfer their credit risk to other parties in the securitization chain, including warehouse lenders, investors, and credit rating agencies. Warehouse lenders hold the loans making up the mortgage pool until securitization deals are completed. Their informational disadvantage could result in an over-valuation of the mortgages held as collateral. Requiring issuers to increase the collateral on the loans that they held mitigated this problem.[95] Due diligence imposed a duty on issuers to look at both preceding and subsequent parties in the securitization chain. Specifically, issuers were required to investigate their purchases from originators in order to protect investors.[96] Theoretically, issuers could have screened the

92. Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles: How Mortgage Regulation Can Keep Main Street and Wall Street Safe-From Themselves*, 163 U. PA. L. REV. 1539, 1591–92 (2015) (discussing the potential losses originators could suffer under risk retention procedures).

93. Douglas W. Diamond & Raghuram G. Rajan, *The Credit Crisis: Conjectures About Causes and Remedies*, 99 AM. ECON. REV. 606, 608 (2009) (discussing how short-term debt exposure exacerbated the liquidity of banks).

94. Moral hazard occurs when risky behavior is protected. For example, although originators made no evaluation of borrowers' ability to repay, they had no responsibility for the delinquent loans. *See* Steven L. Schwarcz, *Markets, Systemic Risk, and the Subprime Mortgage Crisis*, 61 SMU L. REV. 209, 215 (2008) (describing how information asymmetry contributes to moral hazard).

95. Cassandra Jones Havard, *Post-Racial Lending?*, 24 KAN. J.L. & PUB. POL'Y 176, 207 (2014) (suggesting reforms to lessen information asymmetries in warehouse lending).

96. There were financial institutions which originated and issued their own securities, as well as investment banks that purchased mortgages from originators and issued their own securities. *See* Kathleen C. Engel & Thomas J. Fitzpatrick, *Complexity, Complicity, and Liability Up the Securitization Food Chain: Investor and Arranger Exposure to Consumer Claims*, 2 HARV. BUS. L. REV. 346, 349–353 (2012).

mortgages purchased from originators and rejected those of low quality. However, issuers took advantage of a classic securitization tactic: They securitized bad loans and kept the good ones.[97]

Investors acted as free-riders to transfer credit risks. They chose not to pay for their own independent assessments of the underlying securities in an offering, as the rating process was envisioned originally.[98] Instead, investors relied on expert valuations and "hidden information" embedded in credit ratings,[99] and ignored the agency issues in the issuer-pays model of credit ratings. Due to perverse incentives, rating agencies acted in their own best interests by providing the inflated ratings that issuers expected. Investors failed to question whether credit ratings accurately evaluated the quality of underlying assets[100] and were harmed by these inflated ratings.

c. Complex and Opaque Securities

Financial engineering produces synthetic and complex structured financial products. Subprime securities, like other engineered products, were designed to have excessive leverage. Although subprime securities were marketed similarly to prime mortgage-backed securities, assets underlying subprime securities could not withstand significant adverse events because they were collateralized based on unrealized gains in asset prices.[101]

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97. *See* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1230 (2012) (arguing that the increased trade in subprime securities was due to the sale of more loan pools with lemons); *cf.* George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 490–92 (1970) (positing the classic example of warehouse lenders and investors as sophisticated market participants who use contractual clauses to balance the consequences of asymmetric information).

98. *See supra* note 30 and accompanying text.

99. *See* EMILY MCCLINTOCK EKINS & MARK A. CALABRIA, CATO INST., REGULATION, MARKET STRUCTURE, AND THE ROLE OF CREDIT RATING AGENCIES 13–14 (2012), https://object.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf.

100. *See, e.g.*, Frank Partnoy, How and Why Credit Rating Agencies Are Not Like Other Gatekeepers 59 (Univ. San Diego Sch. of Law, Research Paper No. 07-46, 2006), http://lamfin.arizona.edu/fixi/creditmod/Portnoy.pdf (positing that, unlike other gatekeepers, credit rating agencies are conflicted because of their relationship to issuers).

101. Martin Hellwig, Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis 53–58 (Max Planck Inst. for Research on Collective Goods Nov. 2008), http://ssrn.com/abstract=1309442 (discussing how complexity in financial mortgage products makes them less transparent).

As argued above, investors were not able to adequately gauge the risks, rights and priorities attached to securities.[102] The sale of securities presumes that investors will conduct their own due diligence and independently verify external credits.[103] Given that credit rating agencies incorrectly modeled subprime securitizations, investors' over-reliance on credit agency ratings exacerbated the problem.

The actual data disclosed to investors posed another impediment to investors' due diligence, in that the data was not comprehensive enough for investors to make informed decisions.[104] Moreover, without clear explanations of the methodologies used by credit rating agencies, only investors who were well-versed in complex securities transactions could accurately evaluate the rating agencies' data and make an accurate comparison of securities.[105] This resulted in most investors' abrogating their due diligence responsibilities.[106]

More importantly, the lack of transparency in the mortgage market makes it hard for investors and financial institutions to assess their exposure to systematic risks.[107] As evidenced by the subprime crisis, opaque subprime mortgage products caused risks that were hard to monitor, mitigate, react to, and control.[108] On one hand, the rapid growth of the subprime mortgage market outpaced the ability of market participants and regulators to appropriately account for such growth.[109] On the other hand, the opaqueness of financial products made it difficult for investors to value the products, and, more importantly, made it difficult for financial institutions to assess their exposure to counterparty risks. Because of the disintermediation in the

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102. *See supra* note 51. Regulators were also not able to understand these products. *See* Michel G. Crouhy et al., The Subprime Credit Crisis of 07, at 17 (July 9, 2008) (unpublished manuscript), http://ssrn.com/abstract=1112467.

103. John C Hull, The Credit Crunch of 2007: What Went Wrong? Why? What Lessons Can Be Learned? 8–12 (May 2009) (unpublished manuscript), http://www-2.rotman.utoronto.ca/~hull/downloadablepublications/CreditCrunch.pdf.

104. *Id*. at 11.

105. *See* Crouhy et al., *supra* note 100, at 17 (arguing that unsophisticated investors did not have sufficient information about the quality of the underlying assets to make an independent evaluation).

106. Investors were willing to purchase the securities regardless of their riskiness as long as they had a AAA rating. Scharar, *supra* note 57, at 920–27 (discussing the impact of predatory lending in the financial crisis).

107. Hellwig, *supra* note 99, at 6.

108. Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1269–70 (2009) (discussing the systemic risks of subprime loan products).

109. Professor Aalbers argues that the rapid growth of the subprime crisis represents the "financialization" of mortgage markets and describes it as a "highly political project." *See* Aalbers, *supra* note 82, at 148, 152.

market, protection of the financial system depends on rules to limit risk-taking.[110]

d. Regulatory Arbitrage

Innovations in financial products allow banks to circumvent regulatory capital and maintain or create illusory balance sheets. Securitization transfers risks out of the originating bank and is an efficient use of bank capital.[111] However, the downside of securitization is that it can avoid regulatory capital requirements and thus potentially abuse the implicit safety net of deposit insurance.[112] In this regard, regulatory arbitrage—or taking advantage of the regulatory loopholes—occurs.[113] Capital requirements, when exploited, are de-stabilizing. Capital helps to absorb losses and serves to reinforce the bank's solvency. The possibility of default and insolvency increases when a bank's equity or capital declines. Banks that fall below the required capital level shift the risk of loss to the deposit insurance funds.[114]

Moral hazard is identified as a cost of these innovations.[115] When another party can take some responsibility for an institution's behavior, moral hazard disincentives the institution to bear the consequences

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110. Professor Schwarcz argues that systemic risk is best addressed through regulation that correlates risk within the system. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J., 193, 210–234 (discussing alternative ways to regulate systemic risk in the financial system); *see also generally* Markus K. Brunnermeier, *Deciphering the 2007–08 Liquidity and Credit Crunch*, J. ECON. PERSP., Winter 2009 (arguing that opaqueness in financial products leads to systemic risk).

111. Banks finance securitization by using funds from shadow banks. Shadow banks are non-bank institutions that are not subject to regulatory capital rules. Recently, the Financial Stability Board drafted rules governing shadow banks. *See generally* Steven L. Schwarcz, *Regulatory Shadow Banking*, 31 REV. BANKING & FIN. L. 619, 620 (2012).

112. *See* FSB, STRENGTHENING OVERSIGHT, *supra* note 101, at 5. Yet regulators, seeking to avoid abuse of the safety net through regulatory capital arbitrage, have argued that securitization should be pure transfer of risk: Either banks should keep their loan risks on their balance sheets (and have their minimum capital regulated accordingly), or they should sell or securitize those assets without any hidden recourse allowing the transfer of losses back to originating banks if securitized assets perform badly.

113. The term regulatory arbitrage refers to financial institutions' ability to increase profits or reduce costs by choosing the most advantageous regulatory scheme. Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 IOWA J. CORP. L. 211 (1996–97).

114. Helen A. Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429, 443 (1994).

115. *See* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 248 (1996); *see also* Cassandra Jones Havard, *'Goin' Round in Circles'. . . and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV. 737, 753–56 (2008).

of that behavior.[116] One such example is regulatory arbitrage, the ability of regulated institutions to conduct activities beyond the reach of their regulators. The regulatory landscape under which financial institutions operate—including gaps and overlap in regulations on financial transactions—allows these institutions to often circumvent the regulations that control their actions.[117] Financial markets and institutions are interrelated and often perform the same functions. This function equivalence creates the risk that an institution may choose to comply only with the regulation that is the most beneficial to it.[118]

The accounting treatment of asset-backed mortgages illustrates the regulatory arbitrage in subprime mortgage securitization. Specifically, three accounting standards regarding securitizations—reporting of immediate gains, discretion to adjust declining fair values, and slow recognition of losses—all proved useful.[119]

Accounting rules permitted financial institutions, which invested in financial instruments created based on subprime mortgages, to delay recognition of likely losses. First, as explained in Part I of this article, this accounting convention distorted measures of capital adequacy. Second, the accounting rules allowed liberal reporting of the fair values of loans within securitization pools. When the mortgage pool included assets whose fair values were difficult to measure, originators estimated the values.[120] Thus, these loans were improperly classified at a higher value at the outset.[121] As borrowers began to default,

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116. In the context of financial regulation, moral hazard goes hand in hand with "too big to fail." Financial regulation that embraces "too big to fail" is premised on the idea that systemic failure—the failure of an institution or institutions that could bring down the entire financial system—cannot be allowed to occur. Therefore, institutions considered "too big to fail" have little incentive to guard against risk. *See* Jason Rudderman, *Eliminating Wall Street's Safety Net: How A Systemic Risk Premium Can Solve "Too Big to Fail"*, 11 FLA. ST. U. BUS. REV. 39, 53 (2012).

117. *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV 277 (2011).

118. *See, e.g.*, GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE 34–38 (2008), http://www.group30.org/images/uploads/publications/G30_StructureFinancialSupervision2008.pdf (comparing the advantages and disadvantages of multiple versus single regulatory authorities).

119. *See* Clemens, *supra* note 80.

120. Accounting rules required disclosure on the financial statement if using this treatment. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157: FAIR VALUE MEASUREMENTS, 157-13, ¶ 29C (2000), http://www.fasb.org/cs/BlobServer?blobkey=ID&blobwhere=1175823288587&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs.

121. *Id.* at 157–53. This standard determines fair value by classifying assets as Level 1 (assets have observable market prices), Level 2 (assets do not have observable market prices but have inputs that are based on such prices), or Level 3 (assets do not

the loans were re-classified; and this re-classification was inflated because the loans were not adjusted to the true declining value.[122] As a result of using the incorrect estimates, asset balances and portions of the gain were misstated.[123]

This same accounting treatment may have resulted in an overstatement on the originators' balance sheets because liabilities were not properly recorded. For example, some high-risk loans were securitized because they had credit risk insurance.[124] Representations and warranties in the securitization contracts required repurchase under specified conditions. Repurchases triggered losses, whose values were estimated by management. At the time of the original transfer, a proper accounting practice would record "repurchase obligations" as a liability, rather than basing the value of the liability on management estimates.[125]

These accounting treatments allowed management to escape the very banking regulations meant to control their behavior.[126] For example, financial institutions allowed securitizations with implicit recourse,[127] and originating banks evaded the regulatory capital requirements, retained risks, became insolvent, and abused the government safety net of deposit insurance.[128]

B. The Regulatory Landscape of Subprime Securitization

After the collapse of the U.S. financial markets in 1929, Congress created a fragmented regulatory framework with separate agencies focusing on separate financial activities.[129] As discussed below, almost

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have observable inputs; management determines valuation based on internal estimates and models). Loans that should have been classified as Level 3 were initially classified as Level 1 or Level 2. When borrowers began to default, these loans were then reclassified at Level 3, instead of at their true declining value. *See* Kothari & Lester, *supra* note 76, at 348.

122. *See supra* note 118.

123. *See* Kothari & Lester, *supra* note 76, at 349.

124. Crouhy et al., *supra* note 63, at 5.

125. *See* Kothari & Lester, *supra* note 76, at 349.

126. Schwarcz, *supra* note 108, at 209.

127. Regulatory minimum capital requirements are designed to protect deposit insurance funds. *See* FED. DEPOSIT INS. CORP., RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES 2 (2015), https://www.fdic.gov/regulations/safety/manual/section2-1.pdf.

128. Dodd-Frank changes accounting rules to address this problem. In 2008 and 2009, there were 25 and 140 bank failures, respectively, compared with no bank failures in 2005 and 2006, and 3 bank failures in 2007. Nickel, *Looking Back at Bank Failure Rates*, FORBES: MONEY BUILDER (Mar. 25, 2013), http://www.forbes.com/sites/moneybuilder/2013/03/25/looking-back-at-bank-failure-rates/#6b99c2d3598b.

129. *See generally* Carnell Macey Miller, *Dual Banking*, *in* THE LAW OF FINANCIAL INSTITUTIONS 23 (5th ed. 2013).

three decades prior to the financial crisis, a regulatory environment favorable to the banking and securities sectors impacted the asset-backed securities market. Without a concomitant change to the regulatory structure, the mortgage crisis was inevitable.

1. SEC Regulation

In order to increase disclosure and transparency in the primary securities market, the Securities Act of 1933 required businesses to register the initial offer or subsequent sale of any security with the government.[130] In 1934, the Securities Exchange Act (the "Exchange Act") established the SEC to regulate secondary stock exchanges and enforce against fraudulent criminal acts.[131] Credit ratings, prepared by analysts based on their experiences and biases, immediately became a part of the regulatory environment.[132]

Credit rating agencies sold annual bond manuals and used letter ratings for many securities. Investment grade ratings were assigned to railroads, utilities, industrial corporations, and governments.[133] Over time, this "subscriber pays" model was reserved for government debt and public companies, whose financials and other information were on the public record.[134]

The modern issuer-pays credit rating incentivizes low-default originations, high-volume trading, and investor protection.[135] An in-

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130. *See* 15 U.S.C.A. § 77(*l*) (2012) (discussing civil liabilities arising in connection with prospectuses and communications).

131. Firms are required to submit quarterly and annual reports to the SEC. Banking Act of 1935, 12 U.S.C.A. § 228 (2012).

132. Before the 1970s, investors paid a subscription to credit rating agencies to have access to the ratings. Christopher Keller & Michael Stocker, *Reining in the Credit Ratings Industry*, N.Y.L.J. (Jan. 11, 2010), http://www.labaton.com/blog/Reining-in-the-Credit-Ratings-Industry.cfm.

133. Beginning in 1949, Standard & Poor's (S&P) implemented a policy allowing municipalities to pay the rating agency to conduct a rating analysis for marketing small bond issues (if the face value was less than $1 million). In 1968, S&P began charging for all municipal bond ratings. The issuer-pays model then spread to all asset classes and was implemented by competing agencies. *Hearing on Municipal Bond Ratings Before the Subcomm. on Econ. Progress of the Joint Econ. Comm.*, 90th Cong. 193 (1968) (statement of Brenton W. Harries, Vice President, Bond and Data Services Division, Standard & Poor's Corp.).

134. The ratings industry has not always been an issuer-pays model. The subscriber pays model was the accepted model until the 1970s, when subscribers demanded "free, high quality ratings." Joseph A. Grundfest & Evgenia Petrova, *Buyer Owned and Controlled Rating Agencies: A Summary Introduction* 4 (The Rock Ctr. on Corp. Governance, Working Paper Series No. 161, 2009), https://www.sec.gov/comments/4-579/4579-10.pdf.

135. Johnathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 592 (2013); *see also* Guseva, *supra* note 23, at 454–55 (2012).

vestment-grade rating signifies that the security is liquid and creditworthy.[136] The SEC incorporated credit ratings into the regulatory framework and, perhaps unintentionally, signaled their significance to the investor public.[137] This change also made the NRSROs "gatekeepers"[138]: Non-registered rating firms may issue securities' ratings, but those ratings cannot be used as a substitute under the regulatory standards.[139]

The use of investment-grade rating had a spillover effect. Federal and state regulations required certain investment decisions to use NRSRO ratings and treat those investments favorably;[140] this reduced the costs of capital and thus made debt cheaper.[141] Specifically, the banking net capital rules also incentivized banks to invest in NRSRO securities due to the costs, thereby raising the importance of credit ratings to issuers.[142]

In the field of credit ratings, the still fragmented regulatory system governing banking and securities resulted in incongruent and inefficient regulation. "Modernization" of the financial services industry allowed a single firm to operate banking, securities, and insurance subsidiaries.[143] However, monitoring and supervision of these firms

136. Dodd-Frank required the SEC to study the frequency of credit ratings in other sectors. In order to help de-emphasize the role of CRAs, section 939A of the Dodd-Frank Act prohibits the use of credit ratings for a number of statutory purposes. David B.H. Martin & Matthew C. Franker, *Rating Agency Regulation After the Dodd-Frank Act: A Mid-Course Review*, 12 INSIGHTS 3 (2011). The Dodd-Frank Act allows civil remedies against credit rating agencies, thereby rescinding the exemption that such agencies previously enjoyed for rating statements made in the prospectuses.

137. 15 U.S.C. § 78o-7(a)(1)(B) (2008).

138. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308–11 (2004) (describing the NRSRO's reputational capital in issuing accurate ratings as one of two essential "gatekeeper" functions).

139. Moody's, S&P's, and Fitch Ratings, often referred to as the "Big Three," dominate the market because they issue over ninety-five percent of outstanding ratings on U.S. debt securities, qualifying those securities for favorable regulatory treatment. Jack T. Gannon, Jr., *Let's Help the Credit Rating Agencies Get It Right: A Simple Way to Alleviate a Flawed Industry Model*, 31 REV. BANKING & FIN. L. 1015, 1020 (2012).

140. U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 6–9 (2003) [hereinafter 2003 SEC REPORT].

141. Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Release No. 34-7114, File No. S7-15-11 (Dec. 27, 2013).

142. Under Basel II, banks were allowed to invest in NRSRO securities. *See* Patrick Van Roy, *Credit Ratings and the Standardised Approach to Credit Risk in Basel II* 13 (Eur. Cent. Bank, Working Paper Series No. 517, 2005).

143. Robert W. Dixon, *The Gramm-Leach-Bliley Financial Modernization Act: Why Reform in the Financial Services Industry Was Necessary and the Act's Projected Effects on Community Banking*, 49 DRAKE L. REV. 671, 688 (2001).

remain separate: the banking industry relies on direct supervision and enforcement by the regulatory agencies, while the securities industry relies, to some extent, on self-regulation. Thus, innovations in the securities market made it difficult for banking regulators to effectively monitor compliance of new financial products with the rules. In particular, prior to the subprime crisis, the rapid growth of new derivative instruments posed a problem for regulators.[144] As discussed in Part III, as "gatekeepers," credit rating agencies have frequently failed to insulate the market from abuse, but have neither suffered from reputational risks nor received closer supervision.[145]

2. *Banking Regulation of Mortgages*

a. *Banking Deregulation*

After the 1929 market crash, the widespread fear of bank failures forced banks to choose between engaging in simple lending and becoming investment banks to conduct securities underwriting and dealing.[146] Consequently, Congress prohibited banks from "principally engaging" in non-banking activities, such as the securities and insurance business.[147] Congress then created the Federal Deposit Insurance Fund (FDIC), which guaranteed consumer deposit accounts up to a

144. *See* Gubler, *supra* note 51, at 67–68 (discussing how new financial markets emerge when banks created new financial products). As one author explains,

> [d]erivatives are financial instruments that derive their value on their claim to another asset, such as an option to purchase a good or a futures contract on a good. Derivatives can be used to hedge against risk, protecting against a decline in value of the underlying asset. Alternatively, they can be used for simple speculation, to profit off an expected change in value. Derivatives do not involve the actual transfer of assets, so a buyer often does not own the underlying asset.

MATTHEW SHERMAN, CTR. FOR ECON. & POL'Y RES., A SHORT HISTORY OF FINANCIAL DEREGULATION IN THE UNITED STATES 10 (2009), https://pdfs.semanticscholar.org/a771/53a1111a550a99bf2b116621ceb7a445a1b4.pdf?_ga=2.264467783.971105515.1503197195-1271500028.1503197195.

145. The failures of credit ratings on corporate bonds issued by LTC Capital, WorldCom, and Enron resulted in insignificant adjustments in the ratings methodology. *See generally* Frank Partnoy, *The Siskel and Ebert of Financial Markets—Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 630 (1999) (arguing that credit rating agencies should be able to sell regulatory licenses based on credit risk spreads). To continuously influence the market, rating agencies are said to depend on their "reputational capital," or their reputation for objectivity and accuracy. *See* discussion *infra* Part III.

146. In 1933, Congress fundamentally reformed banking with the Glass-Steagall Act. Glass-Steagall also established a system of deposit insurance for consumers with the creation of the Federal Deposit Insurance Corporation (FDIC). Glass-Steagall Act of 1933, 12 U.S.C.A. § 24 (1933).

147. *Id*. § 378 (1933).

certain level, restoring depositor confidence.[148] Congress also created the Federal Home Loan Bank (FHLB) Board to oversee savings and loan associations, known as thrifts, which were designed to fund mortgage loans and encourage savings.[149]

After the 1929 market crash, Congress restricted the interest rates charged by banks on deposit accounts.[150] In the 1980s, with interest rates soaring, Congress de-regulated the financial institutions industry.[151] However, an exception was made for savings and loans ("S&Ls"), which specialized in encouraging mortgage lending within local communities. Thrift institutions were allowed to offer deposit accounts interest at slightly higher rates.[152] The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 removed interest rate ceilings on deposits, and eliminated the thrifts' interest rate advantage over banks.[153]

Such legislation was needed because S&Ls experienced financial distress due to a mismatch of their asset portfolio. Because S&Ls specialized in taking in deposits in the short-term and making mortgage loans in the long-term, they were vulnerable to the costs of high interest rates.[154] The Garn-St. Germain Depository Institutions Act of 1982 allowed S&Ls to act more like banks and less like specialized mort-

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148. Banking Act of 1935, § 21, 12 U.S.C. § 228. In 1936, the Comptroller exercised authority under the 1935 Act to prohibit banks from purchasing speculative-grade securities, as defined in manuals published by rating agencies. U.S. Comptroller of the Currency, *Purchase of Investment Securities, and Further Defining the Term "Investment Securities" as Used in Section 5136 of the Revised Statutes as Amended by the "Banking Act of 1935*,*"* § II (Feb. 15, 1936).

149. The Federal Home Loan Bank Act, 12 U.S.C. § 1421, Pub. L. No. 72–304, 47 Stat. 725 (1932).

150. Under Regulation Q of the Banking Act of 1933, savings accounts were capped at 5.25%, and time deposits were limited to between 5.75% and 7.75%, depending on maturity. Checking accounts were restricted to an interest rate of zero. 12 C.F.R. 217 (1986).

151. *See* BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE, U.S. DEP'T OF TREASURY 137-71, https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf (discussing the public benefits of deregulation).

152. Thrifts were allowed to charge a quarter-percent higher interest than banks. 12 C.F.R. § 217.7 (1980).

153. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-1221, 94 Stat. 132.

154. With high inflation and competitive pressure for deposits pushing up the interest rates they had to pay, most thrift institutions reported large losses in the early 1980s. Net worth of the entire industry approached zero, falling from 5.3% of assets in 1980 to 0.5% in 1982. *See* 1 FDIC, *Savings and Loan Crisis and Its Relationship to Banking*, *in* A History of the 80s: Lessons for the Future 169 (1999), http://www.fdic.gov/bank/historical/history/167_188.pdf.

gage lending institutions.[155] Although the legislation intended to benefit specifically the thrift industry, it unfortunately allowed these firms to enter into new financial territory with new risks.

Also passed in 1982, the Alternative Mortgage Transactions Parity Act lifted restrictions on mortgage loans with exotic features, such as adjustable-rate and interest-only mortgages.[156] The lure of Alternative A-paper ("Alt-A") loans[157] to borrowers came from their low "teaser" rates, which reset at higher interest rates after a few years.[158] Perhaps the most significant deregulation legislation was the Gramm-Leach-Bliley Financial Modernization Act of 1999 ("Gramm-Leach-Bliley").[159] The Act repealed the Glass-Steagall Act and lifted all restrictions on financial institutions engaging in banking, securities, and insurance operations.[160] National commercial banks were permitted to consolidate across state lines, essentially paving the way for the "too big to fail" mega-bank.[161]

Finally, the parity legislation, which gave private mortgage-backed securities the same exemptions as government-backed securities, led to the growth of the subprime mortgage securitization market. The Secondary Mortgage Market Enhancement Act of 1984[162]

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155. The statute allowed S&Ls to engage in commercial loans up to ten percent of assets and offer a new account to compete directly with market mutual funds. Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 325, 96 Stat. 1500 (1982).

156. The Alternative Mortgage Transactions Parity Act (AMTPA) was a part of the Garn-St Germain Depository Institutions Act of 1982, 12 U.S.C. § 226, Pub. L. No. 106-102, 113 Stat. 1338 (1982).

157. "Alt-A loans generally are larger in size than subprime loans and have significantly higher credit quality, with the majority having FICO scores above 680. For this reason, Alt-A loans are sometimes referred to as 'near prime.'" THOMAS P. LEMKE, GERALD T. LINS & MARIE E. PICARD, MORTGAGE-BACKED SECURITIES §3:8 (2016).

158. SHERMAN, *supra* note 144, at 12.

159. Financial Services Modernization Act of 1999, 15 U.S.C. § 6701, Pub. L. No. 106-102, 113 Stat. 1338.

160. The capital limitations on banks, especially in the southeast, kept them from growing and being competitive. Hugh McColl, CEO of the North Carolina National Bank Corp. was among those who lobbied to drop the restrictions on interstate banking. Thomas D. Hills, *The Rise of Southern Banking and the Disparities Among the States Following the Southeastern Regional Banking Compact*, 11 N.C. BANKING INST. 57, 87–88 (2007) (quoting Kenneth Cline, *McColl Downplays Starring Role in Long Campaign for Banking*, AM. BANKER, Sept. 15, 1994, at 4).

161. Arthur E. Wilmarth Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 997–1002 (1992). Professor Wilmarth lists four reasons for Congress' preservation of the "too big to fail doctrine": avoiding a spillover run; credit disruption; preserving the viability of smaller correspondent banks; and the stability of domestic and international payment systems; and all major countries implicitly follow the doctrine. *Id.* at 997–1002.

162. Act of Oct. 3, 1984, Pub. L. No. 98-440, 98 Stat. 1689 (2006) (codified at 15 U.S.C. § 78g).

(SMMEA) revolutionized the private mortgage-backed securities market by exempting private-label mortgage-backed securities ("private-label MBS") from securities and tax laws.[163] Specifically, private-label MBS were exempted from registration requirements, prohibitions on forward trading,[164] state blue sky laws,[165] double taxation for certain entities under the tax code,[166] and exemptions allowed investments by FDIC-insured banks.[167] Significantly, SMMEA also required the exempted securities to receive a rating of AA or higher from a credit rating agency.[168] The legislation effectively lowered the costs of issuance and created liquidity and "trillions of dollars" of mortgage credit over the years.[169] Arguably, SMMEA both furthered an expansion of mortgage credit and created more opportunities for abuse.[170]

These changes led to heavy investment in alternative mortgages.[171] Alt-A loans were in high demand and proved to be complex financial arrangements that were difficult for borrowers to under-

163. The legislative intent was to create parity between the private-label market and the government-sponsored entities (GSEs). *Id.*; *see also infra* note 174 (explaining GSEs). For example, the sponsoring legislator, Senator Tower, supported SMMEA because of the future needed liquidity in the mortgage market. *Secondary Mortgage Market Enhancement Act: Hearing Before the Subcomm. on Hous. & Urban Affairs of the S. Comm. on Banking, Hous., & Urban Affairs*, 98th Cong. 1 (1983) (statement of Sen. John Tower); *see* Havard, *supra* note 113, at 746 n.34.

164. *See* § 102 (codified at 15 U.S.C. § 78g) (removing restrictions on forward trading of private-label MBS under the Exchange Act § 7(c) Regulation T).

165. *Id*. § 106 (codified at 15 U.S.C. § 77r-1).

166. *Id*. § 104 (codified at 15 U.S.C. § 78k).

167. *Id.* § 105 (codified at 12 U.S.C. § 1464(c)(1)); *id.* § 107 (codified at 12 U.S.C. § 1757). Prior to the repeal of Glass-Steagall, this statute exempted private label MBS from registration for FDIC-insured banks. Glass-Steagall Act § 16, 12 U.S.C. § 24 (2000).

168. *See* § 78c(a)(41).

169. *See The Housing Decline: Extent of the Problem and Potential Remedies: Hearing Before the S. Comm. on Fin.*, 110th Cong. 1 (2007) (statement of Michael Decker, Senior Managing Director, Research & Public Policy, Securities Industry & Financial Markets Association (SIFMA)).

170. Brent J. Horton, *In Defense of Private-Label Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 858–59 (2009) (defending SMMEA as "Reagan-era legislation" that is falsely labeled as contributing to the housing bubble).

171. Lenders were allowed to offer adjustable-rate mortgages beginning in 1982. In 1980, federal legislation preempted state-imposed interest rate caps. After the Tax Reform Act of 1986, residential mortgage interest was the only tax-deductible interest allowed for consumer loans. This encouraged home equity withdrawal as a new type of consumer loan. "Cashout" refinancing of a mortgage became a preferred means of financing home improvements and personal consumption. *See* Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473 (2000).

stand.[172] Mortgage lenders also targeted lower-income, higher-risk borrowers with relatively low credit ratings for this subset of subprime loans. As these markets became more profitable, the mortgage industry aggressively pushed these non-conforming loans onto consumers.[173] By 2006, the subprime market had surpassed the conforming loan market in size.[174]

b. Vertical Integration

Two decades prior to the financial crisis, the dramatic changes in the legal and regulatory landscape of financial institutions allowed banks to become vertically integrated and facilitate a vertical supply chain.[175] For mortgages, vertical integration of banks increased availability of credit directly linked to the fees generated in the securitization process.[176]

As banks became more integrated, they began manufacturing securities. Contrary to the idea that securitization encouraged banks to pass risks onto other parties, banks produced and held a large amount

172. In 1970, Government National Mortgage Association ("Ginnie Mae") packaged the first mortgage-backed securities in the nationwide push to foster homeownership. The Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae") soon followed suit. These GSEs bought up mortgage loans to facilitate a secondary market. The securities carried an implicit guarantee from the federal government, and they were required to conform to underwriting standards that ensured loan quality and limited risk. *See* SHERMAN, *supra* note 144, at 12. Innovation in the mortgage finance market produced products that borrowers were unfamiliar with. For example, Alt-A loans mixed aspects of options and futures and insurance contracts, and they allowed financial firms to bet on or hedge against all sorts of possible outcomes. Arthur E. Wilmarth, *The Dark Side of Universal Banking: Financial Conglomerates and The Origins Of The Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1016 (2009). CDOs played a significant role in the subprime crisis. *See* Gubler, *supra* note 51 and accompanying text.

173. As has been documented numerous times, although sixty-one percent of subprime borrowers had credit scores high enough to qualify them for conventional mortgages, they received subprime loans. *See* Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J. (Dec. 3, 2007), http://online.wsj.com/article/SB119662974358911035.html.

174. In 2001, there were twice as many prime loans as there were subprime loans. *See* FOOTE, *supra* note 13.

175. *See* Claudine Gartenberg & Lamar Pierce, *Subprime Governance: Agency Costs in Vertically Integrated Banks and the 2008 Mortgage Crisis*, 38 STRATEGIC MGMT. J. 302, 329–308 (2017) (discussing the negative aspects of vertical integration and monitoring in Washington Mutual securitizations).

176. Jill M. Hendrickson, *The Long and Bumpy Road to Glass-Steagall Reform: A Historical and Evolutionary Analysis of Banking Legislation*, 60 AM J. ECON. & SOC. 849, 849–874 (2001). Two authors argue that diversification allowed banks to change their profit structure from lending to generating fees. *See* Robert DeYoung & Tara Rice, *How Do Banks Make Money? A Variety of Business Strategies*, ECON. PERSP., 4Q/2003, at 34–48.

of mortgage-backed securities and CDOs.[177] Mass production of financial instruments not only generated a steady supply of mortgages, but also guaranteed fees throughout the securitization process. Firms adopted a vertical integration structure, which required holding the mortgages instead of selling them. This also increased the firms' loss exposure if the mortgages defaulted. "[B]y 2007, there were a small number of large financial firms mass-producing mortgage-backed securities products in vertically-integrated pipelines whereby firms originated mortgages, securitized them, sold them off to investors, and were investors themselves in these products."[178]

The decline of interest rates after 2001 increased the demand for mortgage-backed securities, which were viewed as a safe investment with high returns. Vertically integrated banks developed "pipelines" and made record profits by earning fees throughout the securitization process and by making investments in these securities. When the market changed in 2004, vertically integrated banks expanded their origination and securitization of nonconventional mortgages, including subprime mortgages.[179] There were two distinct advantages for banks to do so: First, subprime mortgages offered higher interest rates and returns than conventional mortgages, although they were riskier. Second, because the mortgages were risker, banks re-securitized the subprime mortgage-backed securities and created CDOs. These financial products allowed banks to package tranches of mortgage-backed securities, which were the riskiest and the most difficult to sell, into bonds to make more money.[180]

Pipelines, sometimes called the "industrial control" business model, required constant manufacture of the financial products for sale or leverage. Banks increased the volume of risky mortgage-

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177. Viral Acharya et al., *Securitization Without Risk Transfer*, 107 J. FIN. ECON. 514 (2013) (discussing banks engaged in regulatory arbitrage setting up "asset-backed commercial paper" (ABCP) conduits that reduced regulatory capital requirements but retained risks on their balance sheets); Diamond & Rajan, *supra* note 91, at 609.

178. Countrywide Financial was the originator of the vertical integration pipeline, which generated large profits and led to its industry-wide use. Neil Fligstein & Adam Goldstein, *The Transformation of Mortgage Finance and the Industrial Roots of the Mortgage Meltdown* 5–6 (Oct. 2012) (unpublished manuscript), http://escholarship.org/uc/item/2zx8r7fb.

179. Gartenberg & Pierce, *supra* note 162, at 37.

180. One prominent and illustrative case of this occurred at Goldman Sachs, which used its privileged information about the underlying risk of a particular CDO to bet against it on the investment end while continuing to profit from its production. Brown, *supra* note 22, at 85 (quoting Charlie Gasparino, *Goldman Already a Step Ahead of FinReg*, FOX BUSINESS (July 27, 2010), http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg) (discussing Goldman Sachs's profiteering scheme of mixing its "proprietary" stock-trading operations with other assets).

backed securities in order to produce fees, with little regard for the possibility of default.[181] Riskier mortgages were the best product for this model because the mortgages were originated, securitized, and manufactured into CDOs. [182] As a result, vertical production of loans undermined the quality of subprime mortgages.[183] Large holdings of risky mortgages became the largest market segment for many vertically integrated firms and eventually contributed to those firms' failure.[184]

One group of scholars views the development of mortgage securitization markets as the industrial control mechanism enabling these integrated financial firms to make money.[185] As discussed below, this "markets as politics" approach explains the unprecedented access to credit given to borrowers who usually did not have access to credit and neighborhoods that banks had historically redlined.

c. *Opportunistic Securitization*

Subprime lending becomes predatory when loan terms are abusive.[186] "Although not all subprime loans are predatory, nearly all predatory loans are subprime." [187] Predatory lending violated consumer and anti-discrimination laws that prohibit discrimination in housing finance. Credit became abundant in minority communities that were historically denied access to credit.[188] Lenders ignored the fact that noncompliant loans adversely impacted minority and low-

181. *Id.* at 32.

182. Neil Fligstein & Alexander Roehrkasse, *All the Incentives Were Wrong: Opportunism and the Financial Crisis* 27–31 (Feb. 2013) (unpublished manuscript), available at https://www.law.berkeley.edu/files/csls/Fligstein_Paper_CSLS_23_Sep13(1).pdf.

183. Fligstein & Goldstein, *supra* note 175, at 32.

184. Vertically integrated firms both had to continue to produce risky mortgages for mortgage-backed securities and CDOs to maintain operations and revenue. These securities were difficult to sell because the market for mortgage-backed securities and CDOs was coming to an end. *Id.* at 33.

185. Neil Fligstein, *Politics as Markets*, 61 AM. SOC. REV. 656, 665 (1996).

186. States with strong predatory lending laws have reduced the number of subprime loans. *See* WEI LI & KEITH S. ERNST, CTR. FOR RESPONSIBLE LENDING, THE BEST VALUE IN THE SUBPRIME MARKET: STATE PREDATORY LENDING REFORMS 12, 17 (2006), http://responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

187. Arielle L. Katzman, *A Round Peg for A Square Hole: The Mismatch Between Subprime Borrowers and Federal Mortgage Remedies*, 31 CARDOZO L. REV. 497, 501 (2009).

188. *See generally* Andre Douglas Pond, *Racial Coding and the Financial Market Crisis*, 2011 UTAH L. REV. 41.

income borrowers, and did not take any measures to audit loans for compliance.[189]

The "ball of money" that funded predatory loans is subject to laws prohibiting discrimination in housing finance.[190] Lenders in the financing chain had a duty to monitor the use of funds to comply with fair lending laws. Non-bank mortgage lenders secured money from Wall Street to fund their loans. Wall Street investment firms either securitized the subprime mortgages they purchased and sold the income stream to investors, or became subprime lenders by purchasing a non-bank financial institution.[191] The connections between mortgage lenders, brokers, banks, Wall Street firms, and predatory lending funding are integral to the supply of subprime credit, and, for the most part, have been left unaddressed in post-financial crisis reforms.

III.
TRANSPARENT SECURITIZATION

Although the private market for asset-backed securities slowed after the turmoil of the financial crisis, there is reason to anticipate its return.[192] The return of private-label mortgage funding will require a market stable enough to attract investments and liquid enough to provide a continuous supply of affordable financing. Since the crisis,

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189. *See* Cheryl L. Wade, *Fiduciary Duty and the Public Interest*, 91 B.U. L. REV. 1191, 1208 (2011) (explaining how Delaware fiduciary law protects even grossly negligent board members of financial firms incorporated in that state, who failed to monitor the funding and purchasing of predatory loans in violation of fair lending laws).

190. The Fair Housing Act (FHA) prohibits discrimination on the basis of race throughout all phases of the residential lending process. 42 U.S.C. §§ 3601–3631 (2006). Offering different and less favorable loan terms based on the race of the borrower, as was common in targeting minority borrowers for predatory loans, is also a violation of the FHA. *Id.* § 3605.

191. *See* GARY DYMSKI, KIRWAN INST. FOR THE STUDY OF RACE & ETHNICITY, UNDERSTANDING THE SUBPRIME CRISIS: INSTITUTIONAL EVOLUTION AND THEORETICAL VIEWS, IN THE FUTURE OF FAIR HOUSING AND CREDIT 17 (2010), http://www.kirwaninstitute.osu.edu/reports/2010/02_2010_SubprimeCrisisTheory_Dymski.pdf.

192. Diana Olick, *Private-Label Mortgage Bonds Are Rising from the Grave*, CNBC (Mar. 20, 2017), https://www.cnbc.com/2017/03/20/private-label-mortgage-bonds-are-rising-from-the-grave.html (explaining the new requirements for mortgages that fall outside the strict guidelines of government-backed securitizations). The value of subprime mortgages before the financial crisis was approximately $1.3 trillion in 2008 and almost tripled to $7.3 trillion by 2007, with securitized subprime mortgages increasing from 54% in 2001, to 75% in 2006. Between 2004 and 2006, the share of subprime mortgages relative to total originations ranged from 18% to 21%, although it was less than 10% from 2001 to 2003. *See* DEP'T OF STATISTICS, U.N.C. CHAPEL HILL, SUBPRIME MORTGAGE CRISIS 20 (2012), http://www.stat.unc.edu/faculty/cji/fys/2012/Subprime%20mortgage%20crisis.pdf

transparency in complex securities ratings has become essential.[193] The conflict of interest reflected by the issuer-pays model requires an analysis of the efficacy of securitization from the perspective of borrowers and investors.[194] Misaligned incentives of originators, warehouse lenders, issuers, and credit rating agencies in the mortgage securitization process are diametrically opposed to borrowers' and investors' expectations of sustainability.[195] If the issuer-pays model remains, credit rating agencies must conduct due diligence in order to counter-balance the conflicts-of-interests inherent in the model.

The proposals in this Article support the notion that a robust mortgage finance market is sustainable in all of its facets. Several facts support this argument: Private label funding, though in decline, will at some point, return to mortgage securitization.[196] Regulatory

193. Investors sued the three major credit rating agencies for assigning inflated evaluations to subprime residential mortgage-backed securities. With the credibility of their credit ratings challenged by the subprime crisis, S&P adopted new policies to improve transparency and accuracy. *See S&P Announces New Actions to Enhance Independence, Strengthen the Ratings Process, and Increase Transparency to Better Serve Global Markets*, CBONDS (Feb. 7, 2008), http://cbonds.com/news/item/391180. For example, S&P agreed to a $1.37 billion settlement in February 2015, and also paid $125 million to the nation's largest pension fund, the California Public Employees' Retirement System (CPERS) and $80 million in a settlement with the SEC. While these sums combined are more than ten times larger than any other ratings agency-related settlement, critics argue that they represent a mere slap on the wrist for S&P, which as part of the deal was not forced to admit to any criminal wrongdoing. James Rufus Koren, *CalPERS Settles With Moody's For $130 Million in Ratings Case*, L.A. TIMES (Mar. 9, 2016), http://www.latimes.com/business/la-fi-calpers-moodys-settlement-20160309-story.html; Rebecca Moore, *S&P Agrees to Compensate California Pension Funds*, PLANSPONSOR (Feb. 03, 2015), http://www.plansponsor.com/standard-and-poors-agrees-to-compensate-california-pension-funds; Evan Perez & Ben Rooney, *S&P To Pay $1.4 Billion To Settle U.S. Charges*, CNN (Feb. 3, 2015), http://money.cnn.com/2015/02/03/investing/sp-mortgage-settlement/index.html; *The Credit Rating Controversy*, Council on Foreign Relations (Feb. 19, 2015), https://www.cfr.org/backgrounder/credit-rating-controversy.

194. *See* Schwarcz, *supra* note 21 (discussing the conflicts of credit ratings and how they contributed to the financial crisis).

195. *See generally* Benjamin H. Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 N.C. BANKING INST. 111, 126 (2011) (identifying the issuer pays model as having inherent conflicts due to revenues from ratings and in creating financial products); Peng Liu & Lan Shi, Sponsor-Underwriter Affiliation and the Performance of Non-Agency Mortgage-Backed Securities (Aug. 2014) (unpublished manuscript), available at http://finance.business.uconn.edu/wp-content/uploads/sites/723/2014/08/Sponsor-Underwriter-Affiliation.pdf (concluding that there was a lack of screening in mortgage securitizations when there was a sponsor-underwriter affiliation).

196. Private securitizations since the financial crisis have declined dramatically indicating further evidence of the need for reform. *See* LAURIE GOODMAN, URBAN INST., THE REBIRTH OF SECURITIZATION: WHERE IS THE PRIVATE LABEL MORTGAGE MARKET? 1 (2015), http://www.urban.org/sites/default/files/publication/65901/2000375-The-Rebirth-of-Securitization.pdf (advocating for a reform and return of a nonprime

complexity, uncertainty, ambiguity, and the lack of reform in the government-sponsored secondary mortgage markets contributed to the current stall in the market.[197] Identifying and clarifying the impediments to securitization will help this market sector to regenerate profits. This Article further presumes the need for a sustainable and robust subprime securitized market. Subprime mortgages expand the housing finance market, offer attractive returns on investments, and provide non-traditional but qualified borrowers with access to credit. Requiring credit rating agencies to conduct due diligence would incorporate quality standards into the ratings process and deter abuse. This is a better approach than narrowing the availability of mortgage credit. After a brief discussion of why the Dodd-Frank reforms are limited, this Article presents a proposal for credit rating agencies to conduct due diligence and explains how such due diligence would fill the void in the credit rating agency reform. Ultimately, borrowers and investors will benefit from the increasing accountability and transparency in the ratings process.

A. *Dodd-Frank's Limited Response*

Dodd-Frank required two administrative agencies, the SEC and the newly created Consumer Financial Protection Board (CFPB),[198] to review the securitization process and protect borrowers and investors.

1. *The Qualified Residential Mortgage*

Congress recognized the difficulties that predatory subprime mortgages caused borrowers and enacted rules that required administrative agencies to define responsible lending. Dodd-Frank requires that lenders verify income and provide accurate documentation on mortgages.[199] It further directs federal regulators to define a very safe

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securitization market). Current GSE reform proposals recommend a variety of approaches, with some recommending that the secondary market have no government involvement at all. Susan Wachter & Patricia A. McCoy, *A New Coalescence in the Housing Finance Reform Debate*, 4 U. PA. WHARTON PUB. POL'Y INITIATIVE ISSUE BRIEF, June 2016, at 6 (analyzing recent GSE reform proposals recommending centralization and concentrated control of GSEs' infrastructure and credit risk).

197. Congressional action on proposed reform bills have failed to reach a consensus. For a discussion of several GSE reform proposals, see generally Eric S. Anderson, *Maintaining Capital in the Secondary Mortgage Market: Housing Finance Reform and the Liquidity Coverage Ratio*, 19 N.C. BANKING INST. 53, 55 (2015).

198. *See* Dodd-Frank at §1898.

199. *See* 12 C.F.R. § 1026 (2012) ("Regulation Z"). Section 1026.43(c) describes the requirements for making ability-to-repay determinations, including consideration of eight underwriting factors: 1) current or reasonably expected income or assets; 2) current employment status; 3) the monthly payment on the covered transaction; 4) the

"qualified residential mortgage" (QRM) that would be considered low risk for lenders and borrowers alike.[200] For mortgages that do not meet QRM standards, Dodd-Frank requires originators to retain five percent of the credit risk.[201]

QRM essentially mandates an underwriting standard. Critics of the rule argue that accurate, comprehensive, and consistent reporting of mortgage attributes largely obviates the need for a QRM standard.[202] They assert that investors already receive sufficient information from loan disclosures, FICO scores, loan-to-value ratios, and debt-to-income ratios, with the QRM requirements dis-incentivizing investors from scrutinizing transactions.[203] Finally, such critics argue it may be fallacious to equate QRMs with investment-grade securities.[204]

2. *Risk Retention*

The risk retention rule faces similar criticism. For mortgages that do not meet the QRM standards, Dodd-Frank requires originators to retain five percent of the credit risk.[205] The risk retention rule is a regulatory response to the moral hazard problem, the rationale being that, if issuers retain credit risk, they will have greater incentive to monitor loans and create better-quality mortgages, thus protecting in-

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monthly payment on any simultaneous loan; 5) the monthly payment for mortgage-related obligations; 6) current debt obligations, alimony, and child support; 7) the monthly debt-to-income ratio or residual income; and 8) credit history. Creditors must generally use reasonably reliable third-party records to verify the information they use to evaluate the factors. *Id*.

200. *See id.*; 12 C.F.R. § 244 (2014) ("Regulation RR").

201. Dodd-Frank at § 1898.

202. A market is developing for non-qualified mortgage products. *See* Stephen Ornstein, *Subprime Makes a Comeback, Despite Dodd-Frank's Impediments*, NAT'L MORTG. NEWS (Sept. 23, 2015), http://www.nationalmortgagenews.com/news/voices/subprime-makes-a-comeback-despite-dodd-franks-impediments-1066512-1.html.

203. *See* Thomas J. White, *The 20% Solution: Risk Retention Will Help Reprivatize Mortgages*, AM. BANKER (July 5, 2011), https://www.americanbanker.com/opinion/the-20-solution-risk-retention-will-help-reprivatize-mortgages (positing that down payments are best risk retention rules because investors trust neither home buyers nor investors).

204. *See* Jeff Brown, *Why Investors Own Private Mortgage-Backed Securities*, U.S. NEWS & WORLD REPORT (July 18, 2016), http://money.usnews.com/investing/articles/2016-07-18/why-investors-own-private-mortgage-backed-securities.

205. There is a burgeoning market for nonprime residential market. *See* DIMITRIS KARAPIPERIS, NAT'L ASSOC. OF INS. COMM'RS & THE CTR. FOR INS. POL'Y RESEARCH, FINANCING HOME OWNERSHIP: ORIGINS AND EVOLUTION OF MORTGAGE SECURITIZATION PUBLIC POLICY, FINANCIAL INNOVATIONS AND CRISES 45 (2012), http://www.naic.org/documents/cipr_120812_white_paper_financing_home_ownership.pdf.

vestors. Contrary to popular opinion, mortgage intermediaries retained a lot of "skin in the game."[206]

The risk retention rule is problematic for at least two reasons: First, the rule could expose banks to more losses. As mentioned above, banks held securitized mortgage loans on their books. When institutions failed, those loans had implicit recourse, which means that deposit insurance funds absorbed some of the losses.[207] Second, the policy presumes that investors who purchase mortgage-backed securities are naïve and have not effectively negotiated for protection.[208] The private investment market is replete with contractual arrangements that protect sophisticated and unsophisticated investors. Standard contractual arrangements in purchase contracts bind issuers to certain criteria and allow investors to opt out of the contracts under some conditions.[209] Monitoring and enforcing these agreements is better than exposing the insurance fund to liability.

3. *SEC Rule 15Ga-2*

The SEC responded to transparency concerns surrounding mortgage-backed securities in its recently released Rule 15Ga-2.[210] The

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206. *See* Acharya et al., *supra* note 174, at 3–4, 16–31.

207. *See* Bubb & Krishnamurthy, *supra* note 90, at 1542–47 (positing that a regulatory risk retention requirement is not useful for financial institutions because it implicitly relies on the naïve-investors theory and does not address the origination risks that occurred during a housing bubble).

208. Cheryl D. Block, *A Continuum Approach To Systemic Risk And Too-Big-To-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 289, 315 (2012) (arguing that prudential regulation should be applied to systemically important institutions to avoid a government bailout).

209. Investment contracts provide investors with an opportunity to opt out of a deal if certain conditions and obligations, such as representations and warranties, are not met. Seth Chertok, *The Rise of the Dodd-Frank Act: How Dodd-Frank Will Likely Impact Private Equity Real Estate*, 16 U. PA. J. BUS. L. 97, 141 (2013) (discussing investment contracts in the context of subprime mortgages).

210. Rule 15Ga-2 took effect on June 15, 2016. It implements Section 15E(s)(4)3 of the Exchange Act, which was added by Section 932(a)(8) of Dodd-Frank, 15 U.S.C. 780-7(s)(4). This Section regulates disclosure of third-party due diligence services employed in connection with the issuance of asset-backed securities. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes Rules to Increase Transparency and Improve Integrity of Credit Ratings (May 18, 2011), http://www.sec.gov/news/press/2011/2011-113.htm. The new regulations supplement the former regulations in several respects:

> (i) require NRSRO reports on internal controls over the ratings process, restrict sales and marketing activities from influencing the production of ratings, and require reports to the SEC and "look-back" when an entity subject to a rating employs a person who previously worked for the NRSRO; (ii) require greater disclosure of data on rating performance; (iii) require procedures when a rating firm adopts or revises rating procedures

Rule mandates the release of any information about the credit quality of mortgage loans that NRSROs have received.[211] Specifically, the findings and conclusions in any third-party firms' due diligence reports on loan quality must be available to investors.[212] NRSROs must attach to each credit rating publication a form containing certain qualitative and quantitative information about that credit rating.[213] The disclosure requirement applies to any certifications of third-party due diligence services with respect to mortgage-backed securities.[214] The underlying rationale is that investors will have direct access to the full range of information that goes into the ratings.[215]

Informed investors will revive the secondary mortgage market when they are confident that information about the securities is thorough, clear, reliable, and readily available. Dodd-Frank reforms bring awareness to banking and securities regulatory issues that overlap, but these reforms stop short of regulating the market in a consistent way.[216] The proposal discussed below emphasizes the need for sys-

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> and methodologies, and disclosure of certain information to accompany the publication of a rating; (iv) require third-parties retained for due diligence related to asset-backed securities to provide a certification containing specified information to the NRSRO that is producing a rating for the security; (v) establishing training, experience and competence standards and a testing program for NRSRO analysts; and (vi) require internal policies to assure consistent use of rating symbols.

17 C.F.R. 240.15Ga-2 (2014).

211. *See* 17 C.F.R. §§ 232, 240, 249 & 249b (2014).

212. *Id.* § 232.

213. *Id.*

214. Under the new amendments, "rating action" includes preliminary credit ratings, initial credit ratings, upgrades and downgrades of credit ratings, and affirmations and withdrawals of credit ratings if they are the result of a review using the NRSRO's procedures and methodologies for determining credit ratings. Rule 17g-10 dictates the specifics of the third-party certification Section 15E(s)(4)(B)(10) of the Exchange Act, 15 U.S.C. 78o-7(s)(4)(B). It requires third-party due diligence services providers to deliver the required written certification required on a Form ABS Due Diligence-15E signed by an individual duly authorized to make such certification on behalf of the third-party due diligence provider. *Id.*

215. The Rule 15Ga-2 summary report includes: 1) credit reviews that assess the extent to which the loans in the transaction conform to the originator's lending guidelines; 2) property valuation reviews that assess whether information in the loans' files reasonably support the loans' appraised values; 3) compliance reviews that assess whether the loans were originated in accordance with federal, state and local laws; and 4) data integrity reviews that assess whether the data provided by the issuer is the same as the information in the loan files. 17 C.F.R. 240.15Ga-2.

216. *See* Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 Hofstra L. Rev. 25, 28–29 n.17 (2014) (advocating for dynamic financial regulation given changes in the market); *see also* Foote, *supra* note 13.

tematic oversight of housing finance by monitoring secondary markets' compliance with federal consumer protection laws.

B. The Duty of Due Diligence

The credit ratings agencies' interaction with the loosely-regulated securitization framework facilitated a market failure that will happen again unless steps are taken to stabilize the securitization process. While the SEC must confer the NRSRO status, prior to the financial crisis, the SEC exercised little ongoing regulatory review of the evaluative functions of credit rating agencies.[217] Consequently, these rating agencies were essentially self-regulating.

Dodd-Frank requires the SEC to prescribe the format for certification that third-party due diligence servicers must provide to each NRSRO, which produces a credit rating for an asset-backed security.[218] It also establishes a new requirement that issuers and underwriters of asset-backed securities make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.[219] These reforms provide necessary oversight, but do not go far enough to ensure substantively accurate credit ratings for investor confidence and market protection.

As an administrative agency, the SEC receives deference in determining the method used in, and compensation of, the ratings process. Yet the agency is also charged with designing and overseeing a system that is consistent with the purpose of the ratings function.[220] The SEC's primary responsibility regarding the ratings process is to ensure that information is accurately disseminated to market participants. In that regard, the SEC is responsible for confirming that the ratings model is accessible, usable, and clear, and that issuers are able

217. Dodd-Frank required the SEC to establish an Office of Credit Ratings and complete annual examinations of each NRSRO. Once established, this office will be responsible for administering the rules of SEC in certain areas, promoting accuracy in credit ratings, and conducting annual examinations of each NRSRO. 15 U.S.C. § 78o-7(p)(3).

218. *See* Dodd-Frank § 932(a)(8) (codified at 15 U.S.C. § 78o-7(s)(4)(C)) (adding new paragraph (s)(4)(C) to section 15E of the Exchange Act).

219. *See* Dodd-Frank § 932(a)(8) (codified at 15 U.S.C. § 78o-7(s)(4)(A)).

220. Under the *Chevron* doctrine, a court must grant deference to executive agencies, including the SEC, in interpreting a statute it administers. Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984). Section 939F of Dodd-Frank requires the SEC to study the rating process for structured finance products and associated conflicts of interest, the feasibility of an assignment system, metrics to determine the accuracy of ratings, and alternative means for compensating NRSROs. *See* Dodd-Frank §§ 931–939H.

to determine the applicable fees and compensation.[221] Moreover, the SEC should oversee the rating models to ensure that they work as intended.[222] Specifically, as discussed below, the SEC should assess whether the ratings model enables credit rating agencies to conduct independent internal control.

The SEC is well aware that credit rating agencies do not engage in due diligence.[223] Prior to the financial crisis, due diligence was a part of the underwriting process, before originators sold loans, not a part of the ratings process.[224] Due diligence should be mandatory now for at least two reasons: First, voluntary due diligence as an established industry practice ended as soon as underwriters, who wanted evade the negative opinions of third-parties, no longer considered it feasible. Credit rating agencies were fully aware of this decline in creditworthiness standards.[225] Second, rating agencies have a slim profit margin in providing ratings for mortgage-backed securities. Mandatory due diligence will allow rating agencies to increase their fees across the board to cover the costs of the additional neutral examinations.[226] Overall, mandatory due diligence will achieve several public policy goals, including by increasing transparency in the securitization process and assuring the credibility of information used in rating models.

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221. *See generally* John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and A Proposal for Improvement*, 2009 Colum. Bus. L. Rev. 109, 148–53.

222. Steven L. Schwarcz, *Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs*, 26 Yale J. on Reg. 457, 468 (2009) (suggesting rules that regulations addressing compensation, conflicts of interest and accuracy of ratings signals will address CRAs' weaknesses).

223. *See, e.g.*, 2003 SEC Report, *supra* note 138, at 35.

224. An "underwriter" describes "the person that performs due diligence—or, in the case of continuous due diligence, to describe the person who fails to perform such due diligence." Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After* Worldcom, 30 Cardozo L. Rev. 2001, 2041–42 (2009). Underwriters face strict liability for material misstatements or omissions in the registration statement. *Id.*

225. *See* Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 Wash. U. L.Q. 329, 342–43 (2003) (discussing the complicit willfulness against issuing downgrades and the decline in creditworthiness among the rating agencies).

226. One commentator argues that imposing liability upon credit rating agencies for negligence might increase the accuracy of their ratings. *See* Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability*, 75 Cornell L. Rev. 411, 431 (1990) (positing that credit rating agencies are the "least-cost avoider," have the "optimum level of care," and are best at "risk-spreading").

Transparency in ratings can ameliorate information asymmetry in the securitization process. While the critiques of the issuer-pays model run the gamut, standardization allows investors to learn and understand when to question ratings assessment results.[227] The industry-wide disclosure standards recently adopted by the SEC make it easier for investors to understand credit ratings.[228] Previous SEC credit ratings rules have presumed that investors are sophisticated institutions. However, unsophisticated individual investors regularly avail themselves of mutual funds and pensions funds.[229] These investors need certifications of investment-grade ratings to feel confident enough to participate in the market.

Credit rating agencies must independently verify and assess an offering's compliance with fair lending and consumer protection laws. As discussed above, banks used a business model to locate the riskiest loans in neighborhoods that were traditionally denied credit, many of which were discriminatory. The credit ratings indicated that these loans were investment grade because no independent verification uncovered the fact that these loans violated fair lending laws. While credit rating agencies might not be able to detect the disparate impact of discriminatory lending on homeowners, they might be able to detect a *pattern* of lending that is discriminatory and deleterious to borrowers and investors.

Achieving this level of borrower and investor protection requires an expansion of the regulatory landscape beyond the SEC's current reforms. Rating agencies' effective supervision of issuers and enforcement of the "government-sponsored entity" (GSE) rules would ensure that prime and subprime markets achieve the goals of mortgage securitization, including liquidity, financial stability, and affordable financing. The GSE representation and warranty framework prohibits

227. Hill, *supra* note 41, at 60–62 (presenting three solutions for future enforcement: creating incentives against herding behavior by investors; functioning as a gatekeeper; and imposing individual liability on top managers).

228. The Dodd-Frank Act amended the Exchange Act to provide that the SEC shall require NRSROs to publicly disclose information about their initial credit ratings and subsequent changes to the credit ratings to allow users of credit ratings to evaluate the accuracy and compare the performance of credit ratings across NRSROs. Public disclosure is also required of NRSRO Credit Rating Histories, NRSRO Credit Rating Methodologies, and certain qualitative and quantitative information about the credit rating and certifications from providers of third-party due diligence services with respect to asset backed securities. *See* 17 C.F.R. §§ 232, 240, 249 & 249b (2014).

229. Assets managed by mutual funds between 1990 and 2006 increased 14.35% annually. Pension funds increased from $5,086.3 billion in 1994 to $14,027.6 billion in 2007. *See* Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in The New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 348–49 (2008).

purchase of loans that fail to comply with federal and state regulations. An issuer's non-compliance with lending laws triggers the GSE's requirement for the original lender to repurchase the noncompliant loans;[230] a repurchase would affect the investors' expected income from the loan pool as well. Credit rating agencies should confirm whether the loans offered in the loan pool comply with federal and state laws before issuing ratings, as this practice can prevent originators from passing economic risks onto issuers and investors.

It is crucial to certify that the information going into ratings models is credible. Currently, rating agencies are not required to substantiate the information given to them by issuers. Not only does this mean that the credit agency is not exercising independent judgment and is relying solely on the issuer, but it also means that the issued rating could be flawed. Substantive review of the content of the information used in rating models is imperative to an accurate, efficient assessment of the securities.[231]

Legal protection of the ratings is another reason to require credit agency due diligence. Courts have willingly protected the opinions of rating agencies as financial publishers under the First Amendment.[232] Traditionally, challenges to substantive content of a rating were protected under the First Amendment due to the manner in which rating agency opinions are formed and the public context of the information. Specifically, courts would look at four factors: whether rating agencies (1) rate debt that they are not paid to rate; (2) distribute the ratings through their publications; (3) have independence in gathering and evaluating information used for the rating; and (4) fulfill the general public function of providing information to the financial market.[233] This judicial buffer for credit ratings and the agencies that provide them presumes both a substantive and deliberative process that has a public benefit. The independence and public function elements of the ratings protection test strengthen market confidence and ensure rating agencies act as gatekeepers.[234] Dodd-Frank limits rating agency liabil-

230. *See* Press Release, Fed. Hous. Fin. Agency, FHFA, Fannie Mae and Freddie Mac Launch New Representation and Warranty Framework, Increased Transparency and Certainty for Lenders (Sept. 11, 2012), http://www.fhfa.gov/webfiles/24366/Reps%20and%20Warrants%20Release%20and%20FAQ%20091112.pdf.

231. Mads Andenas & Iris H-Y Chiu, The Foundations and Future of Financial Regulation: Governance for Responsibility 212–213 (1st ed. Routledge 2013).

232. *See* Jones, *supra* note 47, at 209–220.

233. In re Pan Am Corp., 161 B.R. 577, 583–84 (S.D.N.Y. 1993).

234. In *Jefferson County School District No. R-1 v. Moody's Investor's Services, Inc.*, 175 F.3d 848, 856 (10th Cir. 1999), the Tenth Circuit Court of Appeals refused

ity to negligence.[235] However, a court may not protect a rating agency from liability if the agency lacks independence or cooperates with issuers to structure the debt.[236] In order to receive protection for ratings failures, the ratings agencies should have a neutral, objective rating process and make ratings available to a significant number of investors.[237] Mandatory independent due diligence under the issuer-pays model can make rating reports unbiased and protect rating agencies from liability.

Finally, the need for due diligence is also justified by past credit rating failings. Both the SEC and supporters of the issuer-pays model contend that the reputational capital helps rating agencies resist pressures from originators and issuers to provide unwarranted positive ratings. The SEC's position that the "very sophisticated rating models" were accurate predictors of risk and payment is now widely disputed.[238] This view that reputational capital was a check on the ratings process depends on how widely information about a firm is disseminated;[239] it was also inconsistent with the reality that credit ratings functioned poorly and harmed investors and the public at large.[240] As argued below, third-party due diligence is in the public interest.

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to classify the ratings as protected First Amendment speech because the distribution of the information was limited to subscribers.

235. Section 933 extends liability for private securities fraud actions under Section 15E of the Exchange Act to NRSROs. The plaintiff must plead with particularity that the defendant NRSRO knowingly or recklessly failed to conduct a reasonable investigation or obtain reasonable verification of the factual elements used in reaching its conclusions about credit risk. *See* Dodd-Frank §§ 932(a), 933(a), 934, 935 (2010).

236. *In re* Fitch, 330 F.3d 104, 110 (2d Cir. 2003); *In re* Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008); *In re* Enron Corp. Sec., Deriv. & "ERISA" Litig., 511 F. Supp. 2d 742, 820 (S.D. Tex. 2005), *aff'd*, 446 F.3d 585 (5th Cir. 2006).

237. As one court said, there "is no automatic, blanket, absolute First Amendment protection for reports." *In re Enron Corp.*, 511 F. Supp. 2d at 817.

238. *Cf*. David J. Reiss, *Ratings Failure: The Need for a Consumer Protection Agenda in Rating Agency Regulation*, BANKING & FIN. SERVICES POL'Y REP., NOV. 2009, at 12, 16 (proposing that credit rating agencies use licensing process similar to broadcast license renewals which invites public comment on the services provided).

239. *See* Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1613–15 (2010) (arguing that protecting reputational capital may not be an objective shared by individual workers).

240. *See* Jeffrey Manns, *Downgrading Rating Agency Reform*, 81 GEO. WASH. L. REV. 749, 812 (2013) (cataloguing the "numerous empirical studies documented the failures of rating agencies); *see, e.g.*, Adam Ashcraft et al., *MBS Ratings and the Mortgage Credit Boom* 23–24 tbl.3 (Fed. Reserve Bank of N.Y., Staff Report No. 449, 2010) (documenting a pattern of stability in high ratings in spite of declines in diligence of and asset quality in mortgage-backed securities from 2001 to 2008); Efraim Benmelech & Jennifer Dlugosz, *The Alchemy of CDO Credit Ratings*, 56 J. MONETARY ECON. 617, 624–28, 632–33 (2009) (criticizing the lax process for credit rating of CDOs and the conflicts of interest created by the hiring of rating agencies by

C. Independent Credit Ratings and the Public Good

Congress is well aware of the public regulatory function that credit rating agencies perform in financial markets.[241] However, these agencies are not held accountable for whether or not they serve the public.[242] Maintaining the issuer-pays model requires further changes to the practices of credit rating agencies.

It is not certain whether the proposed changes to the credit ratings process will benefit borrowers whose communities were forever changed by predatory lending. Investors should have information about the profitability of the securities, while borrowers should receive a loan with fair terms. Admittedly, borrowers whose homes collateralize mortgage securities are not the intended third-party

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issuers); Allen Ferrell et al., *Legal and Economic Issues in Litigation Arising from the 2007–2008 Credit Crisis*, *in* PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN 163–235 (Yasuyuki Fuchita et al. eds., 2009) (documenting the stability of ratings in spite of marked decline in the extent of diligence into and quality of the underlying mortgages in mortgage-backed securities from 2001 to 2006).

241. *See* the Credit Rating Agency Reform Act, Pub. L. No. 109–291, 120 Stat. 1327 (2006). The statute gave the SEC the power to regulate NRSRO internal processes regarding record-keeping and how they guard against conflicts of interest, and specifically makes the NRSRO determination subject to a Commission vote. The law specifically prohibits the SEC from regulating an NRSRO's rating methodologies. The Commission does however, have the authority to implement a registration and oversight program for NRSROs and to require recordkeeping, reporting, and examination authority over NRSROs. Credit rating agencies are a "convenient surrogate." As stated by one SEC Commissioner:

> During the past thirty years, regulators such as the Commission have increasingly used credit ratings as a convenient surrogate for the measurement of risk in assessing investments held by regulated entities. Specifically, since 1975, the Commission has referenced the ratings of specified rating agencies in certain of its regulations under the federal securities laws. These rating agencies are often referred to as "Nationally Recognized Statistical Rating Organizations" or "NRSROs."

The Role of Credit Rating Agencies in the U.S. Securities Markets: Hearings Before the S. Comm. on Governmental Affairs, 2002 WL 444385 (S.E.C.) (2002) (statement of Isaac C. Hunt, Jr., Comm'r, U.S. Securities & Exchange Commission) [hereinafter 2002 Hearings].

242. For example, although credit rating agencies did not did not consider Enron a credit risk until four days before its bankruptcy, they were not found responsible because the ratings are considered opinions rather than expert advice. *See, e.g.*, *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 511 F. Supp. 2d 742 (S.D. Tex. 2005) (holding that credit rating agencies are entitled to First Amendment protections against lender's claims regarding negligent misrepresentation of debtor's creditworthiness); *see also* Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises*?, 64 SMU L. REV. 1243, 1307 (2011) (criticizing Dodd-Frank's provisions that rating agencies have a "gatekeeper" role in the debt market equivalent to that of securities brokers).

beneficiaries of credit ratings and offerings disclosures. However, credit ratings are designed to encourage a strong market, which can maintain its operation only when all market participants, including borrowers, are equipped with appropriate safeguards.[243]

Moreover, the evidence of opportunistic securitization discussed above presents a strong challenge to a laissez-fare theory of credit rating agency regulation. The argument based on that theory suggests that opportunistic behavior was an aberration in financial markets; and that the market possessed the requisite information and expertise to recognize and reject issuer and originator misconduct. The theory concludes that originators and issuers already had "incentives to maintain transparency and protect their reputations."[244] The existence of rules prohibiting discriminatory lending undercuts this argument. This particular instance reflects the need for strong enforcement of those laws. The availability of credit became almost unlimited in neighborhoods that had previously been redlined; minority borrowers overwhelmingly received loans with relatively worse terms, such as subprime loans when they in fact qualified for prime loans.[245] Foreclosure disproportionately affected minority homeowners and neighborhoods.[246] These facts make for a strong argument that discrimination in lending continues to be a significant concern. Furthermore, vigilant monitoring in all stages of the lending process, including sale in secondary markets, is required.

Finally, two separate but converging functions of credit reporting agencies—the gatekeeping function and the public service function—support the notion that rating agencies should conduct due diligence. The SEC has delegated to NRSROs the function of assessing the viability of securities offerings, and has given them a "quasi-public responsibility."[247] If rating agencies did not perform this function, the

243. While credit ratings do not protect individual investors, optimally they encourage investment and in that way serve a consumer protection function. Macey, *supra* note 133. Although the rating agencies have a "quasi-public responsibilities," the ratings do not "represent a 'seal of approval' of a federal regulatory agency." *See 2002 Hearings*, *supra* note 241, at 2, 5 (statement of Isaac C. Hunt, Jr., Comm'r, U.S. Securities & Exchange Commission).

244. Fligstein, *supra* note 179, at 4.

245. Charles L. Nier, III & Maureen R. St. Cyr, *A Racial Financial Crisis: Rethinking the Theory of Reverse Redlining to Combat Predatory Lending Under the Fair Housing Act*, 83 Temp. L. Rev. 941, 942 (2011) (describing the subprime crisis as "reverse redlining").

246. John P. Relman, *Foreclosures, Integration, and the Future of the Fair Housing Act*, 41 Ind. L. Rev. 629, 631 (2008) (describing minority neighborhoods affected by foreclosure crisis as hyper-segregated).

247. *Id.*

SEC would perform such a function in order to maintain investor confidence and support the market. The SEC currently requires rating agencies to disclose any due diligence performed by a third-party.[248] Yet, in 2002, the SEC disagreed with rating agencies on their independent review of information supplied by issuers.[249] The SEC then recommended that the rating agencies "explore whether NRSROs should incorporate general standards of diligence in performing their ratings analysis."[250]

The increasing complexity of financial products requires that the market be protected from opinions based on limited and biased information. In reaction to this, the SEC has delegated a public duty to protect market participants, including investors and borrowers.

Conclusion

The financial crisis compelled a close-examination of the established credit rating system. Credit rating agencies are critical to the efficient operation of banking and finance markets. Both investors and the market benefit from the meaningful quantitative analysis provided by rating agencies.

This Article argued that, because credit rating agencies perform a quasi-public regulatory function, they should protect investors. Credit ratings have the broad purpose of protecting the market by serving as a check on the originating lenders' screening and monitoring of borrowers. In the secondary mortgage market, where borrowers heavily depend on securitization, borrowers indirectly rely on the accuracy and credibility of credit ratings.

This Article argued that Dodd-Frank's credit rating agency reforms are flawed because they fail to address the conflict of interest in the issuer-pays model. It discussed how Dodd-Frank's reforms—the ability to pay, risk retention, qualified mortgage, and credit rating agency disclosure rules—do not address flawed ratings based on issu-

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248. *See* Final Rule, Nationally Recognized Statistical Rating Organizations Securities and Exchange Commission, 17 CFR §§ 232, 240, 249, and 249b Release No. 34-72936, 327 (10/14/2014).

249. The Report noted:

> The rating agencies tend to have a more limited view of their role in verifying information reviewed in the credit rating process. In general, the rating agencies state that they rely on issuers and other sources to provide them with accurate and complete information. They typically do not audit the accuracy or integrity of issuer information.

U.S. Sec. & Exch. Comm'n, 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 26 (2003).

250. *Id.*

ers' data. Leaving the issuer-pays model in place may work well for the most sophisticated investors, but it does little to provide the protections that the rest of the market, such as investors and borrowers, needs. The Article explained that the rising prices during the housing bubble heightened the informational asymmetry in mortgage securitization. Credit rating agencies have an obligation to provide an objective, neutral, and independent assessment of securities' projected performance. The models used to project the performance data are meaningless if they are simply an aggregate of information provided by the most conflicted parties—the originating lender and the issuer.

Borrowers and investors' common interest in sustainable mortgage financing under the present model is overlooked. The structural flaws and inherent conflict of interest in the issuer-pays model allowed some participants in the subprime securitization process to maximize their profits. Furthermore, without the safeguards that credit rating agencies could have provided, securitization, which provides numerous advantages and works efficiently in many other market sectors, became a tool for abusive and discriminatory lending.

The SEC's recent reform—mandating the disclosure of third-party reports given to the credit rating agency—is important, but does nothing more than make information accessible available. It does not eliminate the dangers that the issuer-pays model poses and merely shows how the regulations emerging from the reforms are biased toward the credit rating agencies. This article proposed an alternative approach—credit rating agency due diligence—that aims for unbiased ratings. This reform would produce balanced and disinterested credit ratings, increasing transparency in the rating process. Such a reform would create a more informed market, better protect investors and serve the public interest in having secure, affordable housing financing.