

TAKING THE CREDIT SUBORDINATION MIX OUT OF REMICS: A  
PROPOSAL FOR LIFTING THE FOG FROM HIGH-RISK MBSS

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**I. Introduction**

In late 2006, the first tremors of a catastrophic financial crisis were felt in the U.S. subprime mortgage market.<sup>1</sup> These tremors would soon shake the entire U.S. economy. As the first decade of the twenty-first century came to a close, a laundry list of disturbing economic indicators still faced the United States: unemployment around 10%;<sup>2</sup> home values down 40 % from their 2006 high;<sup>3</sup> one-third of home mortgages underwater;<sup>4</sup> and a stock market that only managed to break even over the previous ten years.<sup>5</sup> These statistics are symptoms of the financial crisis. The causes of the financial crisis are more complicated and require a variety of responses. That said, the mortgage meltdown is perhaps the greatest—or at least the originating—cause of the crisis, and, as such, this note proposes a policy response aimed directly at the mortgage market.<sup>6</sup>

As a preliminary matter, one must understand the basic players in the mortgage meltdown. The mortgage meltdown has been closely associated with subprime mortgages, but limiting its scope to subprime oversimplifies the situation because Alt-A mortgages also

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<sup>1</sup> See CONG. OVERSIGHT PANEL, 111TH CONG., DECEMBER OVERSIGHT REPORT 8–12 (2009).

<sup>2</sup> *Id.* at 65.

<sup>3</sup> Editorial, *This Year's Housing Crisis*, N.Y. TIMES, Jan. 5, 2010, at A20.

<sup>4</sup> *Id.* (declaring that “an estimated one-third of homeowners with a mortgage – nearly 16 million people – owe more than their homes are worth”).

<sup>5</sup> See Christopher Swann et al., *Time to Revive Stock Dividends*, N.Y. TIMES, Dec. 31, 2009, at B2 (“For the first time in modern stock market history, investors in United States equities are likely to finish a decade empty-handed.”).

<sup>6</sup> See *infra* Part IV.A.

figured prominently in these events.<sup>7</sup> Once this is understood, a more broadly conceptualized culprit can be identified: mortgages with a high risk relative to the conventional prime mortgage.

Yet this is only half of the story. These high-risk mortgages did not spread throughout the economy by sitting on the books of their originators; they were securitized, often many times over.<sup>8</sup> The particular securitization schemes applied to subprime and Alt-A mortgages took the risk inherent in these instruments and obfuscated it to the point where even sophisticated market participants did not understand the characteristics of the resulting mortgage-backed securities (MBSs).<sup>9</sup> It was these risk-camouflaging securitization schemes that—when combined with already-high-risk subprime and Alt-A mortgages—provided the proverbial straw that broke the back of mortgage finance. These securities can be understood as “cloaked high-risk MBSs.”<sup>10</sup>

This note proposes that legislators should use the Internal Revenue Code to strongly incentivize mortgage financiers to refrain from creating cloaked high-risk MBSs. More specifically, legislators should remove the structural backbone of the securitization scheme used for producing cloaked high-risk MBSs: credit subordination (i.e., the allocation of credit risk along a hierarchy of MBS tranches).<sup>11</sup> This can be easily accomplished by forbidding credit subordination within high-risk mortgage securitizations that elect Real Estate Mortgage Investment Conduit (REMIC) tax treatment, which (as will be discussed) is necessarily elected in virtually all securitizations of subprime or Alt-A mortgages.

Part II of this note provides context essential for understanding and critiquing the financial alchemy that came to pervade high-risk mortgage finance and that precipitated the mortgage meltdown. Part III explains the basics of the REMIC tax vehicle and explains how REMICs can be used as the mechanism for preventing credit subordination within high-risk MBSs. Part IV draws on the subprime meltdown to showcase the problems with cloaked high-risk

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<sup>7</sup> See *infra* note 38 and accompanying text.

<sup>8</sup> See *infra* Part IV.B.

<sup>9</sup> See *infra* Part IV.C.

<sup>10</sup> The term “cloaked high-risk MBSs” is meant to be a descriptive expression that illustrates this author’s contention that the relatively high-risk inherent in subprime and Alt-A mortgages was “cloaked” through particular securitizations schemes.

<sup>11</sup> See *infra* Part IV.C.

MBSs and the credit subordination feature that provides for their structure. Finally, Part V recommends that Congress amend the REMIC tax rules to effectively exclude credit subordination from the tool belt of high-risk mortgage finance.

This note focuses on many fine points of mortgage securitization because its recommendation is unavoidably entangled in the intricacies of the complex world of high-risk mortgage finance. However, one should remember not to mistake the forest for the trees. Subprime and Alt-A mortgages, securitization schemes, and REMICs are not the crux of this note but merely the cast of characters necessary to support a broader proposition. High-risk mortgage finance needs to be realigned to a simple precept: mortgage finance has utility as a means to an end, not as an end in itself. If innovation within mortgage finance does not serve its ends, then it is no real innovation at all.

From a utilitarian perspective, mortgage finance serves two related functions.<sup>12</sup> The “mortgage” facet of mortgage finance signifies promoting homeownership through expansion of housing credit.<sup>13</sup> The “finance” facet of mortgage finance refers to providing a mechanism for financial intermediation—shifting capital from savers to users.<sup>14</sup> To be consistent with these ends, a particular mortgage finance innovation should increase homeownership and/or make financial intermediation of housing credit more efficient (cutting down transaction costs) or more available (providing credit to a previously-unmet market demand).<sup>15</sup>

The mortgage meltdown shows that mortgage finance failed to meet its utilitarian ends within the high-risk mortgage sector. It revealed that the recent expansion of subprime and Alt-A housing credit was too often illusory as foreclosures continued to mount and exposed much of this housing debt as being “toxic” to financial

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<sup>12</sup> Because this note concerns mortgages that are used in the residential sector, any discussion of “mortgages” is meant to apply to residential mortgages and not necessarily commercial mortgages.

<sup>13</sup> See JAMES R. BARTH ET AL., *THE RISE AND FALL OF THE U.S. MORTGAGE AND CREDIT MARKETS* 2, 9 (2009) (describing how the mortgage market has for years successfully extended housing credit to millions of Americans, thereby satisfying the “long-standing public policy to promote homeownership”).

<sup>14</sup> See Simon Johnson & James Kwak, *Finance: Before the Next Meltdown*, DEMOCRACYJOURNAL.ORG, Fall 2009, at 19, 20.

<sup>15</sup> See *id.* at 20–21.

intermediaries.<sup>16</sup> This note makes its recommendation in an attempt to remove the cloak from high-risk MBSs so that market functions will once again limit the issuance of high-risk MBSs to the extent appropriate for achieving the utilitarian ends of mortgage finance.

## ***II. Context for Understanding Cloaked High-Risk MBSs***

There are two parts to a cloaked high-risk MBS: the underlying mortgages and the securitization scheme. The mortgages provide the high risk and the securitization scheme, using credit subordination as its backbone, cloaks this underlying risk so that the resulting MBS looks like a better investment than it is. This Part provides some basic context for understanding these securities and for understanding this note's critique of cloaked high-risk MBSs. First, Part II.A gives a brief history of mortgage finance leading to the conception of cloaked high-risk MBSs. Second, Part II.B defines the high-risk mortgages that underlie cloaked high-risk MBSs. Finally, Part II.C describes the origins of mortgage securitization to show that credit subordination should not be treated as some sort of "sacred cow" that is beyond the reach of reform.

### **A. Brief History of Mortgage Finance**

#### **1. The Basic Mortgage Conception**

Mortgages have been around since twelfth-century England.<sup>17</sup> At that time, mortgages functioned primarily as a way for borrowers to raise money and gave lenders very strong rights in the pledged land—i.e., rights to possess the land and rents derived therefrom.<sup>18</sup> However, for most of its existence, America has followed the modern practice of granting the lender a security interest in the pledged land and entitling the borrower to retain rights

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<sup>16</sup> See, e.g., James R. Hagerty, *National House Bargains Drying Up*, WALL ST. J., Feb. 23, 2010, at A3 (discussing implications of "the biggest wave of foreclosures since the Great Depression"); see also Stephen Labaton & Edmund L. Andrews, *Showdown Seen Between Banks and Regulators*, N.Y. TIMES, Apr. 11, 2009, at A1.

<sup>17</sup> Ann M. Burkhart, *Lenders and Land*, 64 MO. L. REV. 249, 251–52 (1999).

<sup>18</sup> See *id.*

to possession.<sup>19</sup> This conception of a mortgage places most of the mortgage's value in the rights to debt payments, unlike the early English conception where most of the value came from the lender's rights to the mortgage land.<sup>20</sup> Cloaked high-risk MBSs (along with any MBSs) are fundamentally premised on this idea that a mortgage is primarily debt.

## **2. The Creation of Government-Sponsored Enterprises (GSEs) and a Secondary Mortgage Market**

In the 1930s, the mortgage market went through an upheaval. The federal government stepped in with sweeping changes meant "to restore stability to a system of housing finance that had been dangerously weakened during the Depression."<sup>21</sup> First, Congress created the Federal Housing Administration (FHA) to restore investor confidence in the housing market by insuring qualifying mortgages, which had the effect of increasing housing credit, reducing costs for borrowers, and standardizing mortgage contracts.<sup>22</sup> Next, Congress created the Federal National Mortgage Association ("Fannie Mae") to improve liquidity within housing finance by buying FHA-insured mortgages from originators.<sup>23</sup>

The FHA and Fannie Mae programs, along with Veterans Administration (VA) guaranteed loans for WWII veterans, substantially developed the primary mortgage market through the 1960s by servicing the strong postwar demand for housing and the associated rise in housing credit.<sup>24</sup> Although Fannie Mae created a

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<sup>19</sup> *See id.* at 267–70.

<sup>20</sup> *See id.* at 264 ("At the same time that the mortgage debt became increasingly more valuable to lenders, the mortgage and the lender's rights in mortgaged land became increasingly less valuable.").

<sup>21</sup> Gordon H. Sellon, Jr. & Deana VanNahmen, *The Securitization of Housing Finance*, ECON. REV. FED. RES. BANK OF KAN. CITY, July/Aug. 1988, at 3, 4.

<sup>22</sup> *Id.*; *see also* Burkhardt, *supra* note 17, at 272–73.

<sup>23</sup> Sellon & VanNahmen, *supra* note 21, at 4–5; *see also* Burkhardt, *supra* note 17, at 273.

<sup>24</sup> Sellon & VanNahmen, *supra* note 21, at 5 ("In the postwar period, the demand for housing grew rapidly and the supply of investment funds flowing into housing expanded. The government programs enacted in the 1930s helped shape the way housing was financed."); *see* Burkhardt, *supra*

secondary market for mortgages, it was limited to FHA- and VA-insured loans, so the secondary market “remained relatively small until the 1970s.”<sup>25</sup>

In 1968 and 1970, Congress created the Government National Mortgage Association (“Ginnie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) “[t]o create an active secondary market for both conventional and government-insured loans.”<sup>26</sup> Ginnie Mae replaced Fannie Mae as the entity that was “primarily responsible for the government’s special assistance and housing support programs.”<sup>27</sup> This switch permitted Fannie Mae and Freddie Mac to concentrate on developing the secondary market for FHA, VA and conventional mortgages.<sup>28</sup> By establishing a thriving secondary mortgage market, these GSEs ushered in a new era of mortgage finance that would become absolutely essential for creating cloaked high-risk MBSs.

### **3. The Shift from the Originate-to-Hold to the Originate-to-Distribute Model of Mortgage Finance**

The GSEs were not only tasked with developing a secondary market for mortgages but were also encouraged to support the creation of MBSs.<sup>29</sup> Prior to the advent of MBSs, mortgage finance was dominated by the originate-to-hold lending model where a single entity (most often a savings and loan association) would originate,

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note 17, at 273 (discussing Fannie Mae’s “success in stimulating the housing market” during this period).

<sup>25</sup> Burkhart, *supra* note 17 at 273; *see also* Andrew R. Berman, “Once a Mortgage, Always a Mortgage” – *The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76, 91–92 (2005) (“[T]he secondary mortgage market remained largely inactive during the 1950s and most of the 1960s.”).

<sup>26</sup> Sellon & VanNahmen, *supra* note 21, at 8.

<sup>27</sup> Robin Paul Malloy, *The Secondary Mortgage Market – A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991, 993 (1986).

<sup>28</sup> *See id.* at 994 (“Together, [Freddie Mac and Fannie Mae] sought to increase the marketability of all mortgages by developing uniform standards to facilitate the purchase and sale of mortgages in the secondary mortgage market and thereby attract new sources of investment capital to the housing market.”).

<sup>29</sup> *See* Sellon & VanNahmen, *supra* note 21, at 8–9 (describing the GSEs role in the emerging MBS market).

service and hold mortgages until maturity.<sup>30</sup> In the 1970s, the GSEs changed this paradigm through guaranteeing and issuing MBSs.<sup>31</sup> Together, the GSEs securitized just \$500 million worth of mortgages in 1970.<sup>32</sup> However, that number soared over the next decade, rising to \$8 billion in 1975 and then to \$23.1 billion by 1980.<sup>33</sup>

Since that time, securitization has become the primary funding source for the mortgage finance industry. In 1980, only 11% of mortgage originations were securitized.<sup>34</sup> By the second quarter of 2008, a majority of mortgages, 59%, were securitized.<sup>35</sup> This rise in securitization signals that mortgage finance has shifted from the originate-to-hold model to the originate-to-distribute model. This new model is driven by securitization, which allows the funding, origination and servicing of a mortgage to be done by different entities.<sup>36</sup> The originate-to-distribute paradigm represents the current state of mortgage finance and is the general setting for the creation of cloaked high-risk MBSs.

### B. High-Risk Mortgages

In his book, *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market*, Professor Immergluck makes the salient point that recent popular media has tended to assign the term “subprime” to all mortgages implicated in the mortgage meltdown.<sup>37</sup> This is imprecise, as both subprime and Alt-A mortgages have figured prominently in the meltdown.<sup>38</sup> Instead, it is more useful to give the guilty mortgages a moniker that

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<sup>30</sup> See BARTH ET AL., *supra* note 13, at 23.

<sup>31</sup> See Sellon & VanNahmen, *supra* note 21, at 8–9.

<sup>32</sup> Berman, *supra* note 25, at 92.

<sup>33</sup> *Id.*

<sup>34</sup> See BARTH ET AL., *supra* note 13, at 24 fig.2.14.

<sup>35</sup> *See id.*

<sup>36</sup> *Id.* at 23–24.

<sup>37</sup> See DAN IMMERGLUCK, *FORECLOSED: HIGH-RISK LENDING, DEREGULATION, AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET 2* (2009).

<sup>38</sup> See, e.g., Peter J. Wallison, *The Price for Fannie and Freddie Keeps Going Up*, WALL ST. J., Dec. 30, 2009, at A17 (describing how subprime and Alt-A mortgages are “defaulting at unprecedented rates” which is responsible for Fannie Mae’s and Freddie Mac’s “2008 insolvency and their growing losses”).

describes their unifying characteristic: high-risk, thus creating the term “high-risk mortgages.”<sup>39</sup>

### 1. The Subprime Mortgage

Subprime mortgages derive their risk from the creditworthiness of the borrower. The term “subprime” is meant to identify mortgages issued to “borrowers of lower credit quality that are more likely to experience significantly higher levels of default.”<sup>40</sup> Lending to these traditionally low income borrowers “has been a long-standing national goal” but is problematic due to issues like scarce resources for a down payment, no credit history or a poor credit history, higher probability of undocumented income and general lack of credit information.<sup>41</sup> “Prime” borrowers, those with higher credit quality, generally do not have these issues.<sup>42</sup>

Although there is a general notion of what subprime means, there is no official definition.<sup>43</sup> However, the Office of the Comptroller of the Currency (OCC), Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) have released a joint statement that defines the general (but not exclusive) parameters of a subprime borrower:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;

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<sup>39</sup> See IMMERGLUCK, *supra* note 37, at 2 (explaining that he would use the term “high-risk” to refer not only to subprime mortgages but also to “higher-risk and higher-cost products” that were aimed at other types of mortgage borrowers).

<sup>40</sup> FRANK J. FABOZZI & VINOD KOTHARI, INTRODUCTION TO SECURITIZATION 21 (2008).

<sup>41</sup> Gary Gorton, *The Panic of 2007* 5–6 (Int’l Ctr. for Fin. at Yale Sch. of Mgmt. Res. Paper Series, Working Paper No. 08-24, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1255362](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1255362).

<sup>42</sup> See FABOZZI & KOTHARI, *supra* note 40, at 21 (“Prime borrowers are viewed as having high credit quality because they have strong employment and credit histories, income sufficient to pay the loans without compromising their creditworthiness, and substantial equity in the underlying property.”).

<sup>43</sup> See Gorton, *supra* note 41, at 7 (“The terms “subprime” and “Alt-A” are not official designations of any regulatory authority or rating agency.”).

- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.<sup>44</sup>

The market's definition of subprime is likewise ambiguous and not standardized.<sup>45</sup> However, the typical subprime borrower usually tracks the above interagency definition to some extent as he or she generally has a FICO score below 640 and either a delinquency within the previous twelve to twenty four months or a bankruptcy filing in the previous few years.<sup>46</sup>

## 2. The Alt-A Mortgage

Alt-A mortgages derive their risk from having nonstandard loan features.<sup>47</sup> The borrower generally has good credit, i.e. "A" creditworthiness.<sup>48</sup> However, the loan itself has risky characteristics such as no documentation of the borrower's income or assets, unusual real property collateral, and/or a high loan-to-value ratio.<sup>49</sup> The most distinguishing feature of Alt-A is its no- or low-documentation of income: only 23% of Alt-A borrowers fully documented their income as opposed to a 60% rate for subprime borrowers.<sup>50</sup>

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<sup>44</sup> Press Release, Fed. Deposit Ins. Corp., Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001), available at <http://www.fdic.gov/news/news/press/2001/pr0901a.html>.

<sup>45</sup> Gorton, *supra* note 41 at 7.

<sup>46</sup> *See id.*

<sup>47</sup> *See* MARK ADELSON, NOMURA SEC. INT'L, MBS BASICS 20 (2006).

<sup>48</sup> *Id.*; LAURIE S. GOODMAN ET AL., SUBPRIME MORTGAGE CREDIT DERIVATIVES 9 (2008).

<sup>49</sup> ADELSON, *supra* note 47, at 20–21; ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RES. BANK OF N.Y., UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 2 (2008).

<sup>50</sup> GOODMAN ET AL., *supra* note 48, at 9, 10 exhibit 1.5, 13.

### C. The Origins of Securitization

Cloaked high-risk MBSs refer to multiple-class MBSs with a credit subordination structure for providing one means of credit enhancement. When mortgage securitization first appeared in mortgage finance, this description would have been nonsense. Securitization has expanded over time to its current, often-bewildering state. This subpart analyzes the beginnings of securitization to provide a frame of reference for understanding why the eradication of cloaked high-risk MBSs would not be detrimental to the MBS market.

#### 1. Mortgage Pass-Through Certificates

When the GSEs began securitizing mortgages, they did so through basic mortgage pass-through certificates.<sup>51</sup> To create them, an entity assembles a pool of mortgages and then issues certificates evincing a right to a pro-rata share of the pool's principal and interest payments.<sup>52</sup> Throughout the 1970s and 1980s, pass-through certificates served the utilitarian ends of mortgage finance because they increased the ability of housing capital sources to locate and meet demand for housing credit.<sup>53</sup>

However, there was one significant drawback to mortgage pass-through certificates: uncertainty. The borrowers whose mortgage payments provide the cash flow for the pass-through certificates may or may not prepay their mortgages.<sup>54</sup> The chance of a significant difference between the expected and actual prepayment rates of borrowers introduced substantial uncertainty into the maturity of

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<sup>51</sup> See THOMAS A. HUMPHREYS & ROBERT M. KREITMAN, MORTGAGE-BACKED SECURITIES INCLUDING REMICS AND OTHER INVESTMENT VEHICLES § 5, at xxiv (1995) (stating that the “popularity of government-guaranteed mortgage pass-through certificates” spurred the creation of the collateralized mortgage obligation); see also Sellon & VanNahmen, *supra* note 21, at 9.

<sup>52</sup> Sellon & VanNahmen, *supra* note 21, at 9.

<sup>53</sup> See *id.* at 10–11 (discussing how mortgage pass-through securities improved liquidity within the mortgage market and eliminated geographic inefficiencies between capital providers and capital users).

<sup>54</sup> See James T. Parks, *The ABCS of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance*, 171 J. ACCT. 41, 41 (1991) (“When homeowners around the country prepay their mortgages, these principal prepayments are passed through to the MBS investor.”).

pass-through certificates.<sup>55</sup> This uncertainty bred two distinctive investment risks for holders of such certificates: one occurring when interest rates rise, the other occurring when interest rates decrease.

The first risk is “reinvestment risk.”<sup>56</sup> If interest rates decrease to a level lower than they were when the certificates were issued, then borrowers become more likely to prepay their mortgages either by refinancing into a mortgage with the new lower market interest rate or by selling their house to reinvest in a different piece of real estate at a lower interest rate.<sup>57</sup> These prepayments extinguish the future payment of principal and interest that was supposed to go to certificate holders and saddles them with cash that they must reinvest in a market that now has lower interest rates.<sup>58</sup>

The second risk is “interest rate risk.”<sup>59</sup> If interest rates rise, mortgage borrowers become less likely to prepay their mortgages since they now hold mortgages at below-market rates.<sup>60</sup> Consequently, investors—who were expecting a normal rate of prepayment leading to an approximately certain maturity date—are left with relatively low-yield pass-through certificates on their books for

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<sup>55</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 5 at xxiv (“A mortgage pass-through certificate . . . could not protect a purchaser against the prepayment of the underlying mortgage loans.”); see also Parks, *supra* note 54, at 41 (“[T]hese [pass-through] securities don’t have a fixed maturity date when all principal is repaid.”).

<sup>56</sup> Parks, *supra* note 54, at 42.

<sup>57</sup> See *id.* at 41 (“The rate of prepayments typically accelerates when interest rates are declining and homeowners are refinancing existing mortgages or buying new homes.”).

<sup>58</sup> Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 503–04 (1989) (“[T]he ability of the mortgagor to refinance his loan during periods when interest rates have decreased, exposes the investor in a mortgage pass-through security to ‘reinvestment risk,’ since he or she may be unable to reinvest the money being distributed by the trust in investments of comparable quality bearing the same yield.” (footnote omitted)); see Parks, *supra* note 54, at 41–42 (“A higher rate of mortgage prepayments reduces the life of an MBS, which means the investor must search for a new investment much sooner than originally anticipated. And because interest rates are falling, comparable new investments have a lower yield.”).

<sup>59</sup> Parks, *supra* note 54, at 42.

<sup>60</sup> See *id.* (“When interest rates are rising, prepayments usually decline . . .”).

longer than they expected.<sup>61</sup> This dilemma can be especially problematic if those investors have to borrow short-term money at the now higher market interest rates. Due to the underperforming pass-through certificates, these investors might be unable to finance these short-term borrowings.<sup>62</sup>

## 2. Multiple-Class MBSs<sup>63</sup>

Multiple-class MBSs were created to address the reinvestment risk and interest rate risk inherent in mortgage pass-through certificates.<sup>64</sup> The original multiple-class MBS solved the uncertainty of borrower prepayment by creating sequential payment classes within a mortgage securitization.<sup>65</sup> To accomplish this, an issuer would split its MBSs into separate classes and then assign each class a different sequential priority to the underlying borrower payments

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<sup>61</sup> *See id.* (describing how, when prepayments decrease, pass-through certificate investors' "now-below-market yielding investment will have a longer effective life").

<sup>62</sup> *See id.* ("If that long-term investment was financed with short-term money, red ink will start to flow once the cost of the borrowed funds exceeds the investment yield.").

<sup>63</sup> There is a lot of ambiguity in the terminology regarding multiple-class MBSs, CMOs and REMICS. As shown in Part III.A, when multiple-class MBSs were first issued they primarily came in the form of a CMO. Since then, the term CMO is often treated as being synonymous with a multiple-class MBS even though, today, such multiple-class securities are primarily issued through REMICs. *See Parks, supra* note 54, at 42 ("Today, almost all multiple-class securities, or CMOs, are issued in REMIC form."). The term CMO is also often treated as being synonymous with REMIC. *See Andrew Kelman, Mortgage-Backed Securities & Collateralized Mortgage Obligations: Prudent CRA Investment Opportunities*, COMMUNITY INVESTMENTS (Fed. Reserve Bank of S.F., San Francisco, Cal.), Mar. 2002, at 20, 22 ("Since 1986, most CMOs have been issued in [REMIC] form for tax purposes. The terms are now used interchangeably.").

<sup>64</sup> *Parks, supra* note 54, at 42; *see also* DANIEL R. AMERMAN, COLLATERALIZED MORTGAGE OBLIGATIONS 39 (1996) ("[S]plitting up borrowings into short- and long-term segments[] was the motivation that drove the creation of the first CMOs."); HUMPHREYS & KREITMAN, *supra* note 51, § 5 at xxiv ("The response to [prepayment risk of pass-through certificates] was the creation of the 'collateralized mortgage obligation.'").

<sup>65</sup> AMERMAN, *supra* note 64, at 250 ("The first CMO issued was composed of sequential tranches, and they dominated the CMO market during the first few years of its existence.").

and prepayments.<sup>66</sup> Stated differently, these new securities “sliced the cash flows from [pass-through certificates or mortgage pools] into various short, medium and long maturity classes or ‘tranches’ that would meet the maturity and cash flow needs of a variety of different investors.”<sup>67</sup> Now investors could hedge against changes in prepayment speeds by buying a MBS with a more predictable maturity.

Solving the prepayment puzzle of pass-through certificates further advanced the purposes of mortgage finance. Multiple-class MBSs created more certainty in MBS payments and allowed MBSs to be structured with differing maturities. These advancements expanded housing credit by creating new types of securities that could appeal to a range of investors that did not find the uncertain terms of pass-through certificates attractive.<sup>68</sup>

Cloaked high-risk MBSs are multiple-class MBSs but with collateral consisting of risky loans and with credit enhancements that address that risk, principal among which is credit subordination. When multiple-class MBSs were created credit subordination was not commonly used; contemporary literature did not mention credit subordination.<sup>69</sup> As shown in this subpart, the first multiple-class mortgage MBSs accomplished their utilitarian ends by tranching MBS classes along the dimension of time—i.e., creating different maturities through sequential payments.<sup>70</sup> Credit subordination came

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<sup>66</sup> Sellon & VanNahmen, *supra* note 21, at 13 (“The basic objective in design of a CMO was to transform mortgage cash flows into bond classes of different maturities so as to reduce the uncertainty about the timing of cash flows caused by prepayment.”).

<sup>67</sup> Parks, *supra* note 54, at 42.

<sup>68</sup> *See id.* at 42 (stating that multiple-class MBSs allow “[i]nvestors with different investment horizons [to] select tranches that meet their specific portfolio needs”); Sellon & VanNahmen, *supra* note 21, at 14 (“[C]MOs may attract new investors to the housing market, investors who did not find pass-through securities attractive.”).

<sup>69</sup> *See, e.g.,* Brant K. Maller, *The Collateralized Mortgage Obligation: The Latest Phase in the Evolution of Mortgage-Backed Securities*, 13 REAL EST. L.J. 299 (1985) (providing an overview of the MBS market just before the passage of REMIC legislation and nowhere indicating the use of credit subordination).

<sup>70</sup> *See* ADELSON, *supra* note 47, at 22 (contrasting credit tranching with tranching that “slic[es] along the dimension of time”).

along later and tranced MBS classes along the dimension of credit.<sup>71</sup> Thus, the original purpose of multiple-class MBSs—creating certainty and flexibility for the timing of MBS payouts—did not require the credit subordination “innovation” that would eventually provide the cloak for cloaked high-risk MBSs.

### III. REMICs

Like the secondary mortgage market, the rise of multiple-class MBSs was strongly influenced by federal government action. By the mid-1980s, “[C]ongress recognized the increasing extent . . . to which multiple-class arrangements are used in the ‘packaging’ of mortgages.”<sup>72</sup> As part of the Tax Reform Act of 1986, Congress passed legislation creating REMICs to “provide a new type of vehicle for the issuance of such multiple class securities, and to provide rules that are as comprehensive as possible for the taxation of all transactions relating to the use of such vehicles.”<sup>73</sup>

Congress expressed its intent that REMICs become the “exclusive vehicle” for issuing multiple-class MBSs.<sup>74</sup> By the 1990s, its intent was fulfilled as “almost all” multiple-class MBSs were being issued as REMICs.<sup>75</sup> This has ramifications for cloaked high-risk MBSs since these MBSs have, by necessity, multiple classes and thus are compelled to elect REMIC status.<sup>76</sup> The remainder of Part III

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<sup>71</sup> See *id.* (describing credit subordination as “slicing along the dimension of credit”).

<sup>72</sup> STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 411 (Comm. Print 1987).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> Parks, *supra* note 54, at 42 (“Today, almost all multiple-class securities, or CMOs, are issued in REMIC form.”); see AMERMAN, *supra* note 64, at 124 (“Almost all CMOs issued today are also *real estate mortgage investment conduits* (REMICs) mortgage securities . . . .”); accord HUMPHREYS & KREITMAN, *supra* note 51, § 1 at xix (“REMIC [is] the primary means to structure multiple-class MBS.”).

<sup>76</sup> See George Oldfield, *Subprime Mortgage Problems: What to Look For and Where to Look*, Finance (The Brattle Group, Cambridge, Mass.), 2007, at 2, [http://www.brattle.com/\\_documents/UploadLibrary/Upload616.pdf](http://www.brattle.com/_documents/UploadLibrary/Upload616.pdf) (“[T]he original subprime mortgage portfolio might support a range of different tranches that vary in subordination, coupon, and stated maturity. Such multi-tranche structures are engineered in an entity that elects REMIC status.”); see also Gorton, *supra* note 41, at 21 fig. (showing that the “basic

explains the tax ramifications of these securitization transactions, including an overview of the REMIC tax rules.

### A. SPVs for Multiple-Class MBSs Before REMICs

Every securitization requires a special purpose vehicle (SPV) to assemble the mortgage pool and issue the securities backed by that pool.<sup>77</sup> From a tax standpoint, an SPV's key to success is achieving tax transparency, which means the SPV should not be subject to a corporate-level tax that will reduce the cash flow from the mortgage borrowers to the MBS investors.<sup>78</sup> Prior to REMICs, there were two such SPVs primarily used for issuing multiple-class MBSs. One was a "fast-pay, slow-pay" trust that satisfied the IRS rules for investor trust tax treatment.<sup>79</sup> The other was a Collateralized Mortgage Obligation (CMO) structured in such a way to have income and expenses offset, making it tax-neutral.<sup>80</sup>

#### 1. Investor Trusts

The fast-pay, slow-pay investor trust was first created by Sears Mortgage Securities Corporation in 1983.<sup>81</sup> These trusts pooled mortgages (or mortgage certificates), tranced the pool into separate sequential-paying classes, and then issued certificates for each

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structure of a subprime RBMS transaction" includes securitization through a REMIC).

<sup>77</sup> Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1266 (2008).

<sup>78</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 7 at xxv (discussing the importance of creating transparent entities for issuing MBSs).

<sup>79</sup> See *id.* § 7.1 at xxvi, § 104.2 at 9–10 (explaining the use of pre-1986 investment trust rules to issue multiple-class MBSs); see also Pittman, *supra* note 58, at 505–06 (describing the creation of multiple-class trusts used for issuing multiple classes of MBSs).

<sup>80</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 7.2 at xxvi, §§ 203.1–4 at 39–44 (explaining the use of § 163 interest and original issue discount deductions to create a CMO that can issue multiple-class MBSs); see also Pittman, *supra* note 58, at 507 ("Since CMOs involve the issuance of debt, the issuer is able to deduct the interest paid to bondholders, thereby sheltering most of the mortgage income from double taxation.").

<sup>81</sup> Pittman, *supra* note 58, at 505.

class.<sup>82</sup> Such trusts “vest[ed] no discretionary power in the trustee over investment of the trust assets and thus assertedly satisf[ied] the fixed investment requirement of the [existing] regulations.”<sup>83</sup> However, the IRS was suspicious of fast-pay, slow-pay trusts because they departed from the traditional trust concept of beneficiaries having only undivided interests in trust assets.<sup>84</sup> The existence of sequential-paying classes indicated that such trusts were “not employed simply to hold investment assets, but serve[d] a significant additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets.”<sup>85</sup>

Soon after the first of these trusts were created, the IRS effectively shut them down by denying them tax transparency. Through regulations effective April 28, 1984, the IRS limited its trust recognition for multiple-class investor trusts to situations where the existence of multiple classes was simply “incidental” to “facilitat[ing] direct investment in the assets of the trust.”<sup>86</sup> Sequential-paying classes primarily existed to “provide investors with diverse interests in the trust assets,”<sup>87</sup> which certainly did not qualify such classes as being “incidental.” Thus, investor trusts ceased to be a realistic SPV for issuing multiple-class MBSs.

## 2. CMOs

Freddie Mac and First Boston Corporation created the first CMO in 1983.<sup>88</sup> Given that investment trusts were effectively banned for use in creating multiple-class MBSs, the CMO is essentially the precursor to the REMIC. Single-purpose corporations or owner trusts were the entities that most often issued CMOs.<sup>89</sup> Using these entities as SPVs, CMOs could qualify as debt and the SPV could achieve

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<sup>82</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 104.2 at 9–10 (describing a typical fast-pay, slow-pay investment).

<sup>83</sup> T.D. 8080, 1986-1 C.B. 371.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Sellon & VanNahmen, *supra* note 21, at 12.

<sup>89</sup> HUMPHREYS & KREITMAN, *supra* note 51, § 202 at 39; JAMES M. PEASLEE & DAVID Z. NIRENBERG, *THE FEDERAL INCOME TAXATION OF MORTGAGE-BACKED SECURITIES* 14 (1994).

effective tax transparency by offsetting the receipt of interest from mortgage borrowers with Code section 163 interest and original discount deductions on the subsequent payments to security holders.<sup>90</sup> However, there was “considerable uncertainty . . . concerning several aspects of the Federal income tax treatment of these types of securities.”<sup>91</sup>

One particularly cumbersome result of this uncertainty was the necessity of having substantial equity interests within the CMO. To perfectly match interest income with interest expenses, the SPV would have to issue all of its equity (mortgages or mortgage certificates) as debt (MBSs).<sup>92</sup> This level of financing creates an infinite debt-equity ratio, which could cause the IRS to reclassify the transaction as, in substance, being the sale of stock instead of the issuance of debt.<sup>93</sup> If this happened, the CMO’s SPV would lose its interest deductions and the deal would become uneconomical.<sup>94</sup> Thus, the SPV must retain some “non-trivial”<sup>95</sup> residual equity amount by doing things like overcollateralizing the pool and/or retaining some portion of the interest received from mortgage borrowers.<sup>96</sup> Satisfying this legal hurdle meant that issuers could not

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<sup>90</sup> See Pittman, *supra* note 58, at 507 (“Since CMOs involve the issuance of debt, the issuer is able to deduct the interest paid to bondholders, thereby sheltering most of the mortgage income from double taxation.”).

<sup>91</sup> STAFF OF JOINT COMM. ON TAXATION, *supra* note 72, at 411; see also HUMPHREYS & KREITMAN, *supra* note 51, § 7.4 at xxvii (“REMIC was Congress’s answer to tax uncertainty caused by other mortgage-securitization vehicles.”).

<sup>92</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 203.1 at 40.

<sup>93</sup> See *id.* § 203.1 at 40–41.

<sup>94</sup> See Maller, *supra* note 69, at 310 (“[T]reatment of a CMO as a sale of equity would cost a corporate issuer interest deductions and would give rise to an income tax at the corporate level.”).

<sup>95</sup> Thomas A. Kasper & Les Parker, *Understanding Collateralized Mortgage Obligations*, 1987 COLUM. BUS. L. REV. 139, 140 (1987) (“CMO’s [sic] are considered debt obligations when the residual component has a non-trivial present value.”).

<sup>96</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 203.2 at 41; see also Pittman, *supra* note 58, at 507–08 (“To assure that the issuer had economic substance, so that investors’ securities would be classified as debt for tax purposes, counsel generally required, apart from any business purposes, that there be a minimum of two percent over-collateralization.” (footnote omitted)).

realize “the most efficient economic result” of having all the SPV’s mortgage collateral pledged to security holders.<sup>97</sup>

### B. The Mechanics of REMICs

Congress introduced REMICs as part of the Tax Reform Act of 1986,<sup>98</sup> thereby solving the uncertainties surrounding tax aspects of CMOs.<sup>99</sup> Now multiple-class MBSs could be issued through an SPV that was explicitly tax neutral and that came with its own blueprints located within the tax code and treasury regulations.<sup>100</sup> Unlike CMOs, “there is no requirement that a REMIC have any minimum equity value or that the payments on regular interests [(tranches)] and the underlying mortgages be mismatched.”<sup>101</sup> In conjunction with the rules applying to Taxable Mortgage Pools,<sup>102</sup> REMICs were intended to “be the exclusive vehicle . . . relating to the issuance of multiple class [sic] mortgage-backed securities, and that availability of other vehicles should be limited to the extent possible.”<sup>103</sup>

The REMIC rules are found in sections 860A through 860G of the Internal Revenue Code and in their extensive corresponding regulations.<sup>104</sup> Although the details get a little complicated, the main thrust of REMICs is relatively simple: any entity can make a REMIC election, which allows it to be a flexible, tax-favored SPV for issuing regular and residual classes of securities substantially collateralized by a pool of qualified mortgages. One can achieve a basic understanding of how REMICs accomplish this goal by examining a

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<sup>97</sup> See PEASLEE & NIRENBERG, *supra* note 89, at 17 (describing how tax rules prevented CMOs from achieving “the most efficient economic result”).

<sup>98</sup> See Pub. L. No. 99-514, §§ 671–675, 100 Stat. 2085, 2308–2320 (1986) (relating to REMICs).

<sup>99</sup> See Lee G. Knight & Ray A. Knight, *Real Estate Mortgage Investment Conduits: Mortgage Vehicles for the 1990s*, ACCT. HORIZONS, June 1991, at 55, 56 (“Congress created REMICs to overcome the uncertainties and problems plaguing pre-TRA ‘86 pooling entities.”).

<sup>100</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 7.4 at xxvi–xxvii (“By meeting the requirements for REMIC status, the Code confers tax transparency on the REMIC entity . . .”).

<sup>101</sup> PEASLEE & NIRENBERG, *supra* note 89, at 23.

<sup>102</sup> See *infra* Part III.B.5.

<sup>103</sup> STAFF OF JOINT COMM. ON TAXATION, *supra* note 72, at 411.

<sup>104</sup> I.R.C. §§ 860A–G (2006); Treas. Reg. §§ 1.860A-1–G-3 (2009).

REMIC's component parts: (1) qualified assets, (2) regular interests, (3) residual interests and (4) tax effects.

### 1. Qualified Assets

An SPV's assets qualify for REMIC treatment if, "as of the close of the 3rd month beginning after the startup day and at all times thereafter, substantially all of the assets . . . consist of qualified mortgages and permitted investments."<sup>105</sup> This standard requires us to know the meaning of "substantially all," "qualified mortgages," and "permitted investments."

"Substantially all" is defined in the regulations, not the code. All possible assets owned by a REMIC entity can be split into three categories: qualified mortgages, permitted investments and other assets. As long as the REMIC only owns a "de minimis" amount of other assets, "substantially all" of its assets will be deemed to be qualified mortgages and permitted investments.<sup>106</sup> The IRS provides a safe harbor where it will consider other assets to be de minimis if the aggregate tax basis of those assets is less than one percent of the tax basis of all the REMIC's assets.<sup>107</sup> If a REMIC fails to meet this safe harbor, then its other assets may still qualify as de minimis based on factors like "whether the REMIC had a reasonable belief that the [other] assets were qualified mortgages or permitted investments, and whether the [other] assets are held for only a short period after discovery that they are not such [qualified or permitted] assets."<sup>108</sup>

A "qualified mortgage" is "any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property" and contributed to the REMIC at or soon after its startup day.<sup>109</sup> Subject to an alternative test and safe harbor, the regulations generally say that "principally secured" means the fair market value of the real estate securing a mortgage is eighty percent of that mortgage's adjusted

<sup>105</sup> I.R.C. § 860D(a)(4) (2006).

<sup>106</sup> Treas. Reg. § 1.860D-1(b)(3)(i) (2009).

<sup>107</sup> *See id.* § 1.860D-1(b)(3)(ii).

<sup>108</sup> PEASLEE & NIRENBERG, *supra* note 89, at 109 n.56.

<sup>109</sup> *See* I.R.C. § 860G(a)(3)(A) (2006). An increase in principal of a reverse mortgage also counts as a qualified mortgage in certain circumstances. *See id.* § 860G(a)(3)(A)(iii).

issue price.<sup>110</sup> Qualified replacement mortgages and other REMIC regular interests are also considered qualified mortgages.<sup>111</sup>

“Permitted investments” are cash flow investments, qualified reserve assets or foreclosure properties.<sup>112</sup> Cash flow investments are merely the payments from mortgage borrowers received by the SPV and held temporarily until payments on the SPV’s securities are due.<sup>113</sup> A qualified reserve asset is “any intangible property which is held for investment and as part of a qualified reserve fund.”<sup>114</sup> A foreclosure property is real property or interests thereof “acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC” and held only for a specific grace period, usually two years.<sup>115</sup>

## 2. Regular Interests

An SPV that elects REMIC status must issue securities that qualify as “regular interests.”<sup>116</sup> Providing a succinct definition of a regular interest is difficult as “the definition of a regular interest[ is] one of the most complex aspects of the REMIC rules.”<sup>117</sup> However,

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<sup>110</sup> See Treas. Reg. § 1.860G-2(a) (2009).

<sup>111</sup> I.R.C. § 860G(a)(3)(B)–(C) (2006). Qualified replacement mortgages are discussed in I.R.C. § 860G(a)(4) and REMIC regular interest are discussed below in Part III.B.2.

<sup>112</sup> I.R.C. § 860G(a)(5) (2006).

<sup>113</sup> See *id.* § 860G(a)(6). The regulations go into more detail: explaining the phrases “payments received on qualified mortgages” and “temporary period.” See Treas. Reg. § 1.860G-2(g)(1) (2009).

<sup>114</sup> I.R.C. § 860G(a)(7) (2006). A qualified reserve fund is primarily a fund that is “reasonably required” to insure a REMIC will be able to pay its operating expenses or meet its obligations to security holders in the event of underperformance of its qualifying mortgages. See Treas. Reg. § 1.860G-2(g)(2) (2009). To determine whether the reserve is reasonable, the regulations consider factors like “the credit quality of the qualified mortgages, . . . the expected amount of expenses of the REMIC, and the expected availability of proceeds from qualified mortgages to pay the expenses.” *Id.* § 1.860G-2(g)(3)(ii).

<sup>115</sup> See I.R.C. § 860G(a)(8) (2006) (giving a vague definition of “foreclosure property” in the code); PEASLEE & NIRENBERG, *supra* note 89, at 130 (explaining the code’s definition of “foreclosure property” without jumping between referenced code sections).

<sup>116</sup> See I.R.C. § 860D(a)(2) (2006).

<sup>117</sup> PEASLEE & NIRENBERG, *supra* note 89, at 177.

one can gain an understanding of its general parameters by going through the elements of a regular interest piece by piece.

First, there are three requirements that are fairly straightforward. One, regular interests must be issued on the SPV's startup day.<sup>118</sup> Two, regular interests have to be designated by the SPV as regular interests.<sup>119</sup> Three, regular interests must have "fixed terms,"<sup>120</sup> meaning that such interests must "irrevocably specify" the principal amount, the terms of interest payments, and the "latest possible maturity date of the interest."<sup>121</sup> Next, regular interests must be entitled to some amount of principal from the underlying mortgages.<sup>122</sup> The purpose of this requirement may be to ensure that regular interests look like debt since "regular interests are taxed as debt,"<sup>123</sup> even though such interests may be issued in any form provided by state law (partnership interest, debt, stock, etc.).<sup>124</sup> However, all the code requires is that a regular interest be entitled to some principal amount, so an interest will not fail to qualify as a regular interest if, for example, no principal is paid to it as the result of defaults on qualified mortgages and permitted investments.<sup>125</sup>

Finally, interest payable by regular interests must be either at (1) a fixed rate, (2) at certain variable rates prescribed by the regulations<sup>126</sup> or (3) consist of a specified, unvarying portion of the interest payments on the REMIC's underlying qualified mortgages.<sup>127</sup> Interest payments calculated through options (1) and (2) may not be "disproportionately high relative to the [regular

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<sup>118</sup> I.R.C. § 860G(a)(1) (2006).

<sup>119</sup> *Id.*; *see also* Treas. Reg. § 1.860G-1(a)(1) (2009) (describing how an issuer designates an interest as a regular interest).

<sup>120</sup> I.R.C. § 860G(a)(1).

<sup>121</sup> Treas. Reg. § 1.860G-1(a)(4) (2009).

<sup>122</sup> I.R.C. § 860G(a)(1)(A) (2006).

<sup>123</sup> PEASLEE & NIRENBERG, *supra* note 89, at 202.

<sup>124</sup> Treas. Reg. § 1.860G-1(b)(4) (2009).

<sup>125</sup> *See id.* § 1.860G-1(b)(3)(ii) ("An interest does not fail to qualify as a regular interest solely because the amount or the timing of payments of principal or interest (or other similar amounts) with respect to a regular interest is affected by defaults on qualified mortgages and permitted investments . . .").

<sup>126</sup> *See id.* § 1.860G-1(a)(3) (outlining the variable rates that are acceptable for regular interests).

<sup>127</sup> I.R.C. § 860G(a)(1)(B) (2006).

interest's] principal amount."<sup>128</sup> In contrast, option (3) was added in 1988 to allow for the issuance of Interest Only (IO) regular interests.<sup>129</sup> The "disproportionately high" rule and the "entitled to principal" rule were waived for regular interests that calculated interest payments in this new manner.<sup>130</sup>

### 3. Residual Interests

In addition to regular interests, a REMIC entity must also issue securities that qualify as "residual interests."<sup>131</sup> There can be "1 (and only 1) class of residual interests (and all distributions, if any, with respect to such interests are pro rata)."<sup>132</sup> Like regular interests, the SPV has to affirmatively designate which interests are residual interests.<sup>133</sup> Other than that, it is not difficult to qualify a class of interests as residual. A residual interest need not have any economic value<sup>134</sup> or "entitle the holder to any distributions from the

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<sup>128</sup> Treas. Reg. § 1.860G-1(b)(5)(i) (2009) ("Interest payments . . . are considered disproportionately high if the issue price . . . of the [regular] interest in the REMIC exceeds 125 percent of its specified principal amount.").

<sup>129</sup> See PEASLEE & NIRENBERG, *supra* note 89, at 179–80.

<sup>130</sup> See Treas. Reg. § 1.860G-1(a)(2)(iv) (2009) ("If an interest in a REMIC consists of a specified portion of the interest payments on the REMIC's qualified mortgages, no minimum specified principal amount need be assigned to that interest. The specified principal amount can be zero.") "A regular interest in a REMIC that entitles the holder to interest payments consisting of a specified portion of interest payments on qualified mortgages qualifies as a regular interest even if the amount of interest is disproportionately high relative to the specified principal amount." See Treas. Reg. § 1.860G-1(b)(5)(ii) (2009).

<sup>131</sup> See I.R.C. § 860D(a)(2) (2006).

<sup>132</sup> I.R.C. § 860D(a)(3) (2006).

<sup>133</sup> See Treas. Reg. § 1.860G-1(c) (2009).

A residual interest is an interest in a REMIC that is issued on the startup day and that is designated as a residual interest by providing the information specified in § 1.860D-1(d)(2)(ii) at the time and in the manner provided in § 1.860D-1(d)(2). A residual interest need not entitle the holder to any distributions from the REMIC.

*Id.*

<sup>134</sup> See STAFF OF JOINT COMM. ON TAXATION, *supra* note 72, at 416 ("The Congress intended that an interest in a REMIC could qualify as a residual interest regardless of its value.").

REMIC.”<sup>135</sup> Moreover, a “residual interest need not be economically different from a regular interest;”<sup>136</sup> there just needs to be a class of interests designated as residual.

#### 4. Tax Effects

In general, if a REMIC entity has qualified assets, qualified regular interests and qualified residual interests, it will not be subject to taxation and all of its income will be passed through to the holders of its interests.<sup>137</sup> The tax structure of the REMIC looks similar to that of a CMO but, as stated above,<sup>138</sup> with the significant advantage of tax certainty and more flexibility.<sup>139</sup> When stripped to its basics, the REMIC entity calculates its gross income as if it were an individual accrual-based taxpayer,<sup>140</sup> deducts the interest paid to holders of regular interests<sup>141</sup> and allocates the remaining net income to holders of residual interests.<sup>142</sup> The REMIC thus achieves tax-neutrality.

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<sup>135</sup> Treas. Reg. § 1.860G-1(c) (2009).

<sup>136</sup> HUMPHREYS & KREITMAN, *supra* note 51, § 305.2.3 at 68.

<sup>137</sup> See I.R.C. § 860A (2006)

(a) General rule.--Except as otherwise provided in this part, a REMIC shall not be subject to taxation under this subtitle (and shall not be treated as a corporation, partnership, or trust for purposes of this subtitle). (b) Income taxable to holders.--The income of any REMIC shall be taxable to the holders of interests in such REMIC as provided in this part.

*Id.*

<sup>138</sup> See *supra* notes 91–101 and accompanying text.

<sup>139</sup> See Pittman, *supra* note 58, at 508 (“The Real Estate Mortgage Investment Conduit (‘REMIC’) legislation allows issuers to avoid dual taxation, in the same fashion as CMOs, but without issuing debt.”).

<sup>140</sup> See I.R.C. § 860C(b)(1) (2006) (stating that REMICs use the “accrual method of accounting” and are taxed “in the same manner as in the case of an individual”).

<sup>141</sup> See Treas. Reg. § 1.860C-2(b)(2) (2009) (“A REMIC is allowed a deduction, determined without regard to section 163(d), for any interest expense accrued during the taxable year.”).

<sup>142</sup> See Treas. Reg. § 1.860C-1(a) (2009) (“Any holder of a residual interest in a REMIC must take into account the holder’s daily portion of the taxable income or net loss of the REMIC for each day during the taxable year on which the holder owned the residual interest.”).

Holders of regular interests are treated like they own debt instruments—i.e., MBSs.<sup>143</sup> Interest income is allocated to these securities according to the terms of the REMIC and, just like any debt security, taxed as interest to the security holders.<sup>144</sup> Alternatively, residual interests were “designed as a ‘clean-up’ mechanism to ensure that no income on the mortgage loans is lost as a result of repackaging the mortgage loans into a REMIC structure.”<sup>145</sup> Thus, residual interest holders are taxed on whatever income or loss is left over in the REMIC after regular interests have been assigned their portions of income and other REMIC deductions have been made.<sup>146</sup>

### 5. Taxable Mortgage Pools

A discussion of REMICs is not complete without mentioning Taxable Mortgage Pools (TMPs). TMPs were passed to cover the tax consequences of multiple-class mortgage securitizations that do not elect REMIC status.<sup>147</sup> By providing a negative alternative tax treatment to such securitizations, TMPs were meant to strongly incentivize issuers to elect REMIC status.<sup>148</sup> Thereby, “Congress intended that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities.”<sup>149</sup>

TMPs ensure that issuers of non-REMIC multiple-class MBSs are subject to income tax.<sup>150</sup> This is accomplished by treating a TMP’s SPV as a separate corporation subject to corporate income tax.<sup>151</sup> The qualification rules for TMPs are found in subsection 7701(i) of the Internal Revenue Code and the corresponding

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<sup>143</sup> I.R.C. § 860B(a) (2006).

<sup>144</sup> See STAFF OF JOINT COMM. ON TAXATION, *supra* note 72, at 418.

<sup>145</sup> HUMPHREYS & KREITMAN, *supra* note 51, § 305.2.1 at 67.

<sup>146</sup> See *id.* (“[O]nce income from the mortgage loans has in effect been allocated to the regular interest holders, any excess is taxed to the residual interest holders.”); see also I.R.C. § 860C (2006).

<sup>147</sup> See Treas. Reg. § 301.7701(i)-1(a) (1967) (“The purpose of [TMPs] is to prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities.”); see also I.R.S. Priv. Ltr. Rul. 9326009 (July 2, 1993) (“Any arrangement that functions like a REMIC but fails to qualify under section 860D is classified as a TMP.”).

<sup>148</sup> See HUMPHREYS & KREITMAN, *supra* note 51, § 402 at 118.

<sup>149</sup> STAFF OF JOINT COMM. ON TAXATION, *supra* note 72, at 427.

<sup>150</sup> See PEASLEE & NIRENBERG, *supra* note 89, at 80.

<sup>151</sup> See *id.*

regulations.<sup>152</sup> The TMP is “a broad concept.”<sup>153</sup> Its “provisions apply to entities or portions of entities that qualify for REMIC status but do not elect to be taxed as REMICs as well as to certain entities or portions of entities that do not qualify for REMIC status.”<sup>154</sup>

### **6. The REMIC as a Mechanism for Removing the Cloak from Cloaked High-Risk MBSs**

This Part explained the REMIC rules to provide a foundation for the recommendation, in Part V, for how to amend the REMIC rules to prevent credit subordination from being used within high-risk mortgage securitizations. The specifics of that recommendation will be left for later (after credit subordination has been properly critiqued in the next Part), but it is important to conclude this Part with the same message that began it: REMICs were meant as and have become the exclusive means of issuing multiple-class MBSs.<sup>155</sup> This means that cloaked high-risk MBSs must elect REMIC status and, consequently, that the REMIC can be used as a sort of choke-point where legislators can design and implement new regulation to constrain these MBSs from debilitating our economy in another, future mortgage meltdown.

### **IV. Subprime Meltdown**

Part IV uses the subprime meltdown to showcase how cloaked high-risk MBSs ran afoul of the utilitarian ends of mortgage finance. Although Alt-A mortgages are half of the “high-risk” in these securities, this part is only concerned with subprime mortgages and MBSs. This is done for two reasons. First, the problematic feature of these MBSs (credit subordination) presents itself upon being used within high-risk mortgage securitizations. Since both Alt-A and subprime mortgages are generally acknowledged to be high-risk,<sup>156</sup> it is sufficient to use only one as an example. Second, there is more literature and data on subprime’s role in the mortgage meltdown, so subprime is a better candidate to illustrate the failings of cloaked high-risk MBSs.

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<sup>152</sup> I.R.C. § 7701(i) (2006); Treas. Reg. §§ 301.7701(i)-1-(i)-4 (1976).

<sup>153</sup> HUMPHREYS & KREITMAN, *supra* note 51, § 403 at 118.

<sup>154</sup> Treas. Reg. § 301.7701(i)-1(a) (1967).

<sup>155</sup> See *supra* notes 72–75 and accompanying text.

<sup>156</sup> See *supra* Part II.B.

## A. The Subprime Mortgage Market

### 1. The Rise of Subprime Mortgages

Subprime mortgages were effectively born in the 1990s.<sup>157</sup> Supported by favorable 1980s legislation,<sup>158</sup> the 1990s subprime boom was primarily characterized by a growth in subprime refinance lending.<sup>159</sup> This type of lending consisted of issuing home equity mortgages for the purpose of “cashing out” the equity homeowners had built up in their homes.<sup>160</sup> At this time, borrowers still had a substantial amount of equity in their homes so these home equity loans “could be made with moderate loan-to-value ratios” and “were most often structured as thirty-year fixed-rate mortgages.”<sup>161</sup> However, these were still subprime borrowers, so the default rates were relatively high.<sup>162</sup>

The second fatal subprime boom began in the early 2000s.<sup>163</sup> This boom increased subprime mortgages dramatically, with outstanding subprime mortgages growing by 800 percent from 2000 to 2007.<sup>164</sup> This era of subprime was characterized by home purchase loans with exotic features.<sup>165</sup> Principal among these was the adjustable rate mortgage, where subprime borrowers were often lured into taking out the loan by low initial fixed rates (teaser rates) that would reset after several years to be substantially higher.<sup>166</sup> Features

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<sup>157</sup> KENNETH TEMKIN, JENNIFER E. H. JOHNSON & DIANE LEVY, U.S. DEP’T OF HOUS. & URBAN DEV., *SUBPRIME MARKETS, THE ROLE OF GSES, AND RISK-BASED PRICING* 7 (2002).

<sup>158</sup> *See id.* at 7–9 (giving an overview of how the Depository Institutions Deregulation and Monetary Control Act, Alternative Mortgage Transaction Parity Act, and Tax Reform Act of 1986 affected subprime lending).

<sup>159</sup> IMMERGLUCK, *supra* note 37, at 68, 73.

<sup>160</sup> *Id.* at 68–69.

<sup>161</sup> *Id.* at 73, 85.

<sup>162</sup> *See id.* at 73–74 (“[S]ubprime refinance loans defaulted at much higher rates than prime refinance loans in the late 1990s and early 2000s . . .”).

<sup>163</sup> *See id.* at 69.

<sup>164</sup> Gorton, *supra* note 41, at 8.

<sup>165</sup> *See* IMMERGLUCK, *supra* note 37, at 84–85.

<sup>166</sup> *Id.* at 85 (“[I]n the second high-risk boom, subprime loans were often structured so that they had adjustable rates, with initial rates fixed for only two or three years and the likelihood of substantial increases in the rates after that.”); Martin F. Hellwig, *Systemic Risk in the Financial Sector: An*

like interest-only or negative amortization payments were also becoming more common.<sup>167</sup> In addition to these risky loan features, subprime issuers engaged in questionable practices like: (1) little or no documentation of the borrower's income;<sup>168</sup> (2) allowing higher and higher debt-to-income ratios;<sup>169</sup> and (3) requiring low or no down payment on the subprime mortgage.<sup>170</sup> Thus, risky practices that were usually within the province of Alt-A mortgages also crept into the subprime market during the exuberance of the second subprime boom.

## 2. The Fall of Subprime

The adjustable rates prevalent in subprime mortgages meant that after two or three years, the subprime borrower's mortgage payment would jump significantly.<sup>171</sup> Subprime borrowers were generally unable to absorb this increase in monthly payments, and they were either forced to refinance or experience foreclosure.<sup>172</sup> In reality, this forced refinancing was built into the subprime business model; borrowers were expected to refinance.<sup>173</sup> If refinancing ceased to be an option, subprime borrowers were in trouble.<sup>174</sup>

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*Analysis of the Subprime-Mortgage Financial Crisis*, 157 DE ECONOMIST 129, 147 (2009) ("These years also saw the resurrection of adjustable-rate mortgages. Their share of the stock of outstanding mortgages went from 6% in 2001 to 26% in 2006."); Gorton, *supra* note 41, at 12.

<sup>167</sup> IMMERGLUCK, *supra* note 37, at 87; *see also* FABOZZI & KOTHARI, *supra* note 40, at 295 ([I]n 2004 and 2005 . . . banks designed mortgage loans with features such as option adjustability, negative amortization, and interest-only payment[s] that increased credit risk to holder[s] of such loans.").

<sup>168</sup> IMMERGLUCK, *supra* note 37, at 85.

<sup>169</sup> *Id.*

<sup>170</sup> *See id.* at 88–92 (explaining rise of very low and zero down payment loans); *see also* Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, *The Subprime Credit Crisis of 2007*, 16 J. DERIVATIVES 81, 83 (2008) ("During 2005 and 2006, subprime borrowers were offered 80/20 mortgage products to finance 100% of their homes.").

<sup>171</sup> *See* Gorton, *supra* note 41, at 12–13.

<sup>172</sup> *See id.* In this way, the adjustable rate reset has the effect of giving the lender the decision as to whether the mortgage will go into default. *Id.* at 17.

<sup>173</sup> *See* Gorton, *supra* note 41, at 17 ("The design of the subprime mortgage creates the refinancing option.").

<sup>174</sup> *See* ASHCRAFT & SCHUERMANN, *supra* note 49, at 18 ("The main source of uncertainty about the future performance of these [subprime] loans is driven by uncertainty over the ability of these borrowers to refinance.").

Between 2002 and 2005 “the average price of U.S. homes . . . rose by 10.6 percent, 10.7 percent, 14.6 percent, and 14.7 percent annually.”<sup>175</sup> Throughout this period, “subprime mortgages worked as they were supposed to” with housing values appreciating and subprime borrowers refinancing as their initial fixed rates expired.<sup>176</sup> In 2006, housing prices stopped rising and began falling.<sup>177</sup> Also at this time, credit started drying up for subprime issuers.<sup>178</sup> This combination of factors made it close to impossible for most subprime borrowers to refinance,<sup>179</sup> and, consequently, subprime foreclosure rates increased dramatically: rising from 5.7 percent in 2005 to 17 percent by the second quarter of 2008.<sup>180</sup>

### B. The Subprime MBS Market

Any reader of the Wall Street Journal (or any newspaper for that matter) over the past few years is aware of the fact that, unfortunately, problems with subprime foreclosures did not stop at the subprime mortgage industry.<sup>181</sup> Subprime mortgages so pervaded the whole financial system that it became impossible to quarantine the effects of subprime delinquencies and foreclosures.<sup>182</sup> This did

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<sup>175</sup> Bruce I. Jacobs, *Tumbling Tower of Babel: Subprime Securitization and the Credit Crisis*, FIN. ANALYSTS J., Mar./Apr. 2009, at 17, 23.

<sup>176</sup> See Gorton, *supra* note 41, at 18.

<sup>177</sup> *Id.* at 50 (“[T]he S&P/Case-Shiller (U.S. National) quarterly home price index declined by 4.5 percent in Q3 2007 versus Q3 2006 – the largest drop since the index started recording data in 1988.”); see also Jacobs, *supra* note 175, at 23 (“In 2006, [house] prices were essentially flat (-0.2 percent) for the year but actually began declining from the second quarter on.”).

<sup>178</sup> See Jacobs, *supra* note 175, at 23 (“[I]n the fourth quarter of 2006 . . . investment banks started shutting down credit lines to independent mortgage lenders . . .”).

<sup>179</sup> Gorton, *supra* note 41, at 51 (“[T]he mortgage market for these [subprime] borrowers to refinance has effectively closed.”); see also Eggert, *supra* note 77, 1259 (“[I]n late 2006, . . . subprime lenders began going out of business rather than buying back problem loans.”).

<sup>180</sup> IMMERGLUCK, *supra* note 37, at 136 fig.5.1.

<sup>181</sup> *E.g.*, Wallison, *supra* note 38.

<sup>182</sup> See Hellwig, *supra* note 166, at 167–69 (explaining how “the difference between . . . other crises and the subprime mortgage crisis is not in the magnitude of the primary losses” but comes from it being impossible to have a “surgical separation of failing assets and failing institutions from the rest of the financial system”).

not occur by happenstance; the subprime contagion was spread through cloaked high-risk MBSs.

Most subprime mortgages were financed through securitization.<sup>183</sup> Subprime mortgage securitization was so prevalent that, by 2006, 80.5% of subprime originations were securitized.<sup>184</sup> Thus, there was a close, direct relationship between the subprime mortgage market and the subprime MBS market: if subprime mortgages did well so did subprime MBSs, and vice versa. This linkage and the widespread securitization of subprime mortgages are what allowed high-risk subprime debt to spread through the whole financial system.<sup>185</sup>

### 1. The Subprime MBS: A Species of Cloaked High-Risk MBSs

Like other multiple-class MBSs, subprime mortgages are securitized through SPVs electing REMIC status.<sup>186</sup> Also, the typical subprime securitization scheme incorporates triggered sequential-payments similar to the basic sequential-payment structure used in the first multiple-class MBSs.<sup>187</sup> However, the similarities end here as the subprime MBS is then saddled with special features that dramatically increase its complexity.<sup>188</sup>

Most of these complicating features are related to the distinguishing characteristic of subprime and Alt-A mortgages: high-risk.<sup>189</sup> To compensate for the credit risk of the underlying subprime mortgages, any securitization involving these mortgages has to

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<sup>183</sup> Gorton, *supra* note 41, at 19.

<sup>184</sup> *Id.* at 20.

<sup>185</sup> See Eggert, *supra* note 77, at 1260.

<sup>186</sup> See *supra* note 76 and accompanying text.

<sup>187</sup> See GOODMAN ET AL., *supra* note 48, at 111–13 (describing the use of sequential payments in a typical subprime deal if triggers fail to provide for a step-down).

<sup>188</sup> See Gorton, *supra* note 41, at 19–20 (“[T]he structure of the securitization will have special features reflecting the design of the subprime mortgages. This latter point means that there will be additional complexity.”).

<sup>189</sup> *Id.* at 20–23 (outlining the complicated structure and triggers put into the typical subprime securitization in an attempt to provide credit enhancement); see also GOODMAN ET AL., *supra* note 48, at 89 (“[A]s you go down the credit spectrum from prime, to Alt-A, to subprime credit becomes the most important risk element.”).

include robust credit enhancements.<sup>190</sup> These enhancements are meant to make the MBSs collateralized by high-risk mortgages look better to investors by achieving “triple-A ratings on at least a portion of the MBS created in a deal.”<sup>191</sup> The most common securitization scheme for subprime securitizations is an excess spread/overcollateralization (XS/OC) structure.<sup>192</sup> This structure deploys three forms of credit enhancement: excess spread, overcollateralization, and credit subordination.<sup>193</sup> Triggers and target metrics are also incorporated into this structure, which affect how each type of credit enhancement behaves.<sup>194</sup>

Excess spread refers to the practice of paying interest to security holders at rates lower than the interest rates received by the entity from subprime borrowers; the excess interest is kept within the SPV to help absorb losses on underlying mortgages.<sup>195</sup> Overcollateralization means that the SPV will not package all of its mortgages into securities but will, instead, keep a percentage as equity within the entity in order “to reduce the exposure of debt investors to loss on the pool of mortgage loans.”<sup>196</sup> Credit subordination is the structural backbone of the subprime MBS, creating multiple tranches of junior securities to support the credit of senior tranches.<sup>197</sup> This note identifies credit subordination as the cloak for cloaked high-risk MBSs. As such, it will be more fully explained and critiqued in Part IV.C.

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<sup>190</sup> See FABOZZI & KOTHARI, *supra* note 40, at 22–23 (“[C]ompared to the securitization of prime loans, the securitization of subprime loans requires a larger amount of credit enhancement . . .”).

<sup>191</sup> See ADELSON, *supra* note 47, at 20.

<sup>192</sup> GOODMAN ET AL., *supra* note 48, at 89. Some Alt-A securitizations also used the XS/OC structure, but a more common scheme for Alt-A MBSs was the “six pack” structure. GOODMAN ET AL., *supra* note 48, at 89–90. This distinction does not matter for the purposes of this note as both structures employ credit subordination. See Gorton, *supra* note 41, at 23 fig. (showing that both structures use credit subordinated tranches).

<sup>193</sup> See Gorton, *supra* note 41, at 21.

<sup>194</sup> See GOODMAN ET AL., *supra* note 48, at 95–97.

<sup>195</sup> ASHCRAFT & SCHUERMANN, *supra* note 49, at 31.

<sup>196</sup> *Id.* at 29.

<sup>197</sup> See ASHCRAFT & SCHUERMANN, *supra* note 49, at 29–31 (describing subordination).

## 2. The Rise of Subprime MBSs

In the early 2000s, interest rates were relatively low.<sup>198</sup> This caused investors to look for investment opportunities offering higher yields.<sup>199</sup> Due to high interest rates charged on subprime mortgages, subprime MBSs offered these relatively high yields.<sup>200</sup> Despite the higher yields, one would expect investors to be leery of any security associated with such risky collateral. This is where credit enhancement becomes useful. Credit rating agencies—Standard & Poor’s, Moody’s and Fitch—would assess the effects these enhancements had on the securitization’s credit risk and assign ratings to the resulting securities.<sup>201</sup> Investors relied heavily on those ratings.<sup>202</sup> Whether it was a lack of information, an inability to predict subprime loan performance, a failure to understand complexities of the security or outright collusion with issuers,<sup>203</sup> these agencies “repeatedly understated and underestimated the underlying risk of subprime . . . lending and the risk to investors in structured finance vehicles backed by these loans.”<sup>204</sup> At the time, investors were unaware of this ratings failure and used these favorable ratings to buy up what they perceived as high-yield, low-risk AAA subprime senior tranches.

This scheme carried the prospect of high fees for security issuers with little credit risk as that risk was passed on to security investors.<sup>205</sup> Thus, there was little incentive for issuers to police these

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<sup>198</sup> Crouhy et al., *supra* note 170, at 82.

<sup>199</sup> *Id.*

<sup>200</sup> See Jacobs, *supra* note 175, at 21 (“The relatively high yields on underlying subprime mortgages—and on structured finance products that included subprime mortgages—were accompanied by irresistibly low perceived risk, which widened the scope of subprime’s popularity.”).

<sup>201</sup> See *id.* at 22 (“Ratings are assigned by third-party credit-rating agencies . . . on the basis of the subordination schedules (including overcollateralization and excess spread) submitted by the structured product packagers.”).

<sup>202</sup> See *id.* (“Credit-rating agencies played a crucial role in the success of subprime mortgage securitization inasmuch as their ratings came to be viewed as virtual guarantees of investment quality.”).

<sup>203</sup> See IMMERGLUCK, *supra* note 37, at 111–20.

<sup>204</sup> *Id.* at 112.

<sup>205</sup> See *id.* at 110 (“[M]ost of the intervening parties had very little downside risk in the transactions other than the borrower and the eventual investor . . . .”); see *id.* at 100 (“Mortgage originators and brokers were given higher commissions to originate inherently high-risk mortgages of various stripes.”); see also Hellwig, *supra* note 166, at 153 (“[T]hese institutions

deals, so market demand was satisfied unabated. This set of factors indicates that the subprime mortgage boom was not driven by prudent lending in response to housing credit demand by subprime borrowers but, instead, was driven by MBS demand from investors.<sup>206</sup> In other words, “[t]he disconnect between the relatively high returns offered by subprime-mortgage-based products and their perceived low risk fueled demand for the products, thereby increasing funding for mortgages, facilitating home purchases, and raising housing prices.”<sup>207</sup>

### 3. The Boom of Collateralized Debt Obligations (CDOs)

Just as traditional investors demanded senior tranches of subprime securities, issuers of CDOs demanded the mezzanine tranches.<sup>208</sup> CDOs would buy these lower-rated tranches and package them with other asset-backed securities to create new AAA-rated securities.<sup>209</sup> CDOs had such a huge appetite for these tranches that they pushed out other market participants, “leaving the CDOs as the sole investors for subordinate credit risk in subprime [MBSs].”<sup>210</sup> This had a huge effect as “CDOs were willing to accept loans in securitizations that the bond insurers and the traditional investors would have rejected.”<sup>211</sup>

The desire of CDOs for these tranches was so big that “[i]ssuance of ABS CDOs roughly tripled over the period 2005–2007 and ABS CDO portfolios became increasingly concentrated in US subprime RMBS.”<sup>212</sup> To make matters worse, credit rating agencies would routinely analyze only the CDO’s underlying subprime

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competed to stake out their turfs in this new line of business, which held a prospect of high fees.”)

<sup>206</sup> IMMERGLUCK, *supra* note 37, at 121 (“[A]ggregate activity in the mortgage markets increasingly was driven more by the ‘demand’ of investors for structured finance investments than by the authentic demand of homebuyers and homeowners for credit.”).

<sup>207</sup> Jacobs, *supra* note 175, at 20.

<sup>208</sup> *Id.* at 21.

<sup>209</sup> *Id.*

<sup>210</sup> Mark H. Adelson & David P. Jacob, *The Subprime Problem: Causes and Lessons*, 14 J. STRUCTURED FIN. 12, 15 (2008).

<sup>211</sup> *Id.*

<sup>212</sup> Gorton, *supra* note 41, at 41.

securities and not those securities' mortgage collateral.<sup>213</sup> This led to CDOs being: (1) another driving factor in the demand for subprime MBSs and (2) another channel for dispersing the risk of subprime mortgages throughout the financial sector.

### C. The Cloak for Cloaked High-Risk MBSs: Singling Out Credit Subordination

As explained above, investors drove the ill-fated boom of high-risk mortgages by demanding high-risk MBSs.<sup>214</sup> Assuming that investors are rational and only want to invest in profitable investments, this begs the question: why did investors get the risk profile of subprime MBSs so wrong? In a broad sense, the answer seems obvious: they did not understand what they were buying. Once again though, why did these investors (or the ratings agencies) not understand what they were buying? Securitization would seem a likely answer to that question as it provided the essential linkage between high-risk mortgages and high-risk MBSs. However, going after securitization would be like targeting a weed with napalm; it goes too far. This subpart argues that the culprit for investor confusion can be identified with more precision: credit subordination.

#### 1. Credit Subordination: Mechanics

In a classic credit subordination structure, there are three levels of tranching—senior, mezzanine and residual—creating a risk hierarchy within the securitization.<sup>215</sup> The residual consists of overcollateralization, so losses are absorbed there first.<sup>216</sup> Then, losses get allocated to the mezzanine level of tranches in order of tranche seniority.<sup>217</sup> The senior level of tranching is protected by both the residual and mezzanine levels.<sup>218</sup> Typically, these ostensibly

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<sup>213</sup> Jacobs, *supra* note 175, at 22.

<sup>214</sup> See notes 206–207 and accompanying text.

<sup>215</sup> See ASHCRAFT & SCHUERMANN, *supra* note 49, at 29–31; see also Gorton, *supra* note 41, at 20–23.

<sup>216</sup> See IMMERGLUCK, *supra* note 37, at 38.

<sup>217</sup> ASHCRAFT & SCHUERMANN, *supra* note 49, at 29. The mezzanine level typically has several tranches of securities “with credit ratings that vary between AA and B.” *Id.*

<sup>218</sup> ASHCRAFT & SCHUERMANN, *supra* note 49, at 29.

“safe” securities constituted the “[t]he lion’s share of the [securitization’s] capital structure”<sup>219</sup> and were usually rated AAA.<sup>220</sup>

## 2. Credit Subordination: The Backbone for High-Risk MBSs

Of course, credit subordination is not the only form of credit enhancement within cloaked high-risk MBSs; the other features of the XS/OC structure are also present. In fact, excess spread, over-collateralization, and their related triggers and cash flow mechanics drive most of the complication in the XS/OC structure.<sup>221</sup> So then, why is credit subordination the backbone for high-risk MBSs? To continue the anatomical metaphors, credit subordination provides the skeleton on which the XS/OC’s complicating features are constructed. Without credit tranches, the XS/OC structure could not use triggers or other metrics to shift losses between “senior,” “mezzanine,” and “residual” classes.<sup>222</sup> If there was no credit subordination, all MBS tranches would necessarily be subjected to the same credit risk and shifting credit risk among classes would be impossible. Thus, credit subordination can be seen as the key to cloaked high-risk MBSs.

Before criticizing credit subordination and its role in the subprime meltdown, it is important to note that high-risk mortgage securitization can be accomplished without this form of credit enhancement. In other words, credit subordination does not have to be the backbone for high-risk MBSs. Prior to 1997, most subprime securitizations relied on bond insurers for its primary credit enhancement.<sup>223</sup> Then, “[a]round the middle of 1997, issuers of subprime [MBSs] started using subordination as the method of credit

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<sup>219</sup> *Id.*; see also IMMERGLUCK, *supra* note 37, at 38 (“[T]he senior tranche typically constituted approximately 80 percent of a subprime CMO structure.”).

<sup>220</sup> IMMERGLUCK, *supra* note 37, at 38.

<sup>221</sup> See GOODMAN ET AL., *supra* note 48, at 316 (“The existence of triggers and the complicated cash flow mechanics make it difficult to calculate how far up the capital structure a given amount of collateral losses will go in a subprime deal.”).

<sup>222</sup> See *id.* at 111–18 (showing that the efficacy of triggers within the XS/OC structure is dependent on the triggers working in conjunction with credit tranches).

<sup>223</sup> Adelson & Jacob, *supra* note 210, at 13 (“Until 1997, the vast majority of [subprime MBSs] had used bond insurance for credit enhancement.”).

enhancement in a growing proportion of their deals.”<sup>224</sup> By the time of the second subprime boom, credit subordination was a mainstay of subprime securitization.<sup>225</sup>

### 3. Credit Subordination: Too Complicated for Investors’ Own Good

One commentator described credit subordination as follows: “Through the magic of subordination, underlying subprime loans were transformed into AAA rated [MBS tranches and underlying BBB rated [MBS tranches were transformed into AAA rated CDO tranches.”<sup>226</sup> “Magic” is a good description for the apparent cloaking effect that credit subordination had on the risk of subprime MBSs. It is this note’s contention that by providing the structure for high-risk MBSs, credit subordination is the feature most responsible for the resulting complexity of cloaked high-risk MBSs.

The postmortem of the subprime meltdown clearly indicates that this complex debt was beyond the ken of market participants as “more than half of all [subprime] securities issued between 2005 and 2007 [were] eventually downgraded by the three major rating agencies.”<sup>227</sup> This complexity was driven by two factors: (1) impaired disclosure of the underlying collateral and (2) inherent complexity within the XS/OC structure.

First, “[t]he complexity of the securitization processes . . . made it difficult to assess the nature of the collateral backing different investments.”<sup>228</sup> Market participants need to properly understand an investment for markets to function effectively.<sup>229</sup> Since MBSs are backed by thousands of mortgages, gathering all the relevant information can be a difficult task in itself.<sup>230</sup> Even if this morass of information is disclosed, performing due diligence on a pool of thousands of mortgages presents obvious problems. It is not

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<sup>224</sup> *Id.*

<sup>225</sup> See GOODMAN ET AL., *supra* note 48, at 89 (discussing how non-agency loans (which includes subprime) were, almost by necessity, securitized in a credit subordinated structure).

<sup>226</sup> Jacobs, *supra* note 175, at 22.

<sup>227</sup> BARTH ET AL., *supra* note 13, at 159.

<sup>228</sup> IMMERGLUCK, *supra* note 37, at 112.

<sup>229</sup> Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 221 (2009).

<sup>230</sup> Eggert, *supra* note 77, at 1298.

surprising then that rating agencies often would not even look at the underlying mortgages when assigning ratings to CDOs.<sup>231</sup>

Second, the XS/OC structure is complex in and of itself. As a preliminary matter, “it is difficult to estimate future collateral losses on a subprime deal,” so the underlying mortgage assets going into the XS/OC structure are already relatively unpredictable.<sup>232</sup> Next, “triggers and complicated cash flow mechanics” are infused into the credit tranches making “it difficult to calculate how far up the capital structure a given amount of collateral losses will go in a subprime deal.”<sup>233</sup> All of this adds up to a securitization structure that is “not intuitive and often confusing.”<sup>234</sup>

## V. *Recommendation*

Despite the current inactivity in mortgage securitization,<sup>235</sup> the securitization industry is unlikely to permanently refrain from securitizing high-risk MBSs.<sup>236</sup> Thus, greater regulation of the industry would be an advisable course of action. Cloaked high-risk MBSs were devastating to the U.S. economy, and something should be done to ensure that these securities—or something like them—do not reappear in a few years or ever. This note’s assertion is that removing the cloak (credit subordination) from high-risk MBSs (subprime and Alt-A MBSs) will go a long way towards achieving that goal.

Former Federal Reserve Board Chairman and financial seer, Paul Volcker, stated the broad point from which this recommendation is extracted. In a recent interview with the Wall Street Journal, Volcker made the provocative declaration that “I have found very little evidence that vast amounts of innovation in financial markets in recent years have had a visible effect on the productivity of the

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<sup>231</sup> See Jacobs, *supra* note 175, at 22 (“For CDOs, however, the agencies routinely analyze the underlying RMBS tranches but not the original mortgages.”).

<sup>232</sup> GOODMAN ET AL., *supra* note 48, at 316.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.* at 110.

<sup>235</sup> See Wallison, *supra* note 38 (“Investors, having lost confidence in the ratings, fled the MBS market and ultimately the market for all asset-backed securities. They have not yet returned.”).

<sup>236</sup> See GOODMAN ET AL., *supra* note 48, at 314 (“It is doubtful if anyone wants to go back to [the days before MBSs], so securitization will remain.”).

economy.”<sup>237</sup> He went on to relay a conversation he had with an “inventor[] of financial engineering” who had won a Nobel Prize for his efforts.<sup>238</sup> According to Volcker, this finance expert readily admitted that recent, complex financial innovation “does nothing” except “moves around the rents in the financial system.”<sup>239</sup> There may have been a little hyperbole in these statements, but they probably contained a significant amount of earnestness as well.

Projecting this sentiment to mortgage finance, it is worth asking whether increased complexity in mortgage securitization helps to advance utilitarian goals of finance, or whether it simply obfuscates risk to advance the profits of financial intermediaries with little skin in the game. The answer is probably debatable, but what is certain is that the subprime meltdown provided a case study for showing that high-risk mortgage finance has been “innovated” to the point where a surreptitious financier could use securitization for reaping ill-gotten gains by hiding risk in complex and opaque MBSs. This note proposes to rollback this “innovation” to a point where market participants can better identify and price the risk inherent in high-risk MBSs.

As argued above, credit subordination provided the securitization structure for hiding subprime and Alt-A credit risk and for spreading that risk throughout the economy.<sup>240</sup> More importantly, and in line with Volcker’s observation, credit subordination is not even necessary to mortgage securitizations as it is only one of many forms of credit enhancement.<sup>241</sup> Given this, there is no compelling reason for its preservation within high-risk mortgage securitizations considering the damage caused by these securities in the mortgage meltdown.

Since credit subordination requires multiple classes of MBSs, and because the securitization of multiple-class MBSs is funneled through REMICs by the tax code,<sup>242</sup> we could use the REMIC rules to strongly incentivize subprime MBS issuers to stop using credit subordination. A possible solution would be to create definitions for “credit subordination” and “high-risk mortgage,”

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<sup>237</sup> Alan Murray, *Paul Volcker: Think More Boldly*, WALL ST. J., Dec. 14, 2009, at R7.

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

<sup>240</sup> *See supra* Part IV.C.

<sup>241</sup> *See supra* Part IV.C.2.

<sup>242</sup> *See supra* notes 74–76 and accompanying text.

making sure that the latter definition is comprehensive enough to cover all risky mortgages. Then, rules could be put in place to disqualify any SPV from REMIC status if (1) a majority of the SPV's "qualified mortgages" meet the definition of "high-risk mortgage" and (2) any "regular interest" is in a "credit subordination" relationship to any other "regular interest." Excess spread, overcollateralization (within the residual interest) and external credit enhancements would still be available if one wanted to securitize subprime or Alt-A mortgages; only the problematic "cloak" would be removed. Making this change in the tax code would strongly discourage the use of credit subordination in high-risk mortgage securitizations as losing tax neutrality makes securitization cost prohibitive.<sup>243</sup>

Making these changes to the REMIC rules in order to effectively exclude credit subordination from high-risk MBSs would make these securities easier to evaluate in the secondary market, help quell artificial future demand for high-risk mortgages, and eliminate a significant tool for hiding credit risk. In turn, these benefits will help to realign high-risk mortgage finance to meet its utilitarian ends. Eliminating credit subordination within high-risk MBSs should aid the promotion of permanent homeownership for suitable subprime and Alt-A borrowers instead of temporary homeownership and costly foreclosures arising from mortgage products that the secondary market does not properly understand but demanded anyway. Also, removing credit subordination should improve financial intermediation within high-risk mortgage finance as savers will be less likely to get duped into expending resources to value and monitor capital transferred to high-risk users within obscure and complex securities. By acting on the lessons of the recent mortgage meltdown we should be able to stop the next high-risk mortgage boom and bust before it starts.

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<sup>243</sup> See *supra* note 78 and accompanying text.