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Real Estate Finance

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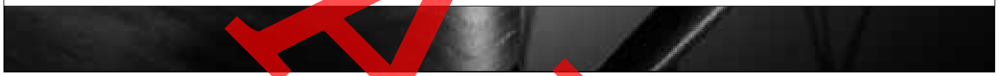
Chapter 1

Wellenkamp to Garn and beyond



Learning Objectives

After reading this chapter, you will be able to:

- recognize key cases and turning points in the law governing mortgage holder enforcement of the due-on clause in trust deeds;
- describe the shift in influence from mortgage holders to buyers, and back again, as due-on rules evolved in response to institutional pressures forcing changes in federal mortgage law;
- understand the government's role in mediating the economy through monetary and fiscal policy; and
- identify the financial and political circumstances which led to the housing bubble and mortgage crisis of the 2000s.

Key Terms

comparative advantage

due-on clause

Federal Home Loan Bank Board (FHLBB)

Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)

formal assumption

further encumbrance

Garn-St. Germain Federal Depository Institutions Act of 1982

mortgage-backed bond (MBB)

recast

restraint on alienation

secular stagnation

subject-to transaction

Lenders vs. owners in the recent past

The positions, goals and anticipations of the lender originating a mortgage (or *mortgage holder* servicing and collecting income from a mortgage) and the owner of real estate are *diametrically opposed.*

This adversarial relationship stems partly from greed, an entrepreneurial trait which is generally what brings both parties to a property in the first place.

California Supreme Court decisions in the 1960s and 1970s brought the confrontation between mortgage holders and owners into sharp focus, as did *anti-deficiency legislation* in the 1930s.

Property owners took one case of mortgage holder injustice after another to the courts. They challenged the mortgage holders' right to flex their *due-on* muscle by raising interest rates at will when the owner of real estate encumbered by a mortgage needed to sell or further encumber the property for funds.

To understand the cause of ongoing mortgage holder-versus-owner battles today (which are today limited to foreclosure conduct), a review of the events in the 1960s and the 1970s is helpful. As case law developed before the early 1980s, important factors included the shifting control of the marketplace from mortgage holders to owners, then back to mortgage holders again, and the often conflicting policies and economies of California and the larger nation.

The early '60s: a stable market

Rising interest rates in the early 1960s produced a severe real estate recession in 1965-1967 while the general economy improved, due solely to the stimulus of war effort employment.

The economic boom experienced just prior to that recession, in 1963-1964, lead to disastrous results for the **savings and loan associations (S&Ls)** in Southern California.

Much like the lending environment during the **Millennium Boom**, individual credit was secondary. Anyone, it was said, was able to use the back of an old envelope to sketch a building plan and obtain a lender's "horseback" commitment for a construction loan. The lender's objective was to get the funds out to as many borrowers as possible.

Lenders viewed the excess monies on deposit as lettuce about to rot on the shelf. Money had to be lent, quickly. As a result, lenders chased deals to place the funds, a classic prelude to investment error whether practiced by lenders or investors.

Broker control during the early '60s

In the early 1960s, builders and buyers selected projects and properties with little concern for the availability of mortgage funds. Funds were readily advanced for the asking. Interest rates were below 7%, and **inflation** was much lower.

To no one's surprise, builders funded by lenders created *excess inventory*. By 1966, vacancy rates and foreclosures soared. Mortgage lenders had lent and sellers had sold to unqualified builders and buyers, soon triggering defaults and increasing foreclosure rates.

Editor's note — During this time, brokers did their job rendering services needed to bring these parties together.

Suddenly, the real estate industry became mired in its own excesses, having grown too fast in the absence of financial safeguards on mortgage lending. Turnover rates for owners and tenants dropped, and sales volume fell naturally.

By the late 1960s, lenders started looking for ways to protect themselves from insolvency, and, with administrative governmental assistance in a rampant series of institutional mergers, regained control of their mortgage investments.

Lenders amass their forces

In 1964, the California Supreme Court modified the common-law application of the **due-on clause**. While receiving little fanfare at the time, this case was the first in a series of rulings relating to the mortgage holder's use of a mortgage's *due-on* trust deed provision.[1]

Common law had rendered *due-on clauses* absolutely **void and unenforceable**. The due-on clause, simply read, limited the free use and disposition of any property ownership interest — known as a **restraint on alienation**.[2]

In *Coast Bank*, the law of *restraints on alienation* was judicially altered, becoming more permissive with regard to a mortgage holder's use of the due-on clause. But it came with one warning: the enforcement of the clause was to be "reasonable."

As a result of this new *reasonable enforcement* test, the lower courts and attorneys for mortgage holders began carving out purposes for a mortgage holder's use of the clause which were arguably reasonable under circumstances surrounding the mortgage.

If reasonable circumstances — a jeopardized security position or increased risk of default, for instance — existed to justify a mortgage holder's call, then the due-on clause was enforced. Payoff of the mortgage balance was demanded, but rate increases were offered as an alternative. However, if the rate increase was not agreed to, foreclosure proceedings were initiated for failure to pay off the mortgage.

due-on clause
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

restraint on alienation
A limit placed on a property owner's ability to sell, lease for a period exceeding three years or further encumber a property, as permitted by federal mortgage policy.

The late '60s: marketplace instability

In 1965, mortgage rates increased and the money supply tightened. Availability of mortgage funds significantly decreased and *inflation* started to soar.

Portfolio lenders did not foresee this massive inflation, which began to adversely affect their solvency. Their **cost of funds** rose while their portfolio assets were fixed rate mortgages (FRMs) with 30-year amortization schedules.

1 **Coast Bank** v. **Minderhout** (1964) 61 C2d 311
2 Calif. Civil Code §711

During this time, approximately a quarter of the *S&Ls* in California were in serious financial turmoil. The S&Ls had lent to everyone secured by anything, and had done so at rates inadequate to cover the risk of inflation reflected in their *cost of funds* – interest paid on deposits.

The result was property foreclosures by the thousands — and by entire tracts — as well as the collapse of many large California-based S&Ls. **Real estate-owned (REO)** became common jargon in the language of the real estate broker. Mortgage holders acquired property in foreclosure which had to be sold, and insolvency ran rampant. Thus, a rapid succession of mergers occurred.

As a result, the big got bigger. As struggling lenders merged into bigger, stronger institutions, the ranks of the brokerage business and the real estate trade organizations were decimated.

Sympathy for lenders in some courts

To top off the bad economic climate of the late 1960s for the real estate industry's non-lending segments, California appellate courts decided two due-on-sale cases in favor of the beleaguered mortgage holders.

It thus became reasonable — and possible — for mortgage holders to use the due-on clause as a profit center. They were permitted to adjust their portfolio yields to reflect higher market yields when a property owner subject to their trust deed lien decided to sell their property.[3]

Although the Supreme Court repudiated the reasoning of one case (*Cherry)* two years later, it took nearly another decade for the legal confusion caused by the reasonableness doctrine of these cases, starting with the earlier *Coast Bank* case, to be put to rest judicially in **Wellenkamp v. Bank of America**.[4]

Disclosure: Fred Crane, the Legal Editor or this publication, was the attorney of record for property owners on the two leading due-on enforcement cases of the time, ***Wellenkamp*** *v.* ***Bank of America*** *(1978) 21 C3d 943 and* ***Fidelity Federal Savings & Loan Assoc.*** *v.* ***de la Cuesta*** *(1982) 458 US 141.*

recast
A mortgage holder's demand to modify the note terms and receive payment of additional fees in exchange for waiving the due-on clause in their mortgage.

Vocabulary development geared to profit mortgage lenders

In the parlance of the day, conventional mortgages requiring *formal assumption* and *modification* upon a buyer's takeover became known as **non-assumable mortgages**. In contrast, **assumable mortgages** were insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA) and did not require formal assumption or modification. [See Chapter 21]

When a buyer assumed a non-assumable mortgage, the interest rate was increased to the mortgage holder's current rate. Points and fees were charged as though the mortgage was newly originated. Terms were **recast** and adjusted upward by exploitation of the due-on clause on the buyer's takeover on a mortgage.

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3 **Cherry** v. **Home Savings & Loan Association** (1969) 276 CA2d 574; **Hellbaum** v. **Lytton Savings and Loan Association of Northern California** (1969) 274 CA2d 456

4 **La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864

Thus, mortgage holders were able to obtain more than the fixed rate of return, their original bargain. On an owner's sale or **further encumbrance** of their property, mortgage holders interfered to exact additional profits with a rate adjustment.

Non-disclosure as the "Medovoi" syndrome

In an effort to rejuvenate sales, brokers and owners developed methods to avoid the due-on clause.

further encumbrance
A claim or lien on a parcel of real estate, such as junior trust deeds, CC&Rs, easements, taxes or assessments.

For example, brokers had the owner transfer title to the mortgaged property into a trust or family partnership. The mortgage holder was advised of the action and explanations were made, though these were hardly the reasons for the establishment of the trust or partnership vesting. Title and escrow companies often held title for the true owners.

Then, without detection by the mortgage holder, the right to the beneficial use of the trust's property was transferred, or the ownership of the partnership was assigned. Both transfers were off the record and the mortgage holder was not aware the due-on clause had been triggered.

Mortgage holders were not advised even when the grant deed transfer was recorded. **All-inclusive trust deeds (AITDs)** became popular. Mortgage holders were completely unaware of transfers as long as sellers continued to make payments and hazard insurance policies remained in place. [See Chapter 30]

When the mortgage holder happened to discover the transfer through tax rolls, insurance policies or inspection of the record for transfers, buyers attempted to avoid full disclosure.[5]

Some of these creative transfer methods had built-in hazards for owners; many sales occurred without documentation or recording. Grant deeds piled up in the safes of escrow companies and brokerage offices to someday be recorded when buyers arranged other financing or resold.

This failure to record caused problems for both owners and mortgage holders since there were too many facilitators handling payments and deeds. In a word: chaos.

Lobbying to vary from fixed

At the outset of the '70s, a few large mortgage holders began to see the judicial handwriting on the wall. They knew the due-on clause was not a long-term tool to correct their erroneous financial decisions.

Lenders and mortgage holders sought legislation to allow them to shift the burden of rising interest rates and costs of funds onto the owners who had borrowed.

The **variable rate mortgage (VRM)** — a California precursor to the **adjustable rate mortgage (ARM)** — was lobbied into existence in 1969.

5 **Medovoi** v. **American Savings and Loan Association** (1979) 89 CA3d 244

The terms of a *VRM* allowed mortgage lenders to pass the cost of inflation on to the owners of real estate encumbered by the VRM mortgage.[6] [See Chapter 6]

Further encumbrance interference

A 1971 California lower-court case dealt with an owner who used their equity to secure borrowed funds while still retaining ownership. The owner further encumbered their property with a second trust deed to secure the mortgage.

The first mortgage holder called the mortgage due, claiming the unconsented-to *further encumbrance* of the property in the form of a junior trust deed breached the due-on clause and triggered the right to prematurely call the mortgage due.

However, the California Supreme Court held a mortgage holder was not permitted to use the due-on clause on the owner's further encumbrance of the property without justifying a *reasonable need* to protect the mortgage based on an increased risk of loss. They held the mere placement of a second mortgage on the property gave the first mortgage holder no legitimate cause for concern over the loss of the mortgage balance or their senior trust deed position held on title to the property. Hence, there was no impairment of the first mortgage holder's security interest in the property due to the further encumbrance without something more.[7]

As a result of the *La Sala* ruling, the market for arranging second mortgages promptly expanded to fill the vacuum brought on by inability to use the equity in a property to secure borrowed funds. Now a lender was able to originate a second mortgage without triggering the first mortgage holder's exercise of the due-on clause.

Misdirected attention to security devices

In 1974, the California Supreme Court again looked into mortgage holders' use of the due-on clause. Here, a mortgage holder prematurely called a mortgage due, claiming the transfer of *equitable ownership* under a **land sales contract** triggered the due-on clause.[8] [See Chapter 31]

The *Tucker* court rejected the mortgage holder's assertion that their need to enhance their portfolio yield with additional profits was reasonable justification to interfere with the change of ownership. The mortgage holder tried to sell the Supreme Court on their **good faith interference**, but the court didn't buy it.

Good faith meant a genuine, fact-supported belief the transfer of ownership either **impaired** the mortgage holder's security interest in the property or created a substantial **risk of default** on the obligation.

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6 CC §1916.5

7 La Sala, *supra*

8 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

Deceptive practices during uncertain times

As control of the real estate industry swung farther into the hands of due-on mortgage holders throughout the 1970s, some agents engaged in deceptive practices when conveying property for their clients. ***Contract escrows*** *were opened in increasing numbers to hold documents off-record until the legal issues regarding due-on clauses were better understood.*

As such, ***reverse trust deeds*** *became popular. In a reverse trust deed, as the name suggests, the economic roles of the buyer and seller in the transaction are reversed. The buyer documents the amount of the down payment on the property as a loan made to the seller, disguised as an owner borrowing money. The seller signs a note for the amount of the down payment and a trust deed in favor of the buyer, which becomes a lien on the property.*

When escrow closes on the sale, the buyer's reverse trust deed is recorded and the seller receives the net proceeds from the down payment. The buyer takes possession of the property under a lease signed by both the seller (as the landlord) and the buyer (as the tenant).

All other documents regarding the buyer's ***actual*** *purchase are left unrecorded and placed into a contract or holding escrow.*

Thus, the official record stated the seller was still the owner, and the buyer was merely a lender of funds to the seller. Yet the change of ownership occurred and possession was transferred and the operative documents were held off-record, avoiding due-on enforcement.

Following *Tucker*, the need for impairment became so clear the mortgage holder in that case later filed only judicial foreclosures to get legal cover when seeking to use the due-on clause (and intimidate the owner).

Tucker made mortgage holders aware of the potentially expensive threat of punitive damages for their **tortious conduct**.

Also, a later case imposed **attorney fees** on a lender who improperly uses the due-on clause against a non-assuming buyer.[9]

Disclosure: Fred Crane, the Legal Editor of this publication, was the attorney of record for this case, ***Saucedo*** *v.* ***Mercury Savings and Loan Association*** *(1980) 111 CA3d 309.*

Time for the Wellenkamp assumption

The earlier *La Sala* case dealt specifically with further encumbrances in the form of second mortgages. A footnote in *La Sala* indicated a further review and application was to be made of the reasonableness standard when a case involving a sale came along.

Tucker, a case involving a carryback sale, became the fulfillment of that footnote. But the carryback sale was structured as a *land sales contract*, not a grant deed, trust deed and note.

9 **Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

The facts of *Tucker* regarding the **carryback financing** device used in the sale distracted nearly everyone from the legal concepts controlling mortgage holder conduct on a change in ownership. [See Chapter 31]

Use of a land sales contract caused uncertainty as to whether the same rule applied to other forms of sale, such as a grant deed conveyance on a **cash-to-loan** sale.

A sale without mortgage holder interference

Mortgage holders continued to take advantage of sellers and their ill-informed brokers and agents who were unaware of a property owner's **right to sell**, further encumber or lease their property without mortgage holder interference.

Mortgage holders played their hand at **assumptions** until sellers, buyers and brokers learned to call these mortgage holders' bluffs. They eventually did so as the result of individual experiences relayed to others, viral rather than organizational efforts. Here, a weak real estate sales market, brought on by increasing mortgage rates, spurred individual buyers and their brokers to challenge the mortgage holders.

Agent's conduct with mortgage holder of record

Between 1974 and 1978, prior to the *Wellenkamp* decision, agents negotiating sales involving mortgage takeovers frequently did not fully understand their clients' rights. Uninformed agents were known to call the mortgage holder of record on the listed property to seek advice from the adversary on a buyer's mortgage assumption before writing a purchase offer.

The mortgage holder's response was always adverse to the client's best interests, be they the seller or buyer. The nature of the inquiry led the mortgage holder to infer the seller and buyer were ignorant of the buyer's right to take over the mortgage in a **subject-to transaction**.

subject-to transaction
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **RPI** Form 156 §5]

On closing a *subject-to transaction*, the mortgage holder was promptly advised of the sale and the buyer's name and address. The transfer arrangements, usually through an independent escrow since title companies colluded fully with mortgage holders, had deliberately avoided a modification and any increased portfolio yield on the 30-year FRM.

Mortgage holders then pressed buyers for a **formal assumption**. When the sellers, buyers and agents — armed with the *Tucker* decision — presented a concerted front against formal assumption, mortgage holders called mortgages and filed **Notices of Default (NODs)** with less frequency. [See Chapter 20]

Wellenkamp prohibited lender profiteering

In 1978, the California Supreme Court put a stop to the mortgage holders' use of the due-on clause to *unilaterally adjust* their mortgage terms. This brought an end to the era of automatic due-on clause use as a tool to adjust portfolio yields.

In California, as in most other states, mortgage law prohibits enforcement of any trust deed provision which purports to restrict the owner's right to sell, lease or encumber their property.[10]

formal assumption
A buyer's promise to perform all the terms of the mortgage, given to the mortgage holder on the buyer's takeover of an existing mortgage, typically involving a modification of the interest rate and payments and an assessment of points and fees. Compare with a subject-to transaction.

The California Supreme Court decision in *Wellenkamp* simply stated what knowledgeable real estate lawyers already knew — California Civil Code §711 made it illegal for mortgage holders to use a due-on clause for profit when the transfer of secured property to a buyer did not place their security interests in danger of **impairment**.[11]

Any lender or mortgage holder interference with a sale was prohibited, except when it was **reasonably necessary** to protect the mortgage holder's security interest in the transferred real estate.

Prohibited restraints on alienation

Significantly, the California Supreme Court described the provision as the due-on clause, not the **due-on-sale clause**.

This meant the ruling was not limited to just the sales aspect of ownership — *any* ownership interest was included. In 1983 the courts accordingly extended this right-to-alienate ruling to *leasehold assignments*, barring a landlord's unreasonable termination of a lease when the tenant assigned it to another tenant (until California deregulated landlords in 1990).[12]

Lenders and mortgage holders were now prevented from shifting the cost of their mortgage rate-setting mistakes onto buyers and borrowers. The risks of forecasting interest rates were to remain with the lenders and mortgage holders who created the portfolio yield problem — until 1982.

Automatic enforcement

In June 1982, the United States Supreme Court gave federally chartered S&Ls the ability to *automatically* enforce their *due-on-sale clauses* for profit and economic viability on the following actions involving a mortgaged property:

- a **sale**;
- a **lease** with a term of three years or more; or
- a **further encumbrance** of the secured property.

The ruling enabled Federal S&Ls to call a mortgage without concern for the impairment of their security or the buyer's **creditworthiness**.[13]

This resulted in serious inconsistencies between state and federal due-on practices. The resale differences for property encumbered by a federal S&L mortgage significantly hindered the federally chartered S&Ls' ability to lend at rates obtainable by other mortgage lenders. To compete, they were lending at rates a quarter of a percent less than market.

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10 CC §711

11 **Wellenkamp** v. **Bank of America** (1978) 21 C3d 943 (Disclosure: the legal editor of this publication was the attorney of record for the property owner in this case.)

12 **Cohen** v. **Ratinoff** (1983) 147 CA3d 321

13 12 Code of Federal Regulations §591.2(b); **Fidelity Federal Savings and Loan Association** v. **de la Cuesta** (1982) 458 US 141 (Disclosure: the legal editor of this publication was the attorney of record for the property owner in this case.)

Borrowers recapitalize their lenders, by federal law

Garn-St. Germain Federal Depository Institutions Act of 1982
A federal law which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

The **Garn-St. Germain Federal Depository Institutions Act of 1982 (*Garn*)** was intended to settle this due-on imbalance and impending widespread mortgage holder insolvency brought on by the 1980s recession, the worst since the Great Depression (until 2008, of course).

Garn extended the rights which *de la Cuesta* gave federally chartered S&Ls to *all* mortgage holders.

Signed into law on October 15, 1982, *Garn* brought about blanket preemption of state law limitations on due-on practices. Together, *de la Cuesta* and *Garn* created a new body of federal mortgage law, eliminating states' rights to protect buyers from mortgage holder due-on interference.

Garn made one limited concession for interference-free mortgage assumptions. A three-year **window period** was established which prohibited due-on interferences on mortgages originated between August 25, 1978 (the date of the *Wellenkamp* decision) and October 15, 1982 (the date *Garn* became law).

The FHLBB steps in

Federal Home Loan Bank Board (FHLBB)
The Depression-era regulatory body established to fund savings and loan associations (S&Ls) and provide mortgage market liquidity. The FHLBB became the Office of Thrift Supervision in 1989, and then dissolved in 2011 shifting its duties to the Consumer Financial Protection Bureau (CFPB) and other federal agencies.

The *Garn* legislation, which persists today, provides only general guidelines for due-on enforcement. *Garn* gave the **Federal Home Loan Bank Board (FHLBB)** and other regulatory agencies the authority to issue rules, regulations and opinions interpreting *Garn*.[14]

In drawing up these regulations, the FHLBB took care to specifically define what events constitute a sale or transfer under *Garn*. The FHLBB defined a *transfer* as the conveyance of any right, title or interest in the mortgaged property, whether equitable or legal, voluntary or involuntary (as in a judgment or tax lien sale).

However, the FHLBB regulations left some significant issues undetermined. Loopholes still exist in the due-on catch-all. Neither the regulations nor *Garn* itself mention anything about transfers structured:

- with delayed purchase agreements;
- with escrow instructions; or
- between limited partnership and limited liability company (LLC) interests.

These loopholes are exploited as paths to avoid due-on enforcement under *Garn*. However, in the evolution by lenders of the due-on wording in trust deeds originating after *Garn*, lenders added wording that prohibited the use of entities for transfers that were to take place off title, by sale of the entity which owned the secured property but not a change in title to the real estate.

The failed financial deregulation experiment

Garn was heralded as an economic catalyst to remedy the cyclical failure of lending institutions in the inflationary 1970s by:

- allowing **S&Ls** to venture directly into exotic, highly speculative investments;

14 12 United States Code §1701j-3(e)

The due-on clause has not been an issue for California buyers and sellers since 1982, the year Garn permitted unfettered mortgage holder interference in ownership transactions on mortgaged properties. After 1982, interest rates followed a 30-year virtuous cycle of decline ending in 2013. All the while, an abundance of mortgage money was readily available to buyers at ever-reducing rates.

*However, when **inflationary conditions** or massive government, corporate or mortgage borrowing develop in the national economy, short- and long-term interest rates rise in response to increased demand and inflationary pressure.*

*Gradually, rising **short-term interest rates** cripple buyer demand. In an initial response, buyers resort to ARMs to extend their borrowing reach and fund home purchases at increased prices. As sales volume peaks, prices subsequently fall. As a result, the related real estate providers of brokers, lenders, credit agencies, title companies, and escrow officers are temporarily paralyzed.*

*Persistent popular expectations of increasing inflation eventually have an adverse effect on the ability to buy and sell real estate. In response, the **Federal Reserve (the Fed)** ultimately induces an economic slowdown to moderate inflationary expectations by raising short-term interest rates. In turn, homebuyers' overreliance on ARMs is stemmed.*

*Short-term interest rates need to increase faster than the rate of inflation if the Fed is to hold inflation at a target level acceptable to the **long-term bond market**. Only then will long-term FRM rates remain fairly constant or decline, provided the Fed's monetary policy does not allow government and corporate borrowing to interfere with market rates.*

The swing in mortgage rates

- raising the **federal guarantee** on individual savings accounts from $40,000 to $100,000;
- allowing mortgage holders unfettered use of **due-on clauses** to increase portfolio yields through *loan modifications* and *recast rights*; and
- eliminating **loan rate competition** between state and federally chartered mortgage lenders by leveling the playing field.

Money market deregulation in the late 1970s and the congressional due-on legislation in 1982's *Garn* brought about sanctioned mismanagement in the S&L industry. By the early 1980s, FRMs and dramatically rising *short-term rates* (over 14%) were blamed in part for extensive S&L insolvency. This eventually led to the multi-billion dollar S&L debacle of the late 1980s.

Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)
Federal legislation enacted in 1989 in the wake of the savings and loan (S&L) crisis to strengthen regulations on lenders and appraisers and improve the availability of mortgage funds.

S&L mismanagement

S&L mismanagement through the mid-1980s ran too long without regulatory oversight, causing losses the industry was unwilling to cover itself. The **Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)** was passed in 1989 to relieve the S&L industry of its financial insolvency due to *undercapitalization*.

FIRREA was designed to prevent the S&L industry, considered a historically stable source of financing for homeownership, from collapsing. It renamed the S&Ls **thrifts** (after a quality they had not demonstrated) and re-regulated the S&L industry.[15]

This re-regulation caused most S&Ls to promptly convert to national banks to avoid the financial burden and corrective regulations imposed by FIRREA.

The due-on clause, however, persisted through FIRREA's legislative reshuffling, remaining as a mortgage holder's profit-making device. A further transfer of wealth from real estate owners to lenders occurred where the mortgage held by the lender was an ARM.

Mortgage holders see dollar signs in due-on clauses

Following the elimination of California's due-on protection in 1982's *Garn*, interest rates began their 30-year cyclical downward trend. Since then, rates have not risen for long enough periods to permit brokers to gain practical experience handling the due-on issue of **mortgage holder interference**. [See Chapter 19]

However, annual **foreclosure sales** increased nearly eightfold in the early 1990s. The glut of foreclosed properties drove down home prices, which were already declining due to late 1980s interest rate increases and California's falling employment and per capita income.

Rupturing the financial levies

In 1998 the Fed started raising short-term interest rates to induce a routine **recession** to orchestrate an adjustment in economic growth. As planned, the recession took hold in early 2001, one year after the Fed finally pushed short-term rates higher than long-term rates.

But this effort to cool the economy was to be short-lived. The economic reaction of both the Fed and the administration to September 11, 2001 froze the price of homes at their artificially elevated peak before the corrective work of a recession took place. Thus, the stage was not set for sustainable future price growth based on historic pricing trends. The public forgot about house values dropping as the natural consequence of a recession.

Following September 11, 2001 the Fed opened the floodgates controlling the flow of money into mortgages. The Fed loaned money and bought **treasuries** in the money markets, adding large amounts of fresh cash to the money supply through bankers of all sorts. The seeds of the *Millennium Boom* thus began to sprout and, unabated by rates or regulations, eventually flowered.

Federal money floods the market

Cheap, short-term federal money provided upwards of $2 trillion to be lent. The availability of this easy unregulated money gave Wall Street bankers the impetus to provide mortgage funds to as many borrowers as possible.

15 Pub. L. 101–73

The result was an aggressive mortgage lending environment on Wall Street which eventually evolved into a proliferation of **subprime** lending. Mortgage standards were further relaxed, luring unprepared or underqualified tenants into homeownership.

Releasing more than just money: mortgage market deregulation

During the same post-2001 period, the U.S. Treasury and Congress continued **deregulating** mortgage lenders and Wall Street bankers. Deregulation, encouraged by the Fed, removed most of the previously established fundamental parameters for safe mortgage lending.

At the same time, Wall Street also began buying up established mortgage banking operators around the nation. By 2005, Wall Street bankers dominated all aspects of mortgage management nationwide, with the exception of broker-packaged mortgage originations.

Short-term rates for acquiring funds were increased to significantly reduce the flow of funds into mortgages. However, by the time short-term rates began to rise, Wall Street was almost exclusively relying on investor funds flowing in from the **mortgage-backed bond (MBB)** market. Thus, Wall Street no longer looked to the Fed to replenish its mortgage coffers. *Mortgage-backed bonds* provided the flow of money needed to originate, bundle and sell positions in America's mortgages.

mortgage-backed bond (MBB)
An asset-backed security representing a claim on the cash flows from payments received on a mortgage.

Financial cause and effect

The Fed's aggressive open-market lending, regulatory failures and unrealistic government homeownership policies after 2001 set the stage for the real estate bust.

Leading up to the collapse of the financial markets, parameters for structuring real estate mortgages had essentially ceased to exist. In their absence, the forces of **comparative advantage** encouraged Wall Street bankers to undertake drastic leveraging efforts to keep investors in their MBB purchase programs. Banks of all sorts and in all countries bought into the scheme, taking on the excessive risk of loss built into increasingly exotic loan products such as *option ARMs*. [See Chapter 6]

comparative advantage
The advantage a person who produces a product at a greater margin of profit has over a competitor.

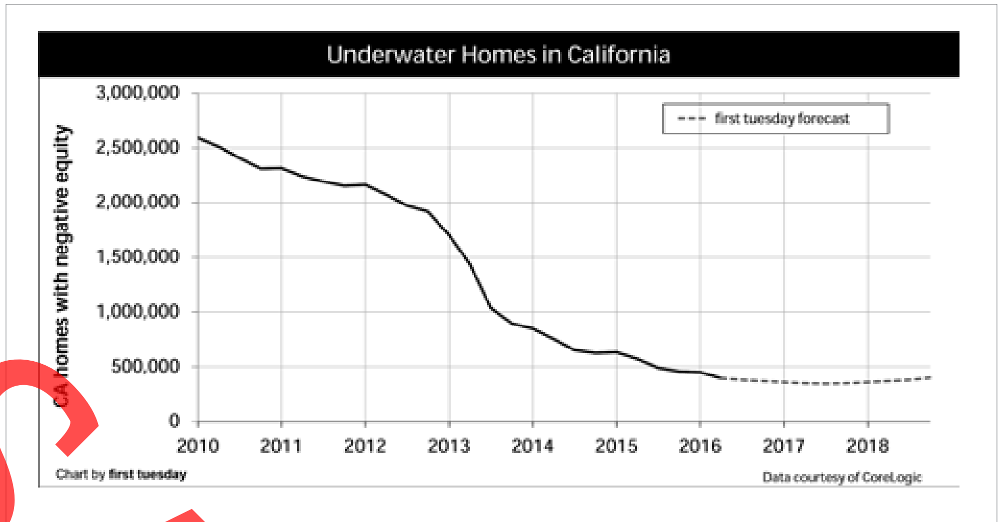
Deregulation allowed increasingly risky mortgage lending up until 2007. That year, mortgage borrowers began defaulting en masse. Lenders and mortgage holders were inundated with foreclosures due to the imprudent lending practices permitted by a deregulated and out-of-control financial sector.

A willing congressional accomplice

Congress was a willing accomplice in this fiasco. By 2005, the legislative branch had succeeded in removing what few restraints remained on mortgage lending by withdrawing bankruptcy court authority to help insolvent and over-mortgaged homeowners. This was the final straw following 25 years of loosening controls over Wall Street's involvement in the mortgage industry.

Figure 1

Underwater Homes in California



Almost overnight during 2007, the cash-engorged hey-day of the Millennium Boom boiled over into what became the **Great Recession**.

The *Great Recession* eliminated trillions of dollars in asset wealth across the nation. It left nearly 40% of California's 6.5 million homeowners in a **negative equity** condition, with their houses worth far less than the remaining amounts owed on their mortgages.

As a result, a majority of homeowners who bought during the Boom became prisoners in their own homes, with no ability to sell and relocate. [See Figure 1]

To compound matters, ARMs began to reset at higher rates causing their monthly payments to swell. Homeowners who bought after 2001 had lost too much of the equity necessary to refinance. California was thus faced with a **foreclosure crisis** of unprecedented proportions.

Back from the bottom

In response to the **vicious economic cycle** caused by the Millennium Boom's implosion, the U.S. Treasury, the Fed and California's state government released a wave of aid specifically targeting the real estate construction, sales and mortgage sectors. This aid took the form of:

- government subsidies (tax credits) to homebuyers; and
- the Fed's purchase of large quantities of newly-issued MBBs to keep funds flowing in the mortgage origination markets.

California's government applied hundreds of millions of dollars to stabilizing the real estate market beginning in 2008. In 2010, the state granted $100 million in **tax credits** toward the purchase of existing homes — primarily *REO* properties — and another $100 million to the purchase of homes in builder inventory.

That, and other state and federal stimulus, temporarily propped up the real estate market in 2009-2010, giving a boost to sales volume and pricing as intended. But those stimulus efforts were inadequate to generate more than a momentary bump and cannibalized sales from the two years to follow. The economic recovery did not take the "V" or "U" shape many hoped for. Instead, the recovery has come to look more like an **aborted checkmark** following the 2009-2010 stimulus effort.

Economic growth since 2008 has been very modest, gaining momentum at times, then dropping back, as was seen in 2011 and 2014. This current recovery paradigm is known as **secular stagnation**: a protracted period of lackluster economic growth, huge increases in disability retirement and early social security benefits and a business demand for lower wages.

secular stagnation
An abnormally lengthy period of sluggish economic growth.

A new paradigm

Nearly three decades of financial deregulation created a mortgage lending environment ripe for abuse. The result was a precarious house of cards, made of poorly vetted and exceedingly risky mortgages and related investment instruments. It all came crashing down in what became the United States' worst economic downturn since the Great Depression.

Lawmakers moved swiftly to ensure such a fiasco is not soon repeated. **The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)** was born from calls for sweeping re-regulation of the financial system aimed at ensuring Millennium Boom conditions will not again threaten our economic stability.

Dodd-Frank, passed into law in 2010, rolled out in the form of regulatory pieces over the following five years. Regulators, including the newly-formed **Consumer Financial Protection Bureau (CFPB)** introduced a host of new protections intended to produce financial stability and the safety of the consumer.

All this regulatory activity has completely rewritten the way real estate transactions are financed and mortgage business is managed. We'll take a closer look those changes in the following chapter.

Chapter 1 Summary

From 1960 to 1965, an overabundance of funds to be lent on real estate drove lenders to make loans for construction and purchase of property to virtually anyone. This excess of investment contributed to overbuilding. Shortly thereafter, vacancies and foreclosures soared.

At the same time, the Supreme Court handed down a ruling which expanded the application of the due-on clause, enabling mortgage holders to use the provision to call mortgages due and immediately payable so long as it was demonstrably "reasonable."

Through the early 1970s, mortgage holders were able to obtain more than the fixed rate of return for which they originally bargained. When a buyer assumed a mortgage, mortgage holders increased the interest rate, charged additional points and fees and recast its terms.

Owners and their brokers, however, devised methods to avoid triggering a due-on clause by covertly transferring ownership out of the mortgage holder's view.

The tide began to turn in favor of owners with a 1971 court decision prohibiting enforcement of the due-on clause on an owner's further encumbrance of the property without justifying a reasonable need to protect against the risk of loss.

Mortgage holders had to demonstrate their interference was done in the good faith belief the transfer of ownership posed a risk to their security interest in the property. However, mortgage holders took advantage of owners who were unaware of their ownership rights to sell.

The 1978 California Supreme Court decision in Wellenkamp v. Bank of America put a stop to mortgage holders' unilateral use of the due-on clause to adjust their portfolio yields.

In 1982, the United States Supreme Court gave some larger mortgage holders the ability to automatically enforce the due-on clause on a sale. That same year, Congress enacted the Garn-St. Germain Federal Depository Institutions Act (Garn) to increase the earnings of struggling savings and loan associations (S&Ls). But deregulation and Garn brought about S&L mismanagement, causing losses the industry was unable to cover.

The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989 was passed to re-regulate the insolvent S&Ls, but the due-on clause persisted after FIRREA and remained a lender's profitmaking device.

To stimulate the economy following the events of September 11, 2001, the Fed added large amounts of cash to the money supply by making loans and buying treasuries in the money markets. Mortgage lending standards became lax and subprime borrowers were lured into homeownership with risky mortgages. At the same time, the government acted to deregulate mortgage lenders and Wall Street bankers by removing parameters for safe mortgage lending.

Mortgage borrowers began defaulting en masse, leaving lenders drowning in foreclosures due to imprudent lending practices. As a result, the Great Recession decimated trillions of dollars in wealth and left over a third of California homeowners in negative equity.

With its creation by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the newly-formed Consumer Financial Protection Bureau (CFPB) is working to introduce a host of new protections intended to produce financial stability and the safety of the consumer.

Quiz 1 Covering Chapters 1-2 is located on page 619.