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TURNING A BLIND EYE: WALL STREET FINANCE OF PREDATORY LENDING*

*Kathleen C. Engel** & Patricia A. McCoy****

INTRODUCTION

Numerous studies have discussed the negative externalities that securitization imposes on creditors.¹ Scholars have paid scant attention, however, to harms caused by securitization to debtors whose loans are securitized.² This issue has erupted in the subprime home mortgage

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1. See, e.g., David Gray Carlson, *The Rotten Foundations of Securitization*, 39 Wm. & Mary L. Rev. 1055 (1998); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 Tul. L. Rev. 101 (1997); Edward J. Janger, *Muddy Rules for Securitizations*, 7 Fordham J. Corp. & Fin. L. 301 (2002); Lynn M. LoPucki, *The Death of Liability*, 106 Yale L.J. 1 (1996); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 Tex. L. Rev. 595 (1998); Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 Duke L.J. 1541, 1580-81, 1585-86 (2001).

2. Kurt Eggert was among the first to discuss this issue, in the context of the holder-in-due-course rule. Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002). Jonathan Remy Nash also highlighted this issue in his work on securitization and environmental superliens. Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securitization*, 59 Wash. & Lee L. Rev. 127 (2002). Other works have examined securitization's effect on third-world countries. See Carl S. Bjerre, *Project Finance, Securitization and Consensuality*, 12 Duke J. Comp. & Int'l L. 411, 434-35 (2002); Anupam Chander, *Odious Securitization*, 53 Emory L.J. 923 (2004); Tamar Frankel, *Cross-Border Securitization: Without Law, But Not Lawless*, 8 Duke J. Comp. & Int'l L. 255, 260, 265 (1998); David W. Leebron, *First Things First: A Comment on Securitizing Third World Debt*, 1989 Colum. Bus. L. Rev. 173.

market, where charges of predatory lending, many of which have been substantiated, are mounting.³

The vast majority of subprime loans are now securitized, leading to claims that securitization facilitates predatory lending and should actively police lenders. Nonetheless, the entities involved in securitization have resisted addressing such concerns and continue to serve as major conduits for predatory loans.⁴ As this excerpt from one prospectus illustrates, securitization turns a blind eye to the underwriting of subprime loans:

With the exception of approximately 20.82% of the mortgage loans in the statistical mortgage pool that were underwritten in accordance with the underwriting criteria of The Winter Group, underwriting criteria are generally not available with respect to the mortgage loans. In many instances the mortgage loans in the statistical mortgage pool were acquired by Terwin Advisors LLC from sources, including mortgage brokers and other non-originators, that could not provide detailed information regarding the underwriting guidelines of the originators.⁵

As this suggests, Wall Street firms securitize subprime home loans without determining if loan pools contain predatory loans. In the worst situations, secondary market actors have actively facilitated abusive lending.⁶

At first blush, securitization's lack of concern about subprime underwriting seems odd. After all, investors in mortgage-backed securities should be concerned about the heightened default risk of subprime loans and predatory loans in particular.⁷ Furthermore, they should be concerned

3. See *infra* note 121. The subprime market charges higher interest rates and fees and is designed for borrowers with weaker credit.

4. For instance, a 2005 study of securitized subprime loans found that 57.2 percent of those loans had one or more predatory features, i.e., a balloon clause or a prepayment penalty with a term of at least three years. See Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments* 22-23, 32 *tbl.6* (Jan. 25, 2005) (unpublished manuscript, on file with the Fordham Law Review). The role of securitization can also be seen in predatory lending lawsuits involving loan assignees or trustees of securitized trusts that hold home loans. See, e.g., *Jackson v. Mundaca Fin. Servs., Inc.*, 76 S.W.3d 819 (Ark. 2002) (assignee); *Stuckey v. Provident Bank*, 912 So. 2d 859 (Miss. 2005) (trustee); *Skinner v. Preferred Credit*, 616 S.E.2d 676 (N.C. Ct. App. 2005) (trust and trustee); *Bankers Trust Co. v. West*, No. 20984, 2002 WL 31114844 (Ohio Ct. App. Sept. 25, 2002) (assignee).

5. Merrill Lynch & Co., Prospectus Supplement to Prospectus dated June 18, 2004 (Form 424B5), at S-16 (June 24, 2004), available at <http://www.sec.gov/Archives/edgar/data/809940/000095013604002052/0000950136-04-002052.txt>. Our thanks to Alan White for drawing this language to our attention.

6. In the most notorious example to date, in 2003, a federal jury held Lehman Brothers liable, as an investment bank and provider of a warehouse line of credit to the subprime lender First Alliance Mortgage Corp. (FAMCO), for aiding and abetting FAMCO's fraud on borrowers. See *infra* notes 106-107 and accompanying text.

7. Subprime home loans are more likely than prime loans to go into default. See, e.g., FitchRatings, U.S. Subprime RMBS in CDOs 5-9 (Apr. 15, 2005); Michelle A. Danis & Anthony Pennington-Cross, *The Delinquency of Subprime Mortgages* 5-6 (Fed. Reserve Bank of St. Louis, Working Paper No. 2005-022A, 2005). Predatory loans present an even

that subprime lenders will try to pass off their worst loans through securitization—the “lemons” problem that George Akerlof described.⁸

Given investors’ concerns, one might expect the capital markets to screen out the riskiest, predatory loans from securitized subprime loan pools. There is growing evidence, however, that securitizing entities perform inadequate screening. When meaningful screening does occur, it focuses on loans originated in states that impose liability on assignees of predatory loans. In states with weak anti-predatory lending laws, screening is minimal or non-existent.

As we explain, securitization solves the lemons problem for investors without requiring the capital markets to screen out predatory loans from securitized offerings. Investment banks employ a variety of techniques, primarily structured finance and deal provisions, to shield investors from virtually all of the credit and litigation risk associated with predatory loans. Market and legal forces provide additional protection to investors. For example, the holder-in-due-course rule shields investors and securitized trusts from most litigation contesting predatory loan terms. Evidence also suggests that investors extract price concessions as recompense for the lemons problem, which pushes up the cost to borrowers of subprime loans. As a result, investors can safely invest in top-rated subprime mortgage-backed securities without worrying about losses, even when the underlying loan pools are replete with questionable loans.⁹

The protections that securitization provides investors do not safeguard borrowers. To the contrary, securitization inflicts negative externalities on subprime borrowers in at least four ways. First, securitization funds small, thinly capitalized lenders and brokers, thus enabling them to enter the subprime market. These originators are more prone to commit loan abuses because they are less heavily regulated, have reduced reputational risk, and operate with low capital, helping to make them judgment-proof. Second, securitization dilutes incentives by lenders and brokers to avoid making loans with excessive default risk by allowing them to shift that risk to the secondary market, which has other ways to protect itself. Third, securitization denies injured borrowers legal recourse against assignees by triggering the holder-in-due-course rule and impeding work-outs. Lastly, securitization drives up the price of subprime loans because investors demand a lemons premium for investing in subprime mortgage-backed securities.

higher risk of default than subprime loans generally. See Quercia, Stegman & Davis, *supra* note 4, at 25, 35 tbl.10.

8. See George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970).

9. See Stephen Wallenstein, *Situating Project Finance and Securitization in Context: A Comment on Bjerre*, 12 Duke J. Comp. & Int’l L. 449, 451 (2002) (“[N]egative effects on select populations are not a concern of . . . securitization (by which I mean the financing aspects).”).

The resulting cost to borrowers is substantial. One recent study estimated that lengthy prepayment penalties in securitized subprime loans boosted borrowers' risk of foreclosure by sixteen to twenty percent.¹⁰ Balloon clauses in those loans raised borrowers' risk of foreclosure by an additional fifty percent.¹¹ Securitization also exacts significant tolls on municipalities by fueling predatory lending. When borrowers, saddled with onerous loan payments, lose or cannot maintain their homes, cities must contend with abandoned and deteriorating properties, which strain city resources and threaten the vitality and stability of neighborhoods.¹²

Given securitization's role in enabling and perpetuating predatory lending, we contend that the law should impose full, quantifiable assignee liability on securitized trusts that do not adopt adequate controls to filter out predatory loans from loan pools. Today, new automated due diligence software makes it technologically and economically efficient to screen out loans with predatory features.

In an earlier article, we proposed federal legislation to require subprime lenders and brokers to make suitable loans.¹³ In this Article, we argue that assignee liability should apply to suitability violations and certain other legal violations by mortgage brokers and lenders. Imposing properly tailored liability on securitizers would force them to take into account the negative externalities of securitization on borrowers and communities.¹⁴

Our analysis of the securitization of subprime residential mortgages expands the debate about negative externalities from securitization by demonstrating that such externalities are not necessarily limited to originators' unsecured creditors. To the contrary, securitization can impose negative externalities on debtors who are liable on the underlying receivables, as well as on surrounding communities.

Moreover, our research helps explain why securitization has taken root. Claire Hill has argued, for instance, that securitization exists because valuing a lender's receivables is simpler than valuing the lender itself. Professor Hill offers the further insight that thinly capitalized lenders—which she dubs “lemons firms”—have the most to gain from securitizing

10. See Quercia, Stegman & Davis, *supra* note 4, at 25.

11. *Id.*

12. See Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 Conn. L. Rev. 355 (2006) (describing externalities that predatory lending imposes on cities); see also William C. Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom 4* (May 11, 2005), available at http://www.hpfonline.org/PDF/Apgar-Duda_study_final.pdf (estimating that vacant properties from foreclosures cost cities more than \$30,000 per unit in some cases); Family Housing Fund, *Cost Effectiveness of Mortgage Foreclosure Prevention 16-17* (1998) (estimating that Minneapolis and St. Paul lost \$2000 on average in tax revenues on vacant homes and spent up to \$40,000 per home rehabilitated and \$10,000 per home demolished).

13. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255 (2002).

14. See Janger, *supra* note 1, at 302, 315.

their receivables.¹⁵ We extend her analysis by arguing that securitization solves two “lemons” problems, not one: the originator’s possible bankruptcy and adverse selection in the loans being sold and ultimately securitized.

Finally, our research implicitly questions the binary nature of the larger debate about negative externalities from securitization. Too often, the debate is framed as whether securitization must be defended from all attack or altered at its core.¹⁶ The parable of the subprime market, however, suggests that there may be a middle, low-cost course that can protect borrowers from loan abuses without impeding securitization.

The Article unfolds as follows: In Part I, we provide a brief definition of predatory lending. Part II describes the growth of subprime securitization, while Part III provides a thumbnail sketch of securitization of subprime home mortgage loans. In Part IV, we discuss the risks posed by subprime securitization and the resulting lemons problem that investors face. Part V analyzes how securitization solves the lemons problem through a variety of techniques, including sequential tranches, pricing, limited due diligence, and contract provisions. In Part VI, we explain why predatory lending persists despite the substantial risk management techniques employed by securitization. Part VII presents normative justifications for imposing assignee liability on residential mortgage-backed securitizations, while Part VIII sets forth the details of our assignee liability proposal. Finally, in Part IX, we respond to critics of assignee liability for predatory loans.

I. PREDATORY LENDING DEFINED

Predatory lending is a syndrome of loan abuses that benefit mortgage brokers, lenders, and securitizers to the serious detriment of borrowers.¹⁷ Such abuses include the following:

(1) Loans structured to result in seriously disproportionate net harm to borrowers: A major example is asset-based lending, which consists of loans to borrowers whom the lender knows cannot afford the monthly payments. Pushing borrowers to take on more debt than they need, steering prime-eligible borrowers to subprime loans, and refinancing low-interest loans into costlier loans with no justification can also inflict seriously disproportionate net harm on borrowers.¹⁸

15. Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 Wash. U. L.Q. 1061, 1091-92 (1996); accord Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. Legal Stud. 161, 180-82 (2005).

16. Compare sources cited in *supra* notes 1, 2, and 10, representing different viewpoints in this debate.

17. Engel & McCoy, *supra* note 13, at 1259-70.

18. Freddie Mac, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America’s Families*, ch. 5 & nn.5-6 (1996), <http://www.freddiemac.com/corporate/reports/moseley/chap5.htm>; see also Mortgage Bankers Ass’n, *MBA Best Practices ¶ III* (2007), available at <http://www.mortgagebankers.org/IndustryResources/StandardsandBestPractices/MBABestPractices.htm> (last visited Feb. 10, 2007); Patricia

(2) Rent seeking: Numerous subprime loans charge fees and interest rates that are exorbitant compared to the risk that the borrowers present. Rent seeking also encompasses steering and charging prepayment penalties and points without a corresponding cut in the interest rate, as is customary in the prime market.¹⁹

(3) Loans involving illegal fraud or deception: Many predatory loans involve fraud or deception by brokers or lenders. For example, brokers or lenders may procure inflated appraisals or make false promises to refinance loans down the road on better terms.²⁰

(4) Other forms of non-transparency that do not amount to fraud: These occur when lenders or brokers withhold information from borrowers in circumstances that fall short of fraud. For example, subprime lenders keep rate sheets containing their prices secret because they do not want borrowers to shop for better rates.²¹ Neither the Truth in Lending Act²² nor the Real Estate Settlement Procedures Act²³ requires disclosure of rate sheets to borrowers.²⁴ This secrecy impedes comparison shopping.

(5) Loans requiring borrowers to waive meaningful legal redress: Subprime loans often contain mandatory arbitration clauses that require borrowers to take disputes to arbitration and preclude them from joining class actions. Such provisions deny borrowers access to the courts.²⁵

(6) Lending discrimination: Many predatory loans impose more onerous terms on members of protected groups, resulting in discrimination even after controlling for risk.²⁶

(7) Servicing abuses: Once loans are securitized, a servicer typically becomes responsible for collecting the loan payments and distributing the

Sturdevant & William J. Brennan, Jr., *A Catalogue of Predatory Lending Practices*, Consumer Advoc., Nov.-Dec. 1999, at 36, 37, 39.

19. Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 Hous. Pol'y Debate 533, 535 (2004); Sturdevant & Brennan, *supra* note 18, at 38-39; Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 Housing Pol'y Debate 503 (2004); Mark Shroder, *The Value of the Sunshine Cure: Efficacy of the RESPA Disclosure Strategy* 11 fig.2, 14-15, 14 tbl.4 (Apr. 4, 2000) (unpublished manuscript, on file with the Fordham Law Review).

20. Dep't of Hous. and Urban Dev. & -Dep't of the Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* 24, 79-80 (2000) [hereinafter Treasury-HUD Report], available at <http://www.huduser.org/publications/hsgfin/curbing.html>.

21. White, *supra* note 19, at 509-12; see also Peter J. Hong & Marcos Reza, *Hidden Costs to Homeowners: The Prevalent Non-Disclosure of Yield Spread Premiums in Mortgage Loan Transactions*, 18 Loy. Consumer L. Rev. 131, 132-34 (2005) (describing rate sheets).

22. 15 U.S.C. §§ 1601-1667 (2000).

23. 12 U.S.C. §§ 2601-2617.

24. See Engel & McCoy, *supra* note 13, at 1305-07.

25. Shelly Smith, *Mandatory Arbitration Clauses in Consumer Contracts: Consumer Protection and the Circumvention of the Judicial System*, 50 DePaul L. Rev. 1191, 1193 (2001).

26. See, e.g., Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* (2006), available at http://www.responsiblelending.org/pdfs/r011-Unfair_Lending-0506.pdf.

proceeds. Some servicers have employed abusive servicing practices, including charging unjustified fees, actively pushing borrowers into default, and employing exploitative collection methods.²⁷

II. THE ADVENT OF SUBPRIME SECURITIZATION

Subprime securitization, a relatively new phenomenon, followed on the heels of securitization in the prime residential loan market, first pioneered in the late 1970s.²⁸ By the early 1990s, technological advances made it possible to estimate and price the risk of subprime home loan pools, paving the way for subprime securitizations.²⁹ In 2005, total securitizations of subprime and home equity loans ballooned to an estimated \$525.7 billion.³⁰ Today, lenders securitize almost eighty percent of subprime mortgages.³¹

III. HOW SECURITIZATION WORKS

Securitization is the financial technology that integrates the market for residential mortgages with the capital markets. In securitization, investment banks take pools of home loans, carve up the cash flows from those receivables, and convert the cash flows into bonds that are secured by the mortgages. The bonds are variously known as residential mortgage-backed securities (RMBS) or asset-backed securities (ABS).

Securitization goes by the moniker “structured finance,” in part because a securitizer structures the transaction to isolate the loan pool from the original lender. This is accomplished by selling the loan pool to a special purpose vehicle or “SPV” that is owned by, but legally distinct from, the lender. The SPV then resells the loan pool to a second SPV, which is also independent of the lender and takes title to the bundle. The second SPV is typically in the form of a trust.³²

27. Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Pol’y Debate 753, 756-61 (2004).

28. See, e.g., Steven L. Schwarcz, Bruce A. Markell & Lissa Lamkin Broome, *Securitization, Structured Finance and Capital Markets* 1-3 (2004); Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. Cal. L. Rev. 1261, 1267-71 (1991).

29. See, e.g., Eric Bruskin, Anthony B. Sanders & David Sykes, *The Nonagency Mortgage Market: Background and Overview*, in *The Handbook of Nonagency Mortgage-Backed Securities* 5, 12-16 (Frank J. Fabozzi, Chuck Ramsey & Michael Marz eds., 2d ed. 2000); Bill Shepherd, *Perils and Phantasm: The Mortgage Securitization Boom Is Threatened by Recession, Legislation and Rate Change*, Investment Dealers Dig., Feb. 3, 2003.

30. See Standard & Poor’s (S&P), *Rating Transitions 2005: U.S. RMBS Volume and Rating Activity Continue to Set Records*, tbl.1 (Jan. 24, 2006).

31. See S&P, *The Subprime Market* 7 (June 17, 2005).

32. See, e.g., Steven L. Schwarcz, *Securitization Post-Enron*, 25 Cardozo L. Rev. 1539, 1552-53 (2004). This Article focuses on the “nonconforming” or “private label” market. The conforming market refers to home loans that conform to underwriting guidelines of government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac. The GSEs purchase and package conforming individual mortgages, create the securities, and market the securities through brokers. See Freddie Mac, *The Secondary Market for Mortgage Loans*,

This two-tiered structure protects investors by preventing lenders' creditors from reaching the assets backing the securities in case the lender goes bankrupt.³³ Bankruptcy remoteness also boosts ratings of securitized offerings. Rating agencies evaluate and rate securitized loan pools. To the extent that SPVs protect investors from the risk of the lender's bankruptcy, it is often possible for the loan bundle to earn a higher rating than the lender itself would receive. In this way, "non-investment grade and unrated originators (the majority of the market) [can] create investment-grade transactions."³⁴

After the loans are transferred to the second SPV, the investment bank for the issuer³⁵ carves the principal and interest payments into tranches of bonds.³⁶ Then, rating agencies gauge the credit risk of each tranche by comparing the loan pool's characteristics with historical data and forecasting the tranche's performance.³⁷ In calculating credit risk,

http://www.freddiemac.com/corporate/about/what_we_do/secmkt.html (last visited Feb. 28, 2007). The nonconforming market, in contrast, finances loans that do not meet the GSE guidelines.

33. See, e.g., Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 142 (1994). In many securitizations, a subsidiary of the lender retains some of the risk, either in the form of subordinate tranches, subordinated excess spread, or cash reserves. If a lender were to retain those residual interests within its own corporate entity and later went into bankruptcy, the bankruptcy court might rule that the lender, not the investors, owned the securitized pool, relegating the investors to the role of secured creditors. See Len Blum & Chris DiAngelo, *Structuring Efficient Asset-Backed Transactions*, in *Asset-Backed Securities* 237, 243-44 (Anand K. Bhattacharya & Frank J. Fabozzi eds., 1996). Only on rare occasions have courts disregarded bankruptcy-remote status. See Michael J. Cohn, Note, *Asset Securitization: How Remote Is Bankruptcy Remote?*, 26 Hofstra L. Rev. 929 (1998); see also Schwarcz, Markell & Broome, *supra* note 28, at 80-86; Kenneth M. Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of "Bankruptcy Remoteness"* (Apr. 2, 2006) (unpublished manuscript, on file with the Fordham Law Review) (finding that bankruptcy remoteness protects investors and is priced into the securities).

34. Henry C. McCall III & Len Blum, *Evolution of the B&C Home-Equity Loan Securities Market*, in *Asset-Backed Securities*, *supra* note 33, at 137, 140.

35. The issuer is the special purpose vehicle (SPV) that issues the securities.

36. Collateralized mortgage obligations (CMOs) use a senior-subordinate tranche structure and are the most common type of nonconforming mortgage-backed security (MBS) today. See Bruskin, Sanders & Sykes, *supra* note 29, at 14. CMOs are derivatives which consist of interest payments plus principal, interest-only (IO) strips, or principal-only (PO) strips. Other, less common types of MBS include mortgage pass-through securities, in which investors buy fractional interests in pools of whole single-family mortgages, and mortgage-backed bonds (MBBs), which are priced according to the liquidation value of the loans and thus require higher collateral than CMOs. See Andrew Davidson et al., *Securitization: Structuring and Investment Analysis* 185-87, 196, 206-08 (2003); John R. Brick, *A Primer on Mortgage-Backed Securities*, in *Current Readings on Money, Banking, and Financial Markets* 25, 26, 29-32 (James S. Wilcox & Frederic S. Mishkin eds., 1987).

37. See Neil D. Baron, *The Role of Rating Agencies in the Securitization Process*, in *A Primer on Securitization* 81 (Leon T. Kendall & Michael J. Fishman eds., 1996); see also Davidson et al., *supra* note 36, at 24-25; McCall & Blum, *supra* note 34, at 142. Typically the loan review scrutinizes the lender's underwriting standards, borrower profiles, the geographical distribution of the loans, loan size, loan-to-value ratios, and the prepayment characteristics of the bundle. The rating agency will perform a static pool analysis on the lender's historical loss and delinquency record, using data on the average loss, slope, and

however, rating agencies do not assess the suitability of the underlying loans for individual borrowers.

The tranche system is termed a “senior-subordinate structure” and is the “predominant structure of choice in subprime RMBS.”³⁸ The tranches are arrayed from the most senior to the most junior, with “as many as five mezzanine or subordinated tranches going down the ratings ladder” from AAA to B.³⁹ The senior class is the AAA tranche, the mezzanine class consists of the AA and A tranches, and the BBB, BB, B, and unrated classes take the junior position.⁴⁰ Any rating of BBB-/Baa3 or above is deemed investment-grade and serves to assuage investors’ concerns about the credit quality of the mortgages backing the securities.

In a feature known as a “waterfall,” the senior tranche is paid off before any other tranche. Once the senior tranche is paid off, the next tranche moves to the head of the line for principal payments until all of the tranches are retired.⁴¹ As a result, the junior tranche is the first to absorb any losses and shields the senior tranches from losses due to loan defaults.⁴² Only in the extremely unlikely event that losses exceeded the amounts due the holders of the junior tranches would the senior tranches absorb credit losses.

Before rating agencies issue investment-grade ratings, they insist on added financial cushions known as “credit enhancements.”⁴³ According to rating agencies, when determining the needed level of credit enhancements, they assume catastrophic losses on an order of magnitude of the Great Depression, with the amount of enhancements depending on the rating desired, the type of collateral, and the reliability of the historical pool data.⁴⁴

peak loss period of the loan pool to forecast future losses and delinquencies. In addition, the rating agency will assess the average coupon rate, seasoning, and average maturity of the loans and sample the loan files to test those statistics. *See* Baron, *supra*, at 84-85; Anand K. Bhattacharya & Frank J. Fabozzi, *The Expanding Frontiers of Asset Securitization*, in *Asset-Backed Securities*, *supra* note 33, at 1, 14; Suzanne Michaud, *A Rating Agency Perspective on Asset-Backed Securitization*, in *Asset-Backed Securities*, *supra* note 33, at 269, 271-73.

38. S&P, *Trends in U.S. Residential Mortgage Products: Fourth-Quarter 2003 LTV Ratios, FICO Scores, and Credit Support Levels* (2004). *See generally* Steven L. Schwarcz, *Structured Finance: A Guide to the Principles of Asset Securitization* § 2.4 (3d ed. 2003).

39. Shepherd, *supra* note 29; *see* Davidson et al., *supra* note 36, at 20; Schwarcz, Markell & Broome, *supra* note 28, at 4-5; Hill, *supra* note 15, at 1070 n.39 (describing the rating systems used by major rating agencies).

40. *See* Lakhbir Hayre, *A Concise Guide to Mortgage-Backed Securities (MBSs)*, in *Salomon Smith Barney Guide to Mortgage-Backed and Asset-Backed Securities* 9, 54-60 (Lakhbir Hayre ed., 2001).

41. *See* Davidson et al., *supra* note 36, at 208-09, 333; Blum & DiAngelo, *supra* note 33, at 257-58.

42. *See* Davidson et al., *supra* note 36, at 333; S&P, *Rating Transitions 2003: Another Record Year of Credit Performance for U.S. RMBS* (2004).

43. *See* Davidson et al., *supra* note 36, at 24-26; Schwarcz, Markell & Broome, *supra* note 28, at 14; Blum & DiAngelo, *supra* note 33, at 252-53; Leon T. Kendall, *Securitization: A New Era in American Finance*, in *A Primer on Securitization*, *supra* note 37, at 4; McCall & Blum, *supra* note 34, at 140-41.

44. *See* Baron, *supra* note 37, at 85; Michaud, *supra* note 37, at 272.

Credit enhancements come in two types, internal and external enhancements.⁴⁵ Normally, the lender will provide sufficient internal enhancements to boost the offering to an investment-grade rating. If the internal enhancements do not raise the senior tranche to a top AAA rating, monoline insurers or other outside providers may add external enhancements to raise the senior tranche to an AAA.⁴⁶

Once investment-grade ratings are in hand, the investment bank will price the mortgage-backed securities and sell them to investors, either through a public offering or a private placement.⁴⁷ If the offering succeeds as planned, the lender receives two forms of revenue. The first is cash from the sale of the securities. The second is “excess spread,” which is the right to any interest on the loans that exceeds the interest paid to the investors after deducting expenses on the asset-backed bonds. In most situations, the present value of the cash proceeds plus the excess spread exceeds the cash that the lender would have received from selling whole loans.⁴⁸

IV. THE LEMONS PROBLEM

In order to succeed, securitization must solve a core problem—that is, why should investors buy mortgage-backed securities when lenders can deceive them about the quality of the loans in the loan pool? Lenders have incentives to cherry-pick their loans and sell the worst ones to investors.⁴⁹ And knowing that they can unload the worst loans onto investors, lenders have less reason to underwrite loans carefully. Thus, securitization gives

45. Internal credit enhancements earmark part of the cash flow from the mortgages to fund a cash buffer to protect the senior and mezzanine tranches from losses. The most common internal enhancements are the senior-subordinate structure, excess spread accounts, and over-collateralization. See Baron, *supra* note 37, at 85-87; Brick, *supra* note 36, at 29-32; Bruskin, Sanders & Sykes, *supra* note 29, at 31-35; Lina Hsu & Cyrus Mohebbi, *Credit Enhancement in ABS Structures, in Asset-Backed Securities*, *supra* note 33, at 277, 281-83. Most external credit enhancements consist of guarantees by monoline insurance companies. See Baron, *supra* note 37, at 86-87; Hsu & Mohebbi, *supra*, at 278-80.

46. See Schwarcz, *supra* note 38, §§ 2:3, 2:4; Hsu & Mohebbi, *supra* note 45, at 278.

47. See Davidson et al., *supra* note 36, at 20; Alfred J. Puchala, Jr., *Securitizing Third World Debt*, 1989 Colum. Bus. L. Rev. 137, 141.

48. See McCall & Blum, *supra* note 34, at 141-43.

49. As the president of one of the largest mortgage lenders put it in announcing that the company planned to securitize all of its subprime loans, “‘We’re looking to hold only pristine product on the balance sheet.’” Ruth Simon & James R. Hagerty, *How American Lenders Shelter Themselves*, Wall St. J., Sept. 22, 2005, at C1 (quoting Stanford Kurland, President, Countrywide Financial Corp.). Similarly, Armando Falcon, Jr., the former director of the Office of Federal Housing Enterprise Oversight, testified before Congress that Fannie Mae cherry-picked the loans it securitized and kept the best in portfolio, consistent with its policy to “keep the best; sell the rest.” *OFHEO Agreement with Fannie Mae: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enterrs. of the H. Fin. Servs. Comm.*, 109th Cong. (2005) (testimony of Armando Falcon, Jr., Director, Office of Fed. Hous. Enterprise Oversight).

rise to the problem of adverse selection or the “lemons” problem, in the words of George Akerlof.⁵⁰

Before the advent of securitization, lenders typically handled loans from cradle to grave. They solicited loan applicants, underwrote and financed the mortgages, serviced the loans, and held the loans in portfolio to maturity. In turn, lenders largely made profits from the interest payments on the loans. Because lenders bore the full risk of default, they had strong incentives to turn down observationally risky borrowers.⁵¹

Securitization alters this incentive structure by unbundling the tasks in lending and parceling them out among a string of market actors. A mortgage broker may recruit loan applicants, a lender may originate the loans, a specialist firm may provide the servicing, a trust may hold the loans, and outside investors may provide the financing.

The lemons problem occurs because unbundling creates information asymmetries that mortgage lenders (or brokers) can exploit to investors’ detriment.⁵² A loan’s credit risk turns on numerous characteristics, some of which are observable and others of which are not. Neither the lender nor investors are privy to characteristics that are unobservable. However, the lender has observable data on borrowers’ default propensities that investors lack.⁵³ Investors do not interview the loan applicants, do not obtain or review property appraisals, and almost never examine individual loan applications, borrowers’ credit reports, or income verifications. Instead, they rely on the issuer’s warranties and representations about the borrowers’ credit quality. Needless to say, in the subprime sector, these information asymmetries can be pronounced because subprime borrowers are prone to have credit flaws that lenders will want to conceal.

In sum, securitization enables lenders “to shift the risk [of the loan’s performance] onto the investor.”⁵⁴ The more that securitization allows lenders to “take the profits and run,” the more adverse selection will rear its

50. See Akerlof, *supra* note 8; Amy C. Cutts et al., *Lemons with a Twist: Adverse Selection and the Role of Securitization in Mortgage Market Evolution and Pricing* (June 2000) (unpublished manuscript, on file with the Fordham Law Review).

51. See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 *Am. Econ. Rev.* 393 (1981).

52. When lenders use mortgage brokers, the brokers have even fuller information than the lenders about observable characteristics of the borrower. Lenders who securitize loans may be indifferent to deceit by brokers about default risks if they can shift the risk of loss wholesale to the secondary market. See Patrick Barta, *Is Appraisal Process Skewing Home Values?*, *Wall St. J.*, Aug. 13, 2001, at A1.

53. See Cutts et al., *supra* note 50; Wayne Passmore & Roger W. Sparks, *Automated Underwriting and the Profitability of Mortgage Securitization*, 28 *Real Est. Econ.* 285, 285 (2000) (describing how lenders try to conceal borrowers’ bad credit histories from investors).

54. Lalitha A. Shivaswamy, *Structured Transactions and Private Placement Criteria and Challenges to Investment in the 144A Market 5* (2004) (unpublished manuscript, on file with the Fordham Law Review). As one set of researchers recently observed, “[T]he market for multi-class MBS is a market for lemon mortgage pools.” Chris Downing, Dwight Jaffee & Nancy Wallace, *Information Asymmetries in the Mortgage Backed Securities Market 20* (May 3, 2005) (unpublished manuscript, on file with the Fordham Law Review).

head.⁵⁵ Solving adverse selection is the key to successful securitization of home loans. In the home mortgage context, securitization must solve the lemons problem for three types of risk—credit risk, prepayment risk, and litigation risk—which we now discuss.

A. Credit Risk

Credit risk is the risk that a borrower will miss payments and the loan will go into default. All loans involve credit risk, but subprime loans involve more risk than prime loans because borrowers with impaired credit are more likely to default.⁵⁶ Furthermore, when a predatory lender makes a loan to a borrower whom it knows cannot afford the monthly loan payments, default will likely become a self-fulfilling prophecy.⁵⁷

Investment banks and rating agencies measure the credit risk in loan pools by extrapolating from historical data on loan pools with similar characteristics. In the subprime market, several factors make these historical inferences more difficult. First, there is less historical data on subprime loan pools than prime pools, because subprime securitizations did not take off until the early 1990s. Second, subprime loan pools present much larger variance in credit risk. Prime loan pools are limited to the most creditworthy “A” grade borrowers and cover a narrow band of the credit risk spectrum. Moreover, the risk associated with that narrow band has been empirically tested and confirmed over time. Newer subprime loan pools, in contrast, can cover the entire risk spectrum, from A and A-borrowers down to the weakest D borrowers.⁵⁸ Third, foreclosure costs vary by state, complicating the job of estimating default costs.⁵⁹ Finally, many subprime securitizations are sold on a to-be-announced (TBA) basis, where the lender does not actually form the loan pool until the mortgage-backed securities have been sold, making historical comparisons impossible

55. See Cutts et al., *supra* note 50; Passmore & Sparks, *supra* note 53, at 285. George Akerlof commented on a similar problem affecting middlemen in India who tried to arbitrage between the cheap loan rates of central city banks and the exorbitant loan rates of local moneylenders who had personal knowledge of the borrowers, observing, “The middleman who tries to arbitrage between the rates of the moneylender and the central bank is apt to attract all the ‘lemons’ and thereby make a loss.” Akerlof, *supra* note 8, at 499.

56. John C. Weicher, *The Home Equity Lending Industry: Refinancing Mortgages for Borrowers with Impaired Credit* 76 (1997); Anthony Pennington-Cross, *Subprime and Prime Mortgages: Loss Distributions* 7 (Office of Fed. Hous. Enter. Oversight, Working Paper No. 03-1, 2003).

57. For discussion of why a lender might make a loan that is virtually certain to go into default, see Engel & McCoy, *supra* note 13, at 1280-89.

58. See Weicher, *supra* note 56, at 56-57 tbl.4.1.

59. See Terrence M. Clauretie & Thomas Herzog, *The Effect of State Foreclosure Laws on Loan Losses: Evidence from the Mortgage Insurance Industry*, 22 J. Money, Credit & Banking 221, 222 (1990); Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 Va. L. Rev. 489 (1991).

before the offering has been closed.⁶⁰ These blind spots in evaluating subprime credit risk can hamper efforts to accurately set prices and gauge returns.

B. Prepayment Risk

Prepayment risk is the risk that borrowers will pay off their principal before maturity. Prepayment disrupts investors' cash flows in two ways. First, it accelerates the return of principal. Second, it cancels future cash flows from interest payments. If borrowers prepay when interest rates are below coupon (i.e., the nominal interest rate on the loan), investors who want equivalent risk are forced to reinvest the principal at a lower rate of return.

Borrowers in the prime and subprime markets prepay for different reasons. In the prime market, prepayment most often occurs when homeowners refinance their mortgages to take advantage of falling interest rates.⁶¹ In the subprime market, borrowers often have more difficulty qualifying for new loans, making them less sensitive to drops in interest rates.⁶² Instead, subprime prepayments tend to occur for two reasons, one voluntary in nature and one involuntary. Voluntary prepayments take place when subprime borrowers improve their credit scores and refinance into prime products at lower rates. Involuntary prepayments, in contrast, are triggered by "loan flipping," in which lenders persuade subprime borrowers to refinance their loans repeatedly at short intervals in order to extract high fees.⁶³ Lenders can manufacture future loan flips by structuring the original loans so that borrowers will eventually be unable to repay.⁶⁴

60. See Jacob Boudoukh et al., *Pricing Mortgage-Backed Securities in a Multifactor Interest Rate Environment: A Multivariate Density Estimation Approach*, 10 Rev. Fin. Stud. 405, 410, 419 (1997).

61. See *id.* at 406, 437; Amy Crews Cutts & Robert Van Order, *On the Economics of Subprime Lending* 3, 7 (Freddie Mac, Working Paper No. 04-01, 2004).

62. Subprime prepayments do rise as interest rates fall. See, e.g., Quercia, Stegman & Davis, *supra* note 4, at 21. But subprime "borrowers' limited refinancing opportunities" mean that "refinancing rates must fall 200 to 300 basis points (bps) to significantly increase prepayments due to refinancing in the [subprime] market versus the 25 to 50 bps that move the private [prime] MBS market." R. Russell Hurst, *Securities Backed by Closed-End Home Equity Loans*, in *The Handbook of Mortgage-Backed Securities* 281, 292 (Frank J. Fabozzi, ed., 5th ed. 2001) (emphasis added).

63. See Eggert, *supra* note 2, at 515; ABSNet, Glossary, <http://www.absnet.net/help/gloss-new.asp#I> (last visited Feb. 28, 2007) (defining involuntary prepayment).

64. For example, a loan might include a hefty prepayment penalty that would be triggered if the borrower refinanced immediately before or after the interest rate on an adjustable rate mortgage adjusted. Alternatively, a large balloon clause can exert pressure on a borrower to agree to a loan flip if the borrower's credit rating has fallen too far to refinance elsewhere on better terms.

C. Litigation Risk

Investors face the further risk that borrowers will sue the trusts that hold the securitized loans for wrongdoing in the origination of those loans. Successful borrower litigation, especially litigation that results in large compensatory or punitive damages awards against the trust, can have a negative and serious impact on investors' returns. Thus, securitization deals must be structured to avoid litigation risk altogether or to predict and price it efficiently.

Trusts expose themselves to liability if they aid or participate in unlawful activities by loan originators, most often by being involved with the actual loan underwriting. Such participation can give rise to liability for violations of an array of laws ranging from consumer protection and credit discrimination statutes to conspiracy and fair housing laws.⁶⁵

Some laws impose liability on assignees even absent active wrongdoing. The Truth in Lending Act (TILA) allows borrowers to recover against assignees for originators' violations if the violations are "apparent on the face of" federal disclosure statements.⁶⁶ The principal federal anti-predatory lending law, the Home Ownership and Equity Protection Act (HOEPA),⁶⁷ imposes strict liability on assignees who purchase specific high-cost loans. In general, holders of HOEPA loans are "subject to all claims and defenses . . . that the borrower could assert against the originator of the mortgage."⁶⁸ Regulations implementing the Federal Trade Commission Act impose liability on assignees for "all claims and defenses which the debtor could assert against the seller."⁶⁹ Lastly, several states have enacted anti-predatory lending laws that impose liability on assignees.⁷⁰ Although these statutes allow for assignee liability, in reality

65. See, e.g., *Wise v. Union Acceptance Corp.*, No. 02-0104, 2002 WL 31730920, at *3 (S.D. Ind. Nov. 19, 2002) (Equal Credit Opportunity Act); *Cooper v. First Gov't Mortgage & Investors Corp.*, No. 00-0536, 2002 WL 31520158, at *13 (D.D.C. Nov. 4, 2002) (consumer protection law); *Hays v. Bankers Trust Co. of Cal.*, 46 F. Supp. 2d 490, 497 (S.D. W. Va. 1999) (conspiracy law); *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 537-38 (N.J. Super. Ct. App. Div. 2001) (Fair Housing Act).

66. 15 U.S.C. § 1641(a), (e)(2) (2000). Furthermore, if an originator fails to make the required disclosures to borrowers, the borrower may exercise the right of rescission against the assignee even if the TILA violation is not apparent on the face of the loan documents. *Id.* § 1641(c).

67. *Id.* §§ 1601-1667.

68. *Id.* § 1641(d)(1).

69. 16 C.F.R. § 433.2 (2005). This so-called FTC Rule only governs home mortgage loans that involve the sale of goods or services. *Id.* Some courts have construed the rule to hold, however, that if state consumer protection laws do not permit affirmative relief, consumers are limited to defensive actions against assignees. See, e.g., *LaBarre v. Credit Acceptance Corp.*, 175 F.3d 640 (8th Cir. 1999).

70. See, e.g., N.J. Stat. Ann. § 46:10B-27(b)-(e) (West Supp. 2006); N.Y. Banking Law § 6-1(7), (11)-(13) (McKinney Supp. 2007). See generally Baher Azmy, *Squaring the Predatory Lending Circle*, 57 Fla. L. Rev. 295 (2005) (surveying state laws). Increasingly, federal regulators have preempted state anti-predatory lending laws that impose assignee liability. See Bank Activities and Operations: Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34) (ruling that OCC

the application of the laws is quite narrow. In some cases, the laws require active participation by the assignees. In others, the laws only apply to a small fraction of loans, as is true for HOEPA.⁷¹

For most potential claims, however, assignees who have distanced themselves from the unlawful activities of originators can find shelter in the holder-in-due course doctrine, which insulates them from most claims for unconscionability, breach of contract, and fraud.⁷² To satisfy the requirements of a holder in due course, the purchaser must be the holder of a negotiable note, who took the note for value, in good faith, and without notice that the note contains certain defects.⁷³ To meet the definition of a “holder,” the assignee must possess the note and the note must be “issued or indorsed to him or to his order or to bearer or in blank.”⁷⁴ If a note is payable to an identified person or entity, the note must bear an endorsement or be among a group of loans to which an allonge was attached.⁷⁵ When assignees qualify as holders in due course, they take the notes free of most defenses to nonpayment and affirmative claims that borrowers could have pursued against the originators.

There are scenarios under which borrowers can defeat assignees’ status as holders in due course. When an assignee has notice of a potential claim, for example, that a note was obtained through fraud, the assignee is deemed to have sufficient notice to abrogate its status as a holder in due course.⁷⁶ Assignees obviously have “notice” if they played a role in the wrongdoing.⁷⁷ Notice similarly exists if the borrower brought the claim against the assignor prior to the assignment.⁷⁸

In other instances, failures by originators to comply with technical requirements of the holder-in-due-course rule can open the door to assignee liability.⁷⁹ Despite the demanding nature of these requirements, failure to

enforcement preempts state anti-predatory lending laws’ application to national banks). On a parallel front, states have preempted many local lending ordinances that contemplate assignee liability. *See, e.g., Mayor of New York v. Council of New York*, 780 N.Y.S.2d 266 (Sup. Ct. 2004) (holding New York City’s anti-predatory lending ordinance preempted by state and federal law).

71. The Home Ownership and Equity Protection Act (HOEPA) covers at best only about five percent of subprime first-lien home mortgage loans. *See, e.g., Truth in Lending*, 66 Fed. Reg. 65,604, 65,608 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226).

72. James White & Robert S. Summers, Uniform Commercial Code §§ 14-1, 14-2 (2000).

73. U.C.C. § 3-302 (2005).

74. White & Summers, *supra* note 72, § 14-3.

75. *Id.*

76. *See id.* § 14-7 (discussing cases).

77. *See, e.g., Williams v. Cent. Money Co.*, 974 F. Supp. 22, 28 (D.D.C. 1997) (denying summary judgment for assignees on fraud and unconscionability claims where there was evidence that the assignee “participated in the fraud perpetrated by” the assignor).

78. *See Fairbanks Capital Corp. v. Summerall*, No. 02AP-864, 2003 WL 1700487, at *3 (Ohio Ct. App. Mar. 31, 2003).

79. For example, a note that requires performance other than a promise to make the payments due is not negotiable and thus does not give rise to the holder-in-due-course defense if it is sold. *See White & Summers, supra* note 72, § 14-4 (discussing cases).

comply with the technical requirements of the holder-in-due-course rule is rarely litigated in predatory home loan cases.

Courts have also held that assignees can lose holder-in-due-course protection if their relationships with loan originators were sufficiently close to make the assignees agents of the originators.⁸⁰ Even where no agency relationship exists between the originator and the assignee, courts have imputed knowledge of an originator's wrongdoing to an assignee based on the strength and nature of ties between the assignor and the assignee.⁸¹

To recap, credit risk, prepayment risk, and litigation risk have the potential to make investors gun-shy about investing in securitizations. Allaying these concerns is a central task of structured finance.

V. HOW STRUCTURED FINANCE SOLVES THE LEMONS PROBLEM

In order to attract outside investors, securitization must solve the lemons problem in all of its three guises: credit risk, prepayment risk, and litigation risk. In this section, we describe how securitization reduces these risks through a variety of techniques. Notably, securitization can insulate investors from the risks of predatory lending without excluding predatory loans from securitized loan pools. In the process, securitization solves the lemons problem for investors without discouraging predatory lending itself.

A. *The Protections Provided by Sequential Tranches*

One way securitization protects investors from credit risk is through sequential tranches. According to Fitch Ratings, defaults in the subprime market “start in month seven, ramp up to a peak in months 28-42, and end at month 120.”⁸² For this reason, risk-averse investors—the ones most concerned with loan default—want to be paid off as quickly as possible. Investors who are most risk-averse buy the AAA tranche, investors who are slightly less risk-averse buy the AA tranche, and so it goes down the line. The senior tranche is retired first, followed by the AA tranche, etc., enabling the investors who are most risk-averse to get paid first. Originators sometimes—but not always—hold the most junior, and therefore the riskiest, tranches.⁸³ This technique has worked so well that the safest subprime tranches—the senior tranches—virtually never suffer credit losses.

Likewise, when notes lack the proper endorsements or are not in the possession of the assignee, they are not negotiable. *See id.* § 14-3 (discussing cases).

80. *See, e.g.,* England v. MG Invs., Inc., 93 F. Supp. 2d 718, 722-23 (S.D. W. Va. 2000) (denying summary judgment on a fraud claim where evidence showed that the originator was acting as an agent of the assignee).

81. *See Williams*, 974 F. Supp. at 26-27 (imputing knowledge to the assignee where an officer of the originator, who had “direct contact” with the borrower, was alleged to be a principal and shareholder of the assignee).

82. FitchRatings, *supra* note 7, at 8, 9.

83. *See infra* notes 123-130 and accompanying text.

B. *Investors in Subprime Offerings Benefit from Conservative Risk Assessments by Rating Agencies*

Individuals and entities who purchase bonds in subprime RMBS offerings can benefit from rating agencies' tendency to overestimate credit risk. As securities trade on the secondary market, the rating agencies reevaluate the performance of the underlying collateral in the securitized loan pools and upgrade or downgrade the affected tranches as needed. If the rating model is accurate and there are no unanticipated credit shocks, tranches should keep their original grades. If the rating agency later upgrades a tranche in response to information on collateral performance, its original credit risk assessment was too conservative. If it later downgrades a tranche due to poor loan performance, its initial assessment was too sanguine.

Standard & Poor's (S&P) reports for 2003 through 2006 expressly tout data that S&P tends to overestimate the credit risk of senior subprime tranches. As the chart on the following page shows, S&P upgrades outpaced downgrades in public subprime home loan securitizations through 2005, and downgrades in the senior subprime tranches were almost nonexistent through 2005 and rare in 2006.⁸⁴

Two aspects of these data are noteworthy. First, until 2006, upgrades outnumbered downgrades. In 2003, for instance, S&P issued almost 2.5 upgrades for every subprime RMBS downgrade (111 upgrades to 46 downgrades). In 2004, this ratio widened, and it widened again in 2005. In 2004, S&P issued 4.22 upgrades for every subprime downgrade (152 upgrades to 36 downgrades); in 2005, there were 4.6 subprime upgrades for every subprime downgrade (235 upgrades to 51 downgrades). This data reveals that, at least through 2005, when S&P made errors, its errors were skewed toward excessive caution.

Second, the senior tranches are the main beneficiaries of S&P's excessively conservative ratings of subprime RMBS. Subprime securities rated A+ or higher had numerous upgrades (70 in 2003, 90 in 2004, 117 in

84. In fact, in 2006, the vast majority (98.5%) of public and private tranches combined rated by S&P either kept their ratings or received upgrades. S&P, *Transition Study: U.S. RMBS Upgrades Are Down and Downgrades Are Up in 2006* (2007). The 1.5 percent of tranches that received S&P downgrades were probably a reflection of the fact that toward the end of 2005, mortgage loan delinquency rates began rising. Al Yoon, *Housing Bubble Bursts in U.S. Mortgage Bond Market (Update 2)*, Bloomberg.com, Dec. 6, 2005, <http://www.bloomberg.com/apps/news?pid=10000103&sid=aDSB370ItSJU&refer=us>. Indeed, S&P's slow response to the inherent risk in subprime securitizations caused Gretchen Morgenson of *The New York Times* to lament, "It's amazing how long it can take investors to see that the wheels are coming off a prized investment vehicle. Denial, after all, is a powerful thing." Gretchen Morgenson, *Will Other Mortgage Dominoes Fall?*, N.Y. Times, Feb. 18, 2007, at C1.

We compiled our data from S&P, *supra* note 42, app. 2 (2004); S&P, *Rating Transitions 2004: U.S. RMBS Stellar Performance Continues to Set Records*, app. 2 (2005) [hereinafter S&P, *Rating Transitions 2004*]; S&P, *Rating Transitions 2005: U.S. RMBS Volume and Rating Activity Continue to Set Records*, apps. 1-2 (2006); S&P, *Transition Study: U.S. RMBS Upgrades Are Down and Downgrades Are Up in 2006*, apps 1-2 (2007).

2005, and 57 in 2006). Conversely, only one of the senior classes rated A+ or higher in 2003 through 2005 suffered a downgrade, despite rising subprime loan default rates. In 2006, this figure rose to thirteen; upgrades of those classes still outnumbered downgrades by more than four to one. As one subprime lender declared, “If you buy the Triple-A, you’re home free.”⁸⁵

Table 1: S&P Upgrades and Downgrades of Public Subprime RMBS, 2003-2006

| Original Rating | AAA | AA+ | AA | AA- | A+ | A | A- | BBB+ | BBB | BBB- | BB+ | BB | BB- | B | B- | CCC+ | CCC | CCC- | CC | D |
|-----------------|-----|-----|----|-----|----|----|----|------|-----|------|-----|----|-----|----|----|------|-----|------|----|---|
| 2003 Upgrades | 0 | 16 | 47 | 2 | 5 | 28 | 0 | 0 | 13 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 2003 Downgrades | 0 | 0 | 0 | 0 | 0 | 3 | 0 | 0 | 8 | 5 | 1 | 7 | 0 | 6 | 0 | 3 | 5 | 10 | 3 | 0 |
| 2004 Upgrades | 0 | 9 | 77 | 1 | 3 | 36 | 0 | 1 | 13 | 9 | 1 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 |
| 2004 Downgrades | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 5 | 4 | 1 | 5 | 0 | 8 | 0 | 0 | 9 | 0 | 3 | 0 |
| 2005 Upgrades | 0 | 21 | 85 | 4 | 7 | 54 | 11 | 16 | 24 | 12 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 2005 Downgrades | 0 | 0 | 1 | 0 | 0 | 3 | 0 | 1 | 11 | 7 | 2 | 10 | 0 | 8 | 0 | 0 | 8 | 0 | 0 | 0 |
| 2006 Upgrades | 0 | 13 | 37 | 3 | 4 | 19 | 7 | 8 | 8 | 3 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 2006 Downgrades | 2 | 1 | 5 | 3 | 2 | 14 | 3 | 11 | 43 | 55 | 4 | 32 | 10 | 24 | 1 | 0 | 11 | 0 | 0 | 0 |

This rosy upgrade experience serves two important marketing functions. First, it allays investors’ concerns about lemon loans. Second, it entices potential investors to purchase senior subprime tranches by holding out the possibility that investors will enjoy upgrades over time.⁸⁶ This upgrade experience, plus a structure that enables senior bonds to mature quickly, helps explain the remarkable growth in subprime RMBS.⁸⁷

C. Diversification

Diversification is another means by which securitization reduces investors’ risk, including the risk of “lemon” loans. Because there is high

85. *H&R Block, Inc. at UBS Global Financial Services Conference—F*, FD (Fair Disclosure) Wire, May 10, 2005.

86. The larger significance of S&P’s upgrade/downgrade data for subprime loan pools is uncertain because S&P does not always report the total number of subprime tranches whose ratings remained unchanged. Some sense of the magnitude can be gleaned from S&P reports, however, that 91.45% of all 17,674 RMBS tranches (including prime and subprime) rated in 2004 maintained the same credit rating a year later, while only 0.82% suffered downgrades and 7.73% experienced upgrades. *See supra* note 84.

87. An empirical study of Freddie Mac multi-class RMBS recently reached the same conclusion, finding that “the capital structures of multi-class MBS” evolved as a solution to the lemons problem. Downing, Jaffee & Wallace, *supra* note 54, at 20.

investor demand for subprime RMBS, lenders can securitize large pools of subprime loans. In turn, large loan pools enable investors to better diversify risk. The greater the diversity in the loan pool in terms of geography, credit risk, prepayment risk, and legal risk, the less likely it is that investors will suffer losses.⁸⁸

D. Pricing

Because of the lemons problem, investors in RMBS demand a risk premium, in the form of a price reduction, to compensate them for the risk of adverse selection. To some extent, investment banks seek to reduce this risk premium by refining their pricing models to calibrate risks more accurately. Nevertheless, empirical evidence suggests that the prices for RMBS still contain lemons premia.⁸⁹

In response, lenders who securitize their loans extract price concessions from subprime borrowers in the form of excessive interest rates, prepayment penalties, and other loan terms. In 2004 and 2005, for instance, rating agencies demanded costlier protections for investors in subprime RMBS, prompting subprime lenders to raise the interest rates on their loans in response.⁹⁰ This evidence is consistent with findings that securitization can push up home mortgage rates.⁹¹

Studies of securitized subprime loans have found evidence of overpricing. Freddie Mac researchers have concluded, for example, that

88. See, e.g., Hill, *supra* note 15, at 1088.

89. See Wayne Passmore & Roger Sparks, *Putting the Squeeze on a Market for Lemons: Government-Sponsored Mortgage Securitization*, 13 J. Real Est. Fin. & Econ. 27 (1996); Downing, Jaffee & Wallace, *supra* note 54, at 4, 21 (finding that Freddie Mac faced a “lemons discount” on the sale of multi-class RMBS).

90. See Erick Bergquist, *Block Quits Subprime Price Fight*, Am. Banker, Sept. 6, 2005, at 1 (reporting that H&R Block’s subprime lender, Option One, raised its interest rates on its home loans by forty basis points because the rating agencies were “demanding more costly protection for investors”); Ed Jones, *Getting into Nonprime Lending Is No Problem with New Technology*, Secondary Marketing Executive, Oct. 2004, at 40 (“Major investors can control both the base and incremental pricing they provide to various [subprime] lenders around the country.”); Allison Pyburn, *Home Equity Sub Spreads Finally Show Signs of Widening*, Asset Securitization Rep., July 4, 2005; Howard Schneider, *Versatility for Long-Term Success*, Nat’l Mortgage Broker Mag., Feb. 2006, available at <http://www.nationalmortgagebroker.com> (“[subprime] investors now are demanding higher yields to compensate for increased risks. Worries about future delinquencies ha[ve] investors pushing prices down on mortgage-backed bonds, causing yields to go up on mortgages made to consumers with low FICO scores.”); *National City at Goldman Sachs Financial Services CEO Conference 2005—F*, FD (Fair Disclosure) Wire, Dec. 6, 2005 (acknowledging “the pressure on gain on sale coming from the capital markets”); *Q1 2006 H&R Block, Inc. Earnings Conference Call—F*, FD (Fair Disclosure) Wire, Sept. 1, 2005 (defending the price hike because, given subprime credit risks, “investors[] ought to be paid more for it”).

91. See Andrea Heuson, Wayne Passmore & Rogers Sparks, *Credit Scoring and Mortgage Securitization: Implications for Mortgage Rates and Credit Availability*, 23 J. Real Est. Fin. & Econ. 337, 347-53 (2001); Passmore & Sparks, *supra* note 89; Steven Todd, *The Effects of Securitization on Consumer Mortgage Costs*, 29 Real Est. Econ. 29 (2001); Downing, Jaffee & Wallace, *supra* note 54, at 4-5, 21.

subprime lenders steered unwitting customers who qualified for prime loans into subprime products, forcing those customers to overpay for credit.⁹² Another Freddie Mac study examined the question whether subprime loans properly price borrowers' risk by comparing the interest rates of prime and subprime (specifically A-) loans securitized by Freddie Mac. After holding credit risk constant, the study concluded that "roughly one-half of the interest rate premium paid by subprime borrowers—100 basis points—cannot easily be explained by the higher levels of risk associated with these types of loans."⁹³ The study made no "attempt to account for or measure the higher average origination points and fees paid by subprime borrowers."⁹⁴ In the authors' view, the "total prices charged to subprime borrowers (rates, points, and fees) are . . . likely in excess of the amounts that can be justified by their differentially higher credit risk."⁹⁵

A new body of research reveals that prepayment penalties similarly push the cost of subprime loans above their risk-adjusted price. Prepayment penalties are common in subprime loans, while prime loans almost never

92. For example, in 1996, Freddie Mac found that ten to thirty-five percent of subprime borrowers could have qualified for prime-rate loans. Freddie Mac, *supra* note 18, ch. 5 & nn.5-6; Wei Li & Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms 8* (2006) (finding that fourteen percent of subprime borrowers studied between 1998 and 2004 were prime-eligible); Lax et al., *supra* note 19, at 565 (finding that "some borrowers end up with subprime loans for reasons other than risk" and calling that finding "disturbing"). Fannie Mae's former President Franklin Raines similarly stated that up to half of all subprime mortgages are eligible for purchase by Fannie Mae under its prime loan guidelines. See HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), 65 Fed. Reg. 65,044, 65,053 (Oct. 31, 2000) (to be codified at 24 C.F.R. pt. 81); see also Darryl E. Getter, *Consumer Credit Risk and Pricing*, 40 J. Consumer Aff. 41, 49-50 (2006) (finding that 36.4 percent of households paying the costliest interest rates on home mortgage "were of high credit quality"); Diana B. Henriques & Lowell Bergman, *Profiting from Fine Print with Wall Street's Help*, N.Y. Times, Mar. 15, 2000, at A1.

93. Lax et al., *supra* note 19, at 569.

94. *Id.*

95. See *id.* at 569; accord Li & Ernst, *supra* note 92, at 15 (finding that nominal interest rates on subprime loans in states without strong anti-predatory lending laws were twenty-five basis points higher on average than on comparable loans in states with strong state laws). Lax and his colleagues discussed a persistent price discontinuity on the order of 200-plus basis points separating A and A- loans, only part of which could be explained by risk. See Lax et al., *supra* note 19, at 567-68. For discussion of the significance of this price discontinuity, see White, *supra* note 19, at 512-13. The finance literature is riddled with the fallacy that securitization reduces the price borrowers pay for credit by lowering the lender's cost of funds. See, e.g., Kendall, *supra* note 43, at 2; Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 Cardozo L. Rev. 1655, 1668 (2004); Michael H. Schill, *The Impact of the Capital Markets on Real Estate Law and Practice*, 32 J. Marshall L. Rev. 269, 280 (1999); Schwarcz, *supra* note 33, at 136; Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 Tex. L. Rev. 1369, 1379-81 (1991). The high transaction costs of securitization are hard to square with assertions of cost savings. See Iacobucci & Winter, *supra* note 15, at 168; Schwarcz, *supra* note 33, at 139-42. Even if there were cost savings, that assumes that the savings are passed on to borrowers. Finally, the cost savings theory fails to take account of the fact that investors demand compensation for the lemons problem.

carry such penalties.⁹⁶ Industry representatives defend prepayment penalties by arguing that subprime prepayment speeds are faster than prime.⁹⁷ However, there is “sparse” empirical data from the industry to support that claim, and what there is consists only of summary statistics.⁹⁸ In contrast, recent multivariate regression analyses have found that prepayment speeds of high-risk borrowers are the same as or slower than speeds of low-risk borrowers.⁹⁹ Two of those studies found that slower prepayment speeds made subprime loans relatively more profitable than

96. Prepayment penalties can stay in force for up to five years and commonly consist of six months of interest on the amount prepaid less twenty percent. See Anand K. Bhattacharya, *Prepayment Penalty Mortgage-Backed Securities*, in *The Handbook of Mortgage-Backed Securities*, *supra* note 62, at 75, 77-78. Studies have determined that anywhere from fifty-one to ninety-eight percent of subprime mortgages carry prepayment penalties, depending on the time period studied. In comparison, prepayment penalties are found in less than two percent of prime mortgages. See Li & Ernst, *supra* note 92, at 8, 12; Treasury-HUD Report, *supra* note 20, at 93; Joshua Brockman, *Fannie Revamps Prepayment-Penalty Bonds*, *Am. Banker*, July 20, 1999, at 16.

97. See, e.g., Weicher, *supra* note 56, at 69; McCall & Blum, *supra* note 34, at 141-42; see also Treasury-HUD Report, *supra* note 20, at 28.

98. Anthony Pennington-Cross, *Credit History and the Performance of Prime and Nonprime Mortgages*, 27 *J. Real Est. Fin. & Econ.* 279 (2003); see also Wayne R. Archer et al., *Household Income, Termination Risk and Mortgage Pricing*, 27 *J. Real Est. Fin. & Econ.* 111, 135 n.1 (2003).

99. See Archer et al., *supra* note 98 (finding no significant difference between prepayment speeds of low-income and more affluent households; also finding that higher loan-to-value ratios substantially slowed prepayment speeds for low-income households); Pennington-Cross, *supra* note 98, at 280-81, 289-94, 296-97, 300 (concluding that prepayment speeds dropped as credit scores dropped and that average A- prepayment speeds were slower than prime prepayment speeds for borrowers with FICO scores under 700); Robert Van Order & Peter Zorn, *Performance of Low-Income and Minority Mortgages* 23 (Joint Ctr. for Hous. Stud. of Harv. Univ., Working Paper No. LIHO-01.10, 2001) (concluding that black and Hispanic borrowers had significantly slower prepayment rates than whites, even after controlling for FICO scores and loan-to-value ratios); Yongheng Deng & Stuart Gabriel, *Risk-Based Pricing and the Enhancement of Mortgage Credit Availability Among Underserved and Higher Credit-Risk Populations* 11, 13-14, 17-19, 32 tbl.1 (May 2005) (unpublished manuscript, on file with the Fordham Law Review) (finding that lower FICO scores, high loan-to-value ratios, and being black, Hispanic, or a single female were predictors of lower prepayment speeds); see also Davidson et al., *supra* note 36, at 330-31; Ivan Gjaja, *Prepayments on RFC Fixed-Rate Subprime/HELs*, in *Salomon Smith Barney Guide to Mortgage-Backed and Asset-Backed Securities*, *supra* note 40, at 519, 537; Infovest 21 LLC, *Strategy Focus: Multi-Strategy Fixed Income* (July 1, 2005) (noting that for mortgage derivatives, “agency derivatives [i.e., issued by Fannie Mae and Freddie Mac] have more prepayment risk” than private label RMBS); Harris Nesbitt, *Asset-Backed Update* 6 (Apr. 2005), available at <http://www.securitization.net/pdf/transaction/Nesbitt29Apr05.pdf> (noting that fast prepayments decrease excess spread, “making the transaction much more sensitive to spikes in losses or deterioration in general performance”); Lakhbir Hayre & Robert Young, *Anatomy of Prepayments: The Salomon Smith Barney Prepayment Model*, in *Salomon Smith Barney Guide to Mortgage-Backed and Asset-Backed Securities*, *supra* note 40, at 131, 161-62; Hurst, *supra* note 62, at 292 (explaining that “prepayment of [subprime home loans] has proved to be much more stable than that of the [prime] MBS market and has resulted in securitization with less negative convexity”). Industry data also suggest that the newest subprime product, interest-only adjustable rate mortgages, “prepay more slowly than regular amortizing ARMs.” Banc of Am. Sec., *ABS Research Note: 2005 Outlook: Cautiously Optimistic* 15-16 (2005); see also Neil J. Morse, *The Interest-Only Craze*, *Mortgage Banking*, Oct. 2004, at 52.

prime loans, even after controlling for differences in credit risk.¹⁰⁰ Conversely, in some interest-rate environments when credit risk is rapidly rising, faster subprime prepayment speeds can actually boost subprime profits. In the summer of 2005, for example, S&P lauded faster subprime prepayment speeds for “driving superior [subprime] performance.” According to S&P, “[e]xtended deals may lead to greater losses” due to heightened risk of foreclosure.¹⁰¹

Subprime lenders also contend that prepayment penalties represent a trade-off for lower interest rates. If this were true, one would expect subprime borrowers with prepayment penalties to pay lower interest rates than comparable subprime borrowers without. This is not the case. A recent study found that prepayment penalties had little or no downward effect on interest rates on subprime refinance loans after controlling for property location, loan terms, and underwriting factors based on borrowers’ characteristics. For subprime home purchase loans, prepayment penalties went hand-in-hand with higher interest rates after controlling for geography and credit risk.¹⁰² Originators have incentives to charge higher interest rates and prepayment penalties because these terms generate higher prices when the loans are sold or packaged for securitization.

To summarize, the lemons problem causes investors in senior tranches of subprime RMBS to pressure lenders to impose excess costs on borrowers. Lenders respond to this pressure by charging borrowers higher interest rates and fees and adding onerous loan terms, such as prepayment penalties.

E. Due Diligence

Due diligence is another technique that lenders, underwriters, rating agencies, and institutional purchasers of subprime RMBS use to manage risk. However, to the extent these entities engage in any due diligence, it is limited in scope. “[I]n the past, Wall Street . . . hoped [investors] could purchase originated assets without having to do much [due] diligence on the origination side.”¹⁰³ Largely, that was because investors depended on the

100. Deng & Gabriel, *supra* note 99, at 20; *see id.* at 5, 22; *see also* Van Order & Zorn, *supra* note 99, at 27 (concluding that for low-income and minority borrowers, “the lower costs from exercising the prepayment option have at least offset these [default costs] for our loan sample”).

101. *See* S&P, *supra* note 31, at 35; *see also id.* at 13, 45, 51; *accord* Banc of Am. Sec., *supra* note 99, at 2. In such environments, prepayment penalties can operate to increase default risk by slowing down prepayment speeds. *See* Quercia, Stegman & Davis, *supra* note 4, at 7.

102. Keith S. Ernst, Ctr. for Responsible Lending, Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages (January 2005), *available at* http://www.responsiblelending.org/pdfs/rr05-PPP_Interest_Rate-0105.pdf. *But see* Michael LaCour-Little, Call Protection in Mortgage Contracts 2-27 (2005) (unpublished manuscript, on file with the Fordham Law Review), *available at* <http://ssrn.com/abstract=881618> (in a study of loans made by one subprime lender, finding that prepayment penalties were correlated with a reduction in the interest rate).

103. Dona DeZube, *Predatory Pandemonium*, Mortgage Banking, Apr. 2003, at 26, 32; *see also* Richard Beidl, *A Balancing Act; eMortgage*, Mortgage Banking, Apr. 2003, at 95.

senior-subordinate structure, not due diligence, to protect them from credit risk.¹⁰⁴

In recent years, three developments have prompted some investment banks, loan aggregators,¹⁰⁵ and investors to intensify their due diligence on subprime RMBS. First, in June 2003, a federal jury issued a \$50.9 million verdict against Lehman Brothers for aiding and abetting First Alliance Mortgage Corp. (popularly known as “FAMCO”) in defrauding subprime borrowers.¹⁰⁶ The verdict sent shock waves throughout the securitization world because Lehman Brothers was found liable in part, as FAMCO’s investment bank and warehouse lender, for faulty due diligence on FAMCO’s securitized loans.¹⁰⁷ Second, some states, including Georgia, Massachusetts, New Jersey, and New Mexico, enacted new anti-predatory lending laws that hold assignees of subprime loans, who fail to conduct adequate due diligence to exclude high-cost loans from securitization pools, liable for loan originators’ predatory practices.¹⁰⁸ Finally, Fannie Mae and Freddie Mac have started buying the better subprime loans and their higher due diligence requirements have forced loan originators to do more due diligence of their own.¹⁰⁹ As we will discuss in Part VI.C below, the extent and nature of this due diligence varies widely.

F. Deal Provisions

Secondary market purchasers also demand contractual protections to mitigate the lemons problem.¹¹⁰ These contractual provisions are designed to shift part or all of the credit risk back onto lenders. The rating agencies

104. See Shivaswamy, *supra* note 54, at 38.

105. See *infra* Part VI.A.

106. See Erick Bergquist, *Experts Say Lehman Case Is Warning, Not Precedent*, Am. Banker, June 18, 2003, at 6.

107. Cf. Austin v. Chisick (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 659-65 (Bankr. C.D. Cal. 2003) (findings of fact). Lehman Brothers allegedly learned of FAMCO’s fraud during due diligence and nevertheless gave FAMCO “substantial assistance” in financing FAMCO’s operations through securitization. See Anand S. Raman et al., *Cutting the Risks Built into Third-Party Lending Relationships*, ABA Banking J., July 2003, at 61. More generally, Professor Christopher Peterson would impose imputed liability on investment banks that structure predatory securitizations. See Christopher L. Peterson, *Predatory Structured Finance* (Sept. 7, 2006) (unpublished manuscript, on file with the Fordham Law Review), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929118.

108. See *infra* notes 243-260 and accompanying text.

109. Neil J. Morse, *Not Exactly Prime*, Mortgage Banking, June 2003, at 60 [hereinafter Morse, *Not Exactly Prime*]; Neil J. Morse, *The Compliance Battle*, Mortgage Banking, Sept. 2003, at 28 [hereinafter Morse, *The Compliance Battle*]; see also U.S. Gen. Accounting Office (GAO), GAO-04-280, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending* 79-81 (2004). For discussion of Fannie Mae’s and Freddie Mac’s due diligence standards for A- mortgages, see *infra* notes 266-267 and accompanying text.

110. See generally Karen B. Gelernt, *Comment: Avoiding Predator Risk in the Secondary Market*, Am. Banker, July 7, 2000, at 9 (recommending contractual protections that investors should demand when assessing offerings and originators).

consistently laud these and other provisions as effectively insulating investors from the risk of lemon loans. As one Fitch representative stated in 2004, “Issuers have provided protective measures to significantly reduce transaction risk and investor assignee liability from predatory lending.”¹¹¹

1. Representations and Warranties

Lenders provide representations and warranties to investors in subprime deals.¹¹² Some of these provisions are specifically designed to guard against the credit risk and litigation risk of predatory loans. Thus, rating agencies, underwriters, and investors insist that lenders warrant that all loans in the loan pool comply with applicable laws, including consumer protection laws.¹¹³ Sometimes lenders also must provide representations and warranties that all loan applicants’ reported salaries fall within a reasonable range of salaries for their specific profession and locale.¹¹⁴

2. Recourse and Collateral Substitution Clauses

Similarly, investment banks and rating agencies may insist on recourse clauses that require lenders to take back loans if specific events occur.¹¹⁵ Events that can trigger recourse clauses include borrower default¹¹⁶ or evidence that the loans contain prohibited terms.¹¹⁷ Similarly, collateral substitution clauses require lenders to substitute performing loans for loans that go into default. Recourse clauses and collateral substitution clauses are

111. Patrick Crowley, *Report Says Predatory Lending Issues Mostly Resolved for RMBS Issuers, Servicers*, Mortgage Daily, Jan. 5, 2004 (quoting Tom Albertson, Senior Dir., Fitch Ratings), available at <http://www.mortgagedaily.com/RatingsSubprime010504.asp>; cf. Moody’s Investor Service, *Predatory Lending and Home Equity Securitizations 1* (Apr. 28, 2000) (stating that allegations of predatory lending were unlikely to “have a widespread negative effect on the credit quality of outstanding securitizations . . . because many securitizations of subprime mortgage loans are fully insured by a monoline bond insurer”).

112. This occurs more often in public offerings than in Rule 144A private placements. See Shivaswamy, *supra* note 54, at 28, 31; *infra* notes 162-165 and accompanying text.

113. See, e.g., JP Morgan Chase & Co., 90 Fed. Res. Bull. 352 (June 2004); Citigroup Inc., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex); Citigroup Inc., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB); Chase Manhattan Corp., 87 Fed. Res. Bull. 76 (Feb. 2001); S&P, *supra* note 31, at 32; Morse, *The Compliance Battle*, *supra* note 109.

114. See Jody Shenn, *How Lenders Cut Risk on Low-Doc Loans*, Am. Banker, Oct. 26, 2004, at 6m.

115. See S&P, *supra* note 31, at 33; Eggert, *supra* note 2, at 541-42, 548; Steven L. Schwarcz, *The Limits Of Lawyering: Legal Opinions in Structured Finance*, 84 Tex. L. Rev. 1, 3, 4 n.12 (2005). Not all subprime securitizations include recourse provisions. As of September 2005, for instance, Option One’s secondary market resales of subprime home loans were made exclusively on a nonrecourse basis. See *Q1 2006 H&R Block, Inc. Earnings Conference Call*, *supra* note 90.

116. See Michaud, *supra* note 37, at 272. In a parallel phenomenon in response to the issuance of the FTC Rule, lenders began insisting that merchants agree to recourse provisions obligating the merchants to purchase notes from the lenders if the borrowers were “dissatisfied.” Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instrument Law*, 35 Creighton L. Rev. 363, 430 (2002).

117. See Eggert, *supra* note 2, at 527.

meant to redress the lemons problem¹¹⁸ by making lenders internalize the risk of loans that go into default or that violate the law.

3. Requiring Lenders to Retain Servicing Rights

Some securitization deals require lenders to retain loan servicing rights. Doing so gives lenders incentives to maximize creditworthiness because servicing costs go up as default risk rises.¹¹⁹ A lender who securitizes its loans but retains the servicing rights has a direct stake in timely repayment, because collection becomes costly when loans become delinquent or go into default. Thus, when lenders retain the servicing rights, they have incentives to hold down credit risk when making loans.

G. Credit-Default Swaps

Wall Street has created a new type of derivative that provides added protection to investors from the credit risk associated with abusive lending. This derivative, called a “credit-default swap,” functions like an insurance policy and pays off investors when default rates in a loan pool exceed a specified level.¹²⁰ These derivatives enable investors to purchase securities backed by predatory loans and then hedge against potential losses if borrowers are unable to repay the loans.

VI. WHY PREDATORY LENDING PERSISTS DESPITE RISK MANAGEMENT

The mechanisms that protect investors from risk should also exert discipline on subprime lenders by forcing them to retain some of the risk associated with the loan pools. All of these measures are designed to give lenders incentives to make good loans and thereby cut default risk. Nevertheless, none of these measures, singly or together, has curbed abusive lending.¹²¹ In this section, we explain why predatory lending persists despite attempts at market discipline by the secondary market.

118. See Schwarcz, *supra* note 115, at 3, 24.

119. See Amy Crews Cutts & Richard K. Green, *Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?* 4-5 (Harvard Joint Ctr. for Hous. Studies, Working Paper BABC 04-19, 2004).

120. Mark Whitehouse, *As Home Owners Face Strains, Market Bets on Loan Defaults*, Wall St. J., Oct. 30, 2006, at A1.

121. A 2004 report by The Reinvestment Fund documented the incidence of predatory lending in home loan refinance transactions. See The Reinvestment Fund, *Predatory Lending: An Approach to Identify and Understand Predatory Lending* (2004), available at <http://www.trfund.com/policy/predatory.lending.htm>; see also Quercia, Stegman & Davis, *supra* note 4. Between 1998 and 2005, the Federal Trade Commission prosecuted predatory lending cases against home mortgage lenders and brokers including Action Loan Co., Amor Mortgage, Abacus Mortgage, Associates First Capital Corp., Barry Cooper Properties, Capital City Mortgage Corp., Capitol Mortgage Corp., Chase Financial Funding, Inc., CLS Financial Services, Inc., Delta Funding Corp., Fairbanks Capital Corp., First Alliance Mortgage Company, First Plus Financial Group, Inc., Fleet Finance and Home Equity U.S.A., Granite Mortgage, LLC, Interstate Resource Corp., LAP Financial Services, Inc., Mark Diamond, Mercantile Mortgage Co., Nationwide Mortgage Corp., NuWest, Inc., PWR

Processing, Inc., R.A. Walker & Assocs., and Wasatch Credit Corp. See Fed. Trade Comm'n, *Prepared Statement of the Federal Trade Commission on Efforts to Combat Unfair and Deceptive Subprime Lending Before the Senate Special Committee on Aging*, 3-8, Feb. 24, 2004, available at www.ftc.gov/os/2004/02/02242004subprimelendingtest.pdf; Letter from Donald S. Clark, Sec'y, Fed. Trade Comm'n, to Sandra F. Braunstein, Dir., Fed. Reserve Sys. Div. of Consumer and Cmty. Affairs (Feb. 23, 2005), available at www.ftc.gov/os/2005/03/050301enforcemnttrpt.pdf; Press Release, Fed. Trade Comm'n, Capital City Mortgage Corp. Defendant Settles with FTC (May 14, 2004), available at <http://www.ftc.gov/opa/2004/05/sanne.htm>; Press Release, Fed. Trade Comm'n, Capital City Mortgage Settles FTC Charges (Feb. 24, 2005), available at <http://www.ftc.gov/opa/2005/02/capitalcity.htm>; Press Release, Fed. Trade Comm'n, FTC Challenges Bogus Mortgage Loan Brokers (June 1, 2004), available at <http://www.ftc.gov/opa/2004/06/pwrprocessing.htm>; Press Release, Fed. Trade Comm'n, FTC, DOJ and HUD Announce Action to Combat Abusive Lending Practices, (Mar. 30, 2000), available at <http://www.ftc.gov/opa/2000/03/deltafunding.htm>; Press Release, Fed. Trade Comm'n, FTC: Mortgage Broker's Deceptive Claims Tricked Consumers Looking for a Good Rate (June 2, 2004), available at <http://www.ftc.gov/opa/2004/06/chasefinancial.htm>; Press Release, Fed. Trade Comm'n, Home Equity Lenders Settle Charges that They Engaged in Abusive Lending Practices; Over Half Million Dollars To Be Returned to Consumers (July 29, 1999), available at <http://www.ftc.gov/opa/1999/07/hoepa.htm>; Press Release, Fed. Trade Comm'n, Home Mortgage Lender Settles "Predatory Lending" Charges (Mar. 21, 2002), available at <http://www.ftc.gov/opa/2002/03/famco.htm>; Press Release, Fed. Trade Comm'n, Midwest Mortgage Lender Agrees to Settle Illegal Lending Charges Brought by FTC, HUD, and State of Illinois, (July 18, 2002), available at <http://www.ftc.gov/opa/2002/07/mercantilediamond.htm>; Fed. Trade Comm'n, FTC Subprime Lending Cases (since 1998), <http://www.ftc.gov/opa/2002/07/subprimelendingcases.htm> (last visited Feb. 28, 2007).

In April 2004, the Office of Thrift Supervision entered into a supervisory agreement with Ocwen Federal Bank designed to eliminate alleged predatory loan servicing practices. Supervisory Agreement, Ocwen Fed. Bank FSB and Office of Thrift Supervision, OTS Docket No. 04592 (Apr. 19, 2004), available at <http://www.ots.treas.gov/docs/9/93606.pdf>. The following month, Citigroup Inc. and its subprime mortgage subsidiary, Citifinancial Credit Company, agreed to a cease-and-desist order in which the Board of Governors of the Federal Reserve System imposed a \$70 million civil money penalty for alleged predatory lending practices. Timothy L. O'Brien, *Fed Assesses Citigroup Unit \$70 Million in Loan Abuse*, N.Y. Times, May 28, 2004, at C1; Press Release, Bd. of Governors of the Fed. Reserve Sys. (May 27, 2004), available at www.federalreserve.gov/boarddocs/press/enforcement/2004/20040527/default.htm. The 2004 Citigroup order followed on the heels of an earlier \$215 million settlement by Citigroup Inc. in 2002 to resolve FTC charges of predatory lending. Press Release, Fed. Trade Comm'n, Citigroup Settles FTC Charges Against the Associates Record-Setting \$215 Million for Subprime Lending Victims (Sept. 19, 2002), available at <http://www.ftc.gov/opa/2002/09/associates.htm>.

In 2005, the Office of the Comptroller of the Currency similarly issued agency sanctions against Chicago Title Insurance Company for fraudulent home loan settlement practices. See Office of the Comptroller of the Currency, Stipulation and Consent Order, In re Chicago Title Ins. Co., #2005-12 (Feb. 24, 2005), available at www.occ.treas.gov/FTP/EAs/ea2005-12.pdf. Finally, the Federal Bureau of Investigation has pursued mortgage fraud aggressively. See, e.g., Fed. Bureau of Investigation, *Statement of Chris Swecker Before the House Fin. Services Subcomm. On Housing and Community Opportunity* (Oct. 7, 2004), available at www.fbi.gov/congress/congress04/swecker100704.htm; Fed. Bureau of Investigation, Financial Crimes Report to the Public (May 2005), available at http://www.fbi.gov/publications/financial/fcs_report052005/fcs_report052005.htm (reporting on investigations into equity skimming, property flipping and mortgage-related identity theft). In 2006, forty-nine states and the District of Columbia reached a \$325 million settlement with Ameriquest Mortgage Company over alleged predatory lending practices. See, e.g., Press Release, Iowa Dep't of Justice, Miller: Ameriquest Will Pay \$325 Million

A. *The Unholy Alliance of Marginal Lenders and Loan Aggregators*

Increasingly, subprime lenders are selling whole loans to outside loan aggregators, who bundle and securitize them. Generally, such aggregators are affiliates of Wall Street investment banks. Major players include Credit Suisse First Boston, Morgan Stanley, Lehman Brothers, Bear, Stearns & Co., Merrill Lynch, Greenwich Capital, UBS, Bank of America, and Deutsche Bank Securities.¹²²

Subprime aggregation is popular because it offers advantages to both investment banks and lenders. These advantages are particularly strong for small or poorly-capitalized lenders. Aggregation permits these lenders to sell loan pools for securitization that would otherwise be too small to provide diversification. More importantly, aggregation enables marginal lenders to obtain financing despite obscure or questionable reputations by “renting” the aggregator’s reputation for quality securities.

Wall Street prizes aggregation because it helps boost investment banks’ underwriting business and helps them assemble diversified loan pools. Furthermore, it allows investment banks to enjoy subprime profits with reduced legal risk, assuming that the aggregators qualify as holders-in-due course and do not participate in underwriting loans. Because they have minimal exposure to suits, aggregators have reduced incentives to guard against abusive practices.

B. *Lenders Do Not Always Retain an Interest in the Subordinated Tranches*

In the process of providing credit enhancements, the lender (through an affiliate) often buys securities in the subordinated tranches, which are rated double- or single-B or are simply unrated.¹²³ While this makes it appear

and Reform its Lending Practices (Jan. 23, 2006), available at http://www.state.ia.us/government/ag/latest_news/releases/jan_2006/Ameriquist_Iowa.html.

122. Loan aggregation is also known as warehouse lending, conduit lending, or “principal finance.” The aggregation business has boomed, accounting for 42% of subprime securitizations in 2002. See Morse, *Not Exactly Prime*, *supra* note 109; Shepherd, *supra* note 29; Bonnie Sinnock, *Morgan Stanley Sees Technology as Key to ‘Strong Credit Culture’*, Nat’l Mortgage News, Mar. 28, 2005, at 3.

123. See Jody Shenn, *Where’s Mortgage Risk? New Answers Emerging*, Am. Banker, May 11, 2005, at 1. Subordinated tranches comprised only a small fraction of the proceeds—no more than fifteen percent—from all RMBS tranches rated by S&P through 2004 (including subprime tranches). Investment-grade tranches (rated BBB or higher and bought by outside investors) accounted for the remaining eighty-five percent. See S&P, *Rating Transitions 2004*, *supra* note 84, at 5 tbl.4; see also Blum & DiAngelo, *supra* note 33, at 253; Frank L. Raiter, *Risk-Based Pricing Nonagency Mortgages and Securities*, in *Subprime Consumer Lending* 145, 151 (Frank J. Fabozzi ed., 1999). Subprime RMBS are often issued through limited offerings or private placements. Under the Securities Act of 1933 and Securities & Exchange Commission regulations, few private individuals qualify to buy investment-grade subprime RMBS through unregistered offerings. See 17 C.F.R. §§ 230.501-230.508 (2006). Instead, institutional investors (banks and thrifts, insurance companies, pension funds, mutual funds and, to a minor degree, hedge funds) plus foreign entities buy the vast majority of those securities. See Hayre, *supra* note 40, at 11-12; Ruth

that the lender retains the riskiest securities, this is not necessarily the case. Instead, outside investors buy many of these so-called “residuals,” some at the time of offering and others through later secondary market re-sales.¹²⁴ There is strong demand by outside investors (principally real estate investment trusts, hedge funds, and overseas investors) for the double- and single-B subprime tranches.¹²⁵ In addition, lenders can resell their subprime residuals to outside investors through bonds known as Collateralized Debt Obligations (CDOs). Essentially, CDOs securitize residuals from RMBS and other assets.¹²⁶ Significantly, U.S. subprime

Simon et al., *Housing-Bubble Talk Doesn't Scare Off Foreigners*, Wall St. J., Aug. 24, 2005, at A1; Infovest21 LLC, *supra* note 99.

124. For lenders who are regulated depository institutions or their operating subsidiaries, regulatory accounting principles may compel the sale of the double- or single-B tranches. *See, e.g.*, Hill, *supra* note 15, at 1069-70 & n.36, 1089 & n.131. Even when lenders retain subprime residuals, they can mitigate their credit risk through conventional mortgage insurance on the underlying mortgages or credit-default swaps that hedge the risk. *See, e.g.*, *Countrywide Financial Corporation Analyst Meeting—Final, FD* (Fair Disclosure) Wire, May 24, 2005 (explaining that “one of the ways that we get down to a lower, net residual position on the sub prime is due to use of mortgage insurance”); Simon & Hagerty, *supra* note 49, at C1. Additionally, the persistence of predatory lending despite retained residuals may suggest that predatory lending is so profitable—largely due to up-front fees and proceeds from securitization—that those profits generally offset the financial risks of holding the residuals.

125. *See* James R. Hagerty & Ruth Simon, *Mortgage Risk: A Hot Export*, Wall St. J., Sept. 22, 2005, at C1, C4; Iacobucci & Winter, *supra* note 15, at 188-89; Sarah Mulholland, *Single-B HEL Classes Emerge: Yield-Hungry Buyers Driving Trend*, Asset Securitization Rep., Aug. 9, 2004; Simon et al., *supra* note 123; *see also* *Countrywide Financial Corporation Analyst Meeting, supra* note 124 (observing that the “ability to sell residuals or the bottom pieces in the credit . . . spectrum whether it [is] double digits or single digits . . . has been substantially broadened in the last few years as a number of investors have reached down the credit curve for a greater yield”); Kevin Donovan, *Large HEL ABS Beefs Up Otherwise Slow U.S. ABS Market*, Asset Securitization Rep., Feb. 2, 2004, (describing a home equity securitization with single-B plus rated bonds and noting “the strong demand for mezzanine and sub classes”).

126. As such, the CDO market provides liquidity for RMBS, including subprime securities. “Through retransching and diversification, CDOs produce higher-rated securities from lower-rated ones.” Shenn, *supra* note 123, at 1, 10. For helpful introductions to CDOs, *see* Olivier Cousseran & Imène Rahmouni, *The CDO Market: Functioning and Implications in Terms of Financial Stability*, 6 Fin. Stability Rev. 43, 44 (2005), and S&P, *Global Cash Flow and Synthetic CDO Criteria 4-13* (2002) [hereinafter S&P, *Global Cash Flow and Synthetic CDO Criteria*]. The authors are indebted to Kevin Byers for his insights on CDOs and NIMS. A typical CDO might contain subprime RMBS with a weighted average rating as low as BB+, meaning that many of those securities are rated below investment grade. *See, e.g.*, Fitch Rates Duke Funding VIII, Ltd./Corp ‘AAA/AA/A-/BBB,’ Bus. Wire, Apr. 5, 2005; Fitch Rates Glacier Funding CDO II, Ltd ‘AAA/AAA/AA/BBB/BB,’ Bus. Wire, Oct. 12, 2004; Fitch Rates G-STAR 2005-5 Ltd./Corp., Bus. Wire, Mar. 16, 2005; Fitch Rates Newcastle CDO VI, Ltd. ‘F1+/AAA/AAA/AA/A/BBB,’ Bus. Wire, Apr. 19, 2005; Fitch Rates Northwall Funding CDO I, Ltd./Inc., Bus. Wire, May 17, 2005; Fitch Rates Sorin Real Estate CDO I, Ltd., Bus. Wire, July 21, 2005; G-STAR 2004-4 Rated ‘AAA/AA/A-/BBB’ by Fitch Ratings, Bus. Wire, Aug. 12, 2004; *see also* Allison Pyburn, *Merrill finds less risk in CDO Collateral Versus HEL ABS Market*, Asset Securitization Rep., Aug. 8, 2005 (noting that “CDOs highly exposed to subordinate [subprime] ABS bonds”); Shenn, *supra* note 123, at 1. One S&P study of CDOs found that the weighted average rating of subprime RMBS backing CDOs dropped from A in 2003 to BBB in 2004. *See* S&P, *CDO Spotlight: U.S. CDO of*

RMBS have comprised the single “largest collateral asset class in [CDOs] since the inception of the product in 1999.”¹²⁷

A central purpose of residuals is to force lenders to retain the bulk of the credit risk they create.¹²⁸ However, when lenders with subprime residuals shift them off their books through CDOs,¹²⁹ they are able to escape the market discipline that residuals were meant to exert. As one CDO manager

ABS Collateral Composition and Performance 6 (2004) [hereinafter, S&P, CDO Spotlight: U.S. CDO of ABS Collateral Composition and Performance]. Any CDO with a weighted average rating of BBB or lower is likely to be backed in part by double- or single-B bonds.

127. FitchRatings, *supra* note 7, at 1; *see also* Morgenson, *supra* note 84; S&P, CDO Spotlight: U.S. CDO of ABS Collateral Composition and Performance, *supra* note 126, at 4.

128. *See* Hurst, *supra* note 62, at 285 (observing that “[r]etention of [the residual] by the seller-servicer provides a primary motivation to maximize the cash flow in the trust (i.e., accelerate collections and minimize losses) so that the value of the residual is realized”).

129. *See* Hagerty & Simon, *supra* note 125, at C1 (“CDOs . . . are the biggest buyers of the riskier types of mortgage securities”); *Nomura Installing Sub-Piece Fund*, Asset-Backed Alert, Nov. 28, 2003, at 2 (describing Nomura’s plans to organize a CDO conduit to “present[] asset-backed issuers with a ready-made buyer for their hard-to-sell B pieces”); Shenn, *supra* note 123, at 10 (describing two subprime transactions and noting that “a healthy appetite for [CDOs] among foreign investors, pension funds, and hedge funds has let many [subprime] securitizers pass lower-quality bonds to CDO underwriters”); FitchRatings, *supra* note 7, at 1; S&P, Global Cash Flow and Synthetic CDO Criteria, *supra* note 126, at 21 (stating that CDO managers “have an appetite not only for senior tranches, but also for mezzanine pieces in senior-subordinated transactions, typically rated in the range of ‘BBB’ to ‘BB’”); *see also* Janet M. Tavakoli, Collateralized Debt Obligations and Structured Finance: New Developments in Cash and Synthetic Securitization 261 (2003); *H&R Block, Inc. Annual Investment Community Conference, New York City—F*, FD (Fair Disclosure) Wire, Jan. 10, 2006 (announcing “we’re going to be more aggressive at monetizing and moving those residuals on a more recurring basis”); Infovest 21 LLC, *supra* note 99 (interviewing a CDO manager who stated that “we might be comfortable buying a single B”); *National City Corp. Analysts’ Conference—Final*, FD (Fair Disclosure) Wire, May 26, 2005, (announcing that “we . . . basically sold the portion of that risk that corresponded from single-A down to double-B”); Jody Shenn, *Pipeline: Too Excited?*, Am. Banker, May 26, 2005, at 11 (explaining that the fact that subprime “originators might not want to hold on to credit risks in this environment” fuels CDOs); Allison Pyburn, *Terwin Priced High Resi Concentration CDO*, Asset Securitization Rep., May 9, 2005 (announcing first CDO, named Northwall I, issued by Terwin Money Management LLC; deal contained 86.5% of subprime RMBS and “[r]oughly 35% of the assets backing the deal came off of Terwin’s books”); *Q4 2005 Ocwen Financial. Earnings Conference Call—F*, FD (Fair Disclosure) Wire, Jan. 26, 2006 (announcing Ocwen’s plan to “target acquisitions of residual securities” to hedge its mortgage servicing operations); S&P, CDO Spotlight: U.S. CDO of ABS Collateral Composition and Performance, *supra* note 126, at 4; *cf.* *Countrywide Financial Corp. Analyst Meeting—Final*, FD (Fair Disclosure) Wire, May 24, 2005 (announcing a new Countrywide private equity fund called Sunfish “investing[] almost exclusively in [Countrywide] sub prime residuals” that enabled Countrywide to “offload[] . . . 100 percent of our residual”; stating that Countrywide was likewise considering issuing CDOs because “we have the product to fill the CDO”; noting that “in the CDO market all the equity gets sold out, much of the equity is not retained”); Andreas A. Jobst, *Risk Management of CDOs During Times of Stress*, EuroMoney Institutional Investor, Nov. 28, 2005, at 8 (“CDO managers are frequently exposed to the equity tranche, which absorbs first losses and, hence, represents the riskiest element . . .”).

put it, CDOs create “an awful lot of moral hazard in the [subprime RMBS] sector.”¹³⁰

C. Due Diligence Is Often cursory

Despite recent spurs to action from the Lehman Brothers case and state assignee liability laws, industry and government observers agree that subprime due diligence is uneven and in need of improvement.¹³¹ This is true for public offerings of subprime RMBS, where institutional investors often have a real chance to insist on meaningful due diligence in advance, and even more so for Rule 144A private placements.¹³² There is such intense demand for Rule 144A offerings that institutional investors usually have to make snap judgments whether to invest without time for any substantive due diligence; most simply rely on lenders, underwriters, and rating agencies, even though none of these entities has the same level of interest in avoiding credit losses as the investors themselves. Thus, due diligence in the private-label subprime market often shoots low and almost never attempts to filter out predatory loan terms or practices unless they are observationally illegal.

1. What Subprime Due Diligence Means Today

In subprime deals, underwriters, rating agencies, and lenders, not investors, conduct most due diligence. Due diligence is typically limited to determining lender compliance with state and federal consumer protection laws.¹³³ For example, automated compliance systems tailor their screening tools to the legal requirements of each jurisdiction.¹³⁴ Similarly, the rating agencies only require screening for legal compliance and nothing more.¹³⁵

130. Allison Pyburn, *CDO Investors Debate Morality of Spread Environment*, Asset Securitization Rep., May 9, 2005; accord Jody Shenn, *MBS Pioneer Has Concerns: Risk-Passing, GSE Reforms, Commercial Realty*, Am. Banker, June 19, 2006, at 1.

131. See, e.g., Beidl, *supra* note 103; Neil J. Morse, *Making and Selling Good Loans*, Mortgage Banking, June 2003, at 107; Morse, *supra* note 99; Shenn, *supra* note 114; GAO, *supra* note 109, at 81.

132. Rule 144A governs private placements of securities, typically to institutional investors. See *infra* notes 152-165 and accompanying text.

133. This is evident both from industry descriptions of the limited due diligence performed and from statements by banking attorneys about the need for improved reviews of legal compliance. See, e.g., The Royal Bank of Scotland Group plc, 90 Fed. Res. Bull. 479, 499 n.51 (2004) (in which an investment bank, in representations to the Federal Reserve Board, limited its description of its due diligence reviews of subprime securitizations to “evaluations to determine if the lenders are complying with federal and state laws”); Bank of America Corp., 90 Fed. Res. Bull. 217, 224 & n.35 (2004) (same). None of these statements discusses compliance with industry standards or even aspires to such compliance. See Shenn, *supra* note 114.

134. See ComplianceEase, ComplianceAnalyzer: Automated Compliance Solutions, <http://www.complianceease.com>.

135. See, e.g., FitchRatings, Can You See Me Now? Screening for RMBS Predatory Lending Loans (Nov. 12, 2003), available at http://www.mbaa.org/industry/reports/03/fitch_1112.pdf [hereinafter FitchRatings, Can You See Me Now?]; FitchRatings, Fitch

Limiting due diligence to legal compliance is problematic, given the large existing gaps in governing law. Today, numerous lending abuses remain legal under state and federal law.¹³⁶ The principal federal anti-predatory lending law, HOEPA,¹³⁷ has strong proscriptions but at best covers the costliest five percent of subprime home loans.¹³⁸ Similarly, many states lack strong anti-predatory lending laws.¹³⁹ With legal protections against abusive subprime loans weak in many states and at the federal level, the absence of meaningful due diligence paves the way for inclusion of predatory loans in securitized loan pools.

When due diligence is required, it is not uncommon for some lenders to honor that requirement in the breach, i.e., to say they performed loan-level review when they did not. In 2004, the General Accounting Office (now the Government Accountability Office or GAO) looked at this issue and concluded that “some companies may be more willing than others to purchase loans that are considered questionable in terms of legal compliance, creditworthiness, or other factors.”¹⁴⁰ As one subprime lender explained to the press, “[w]e’re not structured to do 100 percent due diligence [on certain subprime loan pools], even though Wall Street investment banks might want that.”¹⁴¹ Lenders who offer low- or no-documentation loans are even more prone to skip compliance review.¹⁴²

In the conforming market, both government-sponsored entities do require substantive screening of subprime loans. Fannie Mae and Freddie Mac have best practices standards for residential mortgages to borrowers with

Ratings Updates Rating Criteria Regarding Predatory Loans (Jan. 15, 2004); FitchRatings, Fitch Revises RMBS Guidelines for Antipredatory Lending Laws (Feb. 23, 2005) [hereinafter FitchRatings, Fitch Revises RMBS Guidelines]; S&P, Anti-Predatory Lending Alert: Standard & Poor’s Revises Criteria Related to Anti-Predatory Lending Laws (May 13, 2004).

136. See Azmy, *supra* note 70. Other federal and state laws of a general nature regulate aspects of predatory lending, but those laws have not succeeded in stamping out numerous predatory lending abuses. See Engel & McCoy, *supra* note 13, at 1299-1317.

137. 15 U.S.C. §§ 1601-1667 (2000).

138. See, e.g., Truth in Lending, 66 Fed. Reg. 65604, 65608 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226).

139. See Azmy, *supra* note 70.

140. GAO, *supra* note 109, at 81. Some issuers and servicers apparently still put too much effort into checking for facial, rather than actual, compliance. As one attorney cautioned subprime servicers: “[R]eviewing written policies and procedures tells only half the story. It is imperative also to understand how those policies and procedures are implemented in practice.” Andrew L. Sandler et al., *Risk Management in Mortgage Loan Servicing and Collection*, 71 Rev. Banking & Fin. Serv. 71 (2004) (listing due diligence checklist).

141. Morse, *supra* note 99, at 56-57.

142. See Shenn, *supra* note 114, at 6M (“‘The scary [lenders] are the ones that use [Alt-A loans] as an additional menu item’ without performing any additional controls.”). These so-called low-doc and no-doc loans make up a growing segment of the subprime market. See, e.g., S&P, Trends in U.S. Residential Mortgage Products: Subprime Sector First-Quarter 2005, charts 2 & 6 (July 14, 2005).

blemished credit that are stricter in some respects than the laws in many jurisdictions.¹⁴³

Outside of the conforming market, lenders, issuers, and/or major investors are free to adopt internal standards of their own.¹⁴⁴ Nonetheless, usually only market actors with high reputational risk, such as bank holding companies contemplating mergers or lenders previously sanctioned for abusive lending, go to such lengths.¹⁴⁵ For most other private-label market participants, industry self-policing is virtually non-existent. Thus, in the non-conforming market for subprime RMBS, lenders and underwriters rarely screen out loans that are not prohibited by law, even if those loans violate industry standards or inflict significant harm on borrowers. Furthermore, underwriters are under constant pressure to relax their due diligence, for fear that lenders will move their underwriting business to other underwriting firms.

In sum, the subprime secondary market has not adopted industry best practices voluntarily and will not screen out predatory loans from loan pools unless compelled to by statute, regulations, or court orders.¹⁴⁶

2. Impediments to Meaningful Due Diligence by Investors

When it comes to screening out predatory loans, investors generally rely on due diligence by rating agencies, underwriters, and lenders. With advance opportunity, institutional investors will generally review the disclosures, ratings, structure, and credit enhancements. Otherwise, they

143. See, e.g., Fannie Mae, Eligibility of Mortgages to Borrowers with Blemished Credit Records, Lender Letter No. 03-00, Apr. 11, 2000, available at <http://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2000/lendltrs2000.pdf>; Press Release, Freddie Mac, Freddie Mac Promotes Consumer Choice With New Subprime Mortgage Arbitration Policy (Dec. 4, 2003), available at http://www.freddiemac.com/news/archives/afford_housing/2003/consumer_120403.html; Press Release, Freddie Mac, Freddie Mac Will No Longer Invest in Subprime Mortgages with Prepayment Penalty Terms Greater Than Three Years (Mar. 1 2002), available at http://www.freddiemac.com/news/archives2002/subprime_030102.htm; *Freddie Mac's Stance Against Predatory Lending Practices*, Industry Letter, (Freddie Mac), Dec. 28, 2000, available at <http://www.freddiemac.com/sell/guide/bulletins/pdf/1228indltr.pdf>; *Reports to Credit Repositories*, Industry Letter (Freddie Mac), Feb. 22, 2000, available at <http://www.freddiemac.com/sell/guide/bulletins/pdf/2indltr.pdf>; *Single-Premium Credit Insurance Products*, Industry Letter (Freddie Mac), Apr. 21, 2000, available at <http://www.freddiemac.com/sell/guide/bulletins/pdf/421indltr.pdf>. The Mortgage Bankers Association has adopted weaker, non-binding best practices standards for residential mortgages. Mortgage Bankers Ass'n of America, MBA Best Practices, <http://www.mortgagebankers.org/IndustryResources/StandardsandBestPractices/MBABestPractices.htm>. (last visited Feb. 10, 2007).

144. See, e.g., Raman et al., *supra* note 107 (recommending incorporation of specific best practices standards into screening criteria). See *supra* note 32 for discussion of the differences between the conforming and non-conforming or private label markets.

145. See, e.g., JP Morgan Chase & Co., 90 Fed. Res. Bull. 352 (2004).

146. See Jennifer Harmon, 'Purchaser Can't Test for Compliance in Secondary,' Nat'l Mortgage News, June 7, 2004, at 32.

tend to be passive, especially regarding predatory lending concerns.¹⁴⁷ Only rarely do investors inspect loan files for fraud.¹⁴⁸ Similarly, investors rarely reserve the right post-closing to be notified of predatory lending complaints, to conduct random spot checks, or to perform special audits of lenders when warning signs of predatory lending crop up.¹⁴⁹ Yet after-the-fact monitoring may be the only way to detect certain types of loan fraud and predatory servicing.¹⁵⁰

Even if investors wanted to engage in more extensive due diligence on their own, market and legal forces would often impede their efforts. To begin with, numerous subprime securitizations are floated on a to-be-announced basis. In TBA offerings, when investors buy their securities, the loans have not yet been pooled, leaving the content of the pool up to the lender's discretion.¹⁵¹ While investors can reserve the right to review the eventual loan pool post-closing, that is a risky proposition because they lose much of their leverage once they part with their funds.

The law on Rule 144A placements also impedes effective due diligence. Growing numbers of subprime RMBS offerings are issued as Rule 144A private placements, rather than as public offerings under Section 5 of the Securities Act of 1933.¹⁵² Before 1990, limited offerings and private placements under Rule 144¹⁵³ lacked liquidity because investors could not resell their securities for two years without costly registration under Section 5.¹⁵⁴ To remedy this situation, the Securities and Exchange Commission

147. See Eggert, *supra* note 2, at 543-44.

148. See, e.g., JP Morgan Chase & Co., 90 Fed. Res. Bull. 352 (2004) (describing JP Morgan's "loan sampling process [as including] obtaining a secondary value on the mortgaged property, performing cost tests before purchase, and performing targeted reviews of purchased loans"); Bank of America Corp., 90 Fed. Res. Bull. 217 & n.35 (2004) (describing loan sampling); Citigroup Inc., 87 Fed. Res. Bull. 600 (2001) (EAB); Citigroup Inc., 87 Fed. Res. Bull. 613 (2001) (Banamex). *But see* Mark L. Korell, *The Workings of Private Mortgage Bankers and Securitization Conduits*, in *A Primer on Securitization*, *supra* note 37 at 99-100 (reporting that some investors are asking private mortgage conduits to "dig out data on the underlying loans in individual pools"); Jody Shenn, *New Bear Stearns Unit to Provide Collateral for MBS*, *Am. Banker*, Apr. 20, 2005, at 10.

149. Cf. Sandler et al., *supra* note 140, at 75 ("One of the most effective risk management tools available to non-prime servicers is a process to address customer complaints promptly and professionally, with an appropriate audit oversight to review and improve the process."). Red flags can include press reports of predatory lending allegations, higher-than-expected delinquency or default rates, borrower complaints, government investigations, and predatory lending lawsuits.

150. See Baron, *supra* note 37, at 90; see also *infra* notes 218-230 and accompanying text.

151. See Boudoukh et al., *supra* note 60, at 410, 419; Downing, Jaffee & Wallace, *supra* note 54, at 6-7.

152. 15 U.S.C. § 77(e) (2000); see Dominion Bond Rating Service, U.S. Structured Finance Newsletter, Mar. 28, 2005, available at <http://cache.dbrs.com/pdf/1112204169687.pdf?transactionID=109714> (listing recent Rule 144A subprime RMBS offerings).

153. 17 C.F.R. § 230.144 (2006).

154. 17 C.F.R. § 230.144(d) (1989). In 1997, the Securities Exchange Commission (S.E.C.) reduced the holding period under Rule 144 to one year. See Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9242 (1997).

(S.E.C.) issued Rule 144A in 1990.¹⁵⁵ Rule 144A states that if a private placement or limited offering is offered or sold solely to parties who are reasonably believed to be Qualified Institutional Buyers (QIBs), those investors can resell the securities at any time to other QIBs without registration.¹⁵⁶

In order for a private placement to qualify for Rule 144A treatment, domestic issuers must provide prospective purchasers with some scant information upon request, as follows: (a) a “very brief” statement of the nature of the issuer’s products, services, and business; and (b) the issuer’s financial statements (including balance sheets, profit and loss statements, and retained earnings statements) for the past two years. The information must be “reasonably current” and financial statements “should be audited to the extent reasonably available.”¹⁵⁷ For RMBS, servicers or trustees also need to provide “basic, material information concerning the structure of the securities and distributions thereon, the nature, performance and servicing of the assets supporting the securities, and any credit enhancement mechanism associated with the securities.”¹⁵⁸

The key point here is that Rule 144A does not require issuers to provide prospective purchasers anything beyond basic information about the risk profile of the loan pool. As a result, investors do not have access to the information they need to screen out predatory loans. Because Rule 144A transactions allow re-sales to QIBs, these offerings are in high demand. “Transactions are usually bought and sold very quickly[,] thereby giving the buyer very little opportunity to conduct due diligence.”¹⁵⁹ Thus, in the Rule 144A market, “liquidity comes at a price.”¹⁶⁰ The “lack of sufficient disclosure” and “very little opportunity for due diligence” deprives Rule 144A investors of “the protections accorded to investors in registered public bond offerings.”¹⁶¹

155. 17 C.F.R. § 230.144A (1990).

156. *Id.*; see also Shenker & Colletta, *supra* note 95, at 1408-10.

157. 17 C.F.R. § 230.144A(d)(4)(i) (2006).

158. *Id.* § 230.144A(d)(4); Resale of Restricted Securities, Release No. 33,6862, 55 Fed. Reg. 17,933 (Apr. 30, 1990) (17 C.F.R. pts. 200 & 230); Kutak Rock & Campbell, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1273 (Nov. 29, 1990) (declining to answer questions regarding the adequacy of Rule 144A disclosures for mortgage-backed securities). Even these minimal disclosures are relaxed if the issuer is a reporting company under sections 13 or 15(d) of the Securities Exchange Act of 1934, is exempt from such reporting under S.E.C. Rule 12g3-2(b), is a foreign government, or falls within a category of certain private foreign issuers. 17 C.F.R. § 230.144A(d)(4)(i). In 2005, the S.E.C. promulgated new Regulation AB, which revamped mandatory disclosures for public offerings of mortgage-backed securities to include information regarding the composition and performance of the pool, static pool data, the structure of deals, certain underwriting criteria, and servicing experience. See Asset-Backed Securities, 70 Fed. Reg. 1506 (Jan. 7, 2005). The new disclosure requirements do not apply to Rule 144A private placements of mortgage-backed securities, however.

159. Shivaswamy, *supra* note 54, at 28.

160. *Id.* at 30.

161. *Id.* The placement agent will normally conduct due diligence of some sort before the offering and will obtain comfort letters from lawyers and accountants. See *id.* at 27. Because

The lack of meaningful due diligence by investors is compounded by weak covenants after-the-fact. In Rule 144A deals, “buyers are offered very few covenants and less extensive representations and warranties.”¹⁶² Furthermore, the representations and warranties do not survive the closing of the transactions.¹⁶³ Instead, the assurances “run to the placement agent, not to the ultimate buyer.”¹⁶⁴ As a result, investors cannot rely on contractual guarantees as a backstop for absent due diligence:

Originators try to grant investors as weak a covenant package as possible, thereby giving the originator as much leeway as possible in terms of what it can do with the asset. In that respect, some of the originator’s best assets could be long gone before the senior secured investor finds out and given the weak set of representations and warranties that are made at the time of funding of the transaction, there is . . . very little that can be done at that stage.¹⁶⁵

In sum, due diligence by investors—the people with the most to lose—is hit or miss, particularly in the Rule 144A market.

D. Recourse Clauses Are Limited in Reach and Are Not Consistently Enforced

As we already discussed, recourse clauses are relatively common and require lenders to take back bad loans. Their practical effect is limited, however, by spotty enforcement.¹⁶⁶ In some cases, lenders refuse to honor

the placement agent does not bear credit risk in the transaction, however, it does not have the same incentives as investors for more thorough risk assessment.

162. *Id.* at 28; *see also id.* at 38 (“[W]ith the advent of Rule 144A offerings, market practice has done away with the . . . finer aspects of private placements such as negotiation of covenants and due diligence.”); *see generally* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. Ill. L. Rev. 1 (2004).

163. Shivaswamy, *supra* note 54, at 28.

164. *Id.*

165. *Id.* at 38.

166. *See* Shenn, *supra* note 114 (noting that investors rarely attempt to enforce reps and warranties); Shenn, *supra* note 123, at 1; Interview with Kevin Byers (June 9, 2005). When delinquencies rise, securitized trusts and investment banks are more likely to insist that originators buy back bad loans and that is happening now. Even so, the percentage of affected loans is small. Credit Suisse Group found, for example, that among 208 subprime RMBS bond deals that it studied for 2005 and 2006, the dollar value of mortgages repurchased was “well under 1% of the total value of mortgages in the pools with at least one repurchase . . .” Ruth Simon & Michael Hudson, *Bad Loans Draw Bad Blood*, Wall St. J., Oct. 9, 2006, at C1. Even this limited enforcement of recourse clauses is cyclical in nature and the market has a very short memory. As one commentator observed, “In a rising market, even a bad loan is a good loan.” *Id.* (quoting Nate Redleaf, research analyst, Imperial Capital LLC). In the meantime, recent potential buyers of subprime lenders have sought “to avoid inheriting the subprime sellers’ costly obligation of having to buy back the loans already sold in the secondary market because of borrowers’ defaults.” Lingling Wei, *Subprime Lenders Are Hard Sell*, Wall St. J., Dec. 5, 2006, at C5. The dictates of federal bankruptcy law also place limits on the scope of recourse clauses. Under the bankruptcy code, the sale of loans to the SPV must constitute a “true sale” in order for the receivables to be excluded from the bankruptcy estate in the event of the originator’s failure. *See* Schwarcz, *supra* note 38, § 4:1. If recourse exceeds specific levels—generally defined as historical

recourse clauses and trustees decide that going to court would be unduly expensive.¹⁶⁷ In other cases, poorly capitalized lenders or brokers have gone out of business or lack the funds to buy back their old, non-performing loans.¹⁶⁸ As a prominent industry attorney observed: “[I]f you purchase loans from small operators, there may not be much water in the well of their repentance. . . . If you do postclosing due diligence and you find 10 percent of your portfolio is affected, what loan broker, with no capitalization, can take back the loan?”¹⁶⁹

Even when recourse is successful, investors have to worry about the quality of the replacement collateral. Lenders who accept recourse must substitute new loans for the bad loans. However, lenders often obtain deal provisions that allow them unilaterally to substitute collateral.¹⁷⁰ Thus, recourse provisions, which are supposed to give lenders incentives to desist from making predatory loans, actually enable lenders to substitute one bad loan for another. As one analyst warned:

Once losses eat through the original equity investment, the trading desk has a huge incentive to stuff the portfolio with high margin, risky assets to maximize the residual cash flows. If investors choose to participate in these deals, they need to carefully examine the structural handcuffs that will prevent [such] trading¹⁷¹

Finally, even if a lender does take back a predatory loan, it will not necessarily lose money. If the borrower still has equity in the home, the lender may persuade him or her to refinance the loan, extract new, large fees, and eventually foreclose.¹⁷²

levels of losses—then the “true sale” requirement will be defeated. *See, e.g.,* Bjerre, *supra* note 2, at 417.

167. Interview with Kevin Byers, *supra* note 166. Securitized trusts are more willing to enforce recourse provisions when the market for mortgage-backed securities softens and default risks rise. Jesse Eisinger, *Mortgage Market Begins to See Cracks as Subprime-Loan Problems Emerge*, Wall St. J., Aug. 30, 2006, at C1. In the experience of one of the authors, however, recourse negotiations can take up to two years and still may not result in full recourse.

168. *See* Eggert, *supra* note 2, at 549, 556; *Roundtable: Vendors on New Prevention Tools, New Scams*, Am. Banker, Dec. 9, 2005, at 11, 12 [hereinafter *Roundtable*] (describing “the ease with which [mortgage] entities morph into different businesses”); Shenn, *supra* note 123, at 1.

169. DeZube, *supra* note 103, at 32.

170. S&P, *Rating Affirmations And Their Impact On Investors* (Apr. 20, 2005). Such clauses are permissible in Financial Asset Securitization Investment Trust (FASIT) structures, which Congress conferred with favored tax status in the Small Business Job Protection Act of 1996. *See* Phillip R. Pollock & Michael E. Shaff, *FASIT Flexibility Applied to Subprime Securitizations*, in *Subprime Consumer Lending*, *supra* note 123, at 155, 156-57 (a “major benefit of FASITs over REMICs is the ability to add or substitute assets to the structure after the startup period and to remove collateral”).

171. Tavakoli, *supra* note 129, at 263.

172. Non-bank lenders, in particular, are willing to pursue foreclosure aggressively. *See, e.g.,* David Leonhardt, *Lenders Trying An Alternative To Foreclosure*, N.Y. Times, May 4, 2002, at A1 (stating that “banks, which service many [loans in default, have] a variety of financial incentives to work out new terms and avoid foreclosure” and contrasting predatory lenders, who are willing to aggressively foreclose).

E. *Retained Servicing Rights Are Not the Norm*

It is rare these days for lenders to retain servicing rights. Today, the loan servicing industry is highly concentrated, largely due to economies of scale. Rather than insist that lenders retain servicing rights—as a way to discipline lenders—investors or bond insurers usually press them to employ outside master servicers to ensure a high level of servicing.¹⁷³ As a result, the originator's loan servicing rights are generally sold for a fee to one of a small group of specialist firms in the field.¹⁷⁴ Thus, high potential servicing costs are not disincentives to lenders making predatory loans.

F. *Excess Demand for Subprime Securitizations*

Excess demand is a final reason why investors do not screen subprime RMBS for predatory practices. In 2004, for instance, S&P observed that “the market for subprime mortgage securities [experienced] significantly more demand than availability for many issuances.”¹⁷⁵ Other observers concur that the market for subprime RMBS suffers from excess demand.¹⁷⁶

Rule 144A private placements are in short supply because they offer liquidity. In addition, there is a clamor for subprime RMBS of all types, driven by portfolio regulation of institutional investors such as banks and insurance companies. Many institutional investors have legal limits on the types of investments they can buy for their own account.¹⁷⁷ Given those limits, high yields make subprime RMBS attractive,¹⁷⁸ particularly when other legal investments are in the doldrums. Because the demand for bonds in subprime securitizations exceeds supply, investors are willing to purchase bonds without engaging in thorough due diligence.

In sum, the risk management mechanisms used by securitization do not trickle down to deter lending abuses. At the same time, structured finance

173. See McCall & Blum, *supra* note 34, at 145.

174. See Eggert, *supra* note 2, at 544.

175. S&P, Trends in U.S. Residential Mortgage Products: Subprime Sector, Fourth-Quarter 2004, at 3 (Apr. 12, 2005).

176. See Morse, *Not Exactly Prime*, *supra* note 109, at 63 (“All this investor interest in subprime loans is propelled by the mountain of money piling up on the sidelines of the stock market, fearing entry into that uninviting terrain. ‘Mutual funds, hedge funds, private-equity funds are sitting on a tremendous amount of liquidity,’ says Kenneth Slosser, managing director of investment banking at Friedman, Billings, Ramsey & Co., Inc., Irvine, California.”); Allison Pyburn, *Spread Debate Dominates Global ABS Conference in Barcelona*, Asset Securitization Rep., June 20, 2005; see also Lupica, *supra* note 1, at 630.

177. See, e.g., Patricia A. McCoy, *Banking Law Manual: Federal Regulation of Financial Holding Companies, Banks and Thrifts* § 7.03[1] (2d ed. 2001); Howell E. Jackson, *Regulation in a Multisector Financial Services Industry: An Exploratory Essay*, 77 Wash. U. L.Q. 319, 352-56 (1999).

178. See, e.g., Vikas Bajaj, *Mortgages Grow Riskier, and Investors Are Attracted*, N.Y. Times, Sept. 6, 2006, at C1; Simon et al., *supra* note 124, at A1 (“[I]n an era of low returns, mortgage-backed securities offer yield-starved investors much higher returns than government bonds.”); Banc of America Securities, ABS Research Note, at 2 (Feb. 8, 2005) (reporting that in 1994, “subprime home equity ABS [asset-backed securities] was [sic] the best performing ABS sector, followed by credit card ABS and auto ABS sectors”).

protects investors so well that S&P routinely assures investors that subprime RMBS “should continue to perform in accordance with expectations, given the advances in loan level modeling, structural safeguards, and improvement in loss mitigation techniques.”¹⁷⁹

VII. NORMATIVE JUSTIFICATIONS FOR INTERVENTION IN RESIDENTIAL MORTGAGE SECURITIZATIONS

Securitization successfully protects investors and reaps profits for rating agencies, lenders, and investment banks, without protecting borrowers from abusive loans. This situation gives rise to the question: Should the law create incentives for securitizers to detect and protect against predatory lending? For the reasons that follow, we answer this question in the affirmative.

A. *Predatory Lending Harms Borrowers and Imposes External Costs on Communities*

Under the current legal regime, borrowers, neighborhoods, and cities bear the brunt of abusive lending, while securitization insulates investors from having to internalize those costs. When lenders make loans that borrowers cannot afford to repay, borrowers can lose their homes to foreclosure. Others keep their homes only by reducing spending on necessities such as health insurance, medical bills, day care, and critical home repairs. When predatory lending results in vacant homes and neighborhood decline, cities lose tax revenues and must pay for added police protection and other city services.¹⁸⁰ The total annual cost to homeowners and cities is in the billions of dollars.¹⁸¹

B. *The Secondary Market Can More Efficiently Bear the Costs of Policing Predatory Lenders*

The deregulation of home mortgage loans and the growth of nontraditional lending have impeded comparison-shopping and enabled lenders to market loans with complex terms that borrowers do not understand.¹⁸² As a result, many borrowers enter into complex loans without understanding the terms or their repayment obligations. Currently, the only effective way for borrowers to ensure that they are not entering into predatory loans is to hire lawyers, costing several hundred dollars apiece to review the loan terms and advise them to walk out of closings if loan terms prove abusive.

179. S&P, *supra* note 175, at 5.

180. See Engel, *supra* note 12, at 356-60.

181. See Quercia, Stegman & Davis, *supra* note 4, at 5, 27; Eric Stein, *Quantifying the Economic Cost of Predatory Lending* (2001) (unpublished manuscript, on file with the Fordham Law Review) (estimating losses from predatory lending at \$9.1 billion annually).

182. See Engel & McCoy, *supra* note 13, at 1275, 1311-12.

In contrast, the cost of screening out predatory loans from securitized loan pools is minimal.¹⁸³ One study estimated that manual review of a loan file for predatory terms cost \$43, or about three percent of origination costs.¹⁸⁴ The same study found that automated review cost approximately one dollar per loan.¹⁸⁵ Thus, unlike borrower attorneys, who must review individual closing files at substantial cost, securitizers can capture increasing returns to scale by purchasing technology that electronically reviews files at a fraction of lawyers' cost.

C. *Securitization Impedes Borrowers' Ability to Obtain Relief from
Predatory Loans*

Thinly capitalized lenders and brokers have the most to gain from securitization because they lack other forms of financing.¹⁸⁶ For undercapitalized firms, securitization has two important effects. First, it enables them to enter the subprime industry by providing them with financing.¹⁸⁷ Second, it enables them to stay in operation despite low capital because they can plow the proceeds from securitization into a fresh set of loans, which in turn can be securitized. In the process, originators can render themselves judgment-proof from lawsuits by borrowers by continually shedding their assets through securitization, distributing the profits to shareholders, and draining the company of capital.¹⁸⁸ As one

183. See Lisa Keyfetz, *The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Mortgage Market Participants*, 18 Loy. Consumer L. Rev. 151, 168-69 (2005) (noting that secondary market actors are in better positions than borrowers to detect "bad" lenders); Siddhartha Venkatesan, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. Legis. & Pub. Pol'y 177, 207-08 (discussing ways the secondary market can spread the cost of assignee liability).

184. See Delvin M. Davis & Ellen Schloemer, *Strong Compliance Systems Support Profitable Lending While Reducing Predatory Practices 6* (Center for Responsible Lending 2005), available at http://www.responsiblelending.org/pdfs/ip010-Compliance_Costs-0705.pdf.

185. *Id.* In a study of mortgage origination costs, the Mortgage Bankers Association reported that the net operational origination cost averaged \$1,485 per loan in 2004. See Press Release, Mortgage Bankers Association, *MBA Releases Annual Cost Study* (Oct. 12, 2005), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/32173.htm>.

186. Hill, *supra* note 15, at 1065-66, 1073, 1086, 1092-94, 1100, 1102, 1109; Lupica, *supra* note 1, at 627, 629-31; see also Eggert, *supra* note 2, at 546, 556-57.

187. As Freddie Mac's former chairman Leland Brendsel observed, "[R]elatively little capital is required to start a mortgage banking operation . . . and even less to become a mortgage broker. Lenders lacking the necessary net worth can still originate loans for lenders qualified to sell into the secondary market." Leland C. Brendsel, *Securitization's Role in Housing Finance: The Special Contributions of the Government-Sponsored Enterprises*, in *A Primer on Securitization*, *supra* note 37, at 19, 24.

188. When originators dissolve or go bankrupt, borrowers have little or no real recourse. See Erick Bergquist, *Guess What? Loan Buyers Liable Under Federal Law*, *Am. Banker*, May 7, 2004, at 1.

commentator put it: “Securitization’s structure is designed to divert value away from the originator.”¹⁸⁹

Even when originators can pay judgments against them, borrowers may not be able to obtain meaningful relief. A lawsuit against the original lender or broker cannot halt a foreclosure by the securitized trust. Similarly, rescission or reformation may be difficult or impossible if loans are part of securitized loan pools.¹⁹⁰

D. *Securitization Impedes Work-outs with Injured Borrowers*

Securitization complicates and often blocks work-outs with borrowers who are harmed by predatory loans.¹⁹¹ This is because the underlying securitization contracts tie the trustee’s and servicer’s hands if they attempt to negotiate a repayment plan in lieu of foreclosure. The value of the securities and the amount of their returns are based on cash flows that are determined, in part, by the loan terms. To protect these cash flows, securitization contracts typically prohibit changes to the terms of the underlying loans. In addition, securitization contracts often prohibit servicers from waiving prepayment penalties and other loan provisions.

Another roadblock arises when subprime lenders securitize prepayment penalties through bonds known as Net Interest Margin Securities (NIMS).¹⁹² If a borrower seeks reformation of a predatory loan, the reformation could be deemed a prepayment, thus triggering prepayment penalties. Theoretically, the prepayment penalties could be waived as part of the work-out. However, if the prepayment penalties have been securitized in a NIMS, contractually they cannot be waived. S&P has assured this by insisting that issuers and servicers provide representations and warranties that they will rigidly enforce the prepayment penalties being securitized.¹⁹³

189. Lupica, *supra* note 1, at 598; *see also* Iacobucci & Winter, *supra* note 15, at 170; LoPucki, *supra* note 1, at 25-30.

190. *See* Eggert, *supra* note 2, at 560-66 (discussing the difficulty borrowers encounter if they seek to restructure a loan that has been securitized).

191. *Id.*; *see generally* Eggert, *supra* note 27.

192. *See, e.g.*, Risk World, Standard & Poors Rates First NIMS Transaction 1, *available at* <http://www.riskworld.com/PressRel/2000/00q3/PR00a059.htm>; S&P, Legal Criteria Reaffirmed for the Securitization of Prepayment Penalties 1 (May 29, 2002); Vanderbilt Capital Advisors, Net Interest Margin (NIMs), *available at* http://www.vcallc.com/mailings/additions/net_interest.htm.

193. S&P does allow for exceptions in two instances, both of which erect high barriers to workouts. First, S&P permits waiver where forgiveness would “maximize recovery of total proceeds” and is “standard and customary in servicing similar home equity loans.” Press Release, S&P, Standard & Poor’s Clarifies Criteria For Prepayment Penalty Income In U.S. NIMs Transactions (2005). Second, a NIMS based on prepayment penalty income can “allow the servicer/master servicer to waive prepayment penalties for any other reason,” but only at a steep price. *Id.* In such cases, S&P requires the issuer either to obtain a guarantee or deposit funds in escrow to replace any missing future revenues from prepayment penalties. *See id.*

Finally, servicers have reduced incentives to assist borrowers who go into default. Servicers can earn higher fees if they march borrowers to foreclosure rather than reform the borrowers' loan terms or reschedule payments. In short, securitization creates rigidities that make loan work-outs difficult and often well nigh impossible.

E. Securitization Causes Borrowers to Pay an Excess Risk Premium

Pricing anomalies in the subprime market provide additional support for our assignee liability proposal. As we discussed, borrowers in the subprime market often pay prices that exceed their actual risk. For instance, excess risk premiums arise when originators steer prime-eligible borrowers to subprime loans. Excess premiums also arise when lenders impose prepayment penalties on borrowers that are not justified by risk or trade-offs for lower interest rates. To compound this situation, NIMS make subprime home loans more expensive by creating a strong, artificial demand for costly prepayment penalties that result in hefty fees to borrowers if the penalties are triggered. Ultimately, as excess risk premiums push up loan costs to borrowers, their default risk rises, too.¹⁹⁴ Because securitization creates incentives for lenders to extract rents from borrowers, securitization should bear responsibility for the added default risk.

F. The Holder-in-due-course rule Creates Inequities

The holder-in-due-course rule also creates inequities when loans are securitized. When loans are sold, borrowers lose the ability to assert various defenses and affirmative claims against the new holders of the loans. Thus, the very fact of the loan sale increases the value of the loan to the assignee with no direct benefit to the borrower. At the same time, the borrower is harmed by the loss of full legal relief for a problem loan. The impact of the holder-in-due-course rule becomes particularly perverse when it prevents borrowers from defending foreclosure actions by assignees.

Ultimately, borrowers have no control over whether their loans are sold or held by lenders in portfolio. As a matter of fairness, the law should not prevent borrowers from obtaining complete relief from abusive loans, especially because securitization creates added incentives toward predatory lending.

194. See Donald R. Haurin & Stuart S. Rosenthal, *The Growth Earnings of Low-Income Households and the Sensitivity of Their Homeownership Choices to Economic and Socio-Demographic Shocks* 18 (Apr. 2005) (unpublished manuscript, on file with the Fordham Law Review), available at <http://www.huduser.org/Publications/pdf/EarningsOfLow-IncomeHouseholds.pdf> (when an adjustable rate mortgage adjusts upwards following closing, each percentage point increase makes it thirty percent more likely that a household will terminate homeownership and return to being renters).

G. *Subprime Borrowers Lack Effective Bargaining Power*

The marketing techniques that subprime lenders and brokers employ often impede borrowers' ability to comparison shop and bargain for loans. The most abusive loans are targeted at unsophisticated people who believe that their ability to borrow money is limited.¹⁹⁵ This targeting, coupled with high pressure tactics, such as promoting time-limited deals that require borrowers to commit or lose the option to borrow at "special" rates, leads borrowers to pay application fees immediately and commit to loans that may not be in their best interests. Once the loan application process begins, borrowers become psychologically committed to the loans and, depending on the size of the application fee and the borrowers' liquid assets, may not be able to afford to apply for another loan.¹⁹⁶

At the time of application, subprime lenders typically reveal only the vaguest of terms to borrowers, waiting until closing to disclose the final provisions. These last-minute changes in loan terms are problematic on several fronts. First, borrowers are boundedly rational in the sense that they are able to process some, but not all, loan terms.¹⁹⁷ Typically, they focus on simple price terms, such as the monthly payment amount, and ignore other potentially onerous terms, like prepayment penalties.¹⁹⁸ Lenders can exploit these limits on borrowers' ability to absorb information to their advantage. Second, when the final loan terms are presented to borrowers at closing, essential terms are often obscured in the shuffle of complicated loan papers. Many borrowers may believe that they are obligated to enter the loan at closing even though the law permits them to walk away from the closing or rescind the loan within three days of the closing. Others, who may have experienced credit discrimination or who worry that their access to credit is limited, may fear that they will lose access to future credit if they reject proffered loans.¹⁹⁹ The secondary market benefits from the resulting one-sided contracts and, therefore, should be responsible for some of the damage these contract terms cause.

195. This targeting is often race-based. See Bocian et al., *supra* note 26, at 3-5; Kathleen C. Engel & Patricia A. McCoy, *From Credit Denial To Predatory Lending: The Challenge of Sustaining Minority Homeownership* 35-38 (2006) (unpublished manuscript, on file with the Fordham Law Review) (discussing numerous studies on the link between subprime lending and race); Complaint at 9, Nat'l Cmty. Reinvestment Coal. v. Allied Home Mortgage Capital Corp. (June 14, 2006), *available at* http://www.ncrc.org/pressandpubs/press_releases/documents/2006/HUDComplaint.pdf.

196. Engel & McCoy, *supra* note 13, at 1283.

197. Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law*, 84 Tex. L. Rev. 1481, 1530 (2006)

198. *Id.* at 1539-40; see generally Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. Chi. L. Rev. 1203, 1225-44 (2003) (describing how bounded rationality can lead to contract terms that favor sellers at the expense of unwitting buyers).

199. Engel & McCoy, *supra* note 195, at 30-31.

In sum, although securitization has enabled many people to obtain loans who, in pre-securitization days, could not secure loans, it has also helped to spawn predatory lending and has impeded the ability of borrowers to obtain meaningful relief from abusive loans. These inequities, the other negative externalities that predatory lending imposes on borrowers and cities, and the unwillingness of the secondary market to police predatory lenders effectively justify imposing liability on assignees.

VIII. AN ASSIGNEE LIABILITY PROPOSAL

In the non-conforming market, experience has shown that abusive loans will continue to be securitized unless the law creates incentives to screen out predatory loans. Furthermore, the time has come to hold the secondary market responsible for policing lenders. Accordingly, we propose a system of assignee liability that rewards entities that engage in due diligence designed to detect loans with abusive terms. Our proposal would impose extensive liability on assignees that failed to adopt the due diligence standards we discuss below and would cap liability for those assignees that complied with the specifications we outline.

A. *Considerations When Designing a Due Diligence Standard for Securitizing Residential Mortgage Loans*

In formulating a due diligence standard for securitizing home loans, several considerations must be kept in mind. First, any due diligence standard should ideally contemplate individual loan review. Second, a screening standard must be cost-effective. Any standard that is expensive would counteract the goal of combating abusive lending by pushing up the cost of home loans. Third, screening requires adoption of strong nationwide standards making clear what constitutes a predatory term or practice. Fourth, screening should only apply to abusive terms and practices that are capable of detection on a cost-effective basis. As we recognize, some types of mortgage fraud are not amenable to advance screening. Finally, screening should be adaptable to the to-be-announced and Rule 144A markets.

1. Cost-Effective Screening of Individual Loans

Ideally, due diligence should aspire to more than facial compliance. In particular, it should check for actual compliance with anti-predatory lending criteria by reviewing all individual loans in the loan pool. There are two methods of verifying actual compliance: automated compliance and manual inspection. Each method has its advantages and flaws.

Automated compliance systems have recently come to the fore. These systems check every loan for compliance with state and local anti-predatory laws, federal disclosure laws, and other criteria designated by the lender or

investor.²⁰⁰ The advances in automated compliance followed the recent spate of state anti-predatory lending laws.

Loan aggregators and investment banks use several different automated compliance systems to screen tapes with data on individual loans.²⁰¹ LendTech® by ARC Systems™, for example, provides individually tailored automatic underwriting and due diligence systems to lenders, wholesalers, investment bankers, and investors.²⁰² LendTech® allows lenders to “upload credit and mortgage applications with a full credit file into the automated model” in advance of warehousing or securitizing their loans.²⁰³ A competing product, ComplianceAnalyzer®, is “a pre-close, automated, transaction-level approach” to regulatory compliance.²⁰⁴ The premier version, known as ComplianceAnalyzer® Plus, furnishes “lenders, investors, and securitizers [with] comprehensive regulatory compliance auditing (including ‘high-cost’ and ‘anti-predatory’ lending legislation).”²⁰⁵ The manufacturer of the premier line, ComplianceEase, is so confident about its ability to assure compliance that it offers “a comprehensive and flexible warranty backed by an A.M. Best “A-” or better (Excellent) rated insurer. Each loan can be covered up to \$250,000 and the coverage is also easily transferable to secondary market investors.”²⁰⁶ Other automated compliance systems include InvestorServices by CoreLogic, High Cost Analyzer by Clayton, 2Comply by Mavent, and Wiz Sentinel by PCi Corporation.²⁰⁷ These automated compliance review programs can screen loans for one dollar a loan and probably less.²⁰⁸

200. Indeed, Fitch considers it “virtually impossible for originators of any meaningful size to monitor compliance with predatory lending laws, as is required on a loan-level basis, without the assistance of technology.” FitchRatings, *Can You See Me Now?*, *supra* note 135.

201. See Erick Bergquist, *Some Lenders Turning to Compliance Software*, *Am. Banker*, Apr. 1, 2003, at 12; Mary Dum, *ARC Helps PCFS Get the Brass Ring*, 10 *Mortgage Technology* 41 (2003); Anthony Garritano, *Automating the LAW: Mavent drills compliance down to a few clicks*, *Mortgage Tech.*, Jan./Feb. 2005, at 30; Morse, *Not Exactly Prime*, *supra* note 109. Since the late 1990s, S&P has required issuers to provide S&P with data tapes containing loan level data with a variety of data fields, including credit risk and credit scores. S&P uses the data tapes to assign risk grades to each loan in a loan pool under its automated LEVELS™ credit scoring model. See, e.g., Raiter, *supra* note 123, at 147.

202. See ARC Systems, *Products & Services*, available at <http://www.arcsystems.com/products.htm>.

203. Dum, *supra* note 201, at 41; see ARC Systems, *LendTech Investor*, available at http://www.arcsystems.com/lt_investor_matrix.htm.

204. ComplianceEase, *ComplianceAnalyzer®: Automated Compliance Solutions*, http://www.complianceease.com/mainsite/prod/prod_ca_overview.jsp?content=/opencms/CEContent/prod/prod_ca_overview_m.jsp&right=/opencms/CEContent/prod/r_critical_decisi_on.jsp (last visited Feb. 12, 2007).

205. ComplianceEase, *ComplianceAnalyzer® Plus with AssureCert® Protection*, http://www.complianceease.com/mainsite/prod/prod_ac_overview.jsp?content=/opencms/CEContent/prod/prod_ac_overview_m.jsp&right=/opencms/CEContent/prod/r_verify_assurecert.jsp (last visited Feb. 12, 2007).

206. *Id.*

207. See Davis & Schloemer, *supra* note 184, at 8 tbl.2.

208. See *id.* at 6 & nn.21-24.

Some major lenders have already adopted these systems in order to meet legal compliance criteria that Fitch and S&P have imposed on residential mortgage securitizations.²⁰⁹ Secondary market adoption of automated compliance puts pressure on brokers and lenders to adopt the same safeguards. As one observer put it:

You know, the money controls the game. . . . [I]f an investor is using tools . . . then the broker or the originator will want to use that tool, too. Not for any ethical reasons or not for any obligation to the investor or anything. Because they want to close that loan, and they want to move that loan. The only reason. Hey, whatever it takes.²¹⁰

Automated compliance is not enough, however. “[L]oans may slip through the cracks” of automated compliance if data is entered incorrectly or too late for review or if the software does not apply the correct legal test.²¹¹ Accordingly, due diligence should augment automated systems with manual inspections of loans and tests to confirm that the right legal filters are in place.

In manual inspection, a compliance team makes an on-site inspection of physical loan files and supporting documentation. One advantage of manual inspection is that it can detect some types of loan fraud that automated compliance cannot.²¹² However, manual inspection is time-intensive, taking on average thirty to forty-five minutes per loan.²¹³ While manual inspection could be performed on every loan, normally it is limited to a sample of loans due to cost concerns.²¹⁴ Although manual review costs more than automated screening, it is not financially prohibitive, costing about \$43 per loan.²¹⁵

209. *See id.* at 8-9 & tbl.2. GAO casts doubt on the effectiveness of automated compliance systems on grounds that “data tapes used for loan reviews do not include point and fee information.” *See GAO, supra* note 109, at 79. Whether GAO’s assertion is true, it is beside the point. While the data tapes that lenders provide to rating agencies vary in the extent to which they contain fee information, automated compliance systems must and do review points and fees to ascertain compliance with Truth in Lending Act disclosures and high-cost statutes such as HOEPA and state equivalents that have points and fees triggers. For example, ComplianceEase™ recalculates the annual percentage rate using the interest rate and finance charges from the actual loan documents. *See ComplianceEase Offers Predatory Lending Compliance Certification for Wall Street Rating Agencies* (June 20, 2003), *available at* http://www.complianceease.com/mainsite/about/news/cenews_20030620_m.jsp.

210. *See Roundtable, supra* note 168, at 14.

211. *See FitchRatings, supra* note 200, at 2.

212. *See infra* note 228 and accompanying text.

213. *See Davis & Schloemer, supra* note 184, at 6-7 & n.21.

214. When subprime RMBS underwriters do examine loan files manually, normally they “don’t do due diligence on every single loan in a pool; at most, they do a random sample of, say, 3% of the loans.” Shepherd, *supra* note 29, at 4.

215. *See Davis & Schloemer, supra* note 184, at 6 & n.21.

2. Meaningful Screening Requires Adoption of Strict National Anti-Predatory Lending Standards

Automated compliance systems and manual due diligence are designed to verify compliance with federal, state, and local consumer protection laws, including anti-predatory lending laws. However, the current patchwork of federal, state, and local laws leaves many lending abuses unregulated.²¹⁶ Further, the private-label secondary market does not screen out loans with abusive features unless those abuses are unlawful.

Thus, for screening to effectively curtail predatory lending wherever it occurs, it is necessary to adopt a strong set of anti-predatory lending standards that apply to home loans throughout the country. Ideally such standards would be adopted directly through federal legislation,²¹⁷ but a federal anti-predatory lending statute is not the only way to institute standards with broad national effect. Other avenues might include a uniform state law or a joint rulemaking by federal banking regulators and the Federal Trade Commission declaring predatory practices illegal under the Federal Trade Commission Act. Similarly, laws could specifically prohibit rating agencies from rating loan pools that contain loans with specified predatory terms or require the mortgage industry to adopt anti-predatory lending standards that it would enforce through a self-regulatory organization. However such standards are accomplished, effective screening will not take place until nationwide standards are adopted.

3. Screening and Its Limitations

Screening cannot detect every predatory term or practice. Some types of fraud will pass through automated filters and even manual inspection without detection.²¹⁸ There are ways to uncover evidence of fraud, however, some of which are automated. For instance, Fannie Mae's and Freddie Mac's automated underwriting systems issue alerts when there are

216. Even in states with strong anti-predatory lending laws, the effect of those laws is diluted by federal preemption rulings by federal banking regulators that exempt national banks, federal savings associations, and their operating subsidiaries from such state laws. See, e.g., Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 Ann. Rev. Banking & Fin. L. 225 (2004).

217. For discussion of the contents of such a law, see Engel & McCoy, *supra* note 13, at 1317-63, where we proposed a federal suitability standard for subprime mortgages. In addition, HOEPA and its implementing regulations; the anti-predatory lending laws of a number of states, including North Carolina, New York, New Jersey, and Massachusetts; the screening criteria used by Fannie Mae and Freddie Mac; and the regulations for Veterans Administration loans provide an array of anti-predatory lending standards on which screening standards could be modeled. Those standards include limitations on abusive prepayment penalties, loan flipping schemes, asset-based lending, and balloon clauses. *Id.* at 1366-80.

218. See, e.g., GAO, *supra* note 109, at 79. For a cogent description of mortgage fraud schemes, see U.S. Department of Justice, *Financial Crimes Report to the Public D1-D12* (May 2005).

signs of an inflated appraisal, raising suspicions of property flipping or appraisal fraud.²¹⁹ Automation can also check for other types of fraud. A borrower's identity can be confirmed through an online search. A database maintained by Mortgage Asset Research Inc. lists past participants in mortgage fraud.²²⁰ The Department of Housing and Urban Development (HUD) uses a "Neighborhood Watch" website to screen out originators who have histories of making Federal Housing Administration (FHA)-insured loans with high default rates.²²¹ CoreLogic issues a scorecard ranking every mortgage broker and appraiser on the past quality of their loans.²²² Automatic retrieval of records on loans by the same lender to the same borrower can be instrumental in uncovering loan flipping. These automated anti-fraud safeguards are powerful because they can be applied to every loan in a loan pool.

A new insurance product partners fraud detection programs with fraud insurance.²²³ The Prieston Group (TPG) performs due diligence review of lenders and certifies those that have adopted best practices.²²⁴ TPG also provides various services to assist lenders in preventing and detecting fraud.²²⁵ As part of the package, TPG provides fraud insurance that follows loans when they are sold or securitized.²²⁶ Such products can protect investors from the risk of fraud that may be difficult to detect.²²⁷

Manual inspection can help detect other types of loan fraud. For example, such inspection can detect whited-out information on loan applications, a telltale sign of fraud. In inspections of no- or low-documentation loan files, Fitch has discovered documents with income and asset information blacked out. The inference is that the borrowers' income or assets were too low to qualify for a conventional loan. Due to these and similar fraud concerns, the Office of the Comptroller of the Currency advises lenders to inspect manually a sample of their loan files, particularly for loans that were sold by a broker or processed by inexperienced workers or temporary employees. Manual checks can also be used to verify Social Security numbers and assets and down payments.²²⁸

219. See Erick Bergquist, *Identifying Soft Spots in Fight Against Fraud*, Am. Banker, Sept. 27, 2004, at 7; Jody Shenn, *Freddie Adds Suspicious-Valuation Alerts to LP*, Am. Banker, Oct. 22, 2004, at 7.

220. See Shenn, *supra* note 114, at 8M.

221. See HUD, Enhancements to the Neighborhood Watch Early Warning System, Mortgage Letter 2002-15 (July 17, 2002), available at [http://www.hudclips.org/sub_nonhud/cgi/nph-brs.cgi?d=MLET&s1=02-15\[no\]&SECT1=TXTHLB&SECT5=MLET&u=/.hudclips.cgi&p=1&r=1&f=G](http://www.hudclips.org/sub_nonhud/cgi/nph-brs.cgi?d=MLET&s1=02-15[no]&SECT1=TXTHLB&SECT5=MLET&u=/.hudclips.cgi&p=1&r=1&f=G)

222. *Roundtable*, *supra* note 168, at 12.

223. See Jody Shenn, *Fraud-Guard Venders Team Up*, Am. Banker, Oct. 19, 2004, at 12.

224. The Prieston Group, <http://www.priestongroup.com/app/public/lenders.jsp> (last visited Feb. 10, 2007).

225. *Id.*

226. *Id.*

227. The Prieston Group, TPG Mortgage Assurance Solution, available at <http://www.priestongroup.com/app/public/> (last visited Feb. 12, 2007).

228. See *Roundtable*, *supra* note 168; Shenn, *supra* note 114, at 6A.

When fraud slips undetected through due diligence, often it is possible for trustees to detect it later through post-closing monitoring. In the closing documents, lenders can be required to notify trustees of any complaints, government investigations, or enforcement orders involving their lending practices. Similarly, those contracts can give trustees the right to perform spot audits of loans when red flags of lending abuse appear post-sale.

Screening can be difficult when anti-predatory lending standards are vague. Examples include prohibitions on asset-based lending and refinancings with no tangible net benefit to the borrower that do not provide objective guidelines for determining compliance. Despite the difficulties these types of standards present, rating agencies have devised ways of rating loans from jurisdictions with imprecise lending standards.²²⁹ It is also possible to devise objective measures to determine compliance with vague standards. The Veterans Administration, for V.A. loans, uses two quantitative tests—a debt-to-income ratio and a residual income test—to guard against asset-based lending.²³⁰ Similarly, the Federal Reserve Board, in the regulations implementing HOEPA, regulates loan flipping by prohibiting a lender and any assignee from refinancing a HOEPA loan with another HOEPA loan within one year from closing.²³¹ Both of these standards are objective and thus capable of detection through automated compliance systems.

4. Tailoring Screening to the TBA and 144A Markets

The to-be-announced and Rule 144A markets present unique obstacles to screening, but these obstacles are not insurmountable. Because these markets do not contemplate pre-sale screening, due diligence could take place post-sale. In a TBA offering, the lender and/or the trustee can do automated screening of loans immediately before loans are added to the loan pool. Similarly, in a Rule 144A offering, screening could be performed after the closing.

Nevertheless, screening poses a practical concern in both markets. In the TBA market, post-closing review means that investors lack the leverage they had before closing to walk away from the deal. When TBA offerings are structured as public offerings, the lenders have to provide disclosures and representations and warranties about the quality and legality of the loan

229. For example, S&P looks for factors mitigating aggressive enforcement of statutes, such as laws limiting recovery to a pattern or practice of violations, scienter requirements, an objective safe harbor, the litigation history of the law, or high proof or procedural hurdles to recovery. S&P will require more credit enhancements absent such mitigating factors. *See* S&P, *supra* note 135; *see also* Press Release, S&P, New Criteria Implemented for Including Anti-Predatory Lending Law Lns in U.S. Rtd SF Trans (May 13, 2004) [hereinafter S&P, New Criteria Implemented].

230. *See* 38 C.F.R. § 36.4337 (2006).

231. *See* 12 C.F.R. § 226.34(a)(3) (2006). While the rule recognizes an exception for refinancings that are “in the borrower’s interest,” essentially the one-year rule creates a rebuttable presumption that refinancings within one year violate HOEPA. *Id.*

pool. With those safeguards in hand, the trustee at least has the legal right to reject substandard loans from the loan pool. The real issue, then, is the transaction costs of enforcing those safeguards.

Matters are dicier in Rule 144A offerings. There, investors not only lack the leverage to walk away, but do not benefit from any pre-sale disclosures or binding representations and warranties. Without those deal protections, investors have no contractual guarantee of the minimum quality of loans to be included in the loan pool. While Rule 144A investors and trustees could insist, after-the-fact, that any illegal loans be removed from the loan pool, their weak contract rights would undercut their bargaining position and likely result in prolonged negotiations to no effect. As we discuss in the next section, carefully tailored provisions imposing assignee liability for predatory lending would arm Rule 144A and other investors with the leverage they need to insist on adequate disclosures and binding representations and warranties.

B. *A Proposal for Assignee Liability in Residential Mortgage Securitizations*

1. Due Diligence

The time has come to adopt a national legal standard for due diligence in residential mortgage securitizations and wholesale purchases of home loans. We propose a due diligence standard with the following contours:

(i) **Loan-Level Review for Actual Compliance:** Due diligence should include review of every loan in a loan pool for compliance with substantive screening standards. Lenders and underwriters would have the choice of manual or automated screening. Most lenders, particularly larger lenders, would likely opt for automated screening. All residential loan pools would be subject to loan-level review in full, whether those pools contain prime or subprime loans.

(ii) **Manual Screening for Other Signs of Fraud:** Due diligence should further require manual screening of a random sample of loan files for other indicators of fraud. This review would be in addition to the automated or manual review just described. Indicators of fraud could include the whitening-out of critical underwriting information, inconsistent information, and suspect or absent documentation. The random sample should be sufficiently large to support statistical inferences within specified tolerances about the absence or presence of the type of fraud tested for in the loan pool.

(iii) **Review For Facial Compliance:** Before the advent of automated screening, due diligence by underwriters and rating agencies traditionally consisted of reviewing originators' loan products, sales and training manuals, underwriting policies, broker selection, oversight, compensation policies, and form loan contracts to verify compliance with consumer protection and lending laws. Such due diligence continues to remain

important. Indeed, in the Lehman Brothers case, FAMCO's scripted sales materials allegedly coached FAMCO's loan officers on how to make fraudulent sales pitches.²³² Accordingly, due diligence should retain review for facial compliance. In addition, this phase should review all lawsuits filed, other borrower complaints, and government investigations of or actions taken against the lender for alleged predatory lending practices.

(iv) Determine Outcomes: A well-functioning due diligence system sets benchmarks for how to respond to loans found to violate the screening criteria. In the event of isolated violations, any loan that violated the screening criteria would either have to be rejected from the loan pool or have the defect promptly corrected. Higher volumes of violations would require rejection of the entire loan pool and cancellation of the sale.²³³

(v) Adequate Representations and Warranties and Recourse Clauses Enforceable by the Trust: In addition to ensuring screening, lenders should be required to provide representations and warranties that all loans in the loan pool comply with all applicable laws, including the nationwide screening criteria. All representations and warranties should run to, and be enforceable by, the trustee on behalf of the securitized trust.²³⁴

(vi) Post-closing Monitoring: Due diligence should further require loan originators, loan aggregators, underwriters, and servicers of residential mortgage loan pools to provide written notice to the trustee of any borrower complaints, lawsuits, subpoenas, notices of government investigations, and enforcement orders involving any loans in the loan pool. In addition, trustees should be required to investigate lenders whose loans prove to have higher-than-average default, prepayment, and/or foreclosure rates than loans with comparable risk.²³⁵

232. Austin v. Chisick (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 657-58 (Bankr. C.D. Cal. 2003) (findings of fact).

233. HUD has adopted this approach for Federal Housing Administration-insured loans. See Due Diligence in Acquiring Loans, HUD Mortgagee Letter 2002-21, at 5 (Sept. 26, 2002), available at [http://www.hudclips.org/sub_nonhud/html/nph-brs.cgi?d=MLET&s1=02-\\$\[no\]&op1=AND&SECT1=TXTHLB&SECT5=MLET&u=../html/shortcut.htm&p=1&r=7&f=G](http://www.hudclips.org/sub_nonhud/html/nph-brs.cgi?d=MLET&s1=02-$[no]&op1=AND&SECT1=TXTHLB&SECT5=MLET&u=../html/shortcut.htm&p=1&r=7&f=G).

234. Fannie Mae, Freddie Mac, and the Federal Housing Finance Board already require these contractual enforcement mechanisms. See, e.g., Fannie Mae, Lender Letter No. 03-00, *supra* note 143; Federal Housing Finance Board, Advisory Bull. 2005-AB-08 (Aug. 25, 2005), available at <http://www.fhfb.gov/GetFile.aspx?FileID=4201>; Freddie Mac Promotes Consumer Choice With New Subprime Mortgage Arbitration Policy, *supra* note 143; Freddie Mac Will No Longer Invest in Subprime Mortgages with Prepayment Penalty Terms Greater Than Three Years, *supra* note 143; cf. HUD, *supra* note 233, at 5-6 (noting that best practices involve such provisions).

235. Post-purchase monitoring can effectively detect unusual patterns among loan pools. For example, in 2005, Freddie Mac observed unusually high prepayment rates on loans sold by National City Mortgage. Eric Dash, *Freddie Mac Purchased and Sold Faulty Loans*, N.Y. Times, Apr. 14, 2005, at C3. Elevated prepayment rates can be evidence that originators are engaging in loan flipping. *Id.* Further investigation revealed that one broker was responsible for the questionable loans. *Id.*

We recognize that these standards form the outer parameters for workable due diligence and monitoring. Accordingly, we recommend that a federal agency be empowered to work out the nuts-and-bolts details of due diligence and monitoring through a rulemaking proceeding in which consumer advocates, lenders, and secondary market participants provide input into the types of controls that would best detect and deter predatory lending. Furthermore, that agency should be empowered to update due diligence and monitoring standards as circumstances and technology evolve.

2. Assignee Liability

Our assignee liability proposal aims to achieve three objectives. First, it would cause capital markets to internalize harm to borrowers from financing abusive loans. Second, it would restore the full panoply of remedies to borrowers that they had before their loans were securitized. Finally, it would foster certainty by establishing bright-line rules enabling assignees to estimate their potential liability for any predatory lending claims.

a. *Which Claims Would Be Subject to Assignee Liability?*

Although borrowers can harness an array of claims against originators for predatory lending, we propose extending assignee liability only to specific causes of action. These causes of action are: (1) common law tort claims, such as fraud and improvident lending; (2) contract claims such as unconscionability; and (3) claims under state and local anti-predatory lending laws. In addition, we would impose liability on assignees for violations of a national suitability standard that we previously proposed.²³⁶ This standard, which is akin to the suitability doctrine in securities regulation, would prohibit originators from making unsuitable loans to borrowers.

At this point, we do not propose altering or expanding assignee liability under federal or state anti-discrimination, disclosure, or unfair and deceptive trade practices laws. Doing so would require amending a multitude of statutes. In addition, caution suggests that this foray into federal assignee liability laws not be sweeping. After there has been time for adequate study of the impact of our proposal, policy-makers could consider harmonizing assignee liability standards for discrimination, disclosure, and consumer protection claims to reflect the expanding class of market participants who should be liable under the statutes.

236. Engel & McCoy, *supra* note 13, at 1317-39.

Finally, our proposal would operate as a floor, not a ceiling, and thus would not preempt any stricter assignee liability provisions under state or federal lending laws,²³⁷ such as HOEPA.

b. *Remedies Available Against Assignees*

Trusts that complied with the due diligence and monitoring standards outlined above would be liable for the same declaratory and equitable relief that borrowers could seek against their original lenders or brokers, including rescission and reformation. Borrowers could also obtain compensatory relief to the extent their damages were calculable. Thus, we would permit recovery of relocation expenses, lost equity, excess fees, interest payments, and late payment fees, but not recovery against assignees for emotional distress. We would also permit prevailing borrowers to recover attorneys' fees. Importantly, trusts that employed our due diligence methods would not be subject to punitive damages or statutory penalties that were punitive in nature. This limitation would apply even if the underlying cause of action permitted punitive remedies against brokers or lenders. Conversely, trusts that failed to check all due diligence criteria would be liable for treble damages or other inflation-adjusted numeric statutory penalties, whichever were greater. In no case could indeterminate punitive damages or penalties be assessed against assignees.

Our liability proposal is subject to three provisos. First, assignees could not escape liability by returning the abusive loan in question to the lender under a recourse or other comparable clause and then raising the defense that they no longer owned the loan.²³⁸ Second, borrowers would not need to demonstrate a pattern or practice of weak controls across multiple securitizations in order to assert a claim or defense against an assignee. Lax due diligence in their own securitization would be enough to support treble damages or a statutory penalty. Lastly, none of the limitations on the claims that borrowers could assert against assignees or the relief to which they would be entitled would apply to claims against brokers or lenders.

c. *Comparison to Existing Assignee Liability Provisions*

Assignee liability for predatory lending already exists on a limited scale. The federal government, through HOEPA, and numerous states and cities have adopted anti-predatory lending laws that contain assignee liability provisions. Our proposal differs from these laws in several respects. We contend our proposal offers a more effective approach to assignee liability.

First, our proposal would extend assignee liability to all abusive loans nationwide, including loans that do not meet the HOEPA or state law definitions of "high-cost" loans. Second, our proposal would enable rating

237. See Azmy, *supra* note 70, at 390-404 (discussing how state lending laws provide opportunities to assess the effect of various approaches to regulating lending practices).

238. The assignees could implead originators, however.

agencies to predict potential assignee liability and thus allay secondary market concerns about indeterminate relief. Finally, our due diligence provisions would impose the greatest liability on the assignees least willing to police lenders.

HOEPA and most state and local assignee liability laws apply only to so-called “high-cost” loans that exceed specific interest rate or points and fees triggers. HOEPA only applies to refinance loans²³⁹ where the annual percentage rate at origination exceeds the yield on Treasury securities of comparable maturity plus eight percent on first-lien loans or where the total points and fees exceed eight percent of the total loan amount or \$547 (in 2007), whichever is greater.²⁴⁰ Lenders who make HOEPA loans are limited or precluded from making loans with balloon payments, prepayment penalties, negative amortization, and other potentially onerous terms.²⁴¹ Assignees of HOEPA loans are liable for

all claims and defenses . . . the consumer could assert against the creditor of the mortgage, unless [the assignees] demonstrate, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine, based on the documentation required by this [subchapter], the itemization of the amount financed, and other disclosure of disbursements that the mortgage [was a HOEPA loan].²⁴²

Many state and local anti-predatory lending statutes and ordinances track HOEPA’s structure. Some have adopted HOEPA’s triggers.²⁴³ Most other state and local laws have modified the criteria for covered loans, including lower triggers,²⁴⁴ broader definitions of the fees trigger,²⁴⁵ and imposing maximum loan amounts in the definition of high-cost loans.²⁴⁶ Many have also enlarged the list of prohibited practices for “covered” loans.²⁴⁷

Just as the triggers and other provisions in state and local anti-predatory lending laws take a range of approaches, so do state assignee liability laws. Some states insulate assignees from all liability for abusive loans. Among states that do permit assignee liability, most impose liability only for “high-cost” loans, as defined by statute. The conditions under which assignees may be liable for abusive lending and the remedies available against them vary widely. Some laws exempt assignees from liability if they engage in due diligence to keep “high-cost” loans out of loan pools. Others only cap the liability of assignees who engage in due diligence. Depending on the jurisdiction, assignees who fail to meet the laws’ due diligence standards

239. 15 U.S.C. §§ 1602(i), (w), (bb) (2000); 12 C.F.R. § 226.32(a)(2) (2006).

240. 15 U.S.C. §§ 1602(aa)(1)-(aa)(4) (2000); 12 C.F.R. §§ 226.32(a)(1), (b)(1) (2006); Truth in Lending, 71 Fed. Reg. 46388 (2006); *see generally* Eugene J. Kelley et al., *An Overview of HOEPA, Old and New*, 59 Consumer Fin. L.Q. Rep. 203 (2005).

241. 15 U.S.C. § 1639 (2000).

242. 15 U.S.C. § 1641(d)(1) (2000).

243. *See, e.g.*, Me. Rev. Stat. Ann., tit. 9-A, § 8-103(1)(F-1) (1997).

244. *See, e.g.*, N.M. Stat. Ann. §§ 58-21A-3(H), (L) (Supp. 2003).

245. *See, e.g.*, 815 Ill. Comp. Stat. Ann. 137/10 (Supp. 2006).

246. *See, e.g.*, Ark. Code Ann. § 23-53-103(5)(A) (Supp. 2005).

247. *See, e.g.*, Ky. Rev. Stat. Ann. § 360.100(2) (Supp. 2005).

may face very limited damages or indeterminate punitive sanctions and damages awards. Still other jurisdictions have no due diligence standard and restrict the scope of assignee liability. Finally, a couple of cities have passed ordinances that imposed strict liability on assignees with no safe harbors or limitations on available remedies.

California's Financial Code explicitly exempts assignees from any claims arising under its law restricting abusive loan terms so long as they are holders in due course or "chartered by Congress to engage in secondary mortgage market transactions."²⁴⁸ In contrast, Georgia provides assignees with a safe harbor for reasonable due diligence. Under its state anti-predatory lending statute, borrowers with "high-cost" loans can bring any claims and raise any defenses against assignees that they could raise against loan originators,

unless the purchaser or holder demonstrates, by a preponderance of the evidence, that the purchaser or holder exercised reasonable due diligence at the time of purchase of the home loans, or within a reasonable time thereafter, intended to prevent the purchaser or holder from purchasing or taking assignment of high-cost home loans.²⁴⁹

Conversely, if assignees fail to engage in the prescribed due diligence, borrowers can obtain equitable relief, the balance of the amount due on their loan, and reasonable attorneys' fees.²⁵⁰

Another approach is to allow limited assignee liability even when assignees engage in due diligence. This is the approach New Jersey took in its Home Ownership Security Act. The law insulates assignees from almost all liability for "high-cost" loans if they meet due diligence requirements designed to screen out "high-cost" loans.²⁵¹ The law does, however, provide two exceptions. The first permits borrowers to assert claims against all assignees, even those that engage in due diligence, for violations of the Home Ownership Security Act for the amount "required to reduce or extinguish the borrower's liability under the home loan plus amounts required to recover costs including reasonable attorney's fees."²⁵² Second, "at any time during the term of a high-cost home loan after an action to

248. Cal. Fin. Code § 4979.8 (Supp. 2007).

249. Ga. Code Ann. § 7-6A-6(b) (2004); *see also* Ark. Code Ann. § 23-53-105(a)(2)(A)(ii) (Supp. 2005); D.C. Code § 26-1153.05(a) (2005); 815 Ill. Comp. Stat. Ann. 137/135(d)(1) (2006). Taking a different tack, in Kentucky, assignee liability applies only if "the violation for which the action or proceeding is brought is apparent on the face of the disclosure or the underlying promissory note." Ky. Rev. Stat. Ann. § 360.100(1)(b) (Supp. 2005); *see also* Nev. Rev. Stat. §§ 598D.050, 598D.110.2 (2004) (holding assignees liable if they "willfully engage[d] in any unfair lending practice described in this chapter in connection with a home loan").

250. *See, e.g.*, Ga. Code Ann. § 7-6A-6(c) (2004). Other jurisdictions similarly limit the relief available against assignees. *See, e.g.*, D.C. Code § 26-1153.05 (2005); Ill. Comp. Stat. Ann. 815/137-135(d) (2006); Ark. Code Ann. § 23-53-105(a)(2)(A)(ii) (Supp. 2005).

251. N.J. Stat. Ann. § 46: 10B-27(b) (Supp. 2006). Other states have enacted similar statutory schemes. *See, e.g.*, N.M. Stat. Ann. § 58-21A-11(A) (Supp. 2003); Mass. Gen. Laws ch. 183C, § 15 (Supp. 2006).

252. N.J. Stat. Ann. § 46: 10B-27(c) (Supp. 2006).

collect on the home loan or foreclose on the collateral securing the home loan has been initiated or the debt arising from the home loan has been accelerated or the home loan has become 60 days in default,” borrowers can raise any defense, claim, or counterclaim against assignees.²⁵³ Again, borrowers’ recovery is limited to the “amounts required to reduce or extinguish the borrower’s liability” and attorneys’ fees.²⁵⁴ Assignees who do not satisfy New Jersey’s due diligence requirements are liable for the full range of claims and defenses which borrowers could assert against loan originators.²⁵⁵

New York does not require due diligence to screen for high-cost loans. Rather, it imposes assignee liability in limited situations and restricts the relief to which borrowers are entitled. Borrowers can “assert any claims in recoupment and defenses to payment” arising under the state’s high-cost home loan law “that the borrower could assert against the original lender.”²⁵⁶ This provision only applies to an “action by an assignee to enforce a loan against a borrower in default more than sixty days or in foreclosure.”²⁵⁷

The cities of Los Angeles and Oakland attempted to paint assignee liability with a broad brush by passing ordinances holding assignees liable for any claims arising from high-cost loans that could be asserted against loan originators.²⁵⁸ The ordinances had no due diligence or other safe harbor provisions and no limits on the liability to which assignees could be exposed. The California Supreme Court has held that state law preempts these ordinances.²⁵⁹

While each of these approaches has laudable features, they all suffer from infirmities. First, it is too easy for lenders to write loans beneath the triggers for high-cost loans and thus evade the reach of anti-predatory lending laws. A recent nationwide study of state anti-predatory lending laws, which found evidence that mortgage lenders had switched from fixed-rate to adjustable-rate loans following passage of those laws, suggests that lenders are attempting such evasion.²⁶⁰ As part of the switch to adjustable-rate products, the recent spate of interest-only and option adjustable-rate mortgages made without regard for the borrowers’ ability to repay so

253. *Id.* § 46: 10B-27(c)(2).

254. *Id.* § 46: 10B-27(c). Similarly, Arkansas allows claims against assignees who engage in due diligence, but only in the form of offset actions in default or foreclosure actions. Ark. Code Ann. § 23-53-105 (Supp. 2005).

255. N.J. Stat. Ann. § 46: 10B-27(b); *see also* Mass. Gen. Laws ch. 183C, § 15(a) (authorizing unrestricted liability on assignees who do not adhere to state’s due diligence requirements); Ind. Code Ann. § 24-9-5-1 (2006) (same).

256. N.Y. Banking Law § 6-1(13) (McKinney Supp. 2007).

257. *Id.*

258. Oakland, Cal. Code, Ch. 5.33.070 (2006); Los Angeles, Cal. Municipal Code, Art. 1, § 162.07.

259. *Am. Fin. Servs. Ass’n v. City of Oakland*, 104 P.3d 813 (Cal. 2005).

260. *See* Giang Ho & Anthony Pennington-Cross, *Predatory Lending Laws and the Cost of Credit* 21-23, 26 (Research Div., Fed. Reserve Bank of St. Louis, Working Paper No. 2006-022A, 2006), *available at* <http://research.stlouisfed.org/wp/2006/2006-022.pdf>.

alarmed federal banking regulators in 2006 that they issued a guidance curbing abusive practices in nontraditional mortgages.²⁶¹

There are also signs that predatory lending is starting to infiltrate the prime market. For instance, the number of foreclosure starts for prime loans in Chicago in 2005 exceeded the number of foreclosure starts that year for subprime and high-cost loans combined.²⁶² This suggests that predatory lending laws should not focus solely on high-cost loans.

Second, when laws fully immunize assignees who engage in due diligence from liability, they reap the benefits of the pricing distortions and market imperfections that permeate the subprime market. In contrast, laws like New Jersey's that impose limited liability on assignees who engage in due diligence force assignees to internalize some costs that affected borrowers would otherwise bear.

Our third concern goes to appropriate relief against assignees who do not perform due diligence. Current remedies range from very limited relief to unbounded compensatory and punitive damages. The former provides insufficient incentives to police lenders. The latter are so indeterminate that rating agencies cannot estimate potential assignee liability and therefore the needed level of credit enhancements.²⁶³

The laws that do not have due diligence safe harbors have their own limitations. The law should treat assignees who engage in due diligence more favorably. This satisfies notions of fairness and forces the worst actors to absorb the most costs.

Our proposal solves the problems presented by existing legislation by: (1) eliminating triggers for assignee liability for abusive loans; (2) having clear standards that make it possible for assignees to predict the potential bases for and extent of liability; (3) requiring all assignees to internalize some of the costs that securitization imposes on borrowers; (4) making the extent of assignee liability depend on adequately screening loans; and (5) providing quantifiable damages that will enable rating agencies to evaluate the risks associated with loan pools.

IX. A RESPONSE TO CRITICS

Due diligence standards and assignee liability are controversial propositions in the residential mortgage market. In this section, we respond to criticisms of such proposals.

261. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006).

262. David C. Rose, *Chicago Foreclosure Update 2006* 6, 8 (2006), (unpublished manuscript, on file with the Fordham Law Review), available at http://www.ntic-us.org/documents/ChicagoForeclosureUpdate2006-revised_000.pdf.

263. See S&P, Standard & Poor's Addresses New Jersey Predatory Lending Law (May 2, 2003).

A. *Our Due Diligence Proposal Does Not Espouse Radical Changes to the Secondary Market*

In all modesty, there is nothing new about our due diligence standards. To the contrary, two of the most important purchasers in the conventional secondary mortgage market, Fannie Mae and Freddie Mac, have adopted similar standards. Both government-sponsored entities (GSEs) already require lenders who sell them loans to screen out loans with specified predatory features, regardless of the interest rates on those loans or whether the predatory features are legal.²⁶⁴ The market coverage of such due diligence is impressive: The two GSEs together purchase a large portion of subprime home loans, amounting to 43.7 percent of total subprime securitized issues in 2004.²⁶⁵

Beginning in the mid-1990s, Fannie Mae and Freddie Mac made their first forays into subprime territory, buying the best, A- subprime loans. In April 2000, as predatory lending concerns began to mount, Fannie Mae issued guidelines to sellers of loans mandating screening criteria to protect Fannie Mae from buying predatory loans. Those guidelines require lenders to use Fannie Mae's automated underwriting program to avoid steering of prime-eligible customers to high-priced loans, prohibit loans made without regard to the borrower's ability to pay, and limit points and fees to five percent of principal.²⁶⁶ Freddie Mac issued comparable guidelines to sellers and servicers in December 2000.²⁶⁷ Fannie Mae and Freddie Mac are reputedly aggressive in rejecting predatory loans and in requiring lenders to repurchase such loans if later evidence of predatory lending crops up.

The two GSEs are not the only federal entities that require review of purchased loans. The Office of the Comptroller of the Currency (OCC) stipulates that national banks that buy home loans require intermediaries and originators to conduct proper due diligence to avoid purchasing predatory loans.²⁶⁸ Similarly, HUD has adopted best practices guidelines

264. See, e.g., *supra* note 143; GAO, *supra* note 109, at 79-81. HUD regulations can or do deny credit to the GSEs toward their affordable housing goals for HOEPA loans and mortgages that are "contrary to good lending practices," contain "unacceptable terms or conditions," or "result[] from unacceptable practices." 24 C.F.R. §§ 81.2, 81.16(c)(12)-(c)(13) (2005). Impermissible loans include loans where lenders fail to report repayments by borrowers to credit agencies, asset-based loans, and loans involving steering, excessive fees, abusive prepayment penalties, or prepaid single-premium credit life insurance. *Id.*; see also Regulatory Amendments to Strengthen Prevention of Predatory Lending Practices, 71 Fed. Reg. 33144 (June 7, 2006) (to be codified at 21 C.F.R. pr. 81); Prohibition of Property Flipping in HUD's Single Family Mortgage Insurance Programs, 71 Fed. Reg. 33138 (June 7, 2006) (to be codified at 24 C.F.R. pt. 115) (applying property flipping restrictions to the GSEs).

265. See S&P, *supra* note 175, at 2.

266. See Fannie Mae, Lender Letter No. 03-00, *supra* note 143.

267. See *Freddie Mac's Stance Against Predatory Lending Practices*, *supra* note 143.

268. The OCC requires such guidelines by national banks to impose minimum underwriting requirements, appraisal criteria, and standards on total interest and fees, including provisions on "maximum rates, points, and other charges, and the use of overages

governing due diligence in the purchase and servicing of loans insured by the FHA.²⁶⁹ In the most recent example of this trend, in 2005, the Federal Housing Finance Board instructed the Federal Home Loan Banks to adopt uniform anti-predatory lending guidelines for purchases of mortgages by Federal Home Loan Bank members.²⁷⁰

Already, substantial portions of the secondary market are subject to due diligence or are encouraged by federal regulators to adopt best practices. Nevertheless, much of the private-label resale market continues to escape those guidelines. As a result, numerous predatory loans still slip into securitizations.

B. *Our Proposal Will Not Drive Out Legitimate Credit*

Assignee liability proposals for residential mortgages often face opposition on grounds that they will cause a retraction in available credit to underserved borrowers. This criticism is susceptible to testing. Over the last few years, numerous states have passed anti-predatory lending laws.²⁷¹ Two noteworthy empirical studies with nationwide scope have assessed the impact of specific state laws on the volume of subprime credit.

Economists Giang Ho and Anthony Pennington-Cross have analyzed the impact of state and local anti-predatory lending laws on subprime lending.²⁷² They found that “predatory lending laws have only a modest impact on the cost of credit.”²⁷³ In addition, they concluded that “the

and yield-spread premiums, structured to avoid providing an incentive to originate loans with predatory or abusive characteristics.” See 12 C.F.R. pt. 30, app. C.III.E.3 (2006); see also Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans, OCC Advisory Letter 2003-3 (Feb. 21, 2003).

269. The HUD guidelines recommend loan-level review designed to reject loans involving property flips, appraisal frauds, excessive points and fees, and credit extensions without regard to the borrower’s ability to pay. See HUD, *supra* note 233.

270. In drafting uniform guidelines, the Banks are to consult similar guidelines of the GSEs, HUD, federal regulators, and large financial institutions. In addition to barring purchase of illegal loans, the guidelines must address the purchase of HOEPA loans and loans with certain predatory features, such as prepaid single premium credit life insurance, prepayment penalties with extended terms, and mandatory arbitration clauses. See Federal Housing Finance Board, *supra* note 234.

271. See generally Azmy, *supra* note 70, at 371-76; S&P, Anti-Predatory Lending Law Update (Feb. 7, 2005) [hereinafter S&P, Anti-Predatory Lending Law Update]; S&P, *supra* note 135; S&P, Evaluating Predatory Lending Laws: Standard & Poor’s Explains its Approach (Apr. 15, 2003) [hereinafter S&P, Evaluating Predatory Lending Laws].

272. See Giang Ho & Anthony Pennington-Cross, *The Impact of Local Predatory Lending Laws on the Flow of Subprime Credit* 50 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-009A, February 2006), available at <http://research.stlouisfed.org/wp/2006/2006-009.pdf>.

273. See Giang Ho & Anthony Pennington-Cross, *Predatory Lending Laws and the Cost of Credit* 13 (Fed. Reserve Bank of St. Louis Working Paper No 2006-022A, 2006), available at <http://research.stlouisfed.org/wp/2006/2006-022.pdf>. In a press release dated February 1, 2005, S&P announced that it had completed a study showing that the capital markets only financed \$87 million in high-cost loans in 2004 and surmised that anti-predatory lending legislation had limited either the origination or securitization of such loans. However, S&P did not provide comparative data for prior years and has not made the

typical law has little impact on the flow of subprime credit as measured by loan origination and application.”²⁷⁴ In fact, state anti-predatory lending laws with lower triggers (and thus broader coverage) resulted in increased loan originations and applications. In their opinion, broader anti-predatory lending laws may alleviate consumers’ concerns that they could fall prey to predatory lending and make them more confident about applying for subprime mortgage loans. “In other words,” they observed, “the demand for subprime credit can actually increase when a predatory lending law is enacted.”²⁷⁵

A second study by the Center for Responsible Lending (CRL) of securitized subprime loans reported comparable findings.²⁷⁶ The study compared subprime loan volumes in twenty-eight states with anti-predatory lending laws to volumes in states with no such laws (designated the control states), after controlling for time effects plus economic and demographic variables. When the latter variables were held constant, twenty of the twenty-eight states experienced no change in volume, six had higher volumes, and two had lower volumes, relative to the control states. Furthermore, Georgia—one of the two states with reduced volumes—experienced an increase in subprime loans without prohibited loan terms.²⁷⁷ Finally, the CRL study found that nominal subprime interest rates remained the same or dropped in almost all states with anti-predatory lending laws, compared with the control states.²⁷⁸

Experience under the Federal Trade Commission (FTC) rule abolishing the holder-in-due-course rule for consumer loans, including home loans used to finance goods and services, also suggests that fears of a credit drought are overstated.²⁷⁹ When the FTC promulgated its rule in 1976,

study publicly available. See Press Release, S&P, Study Shows Capital Markets Not Financing High Cost U.S. Mortgage Loan Originations (Feb. 1, 2005). A separate study, commissioned by the National Home Equity Mortgage Association and the National Association of Mortgage Brokers, found that New Jersey lenders planned to cut their subprime cash-out refinance and home improvement lending by sixty-nine percent after passage of New Jersey’s assignee liability law. See Richard F. DeMong, The Impact of the New Jersey Home Ownership Security Act of 2002, at 5 (Mar. 26, 2004) (unpublished manuscript, on file with the Fordham Law Review), available at http://www.mbaa.org/images/namb/documents/PDF/2004_03_26_nj_results.pdf. The NHEMA/NAMB study, however, was based solely on self-reports by lenders and brokers and its quantitative estimates were calculated before New Jersey amended its law to soften its provisions. Other scholars have pointed out that a drop in lending volumes does not necessarily harm social welfare, and in fact enhances it when the reduction is mostly limited to predatory loans. See Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina’s Predatory Lending Law*, 15 Housing Pol’y Debate 573 (2004).

274. Ho & Pennington-Cross, *supra* note 273, at 47.

275. Giang Ho & Anthony Pennington-Cross, *The Impact of Local Predatory Lending Laws on the Flow of Subprime Credit*, 60 J. Urb. Econ. 210, 226 (2006).

276. Li & Ernst, *supra* note 92.

277. See *id.* at 13-14.

278. See *id.* at 15-17.

279. See 16 C.F.R. § 433.2 (2005).

lenders predicted dire effects on the availability of consumer credit. Time proved them wrong. Instead, “suppliers of consumer goods and credit, at least the honest ones . . . accommodated themselves easily to the FTC [Rule], with only a slight drop in the amount of consumer credit available.”²⁸⁰

Finally, there is compelling anecdotal evidence that state anti-predatory lending laws have not had an adverse impact on the flow of subprime credit. After surveying lenders in states with anti-predatory lending laws, including those with assignee liability provisions, Morgan Stanley issued a report in 2002 stating:

We recently conducted a “channel check” among branch managers of several major consumer-finance lenders. We expected to hear that new predatory lending laws were crimping growth and driving capacity out of the margin. Our thinking was that volume might slow, but that improving margins would offer a partial offset. Instead, we discovered that, at least according to the 280 branch managers with whom we conducted detailed telephonic surveys, new laws, and the changes in lending practices that have resulted, are not hurting growth. On the contrary, we heard from a number of branch managers that the changes they have made to comply with the new lending laws may have increased origination volume, as potential customers feel more at ease with the loan process. . . .

Even the toughest new laws, in states like North Carolina, for example, do not seem to be affecting branch volumes.²⁸¹

C. Rating Agencies Do Rate Loans Subject to Damages Caps for Assignee Liability

Some critics have claimed that rating agencies cannot and will not rate subprime loans originated in states with assignee liability provisions. The reality belies this claim. Rating agencies are rating subprime issues from most states with assignee liability laws.²⁸² Their willingness to rate issues from these states typically hinges on whether assignees’ potential damages can be quantified. In this regard, S&P has stated: “Standard & Poor’s

280. Eggert, *supra* note 116, at 429 n.305 (citing William H. Lawrence & John H. Minan, *The Effect of Abrogating the Holder-in-Due Course Doctrine on the Commercialization of Innovative Consumer Products*, 64 B.U. L. Rev. 325, 338 & n.51 (1984)) (describing how The Wharton Forecasting Institute estimated that only a 5.5% reduction in the volume of consumer credit in 1976 was caused by the FTC’s rule); *see also* White & Summers, *supra* note 72, at 508 (“It now appears that [arguments that the holder-in-due-course rule was essential to the free flow of credit] were incorrect”; abolition of the rule for certain consumer transactions “caused barely a ripple on the consumer credit pond”).

281. Morgan Stanley, Channel Check: Surprisingly Strong Subprime Growth 2-3 (August 1, 2002), available at <http://butera-andrews.com/legislative-updates/directory/Media/other/MS-SubPrime.pdf>.

282. *See, e.g.*, S&P, *supra* note 135; S&P, Anti-Predatory Lending Law Update, *supra* note 271; S&P, Evaluating Predatory Lending Laws, *supra* note 271. For a discussion of the application of the credit enhancement criteria, *see infra* notes 283-301 and accompanying text.

believes that when the risk associated with violating an anti-predatory lending law is quantifiable, then Standard & Poor's will allow loans governed by that law in its rated transactions if the risk is supported by the appropriate credit enhancement."²⁸³

S&P has been able to quantify the following elements of damages: unpaid loan balance, principal, interest, and fees paid to date, double or treble damages, attorneys' fees, and costs. In addition, S&P is able to quantify the cost of loan rescission.²⁸⁴

In a handful of controversial situations, S&P has refused to rate high-cost loans in states that enacted assignee liability laws with indeterminate damages provisions.²⁸⁵ The most celebrated instance was in Georgia, which passed a strict assignee liability law in 2002. Thereupon, S&P announced it would refuse to rate all Georgia home loans subject to the law, after which the Georgia legislature amended the law to cap damages on high-cost loans.²⁸⁶ With passage of the amendment, S&P agreed to "review transactions that propose to include [Georgia] high-cost loans on a case-by-case basis."²⁸⁷

Currently, S&P refuses to rate loan pools containing high-cost loans governed by assignee liability laws in Indiana, Massachusetts, and New Jersey on grounds that those laws create indeterminate damages exposure and thus do not permit S&P to calculate the maximum exposure per loan for securitized trusts.²⁸⁸ Our assignee liability proposal, unlike the Indiana, Massachusetts, and New Jersey statutes, is limited to quantifiable exposure and thus is amenable to rating.

283. S&P, *supra* note 135. Because S&P has taken the lead in developing ratings methods for high-cost loans from states with assignee liability, this discussion focuses on S&P's approach.

284. *See* S&P, Standard & Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Anti-Predatory Lending Law Loans in U.S. Rated Structured Finance Transactions (May 13, 2004).

285. *See generally* Azmy, *supra* note 70, at 374-76; David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. St. U. L. Rev. 985 (2006).

286. *See* Azmy, *supra* note 70, at 374-76; Press Release, S&P, Standard & Poor's To Disallow Georgia Fair Lending Act Loans (Jan. 16, 2003); *compare* Georgia Fair Lending Act, Ga. Code Ann. §§ 7-6A-1 to 7-6A-13 (West 2002) with Ga. Code Ann. § 7-6A-6 (West 2004).

287. Press Release, S&P, Standard & Poor's Will Admit Georgia Mortgage Loans Into Rated Structured Finance Transactions (Mar. 11, 2003).

288. In certain cases, S&P will rate high-cost loans from Massachusetts originated by national banks, federal savings associations, and federal savings banks that enjoy federal preemption. *See, e.g.*, S&P, Anti-Predatory Lending Law Update, *supra* note 271; *see also* Press Release, S&P, Standard & Poor's Eliminates Additional Credit Enhancement Requirements For Indiana Home Loans (Feb. 7, 2005) (but not Indiana high-cost loans); S&P, Standard & Poor's Addresses Indiana Anti-Predatory Lending Law (Oct. 18, 2004); S&P, Standard & Poor's Addresses Massachusetts' Predatory Home Loan Practices Act (Sept. 20, 2004); S&P, New Criteria Implemented, *supra* note 229; S&P, *supra* note 284; S&P, *supra* note 263; Press Release, S&P, Standard & Poor's Permits Additional New Jersey Mortgage Loans Into Rated SF Transactions (Nov. 25, 2003).

D. *Our Proposal Will Not Make Legitimate Loans Unaffordable*

Critics of assignee liability also contend that proposals such as ours will render home loans uneconomical. As we have demonstrated, the cost of due diligence is minimal, both in absolute terms and as a percentage of the overall cost of originating a home loan. The more significant cost consideration arises from the possibility that rating agencies might require additional credit enhancements in response to the increased liability exposure of trusts. If they were large enough, credit enhancements could push up the price of loans. As it turns out, there is scant evidence that S&P has required significant added credit enhancements in response to laws imposing assignee liability so long as there is an adequately capitalized lender, a well-crafted assignee liability law, and effective due diligence review.

S&P officially takes the position that high-cost loans originated in states with quantifiable assignee liability laws require added credit enhancements.²⁸⁹ S&P, however, keeps the exact amount of credit enhancements required a mystery.²⁹⁰ Repeatedly, in public statements, S&P has trotted out estimates of the maximum legal exposure per loan (which S&P terms “loss severities”). These loss severities vary by state and go as high as 275 percent of the original loan balance for “high-cost loans” that are originated in North Carolina and Kentucky.²⁹¹ Obviously, if

289. S&P states that it requires elevated credit enhancements or their equivalent for certain high-cost or covered loans originated in Arkansas, Colorado, the District of Columbia, Florida, Georgia, Illinois, Maine, Massachusetts, New Jersey, New Mexico, New York, Ohio, and Oklahoma. The same is true for home loans originated in Cleveland Heights and Toledo, Ohio, and HOEPA loans. *See* S&P, *supra* note 284.

290. *See* Erick Bergquist, *Predator Laws: S&P's Awkward Position*, Am. Banker, May 18, 2004, at 1 (“S&P couches risk warnings on various loan types under the term of potential ‘loss severity’—even in jurisdictions and categories where S&P says it would not require credit enhancements—but does not specify the actual credit enhancement requirement.”).

291. *See* Susan Barnes, Managing Director, S&P & Scott Mason, Director, S&P, PowerPoint presentation 14-16 (May 17, 2004); Susan Barnes, Managing Director, S&P, PowerPoint Presentation at the MBA Nat’l Secondary Market Conference and Expo: Evaluating Anti-Predatory Lending Laws: S&P’s Approach 4 (Apr. 19, 2004); S&P, *supra* note 135; S&P, *supra* note 284. For jurisdictions with assignee liability laws, S&P has estimated loss severities ranging from 37 percent of the original loan balance in Ohio to 275 percent in North Carolina and Kentucky (both of which permit forfeiture of interest charges plus twice the interest paid, attorneys’ fees and costs). *See* S&P, *supra* note 284. An S&P managing director explained how S&P would arrive at a 268 percent loss severity for a 30-year fixed-rate home loan for \$100,000 at 9.00 percent annual interest under a proposed Nevada law to impose treble damages liability on assignees (assuming that damage to the borrower would consist of all interest paid over the life of the loan):

Conservatively assume that average life of a mortgage is 10 years

Total interest paid on loan over 10 years is \$85,984

Assume 10% of the [unpaid principal balance] (\$10,000 in this example) as attorney fees and costs

$\$85,984 * 3 = \$257,952$

$\$257,952 + \$10,000 = \$267,952$ or 268% of original loan balance.

See Barnes, *supra*, at 18.

lenders had to provide credit enhancements equaling 275 percent of the loan principal, subprime securitization would come to a halt.

Despite these predictions, subprime securitization keeps growing, which suggests that loss severity risks are not hampering the securitization market.²⁹² Indeed, “S&P insists that loss severity numbers by themselves do not say much.”²⁹³ Rather, it appears that even where S&P projects high loss severities, the company does not recommend correspondingly high credit enhancements. For example, in a talk before industry representatives, S&P presented a worst-case projection suggesting that for a pool with five percent of high-cost loans originated in an assignee liability state with a loss severity level of 196 percent, the required credit enhancements for the AAA tranche would rise at most by eighteen percent.²⁹⁴ The assumption that five percent of loans in a pool are high-cost is likely excessive, thus inflating S&P’s calculation of the level of needed credit enhancements. S&P’s own estimates suggest that the average proportion of high-cost loans in any one loan pool may be well under five percent.²⁹⁵

Even if S&P applied its formula ruthlessly, the required credit enhancements would exceed (and often far exceed) the actual risk involved. S&P’s formula assumes that every loan in default (plus twenty-five percent of performing loans) will be successfully litigated and result in maximum legal exposure. As any experienced litigator knows, that is virtually never the case. Indeed, state anti-predatory laws have deterred lenders from

292. See David Glehan, Director, S&P, PowerPoint Presentation at the Non-Prime Lending and Alternative Products Conference: The Subprime Market 7 (June 10, 2005), <http://events.mortgagebankers.org/nonprime2005/signatureconferences/nonprime/images/img/TheSubprimeMarket.pdf>.

293. See Bergquist, *supra* note 290, at 9.

294. See Barnes & Mason, *supra* note 291, at 16. The example used was Arkansas H.B. 2598, which authorizes damages in the amount needed to extinguish the borrower’s liability under the loan, plus the total principal, interest, and fees already paid, plus attorneys’ fees and costs. See *id.* at 14. Nominally, S&P calculates added credit enhancements as follows. S&P separately calculates the exposure from defensive claims (claims raised in defense to collection or foreclosure) and affirmative claims under state anti-predatory lending laws and adds them together. For each type of claim, the agency uses the following principle to calculate the required credit enhancement:

$$FF \times LS = CER$$

The foreclosure frequency (FF) is the probability of foreclosure and is assumed to include all loans in default. (On top of the foreclosure frequency, S&P also assumes that one-quarter of subprime loans not in default will result in affirmative claims by borrowers). The loss severity (LS) usually equals the maximum damages exposure in a particular jurisdiction. The required credit enhancement (CER) is then discounted by the percentage of high-cost loans in the loan pool. S&P uses this methodology to price both potential individual claims and class action liability (where the class size can be determined). See *id.* at 14-16; S&P, *supra* note 135; S&P, *supra* note 284; Barnes, *supra* note 291, at 4.

295. S&P has determined that only one-one hundredth of one percent (0.01%) of U.S. home loans that it rated in 2004 were high-cost loans. See S&P, *supra* note 273; cf. S&P, New Criteria Implemented, *supra* note 229 (noting that the proportion was low).

making unlawful high-cost loans.²⁹⁶ Nonetheless, S&P's formula automatically "defaults to the remedy that reflects the worst-case scenario," thereby inflating its credit enhancement projections.²⁹⁷ Perhaps this is why S&P says that "[a]s performance and loss information for the loans subject to additional credit enhancement develops, Standard & Poor's will adjust its criteria as appropriate."²⁹⁸

In reality, S&P rarely requires the credit enhancements it claims are necessary. While S&P's pronouncements on the subject have been inconsistent, its statements reveal wide-scale waiver of the official credit enhancement requirement. Thus, in 2004, S&P officials said that added credit enhancements will be required only for loans from states with assignee liability laws that contain subjective standards and where no mitigating factors otherwise exist.²⁹⁹ Elsewhere, an S&P managing director assured lenders that for loan pools that have undergone satisfactory compliance review, where S&P considers the lender creditworthy, and where the lender reports which loans are governed by an assignee liability law, on "a case by case basis, S&P will allow the loans into a transaction and will track them through its TRENDS Database."³⁰⁰ S&P will also waive added credit enhancements where the lender provides representations and warranties that the loan pool does not contain high-cost loans.

In sum, for creditworthy lenders, S&P has sufficient confidence in automated compliance³⁰¹ to allow high-cost loans into loan pools, subject to tracking, without the need for significant added credit enhancements. This suggests that the cost of assignee liability in terms of added credit enhancements under our proposal would be relatively low. Combined with the low cost of due diligence and the large anticipated welfare effects to consumers and society from eliminating lending abuses,³⁰² assignee liability would improve, not destroy, credit for underserved borrowers.

296. See Li & Ernst, *supra* note 92, at 11-12; Quercia, Stegman & Davis, *supra* note 273, at 593-97.

297. See S&P, *supra* note 284.

298. See S&P, New Criteria Implemented, *supra* note 229.

299. See Barnes & Mason, *supra* note 291, at 2. Mitigating factors that can reduce or eliminate the need for added credit enhancements include: (1) damages arising only from a pattern or practice of violations; (2) liability only for knowing and/or intentional violations; (3) objective standards; (4) little or no litigation history; (5) rebuttable presumptions; (6) cure periods; (7) restrictions on affirmative or defensive claims; and (8) statutes of limitation. See *id.* at 6.

300. Barnes, *supra* note 291, at 19.

301. In a related context, Fitch stated that experience had demonstrated the accuracy and reliability of automated compliance systems:

Based on results of the transaction loan sampling over the past 22 months, Fitch has determined that there has been excellent compliance with Fitch's high cost loan criteria. Furthermore, compliance systems have become a critical component of the underwriting and quality control process, and the investment in these systems and the reliance on them has grown accordingly.

FitchRatings, Fitch Revises RMBS Guidelines, *supra* note 135.

302. Robert Quercia and his co-authors made this point eloquently in a 2004 study of the North Carolina anti-predatory lending law, in which they demonstrated that almost ninety

E. *Our Proposal Could Help Solve Adverse Selection Problems That Harm Securitizers, Lenders and Borrowers*

Our assignee liability proposal could also help to solve the adverse selection problem caused by securitization, which could reduce the level of credit enhancements needed and the cost of credit to borrowers. As we have discussed throughout this article, absent due diligence, “lemon loans” can escape detection during the securitization process. Effective due diligence creates disincentives to adverse selection by lenders, and thus will deter the worst abuses. This will help reduce the credit risk that arises from information asymmetries between lenders and the secondary market and reduce needed credit enhancements. Ultimately, borrowers could benefit from these savings and pay less for their loans.

Similarly, reports of abusive lending may have led potential borrowers, who would be desirable to lenders and the secondary market, to shy away from taking out loans. To the extent that these borrowers believe that powerful anti-predatory lending laws will protect them, the laws may solve another adverse selection problem, which is that reports of predatory lending have driven “good” borrowers from the marketplace.

CONCLUSION

In a 2004 report to Congress, GAO expressed optimism that market discipline by investors in subprime mortgage-backed securities would help drive out predatory lending.³⁰³ That optimism was misplaced. Predatory loans continue to be financed by the capital markets. Furthermore, experience has shown that the private-label secondary market will generally only screen out abusive loans when required to do so by law.

The Department of Housing and Urban Development put it well when it said in the context of FHA-insured loans:

Effective due diligence policies, uniformly applied by mortgagees prior to purchase, would cripple the ability of fraudulent lenders to pawn predatory loans off on others in the mortgage industry. If predatory loans cannot be sold, they are unlikely to be made and all borrowers . . . will be protected.³⁰⁴

For the reasons we have described, the time has come to adopt assignee liability on a nationwide basis for securitized home loans.

percent of the resulting decline in North Carolina refinance loans after passage of that law consisted of a reduction in loans with predatory features. *See* Quercia, Stegman & Davis, *supra* note 273, at 593-97. A 2006 study by the Center for Responsible Lending echoed their finding, reporting that the proportion of loans with specified predatory loan terms fell in many states with anti-predatory lending laws, relative to states without those laws. *See* Li & Ernst, *supra* note 92, at 11-12. As both studies illustrate, the critical question is not whether lending fell in absolute terms, but *what type* of lending fell, bad or good.

303. *See* GAO, *supra* note 109, at 76-79.

304. *See* HUD, *supra* note 233.