

## Ignorance Is Not Bliss

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The evolutionary path of the economy as affected by law has been "driven by artificial selection of changing customs that ignited sets of endogenous forces" (Atkinson 2010, 290). The evolutionary path of the law has been the result of changing economic circumstances. John R. Commons traced this co-evolution of law and the economy through the transformation of property from physical or corporeal property to incorporeal property "consisting of debts, credits, bonds, mortgages, in short of promises to pay" (Commons 1924 [1995], 19). The legal definition of property would encompass intangible property "consisting of the exchange-value of anything whether corporeal or incorporeal property or even intangible property" (19), including granting protection to exchange-values under the Fourteenth Amendment to the U.S. Constitution.

Commons identified transactions as the basic unit of economic analysis. He described them as transfers of legal rights, duties, liberties and exposures. "Each transaction is a process of joint valuation by participants, wherein each is moved by diversity of interests, by dependence upon the others, and by the working rules which, for the time being, require conformity of transactions to *collective action*. Hence, reasonable values are reasonable transactions, reasonable practices, and social utility, equivalent to public purpose" (Commons [1934] 1961, 681; emphasis added). Collective action should

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bring harmony out of conflicts of economic interests, but requires informed participation by all parties in the negotiations. The mortgage market deviated from this standard as parties to transactions were ignorant of the essential facts of the transactions and, therefore, uninformed about the legal rights, duties, liberties and exposures created by their transactions. The collective consequence of these flawed transactions was ruined communities.

### **Secondary Mortgage Market**

Mortgages transformed during the latter part of the twentieth century from incorporeal property held by the lender into intangible property owned by investors who were generally ignorant of the particular assets securing the mortgages. Likewise, as the mortgage market expanded during 2000-2007, mortgage originators developed new, riskier products which were deceptively marketed to borrowers who were ignorant of the risks and consequences of default (Thomas 2013, B1). The secondary mortgage market went through a transition between 1960 and 2000 reflecting the law's endorsement of emerging business practices. The history of the law's role in the development of mortgage-backed securities ("MBSs") follows Commons' analysis of the transformation of incorporeal property into intangible property. Prior to the creation of the Federal Housing Administration ("FHA") in 1934, mortgages were typically balloon mortgages of five to ten years duration. FHA helped create fixed rate mortgages amortized over a 30 year period. The typical holder of such a mortgage was a thrift institution which held the note (incorporeal property) until prepayment or maturity. The investment was illiquid. In 1938 the Federal National Mortgage Association ("FNMA") was established by Congress to improve access to capital in the mortgage market. Mortgages as an

investment remained "relatively illiquid compared with alternative investments competing with them for funds . . . even in the secondary markets, as long as the original instruments are the items being resold" (Downs 1985, 249). In 1960 Congress made it possible for other investors to own mortgages through a Real Estate Investment Trust ("REIT") akin to the emerging mutual funds of that period. "The liquidity of mortgages was enhanced with the creation of government agencies (Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association), which were charged by Congress to foster a secondary market" (Fabozzi and Modigliani 1992, 2). The Government National Mortgage Association ("GNMA") established in 1968 began in 1970 to invest in pools of mortgages insured or guaranteed by FHA, the Veterans Administration or the Farmers Home Administration. These pools of mortgages were the underlying assets for MBSs.

"Diffusion is the spread of something new through the network of potential adopters. . . . But financial innovations involve factors that make them different in important ways . . . ." (Redmond 2013, 525). One of those differences is quality deterioration (528). The policies directed toward achieving greater liquidity in the mortgage market followed a similar trajectory to that identified by Redmond. In 1970 Congress authorized FNMA to purchase conventional mortgage loans not insured by FHA or other insuring agencies while GNMA continued to rely on such insuring agencies for its mortgage pools (Fabozzi and Modigliani 1992, 20). As private financial institutions began to securitize pools of mortgages, it became necessary for these institutions to add credit enhancements to compete with government guaranteed mortgage

pools. This credit enhancement occurred through corporate guarantees, letters of credit and bond insurance (160).

The Secondary Mortgage Market Enhancement Act of 1984 improved the marketability of MBSs not backed by government agency guarantees by allowing privately issued MBSs having a rating of AA or better from commercial rating companies (generally based on credit enhancements) to qualify as legal investments for federally chartered banks. The Department of Labor made such MBSs acceptable as plan assets for pension funds. Law had endorsed the conversion of the illiquid incorporeal property of mortgages into MBSs, intangible property which was liquid and highly marketable even when not guaranteed by government agencies. In this quest for liquidity in the mortgage market, the advocates of liquidity lost sight of the warning by Keynes that

Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole (Keynes [1936] 1964, 155).

By the last decade of the twentieth century the fetish of liquidity in the mortgage market transformed the home mortgage held by a local lender into an indistinguishable piece of a pool of assets securing a MBS held by an investor without any relationship with the borrower nor any particular knowledge about the community in which the mortgaged property was located. The investor's primary concern was return on investment. The law's endorsement of the business practice involving MBSs ignited endogenous forces.

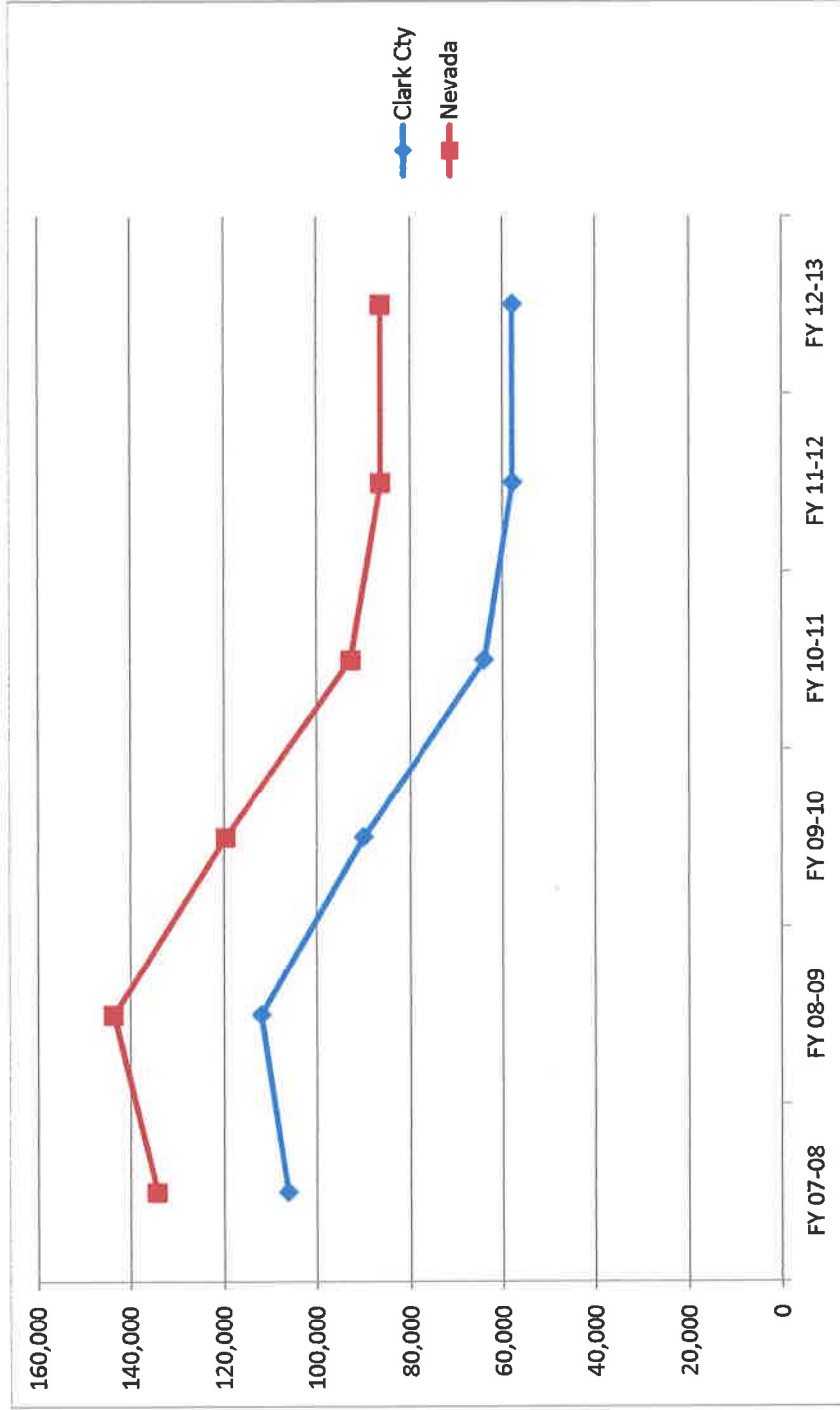
## **Endogenous Forces at Work in Nevada**

Nowhere was the outcome of endogenous forces more devastating than in Nevada. During the boom years for mortgages between 2000 and 2007 homeowners were sold many different mortgage products which were promptly transferred into the secondary market through MBSs. Many of these mortgage products exposed the borrower to greater risks than were disclosed. During this period Countrywide Financial Corporation alone originated 262,622 mortgage-backed loans in Nevada until it stopped originating loans in July 2008 (Masto and Figueroa 2011, 2). In the first six months of 2009 one out of every 13 properties in Las Vegas was in foreclosure; a rate more than six times the national average (Gillette 2013). Graphs 1 and 2 show the trend line which this rate of foreclosures had on assessed values of real estate in the state of Nevada, and in Clark County (Las Vegas) and on property tax revenues for both.

As the mortgage market collapsed and borrowers defaulted, the diffusion of MBSs magnified the effect on local communities. The ignorance of investors about the details of the underlying assets or their location made renegotiating the terms of the mortgages complicated. Investors often had little interest in avoiding foreclosures because they were insulated from the effects of foreclosures by government guarantees and credit enhancements. In Nevada the effects of the resulting foreclosures were exacerbated by a legal system designed to speed-up the foreclosure process.

Under 1911 Nevada law real estate securing a debt may be executed upon by the lender only under an action for foreclosure (Nevada Revised Statutes ("NRS") 40.430). If the owner fails to cure the deficiency at least 5 days before the foreclosure

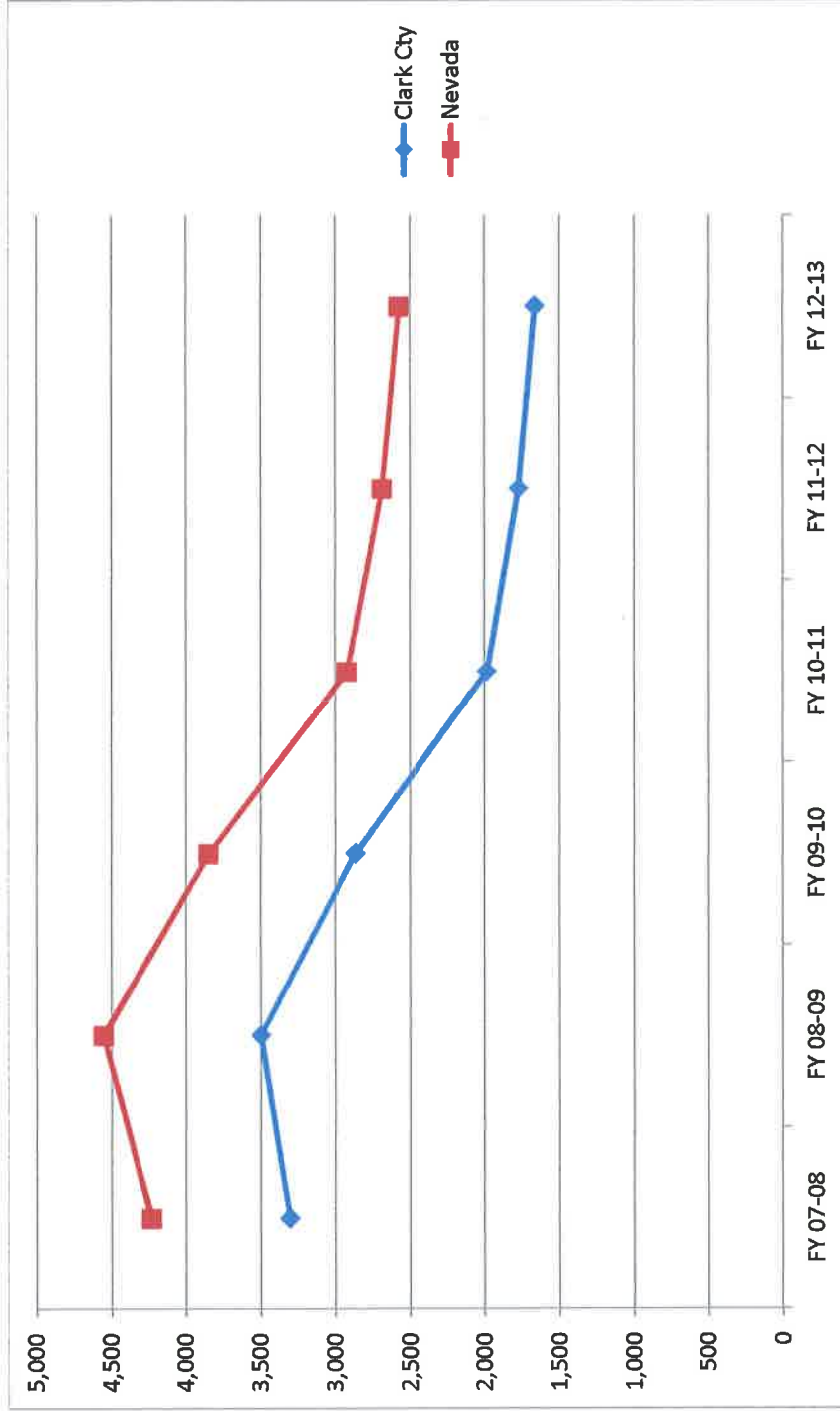
Assessed Value of Real Estate  
(in millions of US Dollars)



Graph 1

Data source: Nevada Department of Taxation, Local Government Finance Redbooks, 2007-2013.

Property Tax Revenue  
(in millions of US Dollars)



Graph 2

sale, the purchaser at auction acquires all of the interest of the owner, subject to the owner's right of redemption. This right of redemption exists for a period of one year from the date of sale (NRS 21.210).

The right of redemption is considered to have the "effect of reducing the interest of potential buyers of the property at a foreclosure sale, lowering the liquidation price that the lender would otherwise receive" (Claurette 1989, 546). Of the 29 states granting rights of redemption, many, including Nevada, permit the lender to avoid rights of redemption through the use of deeds of trust. The owner/borrower enters into a trust for the benefit of the lender with a third party holding the deed. The trustee has a "power of sale" over the real estate in the event of a default. The exercise of this power is a "non-judicial" foreclosure from which there is no right of redemption (NRS 107.080). Since deeds of trust became effective under Nevada law on March 29, 1927, most residential real estate subject to a mortgage is held under deeds of trust.

Non-judicial foreclosures under power of sale may begin after a 35-day period from default by the borrower. During this period the owner may cure the default. If not cured a notice of default and election to sell is recorded and a sale may be made after three months have passed (NRS 107.080(2)(d)). Unlike a judicial foreclosure which requires notice and a hearing followed by a sale and a one year redemption period, sales under non-judicial foreclosures terminate all rights of the owner upon sale permitting foreclosures to proceed more quickly. In addition, if the funds received at the foreclosure sale are insufficient to cover the balance due on the debt plus costs of foreclosure, the borrower may be liable for the unpaid balance of the debt under a deficiency judgment (NRS 40.455).



Typical borrowers for residential property are ignorant of the right of redemption or lack the negotiating power to have a mortgage without a deed of trust. Their ignorance skews the market toward instruments subject to quick foreclosures. In addition some lenders during the boom mortgage years engaged in deceptive practices such as short-term low teaser interest rates, minimum payment mortgages which allowed for negative amortization, inflated appraisals, and incentives to originators to steer borrowers to these high-risk products (Masto and Figueroa 2011, 9-14). Marketing such loans in the secondary market failed to disclose that many of the loans did not follow underwriting guidelines, were based on inaccurate incomes and appraisals, and were subject to multiple layers of risk (15-16).

The initial consequences of speedy foreclosures were empty houses bringing down the values of nearby properties and declining employment in construction. Clark County assessed property values declined 45.5% from \$111,906,539,236 in fiscal year 2009 to \$57,878,334,897 in fiscal year 2013 (see Graph 1). As a percent of total Nevada property values, Clark County's values fell from 79.1% to 67.1%. Over the same period Clark County's property tax revenues dropped from \$3,499,392,487 to \$1,660,032,650 for a decrease of 49.77% (see Graph 2). Between 2007 and 2012 the average number of those employed in construction in Clark County dropped 63.8% from 102,707 to 37,208. Average employment in all industries for Clark County dropped 11.5% from 922,186 to 816,329 (Nevada Department of Training and Rehabilitation). Declining taxable retail sales in Clark County followed the trend in employment, decreasing from \$3,238,798,689 in 2007 to \$2,855,344,030 in 2012, with the lowest volume at \$2,426,856,589 in 2010.

The principal sources of revenue for public services provided by local governments in Nevada are sales tax and property tax. With less construction, the sales tax revenue from construction of buildings and from building materials and other supplies dropped in Clark County from \$170,728,924 in 2007 to \$93,541,258 in 2012. With the effects of foreclosures on property values and the steep drop in construction activity, less tax revenues were available to support public services. Between fiscal year 2007 and 2011 expenditures for public works, transit systems, and economic development and assistance in Clark County declined by 17.2%, 98.9% and 37.9% respectively. Total government expenditures declined by 12% (Nevada Department of Taxation, Division of Local Government Services). Foreclosures precipitated by investors in MBSs who were protected by guarantees and ignorant of the location of real estate plunged communities which were the locations for such properties into circumstances where tax revenues were insufficient to support the public services necessary to keep these neighborhoods from further decline, defaults and foreclosures.

After suffering the consequences of deceptive mortgages subject to speedy foreclosures under deeds of trust sold to investors in MBSs who were ignorant of the risks and locations of the underlying assets, Nevada attempted to ameliorate the effects of foreclosures. The legislature sought belatedly to exercise social control over the impact of deficiency judgments by prohibiting deficiency judgments if (1) the lender is a financial institution, (2) the mortgaged property is a single-family home occupied by the borrower, (3) the borrower used the loan funds to purchase the property, (4) the property was continuously occupied by the borrower as principal residence and (5) the borrower did not subsequently refinance (NRS 40.455). The protection under the law applies only

to mortgages made on or after October 1, 2009 and not subsequently refinanced. Another bill attempted to slow the foreclosure process by requiring notice to the borrower of foreclosure prevention alternatives and prohibiting "dual tracking" where foreclosure proceedings continued while the borrower was electing prevention alternatives (Senate Bill 321 of 2011). Between October 1 and December 31, 2012, 491 requests for mediation were accepted for the entire state of Nevada. In Washoe County (Reno) alone there were 564 Notices of Default filed during that same period. That law was amended to make foreclosure mediation for owner-occupied real estate automatic beginning October 1, 2013 (Assembly Bill 273 of 2013). In September 2013, the month immediately prior to the automatic referral for foreclosure mediation, Notices of Default in Washoe County jumped to 613 from 151 in August 2013. This suggests that investors in MBSs prefer a path to foreclosure not slowed by mediation. While recent legislative activity has been directed at social control over foreclosures, it has yet to show any substantial benefit for the borrower or the communities in which borrowers live.

A simple social control alternative to mitigate the results of large volumes of foreclosed real estate in Nevada would be the use of judicial foreclosures as the *sole* means to foreclose on owner-occupied real estate. It would prevent unimpeded foreclosures and their consequences. It would provide the homeowner with leverage to negotiate new terms. This social control over the foreclosure process, however, has been challenged as one which imposes a burden on secured lenders making the lending process more costly and shifting the increased costs to borrowers in the form of higher interest rates. One study found that a one year right of redemption would increase loss rates for mortgage insurers by 0.21% or \$25,000,000 on a \$40 billion national risk exposure

(Clauret 1989, 552). Such a small increase in the cost of mortgages, even if reflected in higher interest rates, may serve as "a form of insurance against the adverse effects of mortgage default and foreclosure" (Schill 1991, 498). All that would be required is the repeal of the law authorizing the use of deeds of trust to avoid the judicial foreclosure process and the right of redemption.

## **Conclusion**

Commons made transactions the basic unit of analysis rather than exchange. This is a deceptively powerful change in economic analysis because it highlights the importance of evolving property institutions. Exchanges of goods and services must follow the rules laid down by transactions that have been negotiated by affected parties. The institutions of ownership must be established before exchange has any meaning. In an evolving economy, these institutions are dynamic rather than natural as assumed in conventional exchange analysis. Ignoring the transactions that govern exchange enabled economists to ignore conflict and build a system of natural harmony. Beginning with exchange offered a model of humans simply getting a living out of nature. Transactions, on the other hand, begin with conflict over definitions of legal rights, duties, liberties and exposures with respect to property. Therefore, it focuses on conflicts between humans.

Transactions require investigations of interdependence and conflicts between humans before we can evaluate results of exchanges. Relative power must be a central element of such investigations. There is need to create order out conflict, but that order must be reasonable in the eyes of the participants.

We have shown how the transactions governing mortgage markets did not lead to order, and the results were unreasonable because investors in MBSs and home buyers did not understand the rights, duties, liberties and exposures of the transactions governing exchange and the working rules which would apply in the event of a default. Authority to establish MBSs was given by Congress and confirmed by courts under the fetish of liquidity. Reforms at the state level could create more reasonable rules to provide more information to investors and protection to buyers of the corporeal property.

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