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March 28, 2013

VIA E-MAIL

Mr. William R. Breetz, Jr.
Chairman, Uniform Law Commission Drafting Committee
on Residential Real Estate Mortgage Foreclosure Process and Protections
University of Connecticut School of Law
Knight Hall Room 202
35 Elizabeth Street
Hartford, CT 06105

Re: Comments on February 4, 2013 draft of the Uniform Real Estate Mortgage Foreclosure Process and Protections Act ("Act")

Dear Mr. Breetz:

This letter expands upon Mark Greenlee's February 4, 2013 letter to you and his comments during the holder in due course discussion at the February 15, 2013 meeting of the drafting committee for the Act ("Committee"). He urged the Committee not to extend holder in due course protection into the realm of residential mortgage foreclosure proceedings and to preserve homeowner claims and defenses in foreclosure actions brought by the purchasers of home mortgage notes. This letter is our joint effort. It responds to comments made by others at the meeting on both sides of these issues. Please note that the views expressed at the meeting and herein our personal views, and not those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

This letter is divided into five sections: (1) Financial Crisis, (2) Argument, (3) Scope of Committee's Work, (4) Assertion of Holder in Due Course Protection, and (5) Proposed Language for the Act.

1. Financial Crisis

The 2008 financial crisis dealt a serious blow to families, neighborhoods, markets, and the economy. Slide 1 of Exhibit A demonstrates the large fall in the homeownership rate. From 2007 to 2012, more than 13 million residential properties were foreclosed upon.[1] This data highlights that the crisis has hurt people and communities across the county, and this uniform act has the potential to help.

2. Argument

Our arguments for the prospective removal of holder in due course protections in residential mortgage transactions are oriented around historical developments, policy justifications, and changes in the market.

a. History of the Holder in Due Course and Its Application to Consumer Credit Transactions

Historically, the original reason for holder in due course protection as a money substitute no longer applies because of the many means of payment currently available from paper money to checks to wire transfers to PayPal. Outside the Uniform Commercial Code ("UCC"), the trend has been away from holder in due course protection for credit transactions with consumers. This trend started with state court cases in the 1940s, continued with the preservation of claims and defenses in the financed consumer goods and services market in 1975, and imposition of assignee liability in the high-cost mortgage market in 1994.[2] The 2002 revisions to UCC § 3-305 that apply the FTC Holder Rule to instruments even without the required notice extended the trend into the realm of the UCC.[3] The recent promulgation of federal regulations for higher-priced qualified mortgages will further limit the impact of the holder in due course rule.[4]

The holder in due course rule did not play a significant role in the residential mortgage market until the growth of the secondary market for mortgage obligations in the 1980s. The securitization of mortgage obligations fueled this growth.[5] With widespread securitization of mortgage loans, the potential for application of the holder in due course rule grew dramatically. Slides 2 and 3 of Exhibit A show the levels of securitized prime and subprime mortgage debt from 1993 to 2012.

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[1] Figure derived from the annual foreclosure reports issued by RealtyTrac. Properties foreclosed, rather than foreclosure filings, were used in calculating the total. http://www.reatytrac.com.

[2] Mark B. Greenlee & Thomas J. Fitzpatrick IV, Reconsidering the Application of the Holder in Due Course Rule to Home Mortgage Notes, 41 UCCLJ 225 (2008).

[3] UCC § 3-305(e) and (f). The 2002 amendments to the UCC had been adopted by 10 states as of Dec. 31, 2012.

[4] Bureau of Consumer Financial Protection, Ability-to-Repay and Qualified Mortgage Standards Under the Truth In Lending Act, 78 FR 6408 (Jan. 30, 2013)(effective Jan. 10, 2014).

[5] Frank J. Fabozzi & Franco Modigliani, MORTGAGE AND MORTGAGE-BACKED SECURITIES MARKETS (Boston, MA: Harvard Business School Press, 1992).

b. Lack of Convincing Policy Justification

From a policy perspective, the available empirical evidence does not provide a convincing policy justification for the continued availability of holder in due course protection in the residential mortgage market.

i. Decreased Availability of Credit

It is often asserted that elimination of the holder in due holder protection for secondary market purchasers of residential mortgage loans will decrease the availability of credit. Theoretically, we would expect some decrease in the availability of credit from elimination of this discrete characteristic of the market; however, the data that is available suggests that eliminating holder in due course protection will not significantly impact the availability of residential mortgage credit. The evidence comes from the impact of the elimination of holder in due course protection on the consumer goods and services market and the subprime mortgage market.

The Federal Trade Commission ("FTC") issued a rule that preserved the claims and defenses of borrowers purchasing consumer goods and services in 1975 ("FTC Holder Rule").[6] Despite predictions of the demise of the market,[7] the FTC Holder Rule did not destroy the market when it became effective in 1976. The FTC and commentators found that the rule did not significantly restrict the availability of credit.[8] At this time, consumer goods purchases were still being financed with notes, rather than revolving credit, such as credit cards. This market thrived, even without holder in due course protection.[9]

The market for subprime mortgage loans did not dry up when state laws expanded assignee liability. Home Mortgage Disclosure Act data on subprime mortgage lending showed an average increase of 293% from 2000 to 2003 in the 24 states that enacted

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[6] Federal Trade Commission, Preservation of Consumers' Claims and Defenses, 40 FR 53506 (Nov. 18, 1975), as amended 40 FR 58131 (Dec. 15, 1975).

[7] Federal Reserve Chairman Arthur Burns predicted that the consumer-credit business would be "seriously disrupted" by the FTC Holder Rule. Robert D. Hershey, Jr., Wash. & Business: The Shifting Onus of Consumer Credit, N.Y. Times, Oct. 7, 1976, 84.

[8] Federal Trade Commission, Termination of Review, 57 FR 28814 (June 29, 1992): "After carefully considering the comments, the Commission believes that they do not present a sufficient basis to conclude that the Holder Rule has had a significant impact on a substantial number of small entities." Senate Report No. 103-169, at 28, 1912 (1994), reprinted in 1994 USCCAN 188, 1912 (1994): The FTC Holder Rule did not "significantly restrict the flow of consumer credit or interfere with the securitization of auto loans." James J. White & Robert S. Summers, UNIFORM COMMERCIAL CODE 503 (4th ed. 1995): The FTC Holder Rule "caused some adjustments in the market, largely unseen, but it surely has not had the catastrophic impact upon consumer markets that some predicted." See also, Edward L. Rubin, Learning from Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice, 31 Idaho L. Rev. 775, 789 (1995): "What is striking is that the financial community has not been particularly perturbed by the FTC Rule…"). Empirical studies of the impact of the FTC Holder Rule are reviewed by William H. Lawrence & John Minan, The Effect of Abrogating the Holder-in-Due-Course Doctrine on the Commercialization of Innovative Consumer Products, 64 BYU. L Rev 325, 328, n.51 (1984).

[9] Slides 2 and 3 of Exhibit 2 of letter dated February 4, 2013 from Mark B. Greenlee to William R. Breetz, Jr., previously supplied to the Committee.

predatory lending laws.[10] In 2002, a Morgan Stanley survey of 280 subprime branch managers concluded that there is "no evidence to support the view that regulatory pressures, the threat of legal action, or changes to lending practices have dampened growth prospects."[11] However, we must note that these studies lack of specificity with respect to assignee liability.

Studies that specifically investigate expanded assignee liability are inconsistent with it causing a decline in the availability of credit. A 2007 empirical study of the impact of assignee liability on the subprime residential mortgage market suggests that assignee liability had little impact on the availability of credit.[12] It found that the applications for credit dropped, but total originations increased in the presence of stronger enforcement mechanisms, including assignee liability. This behavior is consistent with the reverse lemons hypothesis - offering additional consumer protection through assignee liability encourages applications from qualified applicants because of diminished fear of being taken advantage of.

ii. Increased Cost of Credit

It is often asserted that elimination of the holder in due holder protection for the secondary market purchasers of residential mortgage loans will increase the cost of credit. Theoretically, we would expect enhancing assignee liability to result in some increased cost for loan purchasers because of the additional risks they would bear.

However, we believe that the impact will be insignificant. While empirical research in this area is thin, we base our opinion on findings from empirical studies on the impact anti-predatory lending laws on the cost of credit. Anti-predatory lending laws contain many features, one of which is frequently enhanced assignee liability (lumped into "coverage" in the literature), making studies of them instructive for the Committee's purposes. Generally they find little measurable impact on the cost of credit.[13] Even if price increases much larger than those suggested by the literature are passed on to borrowers, these increased costs are unlikely to have any impact on the ability of borrowers to afford mortgage credit.

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[10] 2005 Mortgage Market Statistical Annual, Vol. 1 (March 2005) quoted in Delvin M. Davis & Ellen Schloemer, Center for Responsible Lending, Strong Compliance Systems Support Profitable Lending While Reducing Predatory Practices (Issue Paper No. 10, July 26, 2005) at 2 and 5.

[11] Kenneth A. Posner & Athina L. Meehan, Channel Check: Surprisingly Strong Subprime Growth, Morgan Stanley Industry Overview (August 1, 2002), at 6; Dennis Hevesi, "New Curbs on Predatory Lending," N.Y. Times, Nov. 10, 2002, sec. 11 at 1.

[12] Raphael W. Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross, & Susan M. Wachter, State and local Anti-Predatory Lending Laws: The effect of Legal Enforcement Mechanisms, 60 J. Eco. & Bus. 47 (2008). See also, Keith D. Harvey & Peter J. Nigro, Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law, 29 J. of Real Estate Fin. & Econ. 435 (2004) and Giang Ho & Anthony Pennington-Cross, The Impact of Local Predatory Laws on the Flow of Subprime Credit: North Carolina and Beyond, (Federal Reserve Bank of St. Louis March 2006).

[13] Wei Li & Keith S. Ernst, "Do State Predatory Lending Laws Work? A Panel Analysis of Market Reforms" 18 Housing Policy Debate 374 (2010) (examining the cost of subprime loans from 1998-2005 and finding no consistent evidence on the impact of anti-predatory lending laws on borrower costs); Giang Ho & Anthony Pennington-Cross, Predatory Lending Laws and the Cost of Credit, 36 Real Estate Economics 175 (2008) (finding that enhanced coverage has no significant impact on fixed rate mortgage borrower costs and lowers adjustable rate mortgage borrower costs by around 11 basis points).

This is because down payments, rather than borrowing costs, are the primary barrier to mortgage credit availability.[14]

Part of the reason these costs may be smaller than anticipated is due to the alignment of incentives for the private market. By forcing the market to internalize the cost of consumer compliance and spread it across all consumers, the market's ability to adjust costs is aligned with the incentive to minimize costs that results from a competitive marketplace. In the absence of assignee liability, these incentives are not aligned. The holder in due course rule artificially lowers the cost of consumer compliance to the market, eliminating the incentive to minimize those costs through competition. Consumers, then, bear the risk of unlawful origination practices, but lack the ability to price it into credit.

iii. Other Justifications

The liquidity of residential mortgage loans and the flow of credit into the residential mortgage market are also cited as reasons for maintaining the holder in due course rule. However, the rule is not needed to maintain liquidity or the flow of capital. Securitization serves that purpose in markets without access to holder in due course protections. It transforms non-liquid notes and mortgages into securities with much greater liquidity, even in markets without holder in due course protection, such as auto loans and distressed debt. The present illiquidity of private label mortgage-backed securities is caused by uncertainty. Once the risk contours of the market become clearer the liquidity of mortgage-backed securities will return.

c. Characteristics of the Market and its Participants

There are two characteristics of the residential mortgage market that support the argument for elimination of holder in due course protection: (1) the unequal footing of the borrower compared to other participants in the residential mortgage market and (2) the unbundled structure of lending functions in the residential mortgage market.

i. Unequal Footing of Participants

The holder in due course rule was established to facilitate 18thcentury transactions between merchants in an economy without paper currency. In this commercial context, the parties were the parties were on relatively equal footing and could bargain away holder in due course status. This is not the case in today's owner-occupied residential home mortgage transactions.

[14] Robert G. Quercia, George W. McCarthy, & Susan M. Wachter, The Impacts of Affordable Lending Efforts on Homeownership Rates, 12 Journal of Housing Economics 29 (2003) (finding that a 200 basis point movement in borrowing costs – from 8 to 6 percent – had no impact on homeownership rates because down payment requirements were binding).

There are enormous information asymmetries between borrowers and originators that result from differences in experience and bargaining power. The parties involved with mortgage lending and securitization are very familiar with the process, the other parties in the process, and its legal intricacies. It is one of many repeated transactions for originators and purchasers, while it is a rare transaction for borrowers. The extent of borrower's bargaining power is that borrowers can select a loan originator based on advertised interest rates and other terms. After borrowers select a loan originator they have even less bargaining power: they are presented with a series of standard forms for signature on a take it or leave it basis. This encourages consumers' rational inattention to loan details.[15]

Empirical studies illustrate consumers' rational inattention. For example, studies show that consumers rely on brokers when faced with complex decisions,[16] and usually do not shop interest rates.[17] With the lack of consumer attention to core loan terms, it seems unlikely that they understand that the securitization process deprives them of the right to assert as claims and defenses in a foreclosure action based misconduct by the loan originator. Even if consumers were aware of the holder in due course rule, it is extremely unlikely that they could bargain for its elimination for their loan. Finally, many borrowers lack the financial resources to litigate holder in due course issues if they experience financial distress that leads to a foreclosure action.

ii. Unbundled Lending Functions

In the contemporary residential mortgage market different parties often solicit, underwrite, originate, aggregate, service, and own residential mortgage loans. This unbundled structure, combined with the holder in due course rule, has altered market incentives in important ways. Without the retention of repayment risk, originators have a substantially reduced incentive to make sure the loans they process are repaid. This was particularly true when the market was overheating. They were rewarded for originating loans; the more loans they made, the greater the fees they earned. Similar fee incentives up the securitization chain caused other parties in the securitization chain to continue financing originators with bad lending practices to satisfy investor appetite for mortgage backed securities.[18]

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[15] Rational inattention results due to the limits of cognitive capacity. Because people do not possess infinite time, perfect memory retention, or infinite intellect, they allocate cognitive resources to the issues most pertinent to their daily lives rather than rarely-occurring events. For a broad description of how this is incorporated into macroeconomics, see Antonella Tutino Rational Inattention Guides Overloaded Brains, Helps Economists Understand Market Behavior, Economic Letter vol.6, Federal Reserve Bank of Dallas (2011).

[16] Robert B. Cialdini, INFLUENCE: SCIENCE AND PRACTICE 9, n.5 (4th ed. 2001); Howard Latin, "Good" Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. Rev. 1193, 1209 fn. 55-57.

[17] Marsha J. Courchane, Brian J. Surette & Peter M. Zorn, Subprime Borrowers: Mortgage Transitions and Outcomes, 29 J. of Real Estate Fin. and Econ. 365 (2004) (finding that less than 50% of prime borrowers, and less than 33% of subprime borrowers shop interest rates).

[18] Kathleen Engel & Thomas J. Fitzpatrick IV, Complexity, Complicity, and Liability Up the Securitization Food Chain: Investor and Arranger Exposure to Consumer Claims, 2 Harv. Bus. L. Rev. 101 (2012), fn 151 and 152.

The holder in due course rule discouraged loan purchasers from investigating originator procedures and practices. The less a purchaser knew about the loan origination process, the less likely they were to discover default, fraud, misrepresentation, or violation of law that would jeopardize the protection from claims and defenses available to holders in due course. Removing the holder in due course protection from the residential mortgage market would re-align the incentives of market participants. Without the protection of the holder in due course, assignees would face increased liability unless they policed the practices of originators. Technology has made it very feasible for loan purchasers to monitor, investigate, and police the market at low cost.[19] Assignee oversight would decrease originator misconduct and drive bad actors out of the mortgage loan business. This dynamic motivated the promulgation of the FTC Holder Rule. We believe that it will have the same impact on the residential mortgage market.

3. Scope of Committee's Work

Our arguments apply to both the notes and mortgages related to residential real property. We believe that action related to mortgages is within the scope of the Committee's charge from the Executive Committee of the Permanent Editorial Board for the Uniform Commercial Code. However, the Executive Committee's authorizing resolution requires the Committee to "return to the Scope and Program Committee for approval if it wishes to address additional issues, or if it believes that revisions to UCC Articles 3 or 9 are necessary."[20] Therefore, we ask the Committee to consider whether it should seek approval from the Executive Committee or Scope and Program Committee to propose revisions to Articles 3 and 9. Committee action related to residential mortgages may not fully address the problems arising from the application of the holder in due course rule to the residential mortgage loans because such action would leave the holder in due course rule in place for residential mortgage notes.

[19] For instance, the Center for Responsible Lending estimated that the cost of manual compliance reviews to be $43 per loan and automated compliance reviews to be $1 per loan. Delvin M. Davis & Ellen Schloemer, Center for Responsible Lending, Strong Compliance Systems Support Profitable Lending While Reducing Predatory Practices (Issue Paper No. 10, July 26, 2005) at 6. The American Securitization Forum developed loan underwriting standards to better align the incentives originators and investors. American Securitization Forum, ASF Project RESTART, http://www.americansecuritization.com/Issues.aspx?taxid=2188. ICP Capital developed a forensic analysis tool called Triaxx that locates bad loans in loan portfolios, which could help investors considering the purchase of mortgage-backed securities. Gretchen Morgenson, How to Find Weeds in a Mortgage Pool, WSJ, Sept. 8, 2012.

[20] Resolution, January 21, 2012, Executive Committee of the Permanent Editorial Board for the UCC.

4. Assertions of Holder in Due Course Protection

Much is made of the importance of the holder in due course rule to the functioning of residential home mortgage markets. But the fact of the matter is that it is an issue in a negligible number of cases when the market is considered as a whole. A series of Lexis searches revealed, once duplicates were removed, 741 cases where holder in due course, mortgages, and foreclosure were mentioned from 1983 to 2013.[21] According to the Home Mortgage Disclosure Act data, in a year of very depressed originations, 2008, there were about 6,800,000 loans originated. The total number of cases relying on holder in due course protection in a 30 year period is about 1/100th of 1% of loan volume in a single year during that period. Even if 741 cases is a dramatic underestimate of the cognizable consumer claims based upon unlawful origination practices,[22] this is still a miniscule part of the market over a 30 year period. There is no question that removing the holder in due course rule, and applying a cap on per-violation damages, would allow such a rare occurrence to be priced into credit without substantially increasing its cost. Yet, the change in law would make a huge difference to individual homeowners subjected to unlawful origination practices.

5. Proposed Language for the Act

Observer George Holler has drafted a remedies section for discussion at the next meeting that includes a limited exception to the holder in due course rule's protection from enumerated foreclosure defenses. We would encourage the committee to take the next step and explicitly remove holder in due course protection. This could be done a number of ways. The FTC approach could be mimicked to require notes created in residential mortgage loan transactions include, or be read as if they included, language explicitly stating that the holder is subject to claims and defenses that the debtor could assert against the originator.[23] Alternatively, language could be inserted at the end of the final sentence in subsection in UCC § 3-305(b) clarifying that the stated protections do not apply in the case of notes created due to a residential home mortgage lending transaction.

In conclusion, we ask the Committee to draft the Act prospectively, eliminating holder in due course protection in the realm of residential mortgage foreclosure proceedings. We think that an Act with these features will re-align incentives and improve the functioning and efficiency of the residential mortgage market for all participants. We are confident in the resilience of the market and the resourcefulness of its participants to adapt to this change

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[21] Results based on the query "holder in due course w/50 mortgag! w/50 foreclos! and date (geq (01/01/1983) and leq (03/21/2013))" run in the following databases after elimination of duplicate cases: (1) Federal and State Cases, Combined, (2) Federal and State Pleadings, Combined, (3) Federal and State Briefs and Motions, Combined, (4) Federal and State Subprime Lending Pleadings, Combined, and (5) Federal and State Subprime Lending Briefs and Motions, Combined.

[22] For example, if the holder in due course rule has a strong deterrent effect, resulting in 99, or even 999, cases in which homeowners do not challenge the rule or do not asset claims to begin with because of it, for each one that does challenge the rule.

[23] Federal Trade Commission, Preservation of Consumers' Claims and Defenses, 40 FR 53506 (Nov. 18, 1975), as amended 40 FR 58131 (Dec. 15, 1975).

and re-price credit accordingly. We expect that a clearly delineated expansion in the liability of the purchasers of residential mortgage loans limited to the amount borrowed will propel innovation and reduce originator misconduct. If this change slightly increases the cost of credit and/or slightly decreases the availability of credit, we believe changes to the cost and availability of credit will be small, once the market reaches its steady state, having no significant impact on the homeownership rate.

Sincerely,

Mark B Greenlee

Thomas J. Fitzpatrick IV
Economist

Mark B. Greenlee
Counsel

Enclosure

cc: Ms. Lucy Grelle
Mr. John Sebert

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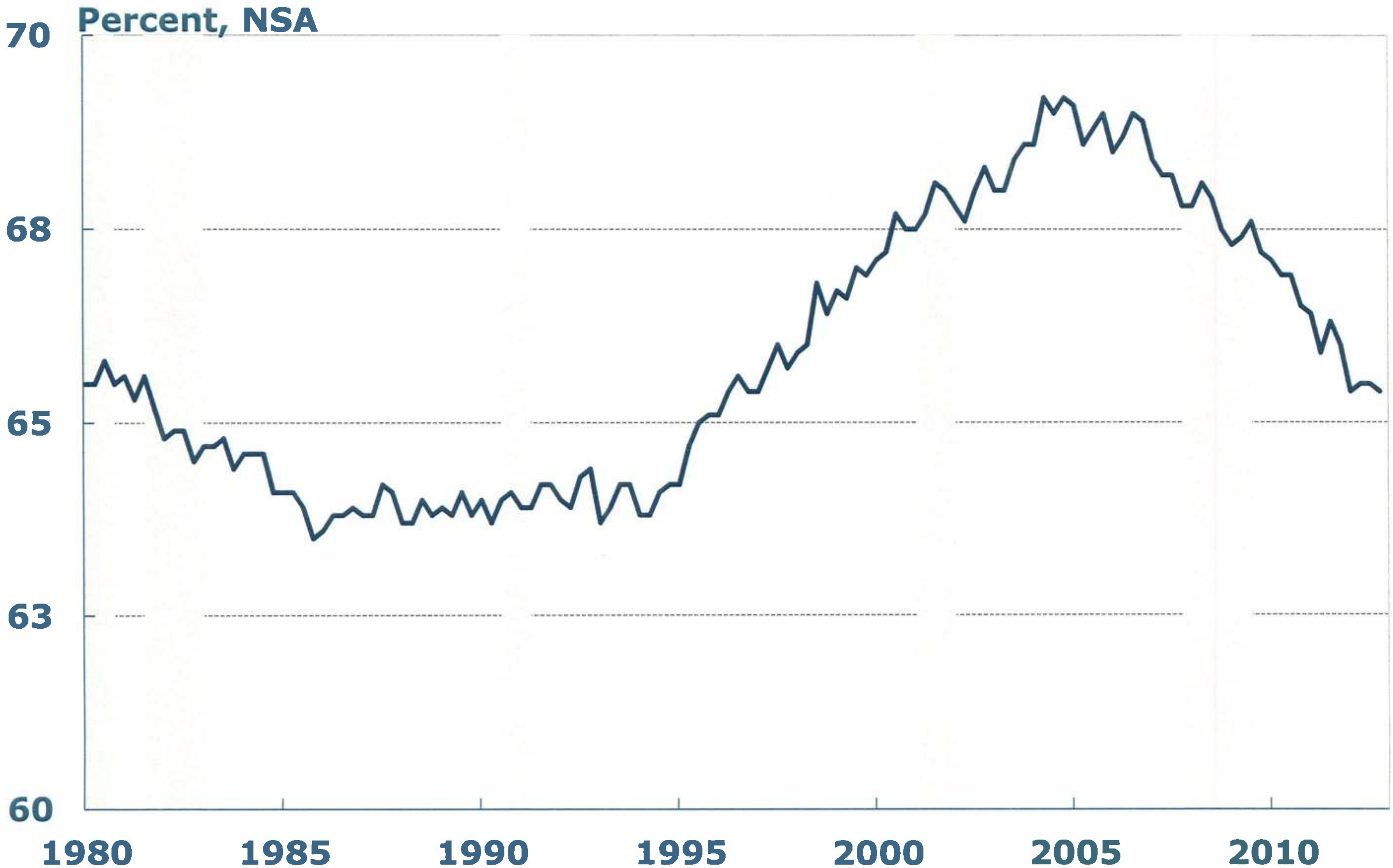
Exhibit A

March 28, 2013

Home Ownership Rate



Note: Grey shading indicates a recession

Sources: Census Bureau: http://www.census.gov/housing/hvs/; Haver Analytics

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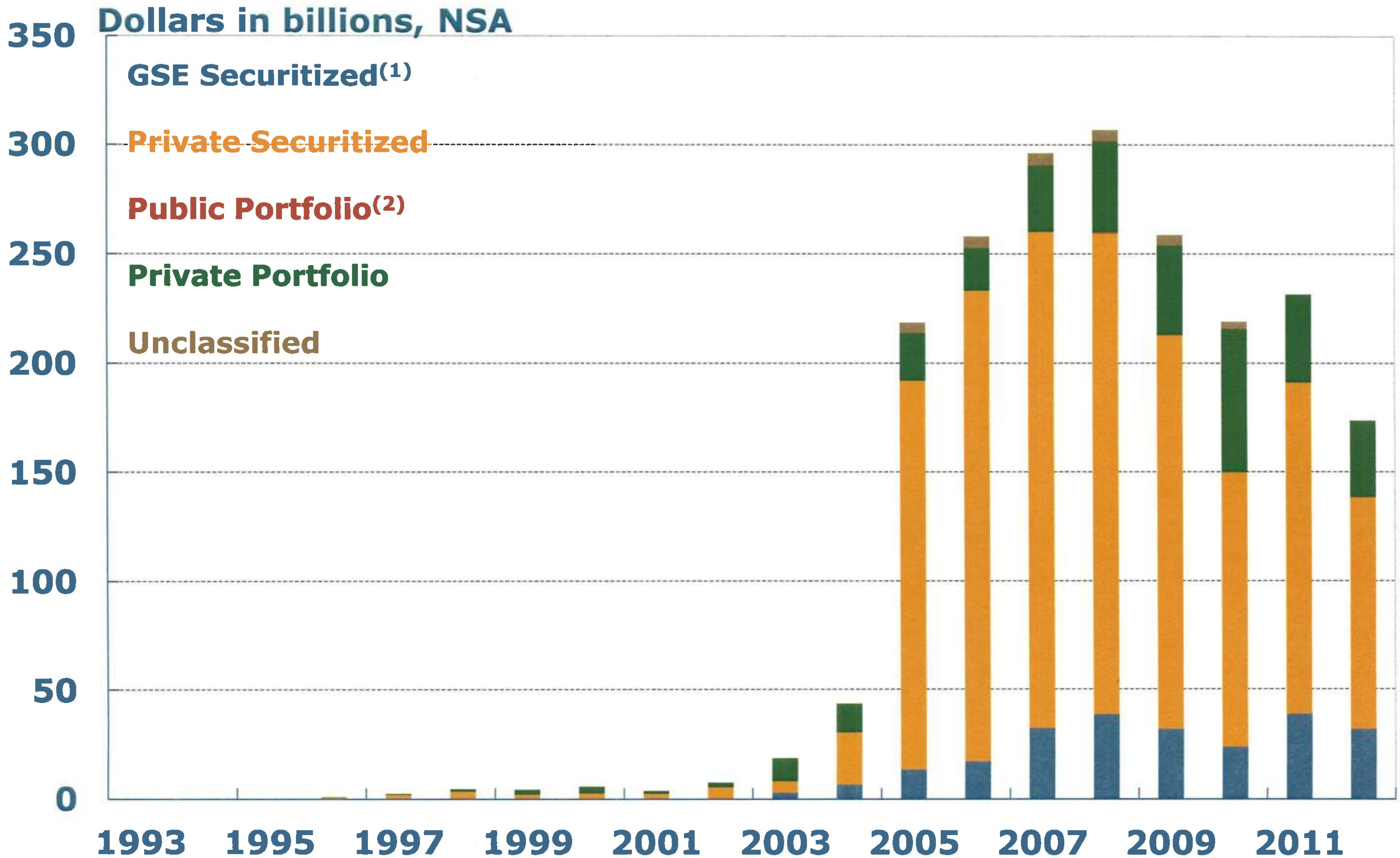
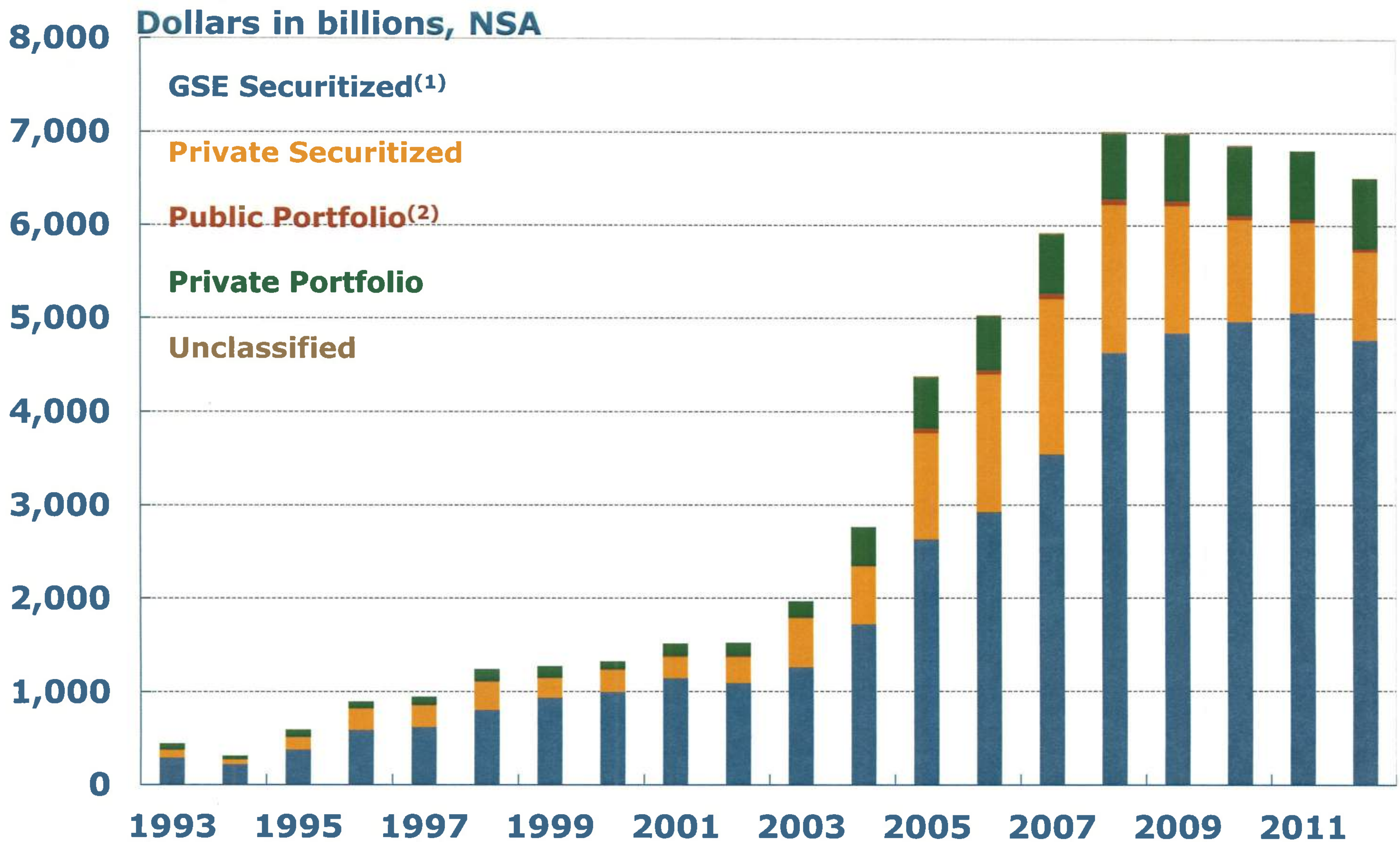
Subprime Mortgage Debt Outstanding



(1) GSE securitized mortgages include: Fannie Mae, Freddie Mac, & Ginnie Mae
(2) Public portfolio mortgages include local housing authorities and FHLB
Sources: LPS Applied Analytics *

Prime Mortgage Debt Outstanding



(1) GSE securitized mortgages include: Fannie Mae, Freddie Mac, & Ginnie Mae
(2) Public portfolio mortgages include local housing authorities and FHLB
Sources: LPS Applied Analytics *

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* Mortgage Debt Outstanding, Prime Mortgage Debt Outstanding , Subprime Mortgage Debt Outstanding

LPS Website: http://www.lpsvcs.com/Products/CapitalMarkets/LoanData/Products/Pages/McDashOnline.aspx

The Residential Mortgage Servicing Database in the RADAR Data Warehouse (DW) contains data from Lender Processing Services Inc. (LPS) Applied Analytics. This data is comprised mainly of the servicing portfolios of the largest residential mortgage servicers in the U.S., at one time from the top 10 mortgage servicers (less so now due to mergers). It covers about two-thirds of installment-type loans in the residential mortgage servicing market. As of year-end 2010, the database contained about 37 million active loans. Overall, this database contains about 130 million individual loans with about 4 billion records of monthly performance history. The database goes as far back as April 1992.

Since the largest servicers span the full spectrum of residential mortgage servicing, this residential mortgage servicing database contains investor types as Fannie Mae, Freddie Mac, Ginnie Mae, private securitized and portfolio loans. It contains subprime (separately identified), nonagency prime jumbos, and Alt A. Product wise, the database contains fixed rate, option arms and all types of hybrid arms (including 2/28s, 3/27s and others). Loan level attributes include borrower characteristics (credit scores, owner occupancy, documentation type and loan purpose); collateral characteristics (LTV, property type, zip code); and loan characteristics (product type, loan balance, and loan status).

Please note that the LPS data was formerly known as the McDash data available from McDash Analytics, LLC, which has been acquired by LPS and renamed since. To deal with the issue of constant name changes of the vendor databases, the RADAR DW would be referring to each database using an appropriate generic naming convention. So instead of referring to the database as either McDash data or LPS data, we would consistently be referring to the term Residential Mortgage Servicing database.