The Mortgage Foreclosure Crisis

Let us be blunt: The mortgage foreclosure crisis, which first burst into full public view with Bank of America's suspension of all foreclosures only a few days ago, has the potential to completely destroy the American real estate sector in an epic legal and economic meltdown that would make the crisis of 2007-2008 look like the proverbial Chinese tea party.

Although a few exceptionally observant souls have been sounding the tocsin for months that the entire foreclosure process was corrupt and that, sooner or later, the banks would be called to task for it, no one in the major media paid much attention until the Bank of America announcement. Only the day before the BOA bombshell, President Obama issued an unusual pocket veto of a little-noticed bill whose passage would have allowed foreclosure business to proceed as usual. But the Obama veto, buttressed by withering pressure from consumer interest groups, sent a clear signal to Bank of America and the rest of the banking sector: the millions of homes now in foreclosure across America may be a legal and financial no man's land, an enormous slice of the world's largest asset group to which no legal ownership can be assigned.

To grasp the enormity of the crisis now unfolding, it is important to understand the nature of mortgages. Until as recently as two decades ago, most mortgages were undertaken entirely by a single creditor, usually a local bank. The mortgage remained at the bank where it was issued, and was either repaid or defaulted on. In the case of the latter, the bank — holder of both the note (the IOU) and the mortgage lien — foreclosed and repossessed the property.

Beginning in the 1990s, it became fashionable to sell mortgages to other parties, and the mortgage securitization industry was born. Mortgages were sold, repackaged, and sold again, and a bewildering array of mortgage-backed securities was created to underwrite this new market. The United States mortgage business not only went national but international as investors worldwide rushed to get a piece of the lucrative American real estate sector.

To help streamline the process, Fannie Mae and Freddie Mac created a national mortgage electronic registry called MERS (Mortgage Electronic Registration System, Inc.), whose purpose was to streamline the transfer of mortgages by helping mortgage securitizers to avoid the costs and inconveniences of recording mortgages at local courthouses.

Unfortunately for the mortgage sector, there were two big problems with that approach. In the first place, mortgages and mortgage transfers are governed by state, not federal laws. By providing a means to circumvent the hassles of state laws and local jurisdictions, MERS effectively ran roughshod over state authority. The other, potentially greater, problem, is that the critical document in a mortgage transaction — the one that empowers the creditor to enforce the terms of the mortgage on a delinquent homeowner — is the note, in 45 out of 50 states. A note, like any claim on assets, must be properly signed to have the force of a title. If it is sold to a new owner, it must be signed again, and so forth. Only thusly can what is called the "chain of title" be legally established.

But many, perhaps most mortgages that have been sold and repackaged again and again over the last few years were done so electronically, thanks to MERS, and typically lack the requisite signatures. Their chains of title, in other words, have been broken.

None of this would have mattered had the housing market continued to boom. But with the unprecedented volume of foreclosures — many of which have hit otherwise creditworthy, responsible individuals hard-pressed by unexpected circumstances — many victims of foreclosure hired lawyers and fought back. Astute lawyers began looking into chains of title, and the entire tangled mess began to unravel.

Nor are banks ignorant of the shaky legal ground on which many foreclosures rest. An entire industry has sprung up over the past few years to assist banks in the foreclosure process by forging documents to reestablish the chain of title. One such firm, outed by Yves Smith of nakedcapitalism.com, DOCX, advertised its "GetNet Document Recovery service" for mortgage holders, including such goodies as "create missing intervening assignment" (fee: $35) and "recreate entire collateral file" (fee: $95.00). This is but one example of the dark side of the foreclosure sector, an entire industry dedicated to bullying homeowners out of their homes by forging lost links in chains of title, if necessary.

These two issues — the ignoring of state mortgage laws and the willful abandonment (and illegal re-forging) of chains of title — threaten to plunge the entire real estate sector into chaos. This time around, the problem is less economic than legal, but the ramifications are truly appalling. It is entirely possible that no title can be established on any mortgaged property unless the mortgage is older than eight or ten years. Millions of mortgage holders — even those not in foreclosure — may be able to abandon their mortgages and leave lenders on the hook, if banks are unable to produce proof of ownership. And the entire banking system could well implode under the weight of untold billions of dollars more in losses that cannot be recouped. The federal government might attempt another TARP-esque bailout — but without any prospect for repayment.

Given the legal actions already underway, none of this seems at all farfetched. A rising tide of court cases across the country have denied the validity of foreclosures originating with MERS, for example, and have even restored houses, mortgage-free, to their original owners. Class action suits are now being filed against LPS (Lender Processing Services, Inc., the nation's largest processor of foreclosures (and the purchaser, in 2008, of the aforementioned DOCX), alleging kickbacks, violations of state mortgage laws, and conspiring to cover up fraudulent activities. And dozens of state Attorneys General are now investigating the whole sordid mess, eager to defend their states' interest against predatory foreclosures.

Then there are the politics of the issue in Washington, as illustrated by the recent pocket veto mini-drama. President Obama, already reeling in the polls and bracing for huge electoral losses in a few weeks as voters vent their wrath on a Congress complicit in the bailouts and other huge spending programs, is in no mood to prostrate himself yet again before the banking and financial sector. The plutocratic Senate, meanwhile, under heavy pressure from their patrons in Big Banking, tried to pass a bill that would allow foreclosure documents to be accepted among multiple states. In this case, the pleading of consumer interest groups — to the effect that the bill would (as was doubtless intended) make it much harder for homeowners to challenge foreclosure documents prepared in other states — carried the day.

By our reckoning, there are at least four major culprits in this new crisis. The first is the entire corrupt Federal Reserve System, whose monetary machinations created the real estate bubble in the first place. The second is the Consumer Reinvestment Act, a truly horrible piece of legislation that forced banks to lend to those who posed high credit risks. The CRA, more than any single piece of legislation, created incentives for banks to dilute credit risks by securitizing mortgages. The third is the evil twins Fannie Mae and Freddie Mac, who aided and abetted the entire mortgage-backed security industry by (among many other things) creating MERS. The fourth, and perhaps most culpable of all, is a U.S. Congress that, by allowing the nationalization of the mortgage industry under the auspices of national regulatory organs in defiance of state laws, has been reprehensibly derelict in its constitutional duties.

Where this crisis may lead is hard to predict, but the legal sector, scenting huge payoffs from the banks, is unlikely to back down. It is not at all farfetched to imagine the entire edifice of U.S. real estate and mortgage law destroyed. And all of this is but another unintended consequence of misbegotten federal government meddling in matters that are neither economically wise nor constitutionally its concern.