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WHERE DO WE GO FROM HERE? THE BATTLE AGAINST PREDATORY SUBPRIME LENDING

When Margaret Newton, a 76 year old stroke victim with difficulty speaking, seeing, and concentrating, was approached by a local contractor, she was persuaded to purchase siding for \$9,990.¹ The purchase agreement arranged financing for Ms. Newton with United Companies Financial Corp., a company that securitized its loans, pooled them and sold them on Wall Street.² When the financing closed, Ms. Newton owed not \$9,990 but \$15,500, which included \$3,050 in points and fees, plus settlement charges.³ Her monthly payment was over \$240.⁴ Moreover, the siding was not properly installed on her house.⁵ Ms. Newton's total monthly income was only \$898, and unsurprisingly, she fell behind on her loan payments, at which point United Companies attempted to foreclose.⁶ She was not alone in being targeted for a high priced loan.⁷ Since the collapse of the housing market however,⁸ "active trading in most mortgage-backed securities and other structured credit products has virtually come to a halt."⁹ In conjunction with the housing collapse and current financial crisis, one professor has even argued for an outright ban on subprime loans.¹⁰

In the 1990s, "subprime lending was handled mainly by finance companies that did not fund their high-risk mortgages with federally

1. See generally the findings of fact in *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444 (1998); This case was brought to my attention by Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder In Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 506 (2002).

2. See generally the findings of fact in *Newton*, 24 F. Supp. 2d 444.

3. *Id.* at 447.

4. *Id.*

5. It had been constructed without installation, and had to be stripped off and re-installed with it to be effective. See *id.*

6. Fortunately for Ms. Newton, she found legal help, sued United Companies, and in November 1998, the court rescinded her loan and awarded her \$2,000, finding that she had not received the proper loan disclosures. *Id.*; cf. *Mox v. Jordan*, 463 N.W. 2d 114 (Mich. App. 1990) (family that fell victim to the holder in due course doctrine were forced to pay back a \$31,000 loan they never received). This case was brought to my attention by Eggert, *supra* note 1.

7. While in the mid 1990s "fewer than five percent of mortgage loan originations were subprime, by 2005 the figure had jumped to approximately twenty percent." Testimony of Sandra F. Braunstein, Dir., Div. of Consumer and Cmty. Affairs—Fed. Reserve Bd., *Subprime Mortgages*, before the Subcomm. on Fin. Inst. and Consumer Credit, Comm. on Fin. Serv., U.S. House of Representatives, (Mar. 27, 2007).

8. See Standard & Poors (S&P), *National Trend of Home Price Declines Continued through the First Half of 2008 According to the S&P/Case-Shiller Home Price Indices*, tbl. 1 (Aug. 26, 2008).

9. Sam Ali, *The Odd Mandate that Ate Wall St. SEC urged to abolish mark-to-market rules*, THE STAR-LEDGER, Oct. 5, 2008, at 1.

10. Alan M. White, *The Case for Banning Subprime Mortgages*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133609#.

insured bank deposits.”¹¹ By 2002, this market expanded, “with big banks [or hedge funds] now controlling ‘five of the nation’s top ten subprime [lenders],’ and several other prominent national banks investing in the subprime market either by extending lines of credit to subprime lenders, or by purchasing subprime loans.”¹² Regulatory changes such as the deregulation of the banking industry, the desire for increased profits, “the absence of mainstream lenders in low-income neighborhoods, tax breaks for interest on second mortgages, and ‘appreciating real estate values’ [all] made conditions ripe for many subprime lenders to engage in predatory practices.”¹³ Currently, however, “[s]everal structural and economic factors have recently slowed subprime growth and increased delinquencies and foreclosures.”¹⁴ The rise in short term interest rates, along with the decrease in the rate of home price appreciation, are just two factors contributing to the rise in delinquencies and foreclosures.¹⁵ “As a result of mounting defaults and delinquencies, one of the largest subprime lenders, New Century Financial Corporation, filed for bankruptcy on April 2, 2007,” and the collapse of this industry has led many other lenders to file for bankruptcy, while others have “simply exited the subprime market altogether.”¹⁶

Most of all, predatory subprime lenders have entered this market because of significant monetary incentives.¹⁷ “The borrowers in this [predatory] market are people who, because of historical credit rationing, discrimination, and other social and economic forces, are disconnected from the credit market.”¹⁸ Brokers and originators continue to exploit borrowers’ disconnection to the credit market and make loans with predatory terms. High-pressure tactics such as door-to-door solicitation and repeated phone calls in order to intimidate homeowners into acquiring high-cost loans are

11. Anne-Marie Motto, *Skirting the Law: How Predatory Mortgage Lenders Are Destroying the American Dream*, 18 GA. ST. U. L. REV. 859 (2002).

12. *Id.* at 859.

13. *Id.* at 859–60.

14. Dr. Faten Sabry & Dr. Thomas Schopflocher, *The Subprime Meltdown: A Primer*, Part I of a NERA Insight Series (June 21, 2007) at 2, http://www.nera.com/image/SEC_SubprimeSeries_Part1_June2007_FINAL.pdf.

15. *Id.*

16. *Id.*

17. It has been estimated that subprime loan originations increased from \$35 billion in 1994 to \$160 billion in 1999, which has been attributed to refinancings and profitable spreads. See DEP’T OF HOUS. & URBAN DEV. & DEP’T OF THE TREASURY TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY HOME MORTGAGE LENDING 30, 45 (June 2000) [hereinafter HUD-TREASURY REPORT], available at <http://www.huduser.org/Publications/pdf/treasrpt.pdf>.

18. “They have a range of credit ratings and some actually would qualify for prime loans . . . while others cannot afford any credit regardless of the terms.” Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1279 (2002) [hereinafter *A Tale of Three Markets*].

just some of the predatory practices they use.¹⁹ Additionally, even if borrowers read the loan documents carefully, these documents are “usually complex enough to make an attorney’s eyes cross, leaving little hope that a[n] [average] consumer can wade through the legal double talk.”²⁰

This exploitation has led to wide-ranging harms to borrowers, who have little legal recourse against lenders and brokers.²¹ First, lenders and brokers shift their litigation risk to the secondary market via securitization of these loans.²² Securitization protects the lenders and brokers from litigation risk because of the protections afforded by the holder in due course rule and weaknesses in the current rules and regulation.²³ Second, “[s]ecuritization drives up the price of subprime loans because investors demand a lemons premium for investing in subprime mortgage-backed securities.”²⁴ As a result, the costs to borrowers are substantial, and “one study estimated that lengthy prepayment penalties in securitized subprime loans boosted borrowers’ risk of foreclosure by sixteen to twenty percent.”²⁵ Third, these foreclosures harm the cities where these borrowers default on their loans, as “declining property values resulting from predatory lending mean reduced tax revenues just as abandoned buildings lead to increased demand for fire and police protection.”²⁶ Therefore, changes must be made to this industry

19. Others include, subprime lenders urging borrowers to “sign loan documents without reading them or with key terms left blank,” and selling borrowers unnecessary insurance or other products along with the loan. See Motto, *supra* note 11, at 860; see also Nat’l Assn of Consumer Advoc., Predatory Lending Practices, <http://www.naca.net/predatory-lending-practices> (last visited Oct. 25, 2008).

20. See Motto, *supra* note 11, at 860.

21. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007) [hereinafter, *Turning a Blind Eye*].

22. *Id.*

23. *Id.*; see also *infra* Part IV and Part V.

24. *Turning a Blind Eye*, *supra* note 21, at 2041. The “lemons premium” exists as a result of the high default risk of borrowers in the subprime lending market, and is the high price on the interest payments that borrowers pay in their loan payments to subprime lenders. This premium makes these securitized loans attractive investments.

25. *Id.* Balloon clauses in those loans raised borrowers’ risk of foreclosure by an additional fifty percent. See generally 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*, Ctr. for Community Capitalism, Kenan Institute for Private Enters. U.N.C., (Jan. 25, 2005).

26. Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355 (2006); see also, e.g., ACORN FAIR HOUS., PREDATORY LENDING IN SOUTH CENTRAL PENNSYLVANIA: A REVIEW OF RISING FORECLOSURE FILINGS AND THE RELATIONSHIP TO PREDATORY LENDING 4 (Dec. 3, 2003), available at http://www.acorn.org/fileadmin/Predatory_Lending/FINAL_REPORT.pdf (documenting a 186% increase in foreclosure filings in south central Pennsylvania between 1997 and 2002); STEVEN C. BOURASSA, URBAN STUDIES INST., PREDATORY LENDING IN JEFFERSON COUNTY: A REPORT TO THE LOUISVILLE URBAN LEAGUE 3 (Dec. 2003), available at <http://www.lul.org/Predatory%20Lending%20Report.pdf> (citing a 288% increase in foreclosures in Kentucky between 1995 and 2002); ZACH SCHILLER ET AL., POLICY MATTERS OHIO, HOME INSECURITY 2004: FORECLOSURE GROWTH IN OHIO 3 (Aug. 2004), available at

to prevent these predatory lenders and special purpose vehicles (SPVs) that securitize these loans from continuing to profit at the expense of borrowers, cities and investors.

Part I of this note provides a brief overview of the subprime lending problem, a definition of predatory lending and an explanation of the typical practices that it entails. Part II describes the emergence, growth and risks of securitization of subprime home mortgage loans. It further explains why predatory lending persists despite the substantial risk inherent in management techniques employed by securitization.²⁷ Part III identifies and discusses remedies available to victims of predatory subprime lending and the inadequacies of the remedies in protecting consumers and preventing further predatory lending. Then, Part IV argues that assignee liability on securitized trusts, put forth in a March 2007 article by Kathleen C. Engel and Patricia A. McCoy (Engel and McCoy), is currently too radical a change to the secondary market.²⁸ Finally, Part V argues that borrowers and investors should have recourse against SPVs, as they are in a position to identify the quality and suitability of the securitized loans for investors, and further discusses potential remedies²⁹ and ways to improve extant remedies to combat predatory subprime lending.

I. PREDATORY LENDING DEFINED

“One of the key financial developments of the 1990s was the emergence and rapid growth of subprime mortgage lending.”³⁰ Access to credit through the subprime lending market is necessary and appropriate for those who cannot obtain credit through a prime loan but are still capable of making their mortgage payments in a timely manner.³¹ “Borrowers who present elevated risk levels can look to the subprime market for credit . . . and take advantage of” lenders looking to provide higher interest loans which can supply “mortgage capital and flexible, subprime loan products.”³² “However, these high-risk borrowers are charged interest and fees by subprime lenders that exceed the rate that traditional prime

http://www.policymattersohio.org/pdf/Home_Insecurity_2004.pdf (noting a doubling of foreclosure rates in Ohio between 1998 and 2003).

27. For more information, see generally *Turning a Blind Eye*, *supra* note 21.

28. *Id.* at 2042.

29. *A Tale of Three Markets*, *supra* note 18, at 1255. The authors argued for a Self Regulatory Organization (SRO), overseen by the federal government, to regulate the lending industry and securitization of loans as a way to deal with the predatory lending problem. This is one such remedy that may effectively combat this problem. *See id.* at 1259.

30. Edward M. Gramlich, Governor, Remarks at the Fin. Serv. Roundtable Annual Hous. Policy Meeting, 1 (May 21, 2004) (transcript available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm>).

31. Kevin M. Cuff, Op-Ed., *Subprime Lending Misconceptions*, THE BOSTON GLOBE, July 22, 2007, available at http://www.boston.com/news/globe/editorial_opinion/oped/articles/2007/07/22/subprime_lending_misconceptions/.

32. *A Tale of Three Markets*, *supra* note 18, at 1279.

borrowers pay.”³³ Subprime lenders provide an important service, but they are not all reputable and some can be destructive.

Predatory lenders are defined by their methods of lending and their target borrowers. “Predatory lenders rely on misrepresentation, threats, unfair pressure and borrower ignorance to engage in their deceptive lending practices.”³⁴ As one court³⁵ notes, predatory lending is a “mismatch between the needs and capacity of the borrower In essence, the loan does not fit the borrower, either because the borrower’s underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood the borrower has the capability to repay the loan.”³⁶ Predatory lenders often target vulnerable populations, resulting in devastating personal loss, including bankruptcy, poverty and foreclosure.³⁷ Subprime lenders who do not engage in predatory practices can be referred to as “legitimate subprime lenders.”³⁸ By contrast, “[p]redatory lenders penetrate communities and, like polluters, leave distressed properties and desperate people in their wake.”³⁹ As a result, there is growing concern that “it may not be in the best interest of borrowers or the neighborhoods in which they reside for such loans to be extended in the first place.”⁴⁰

Predatory lending is comprised of various abusive practices. These practices result in serious disproportionate net harm to borrowers. One example is “asset-based lending,”⁴¹ which entails making loans to borrowers

33. *Id.*

34. Eggert, *supra* note 1, at 507.

35. See generally *Assocs. Home Equity Servs. v. Troup*, 778 A.2d 529 (N.J. Super.2001) (allowing borrowers’ discrimination and unconscionability claims and defenses to proceed in a foreclosure action under the Consumer Fraud Act, the New Jersey Law Against Discrimination, the Fair Housing Act, and the Civil Rights Act).

36. *Id.* This case was brought to my attention by Daniel S. Ehrenberg, *If the Loan Don’t Fit, Don’t Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUS. & CMTY. DEV. L. 117, 119–20 (2001) (pointing out predatory lending is easier to discuss than it is to define).

37. See Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1304 (Summer, 2006) (describing Associates First Capital’s notorious predatory lending practices in 2000, including “high interest rates, upfront fees, balloon payments, and prepayment penalties, [as well as] aggressively selling single-premium credit insurance and ‘flipping’ or refinancing loans to generate additional fees without benefit to the borrower”). See also Nat’l Assn of Consumer Advoc., *supra* note 19.

38. *A Tale of Three Markets*, *supra* note 18, at 1279.

39. Engel, *supra* note 26, at 355.

40. Paul S. Calem et al., *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, 15 HOUS. POL’Y DEBATE 603, 604 (2004).

41. This has been defined as the “pattern or practice” of making high-cost mortgages to consumers based on the consumer’s collateral without regard to the borrower’s ability to repay (based upon the consumer’s current and expected income, current obligations and employment status). See HUD-TREASURY REPORT, *supra* note 17, at 78.

whom the lender knows cannot afford the monthly payments.”⁴² Another practice is harmful “rent-seeking,”⁴³ where the subprime lenders charge fees and interest rates that are exorbitant⁴⁴ compared to the risk that the borrowers present.⁴⁵ Many predatory loans may also involve illegal fraud or deception by brokers or lenders.⁴⁶ For example, brokers or lenders may procure inflated appraisals or make false promises to refinance loans down the road on better terms.⁴⁷ Other forms of non-transparency are harmful but do not amount to fraud, such as when lenders or brokers prevent borrowers from comparison shopping by withholding rate sheets.⁴⁸ A disproportionate number of lenders also engage in lending discrimination, by imposing more onerous terms on members of protected groups, resulting in further injustice.⁴⁹ Perhaps the most oppressive practice in the subprime lending market is requiring borrowers to waive meaningful legal redress in loan documents.⁵⁰ For example, subprime loans often contain mandatory arbitration clauses that require borrowers to take disputes to arbitration and

42. Freddie Mac, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families*, ch. 5 & nn.5–6 (1996), available at <http://www.freddiemac.com/corporate/reports/moseley/chap5.htm>.

43. Cisco Systems defines “rent-seeking” as “[w]hen a company, organization, or individual uses their resources to obtain economic gain from others without reciprocating any benefits back to society through wealth creation. See Cisco Systems Glossary, available at <http://investor.cisco.com/glossary.cfm?FirstLetter=r>. See also Paul M. Johnson, A Glossary of Political Economy Terms, http://www.auburn.edu/~johnspm/gloss/rent-seeking_behavior (last visited Oct. 27, 2008).

44. These fees are not directly reflected in interest rates, and because they can be financed, are easy to disguise or downplay by lenders. Moreover, while on competitive loans, fees below 1% of the loan amount are typical, predatory loans commonly have fees totaling more than 5% of the loan amount. See Nat'l Assn of Consumer Advoc., *supra* note 19.

45. This practice encompasses steering borrowers towards less favorable terms and charging prepayment penalties and points without a corresponding cut in the interest rate as is customary in the prime market. Howard Lax et. al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUS. POL'Y DEBATE 533, 535 (2004); Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUS. POL'Y DEBATE 503, 504 (2004). As noted above, the high interest rates and loan charge fees, and commensurate high returns are what make the securitized subprime loans attractive investments. Thus there is incentive for the parties involved in securitization to allow such an abusive practice to continue.

46. See generally Debra Pogrud Stark, *Unmasking the Predatory Loan in Sheep's Clothing: A Legislative Proposal*, 21 HARV. BLACKLETTER J. 129 (2005).

47. HUD-TREASURY REPORT, *supra* note 17, at 79–80.

48. Neither the Truth in Lending Act nor the Real Estate Settlement Procedures Act requires disclosure of rate sheets to borrowers. See *A Tale of Three Markets*, *supra* note 18, at 1255.

49. 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* at 4 (2006), available at http://www.responsiblelending.org/pdfs/r011-Unfair_Lending-0506.pdf (documenting numerous disparities, including that African-American borrowers with prepayment penalties on their subprime home loans were six to thirty-four percent more likely to receive a higher-rate loan than if they had been white borrowers with similar qualifications. Results varied depending on the type of interest rate (i.e., fixed or adjustable) and the purpose (refinance or purchase) of the loan).

50. See A. Brooke Overby, *Mortgage Foreclosure in Post-Katrina New Orleans*, 48 B.C. L. REV. 851, 872 (2007). See generally Patricia McCoy, *Elder Law; A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725 (2005).

preclude them from joining class actions, thus denying borrowers access to the courts.⁵¹

Unlike predatory loans, legitimate subprime loans do not display *any* of the markers of abuse listed above.⁵² Nevertheless, although “predatory loans are not necessarily subprime,” they are most prevalent in the subprime market.⁵³ Once these loans are securitized and sold in secondary financial markets, the dangers of predatory lending are magnified.⁵⁴

II. SECURITIZATION OF SUBPRIME HOME MORTGAGE LOANS

Securitization “is the process of converting packages of home loans into securities that are backed by collateral in the form of [those] loans.”⁵⁵ The two-tiered structure of securitization protects investors by preventing creditors of lenders from reaching the assets backing the securities if the lender went bankrupt.⁵⁶ This remoteness from bankruptcy in turn “boosts ratings of securitized offerings, [as] rating agencies evaluate and rate securitized loan pools.”⁵⁷ “SPVs protect investors from the risk of the lender’s bankruptcy, [and] often [make it] possible for [a] loan [pool] to earn a higher rating than the lender itself would receive” if rated on an individual basis. “In this way, ‘non-investment grade and unrated originators (the majority of the market) [are able to] create investment-grade transactions.’”⁵⁸

In a securitization, once the original lender has made loans to borrowers, “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).”⁵⁹ Securitizers structure the transaction to isolate the loan pool from the

51. *See Democratic Candidates on Mortgage Reform*, 27-1 AM. BANKR. INST. J. 10, 56 (Feb. 2008).

52. *A Tale of Three Markets*, *supra* note 18, at 1261.

53. *Id.*

54. *See generally* Arthur E. Wilmarth, Jr., *Point – Counterpoint: Federal Preemption: 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, 312–13 (2004) (stating that as of 2004, “the four most costly bank failures since 1997—resulting in total losses to the [Federal Deposit Insurance Corporation] (the ‘FDIC’) of \$ 1.7 billion involved institutions heavily engaged in subprime lending and securitization.”).

55. *A Tale of Three Markets*, *supra* note 18, at 1274.

56. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994).

57. *Turning a Blind Eye*, *supra* note 21, at 2046.

58. *Id.* (quoting Henry C. McCall III & Len Blum, *Evolution of the B&C Home-Equity Loan Securities Market*, in ASSET-BACKED SECURITIES 237 (Anand K. Bhattacharyi & Frank J. Fabozzi Eds., 1996)).

59. *Id.* at 2045.

original lender by selling the loan pool to a SPV⁶⁰ that passively holds the loans, and is owned by, but legally distinct from, the lender.⁶¹ “The SPV then resells the loan pool to a second SPV [typically in the form of a trust], which is also [legally] independent of the lender and takes title to the bundle.”⁶² Next, by adding credit enhancements to the loan pool, the SPV reduces the risks associated with loan payment defaults by borrowers.⁶³ “Internal” credit enhancements include recourse arrangements and senior-subordinated structures, and “external” credit enhancements include irrevocable letters of credit, or financial guaranty insurance from third parties with triple-A credit ratings.⁶⁴ “The SPV then creates and issues the mortgage-backed securities and sells the securities to investors.”⁶⁵ While in some cases, the seller of the loans retains the servicing rights (i.e., collects the loan payments) and distributes the proceeds to investors, in other cases, the SPV services the loans.⁶⁶

The 1980s saw an increase in both the variety of lenders and available capital.⁶⁷ Subprime securitization, first pioneered in the 1970s, allowed lenders to make more loans in low- and moderate-income (LMI) neighborhoods.⁶⁸ In the 1970s, Freddie Mac spearheaded the securitization of mortgages in an effort to increase the amount of available mortgage

60. These are “also referred to as a ‘bankruptcy-remote entity’ whose operations are limited to the acquisition and financing of specific assets.” They “serve as a counterparty for swaps and other credit sensitive derivative instruments.” See Investopedia, SPV, <http://www.investopedia.com/terms/s/spv.asp>.

61. See *Turning a Blind Eye*, *supra* note 21, at 2045; see also Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1552–53 (2004) (focusing on the “nonconforming” or “private label” market).

62. *Turning a Blind Eye*, *supra* note 21, at 2045.

63. *A Tale of Three Markets*, *supra* note 18, at 1274.

64. The SPV will typically raise the credit rating of the securities relative to the lender’s own rating, or relative to what would be assigned to the underlying collateral. The amount of credit enhancements required depends on several factors, including “rating agencies’ views of the historical performance of the assets, the degree of diversification across obligors, industries, etc. and the structure of the transaction.” See Stephen A. Lumpkin, *Fundamentals of Asset-Backed Securities Markets*, Second International Roundtable on Securities Markets in China, OECD Shanghai at 14–16 (June 6–7, 2002), available at <http://www.oecd.org/dataoecd/22/45/2756089.pdf>.

65. *A Tale of Three Markets*, *supra* note 18, at 1274.

66. *Id.* at 1288 (Some investors “are requiring that lenders retain the loan-servicing rights, in which case the lenders would have some interest in creditworthiness because servicing costs rise with the risk of default”); cf. Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUS. POL’Y DEBATE 603, 753–54 (discussing servicing abuses, and explaining that once loans are securitized, a servicer typically becomes responsible for collecting the loan payments and distributing the proceeds, and as a result, some servicers have employed abusive and illegal servicing practices, including charging unjustified fees, actively pushing borrowers into default, and employing exploitative collection methods).

67. *A Tale of Three Markets*, *supra* note 18, at 1273.

68. See *id.*; see also 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).

capital.⁶⁹ Widespread securitization of mortgages began in the 1980s,⁷⁰ and “by 1993, sixty percent of home-mortgage loans were securitized.”⁷¹ Through technological advances in the early 1990s, it became possible to estimate and price the risk of subprime home loan pools, paving the way for subprime securitizations.⁷² Prior to the subprime crisis, most subprime loans were securitized,⁷³ which led “to claims that securitization facilitates predatory lending”⁷⁴ and that the entities involved should actively police lenders.⁷⁵ Although securitization continues,⁷⁶ currently, there are two proposed accounting rule changes by the Financial Accounting Standards Board⁷⁷ (FASB) which some believe may wipe out the market for asset-backed securitization.⁷⁸ The first rule change, to Financial Accounting Standard 140 (FAS 140), proposes “elimination of qualified special-purpose entities, which provide a way for banks to keep securitized assets off their balance sheets.”⁷⁹ According to a TowerGroup report, forcing securitized assets onto the balance sheet could erode banks’ annual net earnings by more than \$60 billion and require billions of dollars in additional loan reserves and recapitalization.⁸⁰ Changes to FASB Interpretation No. 46 (FIN 46(R)), “would provide new, more stringent criteria for when banks are allowed to transfer ownership of securitized assets and liabilities.”⁸¹ Despite fears of a possible halt in securitization, others argue the proposed

69. *A Tale of Three Markets*, *supra* note 18, at 1273.

70. *Id.*

71. *Id.* at 1273 (quoting Leon T. Kendall); *see also* Leon T. Kendall, *Securitization: A New Era in American Finance*, in 172 A PRIMER ON SECURITIZATION 2, 2–3 (Leon T. Kendall & Michael J. Fishman eds., 1996).

72. *Turning a Blind Eye*, *supra* note 21, at 2045.

73. In 2005, total securitizations of subprime and home equity loans ballooned to an estimated \$525.7 billion. As of 2006, and prior to the credit crisis lenders securitized almost eighty percent of subprime mortgages. *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).

74. *Turning a Blind Eye*, *supra* note 21, at 2040. These claims are correct as will be explained later in this note. *See infra* Parts IV and V.

75. *Id.*

76. According to a survey by Asset Backed Alert, as of October 23, 2008, the year to date volume of asset-backed securities issued totaled \$696.4 billion versus \$917.2 billion in 2007. *See* Asset Backed Alert, Banker’s Glossary, <http://www.abalert.com/Public/MarketPlace/MarketStatistics/index.cfm>.

77. “Officially recognized as authoritative by the Securities and Exchange Commission,” the FASB services “the investing public through transparent information resulting from high-quality financial reporting standards.” “Since 1973, the FASB has been the designated organization in the private sector for establishing standards of financial accounting and reporting.” Financial Accounting Standards Board, Facts about FASB, <http://www.fasb.org/facts/index.shtml#mission>.

78. *See* Alan Rappeport, *Securitization’s Last Throes?*, CFO.com, (Oct. 24, 2008) *available at* http://www.cfo.com/article.cfm/12494397?f=most_read.

79. *Id.*

80. *See* Joseph Rosta, *Proposals Take Aim at Securitization*, U.S. Banker, (Oct. 2008) (quoting research director for bankcards at TowerGroup Dennis Moroney), *available at* http://www.americanbanker.com/usb_article.html?id=20081028105Q7710.

81. Rappeport, *supra* note 78. For a more detailed discussion, *see* Rosta, *supra* note 80.

rule change would have “little impact”⁸² or will not take effect until “after the financial sector is well on the mend.”⁸³ Nonetheless, entities involved in securitization profit from these practices, so they continue to resist addressing these problems and serve as major conduits for predatory loans.⁸⁴ As an excerpt from the now embattled⁸⁵ Merrill Lynch & Co. prospectus in 2004 illustrates, the entities involved in securitization rarely investigate the process of underwriting subprime loans before the crisis:

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.⁸⁶

Merrill Lynch’s admission exemplifies how Wall Street firms have been securitizing subprime home loans without determining if loan pools contain predatory loans. In the worst situations, secondary market actors have actively facilitated abusive lending.⁸⁷ In fact, as of 2002, Kathleen Engel and Patricia McCoy said “it is now routine for lenders to originate loans, and sell them to secondary-market institutions, which provide a steady stream of capital to lend.”⁸⁸ As a result, subprime securitization helped perpetuate the predatory lending cycle.

The process of spreading risk through “tranches” has further hidden the inherent risk in predatory lending. Once loans are transferred to the second

82. *Id.* (quoting former FASB member Ed Trott). James Mountain, a partner at Deloitte & Touche agreed. *See id.*

83. Rosta, *supra* note 80.

84. Predatory lending lawsuits continue to arise over these practices. *See, e.g.*, Stuckey v. Provident Bank, 912 So. 2d 859 (Miss. 2005); Bankers Trust Co. v. West, No. 20984, 2002 WL 31114844 (Ohio Ct. App. Sept. 25, 2002).

85. The troubled Merrill Lynch & Co. was bought by Bank of America in a \$50 billion all stock transaction. *See Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm*, (Sept. 15, 2008), http://newsroom.bankofamerica.com/index.php?s=press_releases&item=8255; *see also* Ellen Messmer, *Lehman failure, Bank of America/Merrill Lynch buyout shake Wall Street again*, NETWORK WORLD, (Sept. 15, 2008), <http://www.networkworld.com/news/2008/091508-wall-street-shakeup.html?fsrc=netflash-rss>.

86. Merrill Lynch & Co., Prospectus 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>.

87. *See* Austin v. Chisick, (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 659–65 (Bankr. C.D. Cal. 2003) (findings of fact). After allegedly learning of FAMCO’s fraud during due diligence, Lehman Brothers nevertheless gave “substantial assistance” through securitization to help finance FAMCO’s operations. This case was brought to my attention by Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2061 n.107 (2007).

88. *A Tale of Three Markets*, *supra* note 18, at 1274.

SPV, tranches of bonds are created by the investment bank for the issuer.⁸⁹ Rating agencies then measure the credit risk of each tranche by comparing historical data with the loan pools and forecasting the tranche's performance.⁹⁰ Sequential tranches are one way in which securitization protects investors (assignees) from credit risk, as investors benefit from conservative risk assessments by rating agencies⁹¹ and can avoid risk through investing in the more highly-rated tranches.⁹² However, if the suitability of these loans to the borrowers was taken into account, tranches would logically receive lower ratings when comprised of unsuitable loans to subprime borrowers.⁹³ The less suitable the loans, the less likely the borrowers are able to pay off the loans and thus, the more unlikely it is that investors in these bonds will get paid back.⁹⁴

By making possible a constant flow of money to the home mortgage market, securitization dramatically altered the once highly regulated business of mortgage lending. Prior to the current credit crisis, banks and other lenders no longer suffered from liquidity restraints and more funds became available to lend.⁹⁵ At the height of the subprime bubble, lenders no longer needed "to be large financial institutions with significant deposits and capitalization, and instead sparsely capitalized mortgage bankers and finance companies originated loans for sale on the secondary market."⁹⁶ As a result, the illegitimate subprime lenders successfully took advantage of borrowers through predatory lending. In addition, predatory lenders continue to avoid liability, and are not forced to obey proper lending practices because of continued failure of risk management in this industry.

89. *Turning a Blind Eye*, *supra* note 21, at 2046. The "issuer" is the SPV that issues securities.

90. However, rating agencies do not assess the suitability of the underlying loans for individual borrowers in calculating the credit risk. *See id.*

91. This is because the rating agencies work for the lenders, and are thereby incentivized to provide them with conservative risk assessments. *See* Ethan Penner, *Can the Financial Markets Make a Comeback?*, WALL ST. J., Aug. 27, 2007, at A11; *see also infra* Part VI.

92. Although not the focus of this comment, in their Fordham Law Review Article, Kathleen C. Engel & Patricia A. McCoy provide a clear, detailed explanation of how, through conservative risk assessments by rating agencies, senior tranches have had numerous upgrades in their ratings, yet only one downgrade between 2003 and 2005, despite rising subprime loan default rates. *See Turning a Blind Eye*, *supra* note 21, at 2055–56.

93. *Id.* at 2046–47.

94. Investor's likelihood of repayment is a major aspect of bond ratings. The "tranche system," the predominant structure of choice in subprime RMBS, is termed a "senior subordinate structure" and tranches are arrayed from the most senior (AAA tranche) to the most junior (BBB, BB, B and unrated tranche classes). A rating of BBB-/Baa3 or above is deemed investment-grade, a title that serves to calm investors' concerns about the credit quality of the mortgages backing the securities that they are investing in. The tranche system is paid off in a "waterfall" system, and the senior tranche is paid off before any other. Consequently, the junior tranche is the first to absorb any losses, making it appear doubtful the senior tranche will absorb credit losses. *See id.* at 2046–47.

95. Moreover, non-bank lenders have entered the home-mortgage market through the opportunities created by securitization. *A Tale of Three Markets*, *supra* note 18, at 1274.

96. *Id.*

III. WHY PREDATORY LENDING PERSISTS DESPITE RISK MANAGEMENT

In a 2007 article, Engel and McCoy identify numerous problems with attempts in risk management to protect investors from risk and curb continued predatory lending practices.⁹⁷ They examine how, despite attempts at creating lending-market discipline by the secondary market, predatory lending has persisted through diversification, the tranche system, lax disclosure and the excess demand for securitization.⁹⁸ The article discusses the need to exert discipline on subprime lenders and proposes forcing them to retain some of the risk associated with loan pools.⁹⁹ It focuses on how, although risk management measures are designed to incentivize lenders to make proper loans and cut default risk, none of these measures, singly or together, have curbed abusive lending.¹⁰⁰

A. THE EVIL ALLIANCE

The first problem identified by Engel and McCoy is the conflict of interest created when lenders work for the SPVs, or, as they call it, the “unholy alliance of marginal lenders and loan aggregators.”¹⁰¹ It has increasingly become the practice for subprime lenders to sell whole loans to outside loan aggregators, generally affiliates or subsidiaries wholly-owned by Wall Street investment banks,¹⁰² who bundle and securitize them. Because subprime aggregation offered advantages to both the investment banks and lenders, it increasingly became popular, “accounting for 42% of the subprime securitizations in 2002.”¹⁰³ It furthered investment banks’ underwriting business and helped them assemble diversified loan pools.¹⁰⁴ The advantage of a diversified loan pool is that the bad loans with low ratings are aggregated with the better higher rated loans, and thus the overall pool receives a high enough rating to be securitized and sold to investors.¹⁰⁵ The advantage of aggregation is particularly strong for small or poorly capitalized lenders, as aggregation permits them to sell loan pools for securitization “that would otherwise be too small to provide

97. *Turning a Blind Eye*, *supra* note 21, at 2063.

98. *Id.* at 2064–65.

99. *Id.* at 2064.

100. *See id.*; *see also* Quercia, *supra* note 25, at 4–5.

101. *Turning a Blind Eye*, *supra* note 21, at 2065. “Loan aggregators” refers to SPVs who securitize the loans and sell them to investors on the secondary market.

102. At the height of the securitization market, major players included Credit Suisse First Boston, Morgan Stanley, Lehman Brothers, Bear, Stearns & Co., Merrill Lynch, Greenwich Capital, UBS, Bank of America, and Deutsche Bank Securities. *See* Bill Shepherd, *Perils and Phantasm: The Mortgage Securitization Boom is Threatened by Recession, Legislation and Rate Change*, Investment Dealers Dig., Feb. 3, 2003 available at <http://www.adco.com/announcements/IDD.pdf>; *see also* *Turning a Blind Eye*, *supra* note 21, at 2065.

103. *See* *Turning a Blind Eye*, *supra* note 21, at 2065 n.122.

104. *Id.* at 2065.

105. *See generally id.*

diversification.”¹⁰⁶ Thus, aggregation allows investment banks to enjoy subprime profits with reduced legal risk through diversification. Consequently, “Wall Street prizes aggregation” and “[b]ecause they have minimal exposure to suits, aggregators have reduced incentives to guard against abusive practices” by lenders.¹⁰⁷

B. THROWING OUT THE TRASH

The second issue the article discusses is that lenders do not always retain an interest in the subordinated tranches that they have helped create, so they are disinterested in the quality of the loans in those tranches.¹⁰⁸ Through an affiliate, lenders often buy securities in the lowest-rated tranches, and in conjunction provide those tranches with credit enhancements.¹⁰⁹ Although it appears that the lender retains the riskiest securities, this is not necessarily the case because lenders typically sell to outside investors (principally real estate investment trusts, hedge funds and overseas investors) who want to buy many of these so-called “residuals,”¹¹⁰ either at the time of offering, or through later secondary market resales.¹¹¹ Moreover, lenders can sell their subprime residuals to outside investors “through bonds known as Collateralized Debt Obligations (CDOs),” which essentially securitize residuals from RMBS and other assets.¹¹² Because

106. More importantly, “aggregation enables marginal lenders to obtain financing despite obscure or questionable reputations by ‘renting’ the aggregator’s reputation for quality securities.” *See id.*

107. *Id.*

108. *Id.*

109. *Id.* These credit enhancements are “usually in the form of an insurance policy or a letter of credit from a financial institution that backs some or all of the securities issued in the transaction (e.g., total value of the asset pool or securities issue, or possibly a governmental guarantee on mortgage loans).” *See* Angela Petrucci, Note, *Accounting for Asset Securitization in a Full Disclosure World*, 30 J. LEGIS. 327, 331 (2004).

110. The residuals are the lowest rated tranches that “receive the excess cash flow that remains after all of the payments due to the holders of other tranches and all of the administrative expenses have been met,” and are the BB- and B- subprime tranches. *See* American Banker, Banker’s Glossary, available at <http://www.americanbanker.com/glossary.html?alpha=R> (last visited Oct. 30, 2008). These are attractive investments for those who have a greater appetite for risk, because the potential payoff far exceeds those of the senior, more highly rated tranches.

111. *See Turning a Blind Eye*, *supra* note 21, at 2065; *see also* Ruth Simon et al., *Housing-Bubble Talk Doesn’t Scare Off Foreigners*, WALL ST. J., Aug. 24, 2005, at A1.

112. “Significantly, U.S. subprime RMBS have comprised the single ‘largest collateral asset class in [CDOs] since the inception of the product in 1999.’” Although the central purpose of residuals is to force lenders to retain the bulk of the credit risk they create, when lenders with subprime residuals are permitted to transfer them off their books through CDOs, “they are able to escape the market discipline that residuals were meant to exert.” *See Turning a Blind Eye*, *supra* note 21, at 2066.

For example, if a bank issuing mortgage backed securities had \$1 billion in mortgages, and they created a CDO for the \$1 billion with \$300 million for the residual tranche, \$300 million for the junior tranche and \$400 million for the senior tranche it would be cut up as follows: the bank would sell 400,000 shares at \$1,000 per share and 6% interest to the senior tranche, which would amount to a \$24 million per year interest payment for the senior tranche. If to the junior tranche

predatory lenders can dispose of these residuals (the riskiest tranche classes), the incentive for these lenders to avoid making predatory loans is removed.¹¹³ “As one CDO manager put it, CDOs create ‘an awful lot of moral hazard in the [subprime RMBS] sector.’”¹¹⁴ Thus, this attempt at risk management in lending is subverted as predatory lenders are able to sell the residuals and their accompanying risk on the secondary market.

C. THE NOT SO DILIGENT

Engel and McCoy next address how the due diligence required by current state and federal law is often cursory and is consequently ineffective.¹¹⁵ Because of inherent conflicts of interest, the best practices adopted by Fannie Mae and Freddie Mac have not been adopted in the subprime secondary market voluntarily, and will not screen out predatory loans from loan pools unless compelled by changes in regulation.¹¹⁶ Despite recent court reactions such as *In Re First Alliance Mortgage Co.*,¹¹⁷ and state assignee liability laws, “industry and government observers agree that subprime due diligence is uneven and in need of improvement.”¹¹⁸ This is true for both 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.¹¹⁹ In fact, the high demand for Rule 144A offerings has forced institutional investors to make snap judgments whether to invest, without time for any substantive due diligence.¹²⁰ Most simply rely on the efforts of lenders, underwriters, and rating agencies, “even though none of these entities has the same level

they sold 300,000 shares at \$1,000 per share and 7% interest which would amount to a \$21 million per year interest payment. Everything else would go to the residual, which here would be 300,000 shares at \$1000 and 18.3% interest which equates to a \$55 million per year interest payment. Thus, although the residual has the potential to be paid the most per year, they have to wait to be paid until all the more senior tranches have been paid first, which if there are significant defaults. This hypothetical was addressed by Professor Minor Myers, B.A., J.D., of Brooklyn Law School.

113. *Turning a Blind Eye*, *supra* note 21, at 2066.

114. Allison Pyburn, *CDO Investors Debate Morality of Spread Environment*, Asset Securitization Rep., May 9, 2005, <http://www.asreport.com> (on file with author).

115. *See generally Turning a Blind Eye*, *supra* note 21.

116. *Id.*

117. *Austin v. Chisick*, (*In re First Alliance Mortgage Co.*), 298 B.R. 652, 659–65 (Bankr. C.D. Cal. 2003).

118. *See Turning a Blind Eye*, *supra* note 21, at 2068.

119. “Rule 144A provides an exemption and permits the public resale of restricted or control securities if a number of conditions are met, including how long the securities are held, the way in which they are sold, and the amount that can be sold at any one time. But even if you’ve met the conditions of the rule, you can’t sell your restricted securities to the public until you’ve gotten a transfer agent to remove the legend.” Securities Act Rule 144, U.S. Securities and Exchange Commission Homepage, <http://www.sec.gov/asnwrs/rule144.htm> (Oct. 6, 2003). Rule 144A private placements, thus allow predatory subprime loans to get past SEC regulation, if they qualify for the exemption, which can easily be accomplished by the sophisticated parties involved in these transactions. *See Turning a Blind Eye*, *supra* note 21, at 2068.

120. *Turning a Blind Eye*, *supra* note 21, at 2068.

of interest in avoiding credit losses as the investors themselves.”¹²¹ As a result of this reliance, due diligence in the private-label subprime market often sets a very low bar and rarely succeeds in screening out predatory loan terms or practices.

As of 2007, underwriters, rating agencies, and lenders conducted most subprime due diligence, *not* investors, and typically, due diligence was limited to determining “lender compliance with state and federal consumer protections laws.”¹²² “For example, automated compliance systems tailor their screening tools to the legal requirements of each jurisdiction.”¹²³ Only screening for legal compliance has been required for rating agencies, and they have not been required to follow the industry’s “best practices.”¹²⁴ For example, the principal federal anti-predatory lending law, the Home Ownership and Equity Protection Act (HOEPA),¹²⁵ has strong proscriptions against predatory lending, but at best covers the costliest five percent of subprime home loans.¹²⁶ Many states are in need of resilient anti-predatory lending laws, and as legal protections against abusive subprime loans are also weak at the federal level, this lack of meaningful due diligence allows securitized loan pools to include predatory loans without meaningful consequences.¹²⁷

Even where due diligence is required, it is not uncommon for some lenders to say they performed loan-level review when they did not.¹²⁸ In the

121. Only those that are “observationally illegal,” are attempted to be screened out. *Id.*

122. *Id.*

123. See *Turning a Blind Eye*, *supra* note 21, at 2068; see also ComplianceEase, ComplianceAnalyzer, <http://www.Complianceease.com>.

124. This is problematic, as there are large existing gaps in governing law, and therefore numerous lending abuses remain legal under state and federal law. Although not the focus of this comment, legislators continue to debate the proper path to take in order to close the gaps that exist in current state and federal laws. See *Turning a Blind Eye*, *supra* note 21, at 2068–69.

125. 15 U.S.C. §§ 1601-1667 (2000). This act amended the Truth in Lending Act (TILA) and established requirements for certain loans with high rates and/or high fees, setting out disclosure requirements, prohibited features, and actions that one may take against a lender who is violating the law. See Federal Trade Commission Homepage, *Facts for Consumers: High-Rate, High-Fee Loans (HOEPA/Section 32 Mortgages)*, (Jan. 2007), <http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea19.shtm>.

126. See, e.g., Truth in Lending, 66 Fed. Reg. 65604, 65608 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226); but 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, 152 (arguing that, although it has limits, HOEPA can be a “powerful vehicle for regulating the home equity lending market and for challenging abusive lending practices through the courts.”).

127. See *Turning a Blind Eye*, *supra* note 21, at 2069.

128. “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.’ Moreover, as one subprime lender explained to the press, “[w]e’re not structured to do 100 percent due diligence [on certain subprime pools], even though Wall Street investment banks might want that.” See *id.*

conforming market,¹²⁹ both government-sponsored-entities (GSEs) (i.e. Fannie Mae and Freddie Mac) require substantive screening of subprime loans.¹³⁰ They “have best practices standards for residential mortgages to borrowers with blemished credit that are stricter in some respects than the laws in many jurisdictions.”¹³¹ Yet, as of September 7, 2008, “the government seized Fannie and Freddie which together own or guarantee half the nation’s mortgages, after months of uncertainty about their future.”¹³² Federal Housing Finance Agency (FHFA) Director James B. Lockhart explained “after exhaustive review [of Fannie and Freddie] I have determined that the companies cannot continue to operate safely and soundly and fulfill their critical public mission, without significant action to address our concerns” and placed the GSEs in a conservatorship.¹³³ While their fate remains undetermined, Federal Reserve Chairman Ben Bernanke recently suggested “[h]aving Fannie and Freddie compete as private firms—perhaps after breaking them into smaller units” as a way to “eliminate the conflict between private shareholders and public policy, diminish risks to the overall economy and financial system and allow them to be more innovative by operating with less political interference.”¹³⁴

Until the recent financial crisis, outside of the conforming market, “lenders, issuers, and/or major investors [were] free to adopt internal

129. The conforming market refers to “[a] mortgage that is equal to or less than the dollar amount established by the conforming loan limit set by Fannie Mae and Freddie Mac’s Federal regulator, the Office of Federal Housing Enterprise Oversight (“OFHEO”) and meets the funding criteria of Freddie Mac and Fannie Mae.” See Investopedia, Conforming Loan, <http://www.investopedia.com/terms/c/conformingloan.asp>.

130. See Benjamin J. Keys, et al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans*, 1, 4 World Bank, (April 2008) (discussing the fact that the underwriting guidelines established by Fannie Mae and Freddie Mac cautioned against lending to borrowers with FICO scores below 620 because such a score is a “strong indication that the borrower’s credit is not acceptable.”), available at <http://siteresources.worldbank.org/INTFR/Resources/VigSecuritize0808.pdf>.

131. 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’s stance against predatory lending practices (Dec. 28, 2000), available at <http://www.freddiemac.com/sell/guide/bulletins/pdf/1228indltr.pdf>.

132. Sudeep Reddy, *Bernanke Says the U.S. Needs to Maintain a Role in Mortgage Securities*, WALL ST. J. Nov. 1, 2008, at A2, available at http://online.wsj.com/article/SB122547596549288517.html?mod=googlenews_wsj.

133. James B. Lockhart, FHFA Director, Statement of FHFA Director James B. Lockhart, 1, 5 (Sept. 7, 2008) (transcript available at http://www.ustreas.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf).

134. See Reddy, *supra* note 132. Bernanke further stated that “whether the GSE model is viable without at least implicit government support is an open question.” See *id.* For a more detailed discussion of Bernanke’s blueprint for handling the mortgage-securitization crisis, see *id.*

standards of their own.”¹³⁵ Nevertheless, in general, “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” to attain proper standards.¹³⁶ For the majority of market participants, industry self-policing is virtually nonexistent, and as a result, in the nonconforming market for subprime RMBS, lenders and underwriters “rarely screen out loans that are not [expressly] prohibited by law, *even if those loans violate industry standards or inflict significant harm on borrowers.*”¹³⁷ Moreover, underwriters are “under constant pressure to relax their due diligence, for fear that lenders will move their underwriting business to other underwriting firms,” with more lax standards of due diligence.¹³⁸ In sum, because of these inherent conflicts of interest, the best practices have not been voluntarily adopted in the subprime secondary market and will not screen out predatory loans from loan pools unless compelled by changes in regulation.

Investors, looking to screen out predatory loans, tend to rely on due diligence by rating agencies, underwriters and lenders.¹³⁹ While institutional investors will generally review the disclosures, ratings, structure, and credit enhancements if presented with advance opportunity, if they are not, institutional investors tend to be passive, especially regarding predatory lending concerns.¹⁴⁰ The futility of such reliance is shown by at least one study examining securitized subprime mortgage loan contracts, which suggests that “securitization adversely affects the screening incentives of lenders.”¹⁴¹

D. THE DANGERS OF DEMAND

Lastly, Engel and McCoy identify excess demand for subprime securitizations as the final reason why investors do not screen subprime RMBS for predatory practices.¹⁴² “In 2004, for instance, Standard & Poor’s

135. *Turning a Blind Eye*, *supra* note 21, at 2070; *see generally* *Securitization Post-Enron*, *supra* note 61, for a discussion of the differences between the conforming and nonconforming markets.

136. *See* *Turning a Blind Eye*, *supra* note 21, at 2070.

137. *Id.* (emphasis added).

138. *Id.*; *see also* Penner, *supra* note 91, at A11.

139. *Turning a Blind Eye*, *supra* note 21, at 2070.

140. Moreover, “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.” However, it is this after-the-fact monitoring that may be the only way to detect certain types of loan fraud and predatory servicing. Further, numerous subprime securitizations are floated on a to-be-announced (TBA) basis, and investors cannot exercise due diligence even when they want to. This is because in TBA offerings loans have not yet been pooled, and although investors can reserve the right to review the eventual loan pool chosen by the lender post-closing, this is risky because the investor has lost leverage once they have parted with their funds. *See id.* at 2071.

141. *See* Keys, et al., *supra* note 130, at 2.

142. *Turning a Blind Eye*, *supra* note 21, at 2075.

(S&P)¹⁴³ observed that ‘the market for subprime mortgage securities [experienced] significantly more demand than availability for many issuances.’¹⁴⁴ The liquidity of Rule 144A private placements makes them in short supply.¹⁴⁵ As a result of the demand for bonds in subprime securitization exceeding the supply, ‘investors are willing to purchase bonds without engaging in thorough due diligence.’¹⁴⁶

Consequently, the risk management techniques used by loan securitizers do not trickle down to deter lending abuses. Until the recent financial crisis, it was believed investors were protected so well by structured finance that S&P routinely assured investors that subprime RMBS ‘[would] continue to perform in accordance with expectations, given the advances in loan level modeling, structural safeguards, and improvement in loss mitigation techniques.’¹⁴⁷ It is clear now that such assurances were unwarranted, as ‘the world’s two largest bond-analysis providers,’ S&P and Moody’s Corp,¹⁴⁸ were engaging in a ‘race to the bottom,’ and ‘repeatedly eased their standards as they pursued profits from structured investment pools sold by their clients, according to company documents, e-mails and interviews with more than 50 Wall Street professionals.’¹⁴⁹

These lending abuses have led to significant harms. When lenders make loans that borrowers cannot afford to repay, borrowers must either reduce spending on necessities such as health insurance, medical bills, day care and critical home repairs, or lose their homes to foreclosure. ‘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.’¹⁵⁰ The total cost to homeowners and cities is in the billions of

143. Standard and Poor’s is ‘the world’s foremost provider of independent credit ratings, indices, risk evaluation, investment research and data.’ Standard & Poor’s, <http://www.standardandpoors.com> (last visited Nov. 1, 2008).

144. *Turning a Blind Eye*, *supra* note 21, at 2075 (quoting S&P, Trends in U.S. Residential Mortgage Products: Subprime Sector, Fourth-Quarter 2004, at 3 (Apr. 12, 2005)).

145. Additionally, there is demand for subprime RMBS of all types, driven by portfolio regulation of institutional investors such as banks and insurance companies, and many institutional investors have legal limits on the types of investments they can buy for their own account. Because of these limits, high yields make subprime RMBS attractive, particularly ‘when other legal investments are in the doldrums.’ *Turning a Blind Eye*, *supra* note 21, at 2075.

146. *Id.*

147. *Id.* at 2076 (quoting S&P, Trends in U.S. Residential Mortgage Products: Subprime Sector, Fourth-Quarter 2004, at 3 (Apr. 12, 2005)).

148. ‘Moody’s Investors Service is among the world’s most respected and widely utilized sources for credit ratings, research and risk analysis.’ Moody’s Investor Service, *Introduction to Moody’s*, http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=intro&redir_url=/cust/AboutMoodys/staticRedirect.asp (last visited Nov. 1, 2008).

149. Elliot Blair Smith, ‘Race to Bottom’ at Moody’s, *S&P Secured Subprime’s Boom, Bust*, BLOOMBERG, Sept. 25, 2008, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=ax3vfya_Vtdo (last visited Oct. 10, 2008).

150. Engel, *supra* note 26, at 355–60.

dollars.¹⁵¹ Thus, while investors receive some protections, these come at the expense of borrowers and cities.

IV. A MENU OF INADEQUATE REMEDIES

Although the states and federal government are working towards establishing standards and regulations to redress predatory lending, as the law stands today, the remedies that exist are inadequate. “Instead, victims of predatory lending currently must rely on a loose assortment of statutes and common-law rules that were not designed to address the devastating harm [to cities, borrowers and even investors] inflicted by predatory lenders.”¹⁵² Remedies are rooted in traditional liberal notions of “informed consent and free will,” and “consistent with that liberal ideology, under current remedies, predatory-lending contracts are generally enforceable except where fraud or nondisclosure has operated in some way that is inimical to free will.”¹⁵³ However, “[b]arring this sort of culpable [process-oriented] misrepresentation [by the securitizer or lenders], . . . the law normally does not question the substance of predatory-loan terms.”¹⁵⁴

A. THE FAILURE OF TRADITIONAL CONTRACT LAW REMEDIES

Remedies under contract law and the Uniform Commercial Code (UCC) are inadequate. “Most contract defenses go to defects in formation of assent, rather than to disparities in bargaining power or fairness in contracts’ substantive provisions.”¹⁵⁵ Although the three doctrines of unconscionability, impracticability, and frustration under the law of contracts and the UCC permit challenges to the underlying substance of contract provisions,¹⁵⁶ the latter two “generally do not apply to predatory-lending cases.”¹⁵⁷ Moreover, the doctrine of unconscionability’s value in practice is nominal at best.

“If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract.”¹⁵⁸ Further, a court “may enforce the remainder of the contract without the unconscionable clause, or . . . limit the

151. See Quercia, *supra* note 25, at 5, 27; Eric Stein, *Quantifying the Economic Cost of Predatory Lending* (2001) (estimating losses from predatory lending at \$9.1 billion annually) available at <http://www.selegal.org/Cost%20of%20Predatory%20Lending.pdf>.

152. *A Tale of Three Markets*, *supra* note 18, at 1298.

153. *Id.*

154. *Id.*

155. *Id.* at 1299.

156. See *id.*; see generally Robert A. Hillman, *An Analysis of the Cessation of Contractual Relations*, 68 CORNELL L. REV. 617 (1982) (discussing the viability of different justifications for a party seeking a cessation of contractual relations).

157. *A Tale of Three Markets*, *supra* note 18, at 1299.

158. *Id.* at 1300.

application of [the] clause to avoid any unconscionable result.”¹⁵⁹ As applied to home loans, this attempts to account for the complexity of loan terms by voiding certain predatory terms. In addition, rules exist when parties who purchased loans on the secondary market sue delinquent borrowers.¹⁶⁰ “In those cases, the borrowers’ ability to raise defenses is severely limited by the holder-in-due-course doctrine,”¹⁶¹ which defines a holder in due course as the holder of an instrument if:

- (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
- (2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in § 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in § 3-305(a).¹⁶²

This allows a secondary-market purchaser to defeat all “personal” defenses to the loan agreement, including unconscionability, if it meets the requirements of a holder in due course.¹⁶³

Finally, unconscionability claims and defenses are extremely expensive to litigate, dampening incentives to bring those claims, and a lender may be able to defeat the claim by adducing proof that the high price of the loan is justified by risk-based pricing, where prices rise in response to the added risk presented by the borrower.¹⁶⁴ As a result, these limitations make it exceedingly difficult for borrowers to challenge predatory-loan agreements as void under traditional contract law or the UCC.

159. *Id.* Unconscionability has been defined to include “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.” *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965). For a number of reasons, many courts have been reluctant to condemn excessive prices as unconscionable, without more. *See id.*

160. *A Tale of Three Markets*, *supra* note 18, at 1300.

161. This doctrine is contained in U.C.C. § 3-302 (2005).

162. *Id.*

163. *A Tale of Three Markets*, *supra* note 18, at 1300.

164. *See* Creola Johnson, *Welfare Reform and Asset Accumulation: First We Need a Bed and a Car*, 2000 WIS. L. REV. 1221, 1256 (2000) (“[D]isgruntled consumers are not likely to succeed in litigation on grounds of unconscionability”); Arthur Allen Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349, 354–57 (1970).

B. ANTIQUATED AND INEFFECTIVE

Antifraud laws are designed to redress information asymmetries in the formation of contracts.¹⁶⁵ However, their extensive proof requirements and limited scope make them antiquated and ineffective. “Common-law fraud requires proof of affirmative misrepresentation and does not encompass misleading omissions or manipulation,” in addition to requiring “proof of detrimental reliance by the borrower,”¹⁶⁶ which victims of predatory lending must show for the protection of these laws. Thus the “limited scope of common-law fraud, coupled with pragmatic concerns, has constrained the number of criminal fraud prosecutions against predatory lenders and brokers.”¹⁶⁷ Moreover, “[e]ffective criminal fraud prosecution depends on the willingness of district attorneys to prosecute predatory-lending fraud,” and “limited local expertise, constrained resources, and other pressing prosecutorial demands—such as violent crime and drug trafficking—combine to militate against prosecuting predatory lenders.”¹⁶⁸

Although private causes of action for common-law fraud are an alternative route for victims of predatory lending, “fraud” is narrowly defined in common law, making it difficult to pursue such an action.¹⁶⁹ Moreover, common-law fraud actions may not afford victims full relief in the form of loan forgiveness.¹⁷⁰ This, coupled with the high cost of attorneys’ fees, makes incentives to file suits for equitable relief (such as rescission or loan forgiveness) inadequate for private action, as these cases generally do not generate sufficient funds to compensate plaintiffs’ counsel.¹⁷¹ Furthermore, the need to prove individual reliance in fraud cases often makes it difficult to bring class actions, so potential plaintiffs have difficulty working together to protect their rights.¹⁷² In addition, “mandatory-arbitration clauses in many predatory loan-agreements preclude resort to court altogether.”¹⁷³ These problems have not been solved despite federal and state attempts at protective legislation.

As a response to the limitations of common-law fraud, the unfair and deceptive acts and practices legislation (UDAP) has been passed in all fifty

165. *A Tale of Three Markets*, *supra* note 18, at 1301.

166. *Id.* See also, e.g., RESTATEMENT (SECOND) OF TORTS §§ 525, 537–45 (1977).

167. *A Tale of Three Markets*, *supra* note 18, at 1302.

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. These difficulties are both practical and legal. From a practical standpoint, in a very large class with plaintiffs from all over the country, it is difficult to show individual detrimental reliance for each borrower, as one would have to go above and beyond the normal requirements in certifying a class for such an action and actually handle each class member’s case on an almost individual basis to show such reliance. From a legal standpoint, this could cause a case to last such a long time as to threaten the judicial economy that class actions are meant to serve. See *id.*

173. *Id.* at 1302–03.

states, the District of Columbia, and in Congress.¹⁷⁴ Although the federal statute, which prohibits unfair or deceptive acts or practices in or affecting trade or commerce,¹⁷⁵ grants enforcement to the Federal Trade Commission¹⁷⁶ (FTC), it does not provide a private right of action (either express or implied).¹⁷⁷ Moreover, while state UDAP statutes usually allow for private damage actions as well as state enforcement, they are sometimes restricted in their scope.¹⁷⁸

C. STATUTORY FAILURE

While several federal statutes mandate the disclosure of standardized price information on loans in consumer lending,¹⁷⁹ these statutes all have major weaknesses. Although more recently states have responded to the problem of evading HOEPA by adopting measures that lower the coverage triggers for lenders in those states,¹⁸⁰ this increased disclosure is not enough because lenders will always find ways to evade disclosure requirements. Furthermore, the majority of victims of predatory lending already find

174. See generally National Consumer Law Center, *Unfair and Deceptive Acts and Practices* 1.1. (4th ed. 1997 & Supp. 2000) [hereinafter UNFAIR AND DECEPTIVE ACTS AND PRACTICES].

175. See Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(2) (2000).

176. While the FTC has filed a number of recent enforcement actions challenging actions by predatory lenders as unfair and deceptive under Section 5 of the Federal Trade Commission Act, with some resulting in monetary relief to borrowers, the absence of a private cause of action, shifting political winds, and constraints on the FTC's enforcement resources "make private relief under the Federal Trade Commission Act highly unlikely for the vast majority of victimized borrowers." *A Tale of Three Markets*, *supra* note 18, at 1304.

177. See UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 174, at 9.1; *A Tale of Three Markets*, *supra* note 18, at 1304.

178. For example, some state statutes exclude credit and insurance transactions, often because financial institutions are exempted or because credit and insurance are deemed not to be "goods and services." This essentially would exempt the lenders and SPVs who are involved in these transactions from liability under such a statute. Moreover, weak attorneys' fees provisions in some state UDAP statutes discourage the private bar from bringing state UDAP claims, leaving plaintiffs with little recourse, even in instances of fraud. See *A Tale of Three Markets*, *supra* note 18, at 1304; UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 174, at 8.1.

179. For example, TILA requires lenders to disclose finance charges and annual percentage rates to applicants for home mortgages, and the Real Estate Settlement Procedures Act (RESPA) entitles home-mortgage borrowers to good-faith estimates of settlement costs (GFEs) and statements of their actual closing costs in HUD-1 settlement statements. See *A Tale of Three Markets*, *supra* note 18, at 1304; 15 U.S.C. 1601-1693(c) (2000) (TILA); see also 12 U.S.C. 2601-2617 (2000) (RESPA).

180. Enacted in 1999, North Carolina's predatory-lending statute was the first. It retained the federal trigger for APRs of ten percent, but lowered the trigger for total points and fees to five percent for total loan amounts greater than or equal to \$ 20,000, or the lesser of \$ 1000 or eight percent of principal for smaller loans. The statute is also broader than HOEPA in that it covers home mortgages with prepayment penalties that either exceed two percent of the amount prepaid or are payable more than thirty months after closing. In 2000, the New York Banking Board amended part 41 of its regulations to lower the APR trigger from ten to eight percent and the trigger for total points and fees from eight to five percent. See *A Tale of Three Markets*, *supra* note 18, at 1304; N.C. Gen. Stat. 24-1.1E(a)(4), (a)(6) (1999); N.Y. Comp. Codes R. & Regs. Tit. 3, 41.1(d)-(3) (2000).

current disclosures incomprehensible, and piling on more disclosures will not help.¹⁸¹

Federal statutes have not succeeded in filling in the gaps left by state law. For high-cost, closed-end mortgages (other than purchase money-mortgages), HOEPA requires additional disclosures three days before closing.¹⁸² Although violations of the Truth in Lending Act (TILA), the Real Estate Settlement Procedures Act (RESPA), and HOEPA are subject to agency enforcement, violators of TILA and HOEPA are also subject to criminal penalties.¹⁸³ “In addition, TILA,¹⁸⁴ RESPA,¹⁸⁵ and HOEPA¹⁸⁶ authorize private rights of action, but differ significantly in the types of relief they afford borrowers.”¹⁸⁷ These statutes do not succeed in the activities they seek to prohibit and the relief they provide.¹⁸⁸ For example, TILA “has not lived up to its goal of standardizing disclosures on the total cost of credit because a long list of closing costs are currently excluded

181. *A Tale of Three Markets*, *supra* note 18, at 1309.

182. Under HOEPA’s advance disclosure provisions, the lender must inform the borrower of the annual percentage rate (“APR”), which is the effective interest rate the borrower will pay on a loan, the dollar amount of the periodic payments, the size of any balloon payments, the amount borrowed, and any charges for optional credit insurance or debt-cancellation coverage. HOEPA lenders must also advise borrowers in writing that they may lose their homes and are not obligated to proceed to closing simply because they signed a loan application or received disclosures. Lastly, for adjustable-rate mortgages that fall within HOEPA, lenders must disclose that the interest rate and monthly payment could increase, plus the amount of the single maximum monthly payment. *See A Tale of Three Markets*, *supra* note 18, at 1305; 15 U.S.C. 1601, 1602(aa), 1639(a)-(b) (2000) (TILA).

183. “Lenders who willfully and knowingly violate any requirement of TILA or HOEPA, for example, face a maximum fine of \$ 5000 and imprisonment for up to one year.” *A Tale of Three Markets*, *supra* note 18, at 1305 n.212; *see also* 15 U.S.C. 1611 (2000) (TILA).

184. “Under TILA, injured borrowers may seek actual damages, statutory damages, and attorneys’ fees, either individually or in class actions, and may stave off foreclosure for up to three years after closing under TILA’s provisions, where specified disclosures were not correctly made at closing.” *A Tale of Three Markets*, *supra* note 18, at 1306; *see generally* NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING ch. 8 (4th ed. 1999) [hereinafter TRUTH IN LENDING].

185. “Under RESPA, private damages for erroneous disclosures generally cannot be awarded unless borrowers can prove that lenders: (1) failed to inform them that their loans could be transferred, (2) received kickbacks, or (3) steered them to title companies. Specifically lenders have no liability under RESPA for errors in GFEs or HUD-1 settlement statements, thereby weakening their incentives for accuracy.” *See A Tale of Three Markets*, *supra* note 18, at 1306; 12 U.S.C. 2605(f)-2608 (2000) (RESPA).

186. “HOEPA’s private remedies include all of the remedies that are available under TILA, plus special enhanced damages consisting of all finance charges and fees paid by the borrower and expanded rights of rescission.” *A Tale of Three Markets*, *supra* note 18, at 1306; *see also* 15 U.S.C. 1640(a)(4) (2000) (TILA); *see generally* TRUTH IN LENDING, *supra* note 184, at 10.3.3, 10.6.

187. *A Tale of Three Markets*, *supra* note 18, at 1306–07.

188. HUD and the Federal Reserve Board raised concerns about the efficacy of these statutes in a joint report to Congress. *See* DEP’T OF HOUS. & URBAN DEV. & FED. RES. BOARD, JOINT REPORT TO CONGRESS, TRUTH IN LENDING ACT AND THE REAL ESTATE PROCEDURES ACT, EXECUTIVE SUMMARY II (1998), *available at* <http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf>.

when computing financial charges and annual percentage rates.”¹⁸⁹ In addition, although HOEPA has made improvements, it is easy to evade because of its narrow coverage, and it does not apply to purchase-money mortgages, reverse mortgages, or open-end credit lines of any kind.¹⁹⁰ More importantly, HOEPA only applies if (1) the annual percentage rate at consummation exceeds the yield on Treasury securities of comparable maturity plus eight percent for first-lien loans (or ten percent for subordinate-lien loans); or (2) the total points and fees exceed eight percent of the total loan amount or \$400 (subject to annual indexing), whichever is greater.¹⁹¹ As a result, to evade HOEPA, a lender can either style a loan as an open-end extension of credit, or keep the interest or total points and fees below the respective ten-and eight-percent triggers, which are so high that most lenders, including predatory lenders, are able to price their loans below them.¹⁹²

V. IT'S NOT THEIR FAULT: WHY ASSIGNEES SHOULD NOT BE HELD LIABLE

In their March 2007 article, Engel and McCoy argue that, given “securitization’s role in enabling and perpetuating predatory lending . . . 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.”¹⁹³ In addition, they argue that assignee liability should apply to suitability violations and certain other legal violations by mortgage brokers and lenders.¹⁹⁴ Their proposal seeks to hold the secondary market responsible for policing lenders.¹⁹⁵ A system of assignee liability is used whereby entities that engage in due diligence designed to detect loans with abusive terms have their liability capped.¹⁹⁶ Further, they propose extending assignee liability only to specific causes of action, including: (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.¹⁹⁷ Additionally, they would impose liability on assignees for violations of a national suitability standard that they previously proposed in an earlier article.¹⁹⁸

189. *A Tale of Three Markets*, *supra* note 18, at 1306–07.

190. *Id.* at 1307. *See also* 15 U.S.C. 1602(i), (w), (bb) (2000) (TILA).

191. *See* 15 U.S.C. 1602(aa)(1)–(4) (2000) (TILA); TRUTH IN LENDING, *supra* note 184, 3.9.

192. *See A Tale of Three Markets*, *supra* note 18, at 1307–08; *see also* HUD-TREASURY REPORT, *supra* note 17, at 85; TRUTH IN LENDING, *supra* note 184, at 10.1.1.

193. *Turning a Blind Eye*, *supra* note 21, at 2042.

194. *Id.* at 2081.

195. *Id.*

196. *Id.*

197. *Id.* at 2089.

198. *See A Tale of Three Markets*, *supra* note 18, at 1366.

Although their proposal would provide new forms of redress for borrowers who have been victims of predatory lending, it seeks to do so by holding liable those who have purchased these securitized predatory loans on the secondary market.¹⁹⁹ This seems counterintuitive, in that borrowers have had no contact whatsoever with these purchasers, nor were the purchasers involved at any stage of the lending process.²⁰⁰ While Engel and McCoy insist that this proposal would not espouse radical changes to the secondary market by comparing the due diligence proposed to that currently adopted by GSEs Fannie Mae and Freddie Mac,²⁰¹ those organizations are substantially larger than many of the private actors involved in this market, so the proposal could drive out many of these actors from the market. Through increased costs of due diligence, there is a danger of driving out legitimate credit if such a proposal were imposed. As stated earlier, legitimate subprime lending is necessary to provide a source of credit to borrowers that otherwise may have no such access to credit.²⁰² By imposing such heightened due diligence requirements on secondary market actors, actors that had nothing to do with the original loan process would subject themselves to substantial potential liability to borrowers, in addition to the high costs of such heightened due diligence. Engel and McCoy state that there is evidence that state anti-predatory lending laws have not had an adverse impact on the flow of subprime credit.²⁰³ However, as they themselves made clear in this and an earlier article,²⁰⁴ the current state anti-predatory lending laws are quite ineffective, and as such, one would not “expect them to have had too strong of an impact on ‘the flow of subprime credit.’”²⁰⁵

As a result, although Engel and McCoy are truly experts in this field, their most recent proposal seems, at this point, to go too far in looking to impose assignee liability on secondary market actors. However, it remains to be seen whether, if there is a regulator either created or assigned to this industry, their proposal could be in turn adopted.²⁰⁶ If there were such a regulator for the industry, then at least some of the costs associated with

199. See generally *Turning a Blind Eye*, *supra* note 21.

200. Purchasers on the secondary market buy securities that include loans made by banks and SPVs to borrowers that already contain the predatory loans. This is because the “lenders [don’t] care,” because they have sold the mortgages and “their hands [are] clean.” See David Hendricks, *Financing of Homes Must Change*, MY SA BUSINESS, Sept. 9, 2008, http://www.mysanantonio.com/business/columnists/david_hendricks/Financing_of_homes_must_change.html.

201. See *Turning a Blind Eye*, *supra* note 21, at 2095.

202. See *supra* Part I.

203. *Turning a Blind Eye*, *supra* note 21, at 2098.

204. See generally, *A Tale of Three Markets*, *supra* note 18.

205. *Turning a Blind Eye*, *supra* note 21, at 2096–7.

206. A regulator was proposed in Engel & McCoy’s earlier article *A Tale of Three Markets*, *supra* note 18.

their proposal would be reduced, and there would be much lower risk of losing critical actors in what was at one time a profitable and vital industry.

VI. HELP IS AROUND THE CORNER

Current regulation and remedies in the subprime industry do not address the grave problems in the subprime lending industry. Remedies and regulations, some of which allow actors like extant SPVs to avoid any liability despite being involved in the securitization of loan pools that include predatory loans, are one major problem.²⁰⁷ Coupled with the lack of a true regulator for the subprime lending industry, these matters have allowed the entities involved in this industry to continue to avoid liability despite dealing in illegal predatory loans. Although there are agencies that regulate certain entities involved in securitization,²⁰⁸ these agencies do not regulate the subprime lending industry as a whole. Legislation should thus be passed to either create a new regulatory organization to oversee the lending industry and resulting securitization, or designate the U.S. Securities and Exchange Commission (SEC) as the industry's regulator. By having a regulator specifically for the lending and securitization industry, consumer-protection mechanisms or remedies that do have potential to be effective may be more properly applied, in addition to creating true accountability for those who continue to violate proper lending practices. This, in turn, would allow for SPVs to be held accountable for engaging in securitization of loan pools that contain predatory loans, without leaving it in the hands of secondary market actors, or lenders themselves to comply with proper lending practices. Therefore, legislation must be passed to cover this industry and force industry actors to comply with appropriate lending practice standards.

A. THE NEED FOR A REGULATOR

First, all entities that desire to be involved in the lending industry and resulting securitization should be required to register with this new regulator, similar to member firms who register with the Financial Regulatory Authority (FINRA) in order to participate in trading securities.²⁰⁹ In conjunction with this requirement, these actors should be required to adopt the "best practice standards" that were created by the

207. See generally *Turning a Blind Eye*, *supra* note 21.

208. For example, the Office of the Comptroller of the Currency "charters, regulates, and supervises all national banks." As a result, although they have worked towards identifying predatory practices within their regulation of national banks, most mortgage creating institutions are outside this scope, and other agencies have to fill this regulatory gap in order to be successful in stopping predatory lending practices. See Comptroller of the Currency Administrator of National Banks, About the OCC, <http://www.oectreas.gov/aboutocc.htm> (last visited Oct. 29, 2007).

209. "FINRA is the largest independent regulator for all securities firms doing business in the United States." See FINRA homepage, <http://www.finra.org/index.htm>.

GSEs involved in this industry, Fannie Mae and Freddie Mac. This would require, for example, that lenders eliminate certain prepayment terms and balloon clauses that make their loans predatory. As stated above, those currently outside of the “conforming market” are free to adopt internal standards of their own, which has resulted in very few actors adopting the “best practices.”²¹⁰ By requiring all entities in this industry to adopt the best practices in order to qualify to participate in this market, there would finally be a new sheriff in town.

To ensure compliance with the “best practice” standards, the SPVs’ securitized products should be subject to a thorough investigation prior to being sold on the secondary market to investors (assignees). A regulator could apply the fraud provisions²¹¹ from the Securities Exchange Act of 1934 to these securities if they have not complied with the required standards, thus subjecting them to criminal liability, in addition to a private right of action that courts have implied in cases under this statute.²¹² The best practice standards would require heightened disclosure by the SPVs of the quality of loans being securitized, as well as an explanation by lenders to borrowers of the clear meanings of the various loan terms. By subjecting the entities involved in subprime lending to such standards, in addition to regulation by an industry regulator, those that did not comply with the disclosure requirements would violate the fraud provisions for making a material misstatement. This would incentivize SPVs to fulfill their due diligence and disclosure requirements more properly and not just engage in aggregation of acceptable loans and predatory loans in order to assemble more diversified loan pools, without increasing significantly the costs of secondary market actors to participate in this industry.²¹³

B. EVENING THE PLAYING FIELD

Moreover, SPVs should be exempted from the protection of the “holder-in-due-course” rule that reduces SPV’s legal risk. The new regulator of this industry should apply a rebuttable presumption of bad faith when an SPV attempts to sell securitized loan pools that contain predatory loans to investors. This would be fair, as the SPVs would be aware that they were subject to heightened due diligence requirements in selling these loans, and as a result should have screened out such predatory loans prior to securitizing and attempting to sell the product to investors. Thus, the SPV

210. *See supra* Part III, C.

211. *See* Securities and Exchange Act of 1934, § 2B, 15 U.S.C. §78(j)(b) (2000); *see also* 17 C.F.R. §240.10b-5 (2007).

212. *Id.*

213. This is because if the regulator would be responsible for investigating loan pools to make sure they comply with the requisite standards as opposed to the secondary market actor being solely responsible for ensuring compliance, the overall costs can be reduced for the secondary market actors, shared with the regulator. Further, if the regulator is funded by the government, then costs will be spread throughout the nation from United States tax dollars.

would not qualify as a “holder-in-due-course,” because to do so, holders of an instrument must be doing so in good faith.²¹⁴ It could be argued that this would disincentivize SPVs from participating in the lending industry because of the potential liability and increased costs. However, because of the potential for lucrative profits, and the marginal costs in requiring SPVs to conduct proper due diligence and comply with best practice standards (when they would be doing so in conjunction with a regulator also using its resources to screen loan pools), this would help curb the predatory lending problem, without removing these entities from this profitable market.

C. WE NEED DILIGENCE

In conjunction with removing SPVs from the “holder-in-due-course” exemption, there should be changes made in the due diligence requirements that currently exist in this industry. SPVs must be incentivized to insist on proper due diligence compliance by lenders, such as subjecting them to liability along with lenders²¹⁵ (for example a substantial fine, and after multiple violations a bar from participating in the lending and securitization markets). Moreover, in cases of Rule 144A offerings, substantive due diligence on the part of the institutional investor (the SPV) should be required apart from any conducted by the lenders, underwriters, or rating agencies. As stated above, predatory loans may avoid SEC regulation if they qualify for the Rule 144A exemption, which can be easily achieved. It is necessary to remove Rule 144A offerings from this exemption, and subject them to SEC regulation or at least to that of a new industry regulator.

Another change that should be made is to require lenders to retain their interest in the subordinated tranches that they helped create in securitizing the loan pools. By forcing these lenders to retain their residuals, they would be incentivized to make sure that they were safe loans in the first place. The central purpose of residuals is to force lenders to retain the bulk of the credit risk they create and by forcing them to retain the residuals, they would not be able to avoid the credit risk of improper loans and the potential defaults on re-payment of such loans. As a result, this would allow the market discipline that residuals were meant to exert on lenders to actually be effective.

As stated above, the current federal and state law regimes have numerous holes that allow predatory lenders to escape their reach.²¹⁶ Although some states have begun to resolve this problem by lowering coverage triggers within their state, states are not equipped with the

214. U.C.C. § 3-302 (2005).

215. As stated above, this would at least in part be due to SPVs exemption from the protections of the holder-in-due-course rule, whenever predatory loans comprised part of a securitized loan pool that was being sold to investors.

216. See *supra* Part IV.C.

financial experience and regulatory capacity necessary to combat the creativity of predatory lenders.²¹⁷ Thus, the SEC, or a regulator that would be specifically created for this industry, would apply its expertise in this area to determine whether an appropriate coverage trigger for applying HOEPA would be nationwide.

Moreover, even where due diligence is required, there is an inherent conflict of interest when the underwriters who appraise the scrutinized loans work for the lenders. “Securitization may be the only business in the world where the appraiser is hired by, paid by, and thus works for, the seller rather than the buyer.”²¹⁸ For example, “it would be unthinkable in a real estate transaction for the seller of a property to expect that the buyer would accept a seller-provided appraisal as the basis of the buyer’s valuation, and yet this is exactly what transpires in the bond market.”²¹⁹ Thus, this conflict of interest must be removed and realigned. This could be accomplished by either requiring the rating agencies to work for the bond buyers, or at the very least by requiring full disclosure to the borrowers that the agencies work for or with the lenders. If these agencies do not comply with such disclosure requirements, they should be subject to criminal liability brought by the regulator of the industry, as well as a private cause of action brought by a victimized borrower.

D. GIVING BORROWERS A CHANCE

Another necessary change in the current remedial structure is an adjustment of the requirements for common law fraud actions pursued by borrowers against lenders who have purveyed predatory loans. As stated previously, the current state of the law makes it very difficult for borrowers to successfully bring individual anti-fraud actions, as they are costly and have difficult proof requirements for plaintiffs. The “American Rule,”²²⁰ in which each party bears its own attorneys’ fees and costs, provides incentives to file suits for injunctive relief, such as rescission or loan forgiveness inadequate for the private bar. This, coupled with the need to prove individual reliance in fraud cases, often makes it difficult to bring class actions.²²¹ However, there are solutions to these complex problems.

One solution would be to adjust the traditional “American Rule” in the context of cases involving fraudulent predatory loans to borrowers. If legislation is passed to allow recovery of attorneys’ fees and costs by the prevailing party for specifically these circumstances, borrowers with legitimate suits could afford to bring claims against a fraudulent lender who

217. See *A Tale of Three Markets*, *supra* note 18, at 1305.

218. Penner, *supra* note 91, at A11.

219. *Id.*

220. See The eLectric Law Library’s Lexicon On, “American Rule,” <http://www.lectlaw.com/def/a107.htm>.

221. See *supra* note 172, and accompanying text.

has purveyed a predatory loan. This would not threaten the judicial economy, as borrowers with frivolous suits would be deterred from bringing such a suit for fear of having to pay the other side's attorney's fees and costs, while incentivizing those with legitimate suits to come forward and help combat the predatory lenders that exist throughout the nation.

Another solution to these complex problems of bringing a loan fraud action for borrowers is to change the proof requirements when bringing a class action. Instead of requiring proof of individual reliance in fraud cases, which is quite impractical, this area of the law could adopt the fraud-on-the-market theory, which is applied in the case of materially misleading statements made by directors on a corporation's behalf to the detriment of shareholders.²²² This theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.²²³ Thus, misleading statements will defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.²²⁴ As applied to the lending industry, this would allow for class action borrowers to avoid having to show direct reliance on a fraudulent misstatement regarding the loan terms. Instead, a rebuttable presumption of reliance would be applied. It would then be the lenders' burden to rebut such a presumption. The policy behind this theory is that requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would prevent these plaintiffs (borrowers) from proceeding with a class action, since individual issues then would overwhelm the common ones.²²⁵ While this is a different situation than the case in which the doctrine developed, the central principle remains the same: investors or borrowers rely on the integrity of the price set by the market, and forcing plaintiffs in these cases to show a speculative state of facts (for example, how he or she would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made), would place an unrealistic evidentiary burden on the plaintiffs. The presumption of reliance employed in these instances is consistent with congressional policy embodied in the Securities Exchange Act of 1934.²²⁶

222. This theory was applied in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), where a corporation issued three public statements denying that it was engaged in merger negotiations when it really was, and as a result, plaintiffs alleged they had sold their shares at artificially depressed prices in a market affected by the corporation's misleading statements in reliance thereon.

223. *Id.*

224. *Id.*

225. *See Basic*, 485 U.S. at 224.

226. *Id.*

VII. CONCLUSION

Consequently, it is apparent that in the current state of affairs, the subprime lending industry will not fix itself through self-regulation or existing remedies. There are significant gaps existing in the current law, and the remedies that are available for borrowers are inadequate. Further, the entities involved in predatory subprime lending and securitization of loan pools that include predatory loans have no incentives to divert from their current behaviors, as they have not been faced with liability for noncompliance with the standards and practices of proper subprime lending. Thus, it is clear that these entities need to be regulated, and through SRO regulation, current standards and mechanisms that exist to prevent predatory subprime lending must be adjusted to properly combat this harmful practice. In addition to this regulation, if at least some of the aforementioned changes are made to the current remedial system in place, borrowers and investors will receive meaningful recourse, without subjecting profit-seeking actors in the subprime lending and securitization industry to prohibitive costs. Furthermore, going forward, noncompliance with new regulations and rules would subject the entities in this industry to fines, a bar from the industry, and criminal or substantial civil liability. Inscribed on the pediment of Winston Churchill's statute at the site of the Winston Churchill Memorial and Library is the epigraph from Churchill's *History of the Second World War*: "In war, resolution. In defeat, defiance. In victory, magnanimity. In peace, good will."²²⁷

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227. See University of Missouri Press, <http://press.umsystem.edu/fall1995/kemper.htm> (last visited Nov. 2, 2008).

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