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Welcome to the Fall 2020 issue of *The Journal of Structured Finance*. It has been a crazy summer dealing with the coronavirus. Markets seem only loosely connected to the real economy. The unemployment rate is down to 8.4% (as of August), after peaking at 14.7% in April. Despite the improvement, it still seems high, especially compared to the January rate of 3.6%. The last time unemployment was this high was in 2011, during the mortgage meltdown and the financial crisis.

Also, the federal budget deficit has reached $3.3 trillion for 2020, and the national debt has grown by more than $4 trillion (Exhibit 1):

Exhibit 1
US National Debt ($ trillions)

	Total Debt	Public Debt	Intragovernmental Holdings
9/30/2019	22.72	16.81	5.91
9/29/2020	26.79	20.90	5.89
Change	4.07	4.09	(0.02)

Along the way, the Federal Reserve balance sheet has grown by nearly $3 trillion and now stands at more than $7 trillion, compared to roughly $4.2 trillion before the pandemic.

Despite this aggressive fiscal stimulus and very accommodative monetary policy, US GDP declined by roughly $2.2 trillion during the first half of the year, to an annual rate of $19.5 trillion in 2020Q2 (down from an annual rate of nearly $21.8 trillion in 2019Q4). Many households are enduring increasing hardship as they exhaust their resources and as federal relief programs—including direct cash payments, forbearance initiatives, and foreclosure/eviction moratoriums—start to expire.

Interest rates are extraordinarily low; monetary policy has more than counterbalanced the ballooning debt levels, at least for now. The federal funds rate stands at 0.08%, compared to 1.90% a year ago, and the 10-year Treasury yield stands at 0.69%, compared to 1.68% a year ago. The going rate on a conforming 30-year fixed-rate mortgage is just under 3.0%.

So, what do equity markets make of all this? They seem to like it. The Dow Jones Industrial Average closed at 27,781.70 on September 30. Housing prices are also strong. One has to ask, however, whether the high equity valuations and house prices are fundamentally sustainable. GDP has a lot of ground to make up, and the current level of national debt may slow future growth. Also, the high level of debt, together with the size of the Fed's balance sheet, suggest that today's super-low interest rates cannot last indefinitely. Even if they stay low in the short term,

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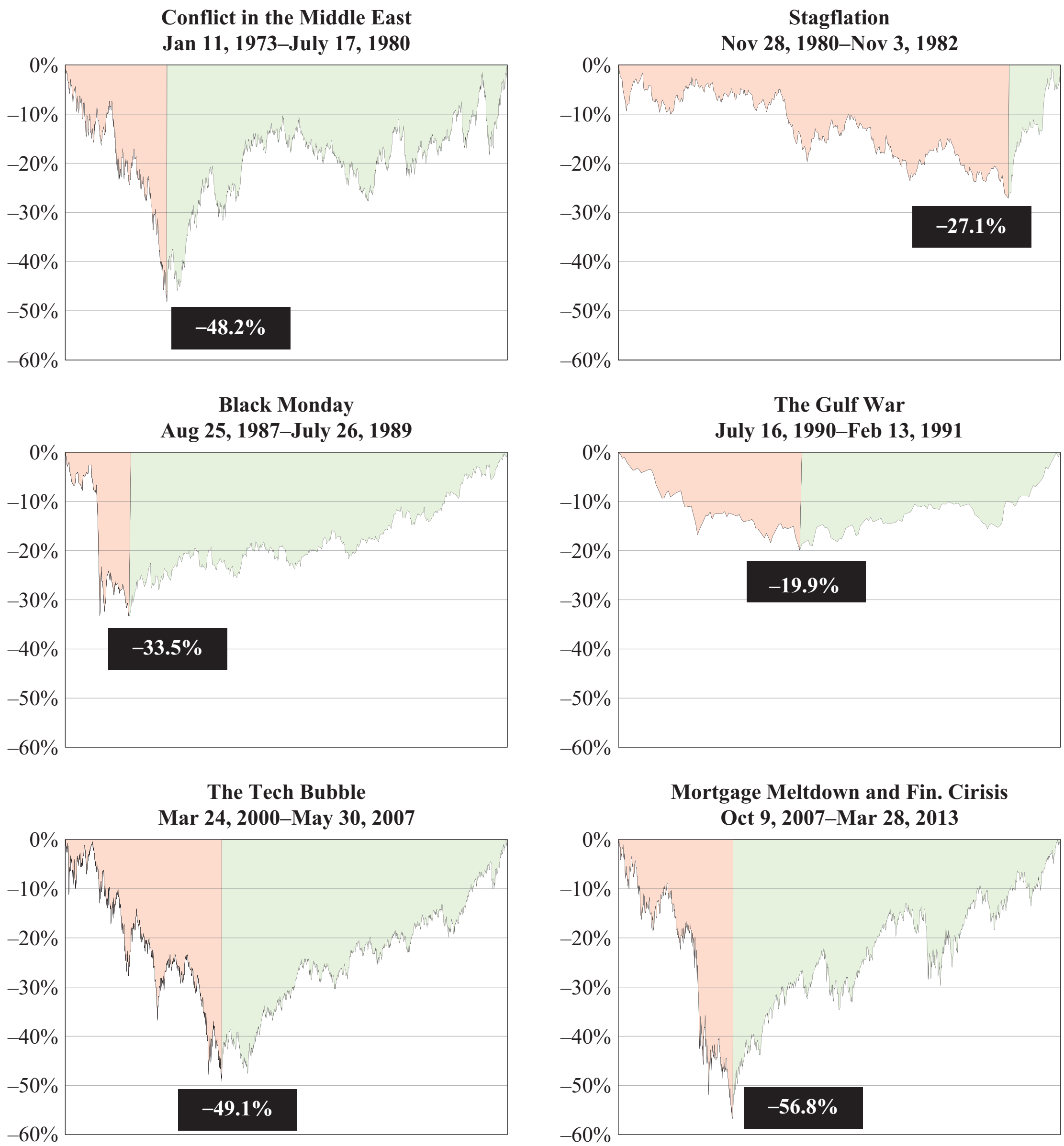
Exhibit 2

S&P 500—Major Declines and Recoveries over the Past 50 Years



Note: Adapted from Quinn (2020).

they must eventually adjust. When they do, there will be pressure for equity markets and house prices to adjust downward. Those adjustments could be as pronounced as the market's 37% drop in February and March of this year, and likely will last for much longer. Still, history suggests that, when it comes, a downward adjustment is unlikely to last much more than two years. However, the subsequent recovery could take longer (Exhibit 2).

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This issue has a mortgage theme. We planned it roughly six months ago, before the mortgage market began its boom. According to the Mortgage Bankers Association (MBA), single-family mortgage loan originations were $1.49 trillion in the first half of 2020 (up from $826 billion during the same period last year). The MBA projects that originations will reach $2.82 trillion for the full year (up from $2.17 trillion for 2019). Meanwhile, Ginnie Mae, Fannie Mae, and Freddie Mac have issued $2.12 trillion of MBS through August, and are on track to issue over $3.1 trillion for the full year. That would be double last year's agency MBS issuance level of $1.55 trillion. Also, agency MBS issuance accounts for over 97% of this year's total residential MBS issuance. The other side of the coin, however, is that non-agency MBS issuance accounts for less than 3% of the total. For the first half of the year, non-agency MBS issuance was just $38.9 billion, including $4.8 billion of re-REMICs and $12.9 billion of scratch-and-dent deals. The non-agency sector's share of total residential securitization remains far below the 18% level that it averaged from 1990 to 2003. And there's the rub…

It has been 10 years since the Dodd–Frank Act became law, but the non-agency MBS market remains in the doldrums. It now seems that the Dodd–Frank Act might have failed to address the real issues. Additionally, the securitization industry's attempts to revive the sector did not succeed. The American Securitization Forum's (2008) "Project RESTART" failed, as did SFIG's (2017) "RMBS 3.0" initiative. A contributing factor is that many market participants have not been willing to change their practices to address the continuing issues. To return in scale to investing in non-agency MBS, investors will need to have confidence that they are receiving what has been represented to them *and* that they have efficient and reliable remedies if not. Enforcement mechanisms for the repurchase of loans with missing or defective documentation and those that breach representations and warranties (R&Ws) are often no better in today's non-agency MBS deals than they were in pre-meltdown transactions. In fact, they often seem worse.

The contractual language describing enforcement of repurchases started to change during the mortgage meltdown. New transactions started including language to limit or qualify the trustee's duty to enforce repurchases of loans that breached R&Ws. A common formulation was to state that the trustee would sue to enforce repurchases—the ultimate step in enforcement—*only if directed to do so* by at least half of a deal's investors. Two transactions by Sequoia Residential Funding illustrate the change: Sequoia Mortgage Trust 2007-4 (SEMT 2007-4) contains the normal "shall enforce" formulation without any qualification. Section 2.04(a) of the deal's governing agreement provides that "if the Depositor does not deliver such missing document or cure such defect or breach in all material respects during such period, *the Trustee shall enforce* the Seller's obligation under the Mortgage Loan Purchase and Sale Agreement and cause the Seller to repurchase that Mortgage Loan…"[1] By contrast, the governing agreement for Sequoia Mortgage Trust 2010-H1 (SEMT 2010-H1) has a qualification. Although it includes the "shall enforce" provision in its § 2.04(a), the next section narrows and diminishes the trustee's duty. According to § 2.05, the trustee will sue to enforce repurchases only if directed to do so by half or more of the trust's investors.[2]

The change in the key contractual language during the mortgage meltdown is important. It reflects an intentional reduction in the trustee's enforcement duties. Naturally, the change in contractual language was accompanied by a change in prospectus disclosures as well, reflecting that the change was a material one.

Also, Moody's tracked the change (though on a lagging basis) in its "benchmark" language for MBS R&Ws. Version 1.0 of the Moody's benchmark provides that "the Trustee *shall enforce* the Seller's obligation under the Mortgage Loan Purchase and Sale Agreement to

[1] Sequoia Mortgage Trust 2007-4. Pooling and Servicing Agreement § 2.04(a). August 1, 2007. https://www.sec.gov/Archives/edgar/data/1410013/000114420407049213/v087480_ex10-1.htm.

[2] Sequoia Mortgage Trust 2010-H1. Pooling and Servicing Agreement §§ 2.04(a), 2.05(a), (c). April 1, 2010. https://www.sec.gov/Archives/edgar/data/1490028/000114420410022992/v182771_ex10-1.htm.

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repurchase that Mortgage Loan from the Trust Fund…" (Moody's 2011, ¶ II.E.(a)). By contrast, version 2.0 of the Moody's benchmark added the sorts of limitations present in SEMT 2010-H1 and subsequent deals (Moody's 2015, ¶ II.C).

Changes of the type just described seem like a step in the wrong direction. Other changes also seem counterproductive to the goal of reviving the non-agency sector (Pereira 2018).

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This issue of JSF opens with a brief commentary about CLO ratings by Gene Phillips (of PF2 Securities Evaluations) and me. We air several criticisms about recent CLO rating actions.

The issue's first group of articles focuses on the effects of the coronavirus on various aspects of the mortgage market. The first one, by Mike Fratantoni (chief economist of the Mortgage Bankers Association), examines forbearances. Significantly, he considers potential outcomes when forbearance periods expire. The second article discusses how the pandemic has revealed the possible benefits from having a government-sponsored liquidity facility to support mortgage servicers dealing with forbearances. Authors Laurie Goodman (co-director of the Urban Institute's Housing Finance Policy Center), Karan Kaul (a senior research associate at the Housing Finance Policy Center), and Ted Tozer (former president of Ginnie Mae) conclude that such a liquidity facility is necessary. The third article, by Frank Nothaft (chief economist at CoreLogic), examines the pandemic's effects on the housing market and mortgage delinquencies. The fourth article, by David Zhang (managing director and head of securitized product research at MSCI), Yihai Yu, and Joy Zahng (both executive directors at MSCI), explains a new model for projecting house price appreciation in the pandemic environment. The fifth article, by Francis Parisi (formerly S&P's chief credit officer for structured finance), discusses the effect of the coronavirus on MBS market activity, with a focus on how those effects link to the general economy.

The issue's sixth article, by Alexander Malyshev (a partner a Carter Ledyard & Milburn), discusses the recent Supreme Court decision in *Seila Law v. CFPB*. The case itself is not about mortgages, but it may offer a preview of how the Court will handle *Collins v. Mnuchin* (No. 19-563), which is scheduled for oral argument on December 9. That case will decide (among other things) whether the structure of the FHFA violates the Constitution. The issue's seventh article considers the potential for future CMBS and CLO litigation against the backdrop and experience of the past decade's residential MBS litigation. Authors Manisha Sheth (co-chair of the government and regulatory litigation practice at Quinn Emanuel and formerly the executive deputy attorney general for the Division of Economic Justice at the Office of the New York Attorney General) and Toby Futter (of counsel at Quinn Emanuel) explain the variety of disputes that can trigger litigation in both the CMBS and CLO settings. The issue's eighth and final article—last but certainly not least—considers the drivers of mortgage spreads across housing and business cycles. Authors Hamilton Fout (a vice president at Fannie Mae) and Doug Duncan (Fannie Mae's chief economist) consider not only the historical drivers, but also the effects of recent Fed activity and the impact of the pandemic.

As usual, this issue includes highlights from *GlobalCapital* and a selection of industry news items from the Structured Finance Association, in both cases covering Q3 2020.

We welcome your submissions. Please encourage those you know who have good papers or who have made good presentations on structured finance- or project finance–related subjects to submit them to us.

Submission guidelines can be found at https://jsf.pm-research.com/authors. If you have comments or suggestions, you can e-mail me directly at M.Adelson@PageantMedia.com.

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