For much of the twentieth century, the mortgage market mainly consisted of banks and savings and loan associations that would originate, fund, own, and service mortgages. Banks competed by offering fixed-rate mortgages at rates as low as possible, considering the borrower’s risk. If the bank wrote mortgage loans to customers who could not afford to repay, the bank suffered losses. If the bank deceived the homeowner, the homeowner would complain to the bank and defend any foreclosure action based upon the bank’s deception. Mortgage products were far simpler than those offered in recent years and consumers were better able to shop based on the rate offered.

But more recently, particularly during the period from 1994 to 2007, incentives that can work at cross purposes became common in the mortgage market. And the market grew to be structured in ways that minimized self-policing. As a result, unregulated market forces easily led to the problems seen during the recent crisis. Incentives in the modern origination process encouraged lenders to make bad loans and to behave badly. Brokers were paid irrespective of a mortgage loan’s risk and were paid more to sell loans with higher interest rates. Originators and other intermediaries made money on volume, irrespective of risk, and passed the risk on to others. The entities who foreclosed were far removed from those involved in any misconduct during origination and claim immunity from such misconduct.

One of the new features of the modern mortgage market was an explosion in the use of mortgage brokers, whose numbers increased from 7000 in 1987 to well over 50,000 in 2004.238 Brokered loans were, on average, more costly than non-brokered loans.239 Brokers were able to overcharge borrowers, and disproportionately borrowers of color, because of discretionary pricing.

In an unregulated market, the broker could choose how much he would get paid by the creditor as a function of what interest rate was charged on the loan and other loan terms. The resulting payment was called a “yield spread premium.” While brokers typically collected up-front fees from the homeowner and financed them as part of the loan principal, their bread and butter was to rack up hugely profitable yield spread premiums on top of the up-front fees.

As the name suggests, yield spread premiums were “premiums,” or commissions, paid by the lender to the broker based on the “yield spread” of a given loan. The yield is the interest paid to the lender. The spread was defined as the difference between the “par rate” and the (higher) rate arranged by the broker. The par rate is the interest rate the borrower qualifies for under the lender’s guidelines (considering such items as credit score, debt-to-income ratio, loan-to-value ratio, and so on). The greater the spread between the par rate and the actual loan rate, the higher the commission paid to the broker.

In an unregulated market, the broker was allowed (and, indeed, encouraged) by the lender to close the loan at a higher interest rate than the minimum rate offered by the lender to a homeowner with a given risk profile, thus generating more interest for the lender. In return for brokering a higher-rate loan, the lender paid the broker a commission that was typically set at one or two percent of the principal loan amount. This process was invisible to the borrower, who paid more for the loan in order to support these higher payments to brokers.240

In fact, because the broker controlled the homeowner’s mortgage business, mortgage lenders would compete with each other for the broker’s business by offering the broker as high a commission as possible. Higher commissions require higher prices for the mortgage product, so that the use of brokers created reverse competition. In other words, when there are more lenders seeking out the broker’s business, the result is higher mortgage rates.241

Another feature of the 1994–2007 mortgage market was the secondary market and use of securitization. In 1994, approximately $11.5 billion worth of subprime home equity loans were securitized in the private market.242 By the end of 2005, the volume of securitized subprime loans had leaped to about $507 billion.243 This flooded the mortgage industry with capital and enabled companies specializing in home equity lending to operate much more profitably.244

Through the securitization process, loan originators (and their partners on Wall Street) bundled mortgage loans into large portfolios, transferred them to a trust, and then sold fractional interests in the trust’s assets to investors.245 But, regardless of whether the loan was sold whole or securitized, the end result was that the ultimate mortgage holder was typically no longer the bank or mortgage company that originated the loan. This “back-end” income stream meant lenders could operate with little of their own money. They could obtain a line of credit from a major bank, originate predatory loans (collecting high, up-front fees), and then dump the loans onto the secondary market.

Originators had little reason to care how their loans would perform once sold into the secondary market because the originator would be paid quickly, soon after selling the loan.246 While contracts with secondary-market partners often required lenders to repurchase loans that fail within a short time after sale, such requirements provided borrowers and investors no significant...
protection from predatory lending. Instead, these repurchase agreements may have even contributed to the use of so-called “teaser rates”—interest rates that were artificially low at the outset—and thereby delayed the risk of default—but which then increased rapidly after a fixed period of time (often two years).

In fact, loan products were designed more for secondary market buyers than for the benefit of the homeowners receiving the loans. The secondary market’s appetite for loans that would generate high returns for investors made loans with some characteristics easier to securitize than others. High returns for investors often came at the cost of greater risk for borrowers on the other end of the transaction. The loans most desired by the securitization market proved substantially more likely to default than those with more conventional terms.

Footnotes


Prime, subprime, and Alt-A mortgage loans are defined in § 2.4 [2], infra.

244 [244] See § 1.2.3 [3], supra (describing the origins of the modern secondary market).

245 [245] See § 1.5 [4], infra (describing securitization in more detail).

247 [247] See § 2.6.6 [5], infra (discussing nontraditional mortgage loans).