

Predatory Lending: What Does Wall Street Have to Do with It?

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Abstract

In this article, we examine the contention that the secondary market will exert sufficient market discipline to drive predatory home loan lenders from the subprime marketplace. Using a so-called lemons model, we identify the potential risks that investors encounter if they buy securities backed by predatory home loans. We then explain how structured finance, deal provisions, pricing mechanisms, and legal protections shield investors from much of the risk that those loans entail.

While the secondary market does impose some discipline on the subprime home loan market, it is not enough to bring predatory lending to a halt. We provide rationales for imposing liability on the assignees of predatory loans and describe the parameters of our proposed assignee liability legislation.

Keywords: Assignee liability; Securitization; Subprime and predatory lending

Introduction

Some commentators have questioned whether further legal intervention is needed to redress predatory lending, arguing that market discipline by secondary market purchasers will eventually drive out predatory lenders. (See, for example, U.S. General Accounting Office 2004, at 76.) To date, this contention has been largely overlooked in policy analyses and in the legal and economic literature on subprime lending abuses. It deserves serious consideration, however, because the secondary market supplies a vast proportion of the

capital that finances subprime home mortgages,¹ including predatory mortgages. If the secondary market has the incentive and ability to deter predatory lending through such market devices as pricing, contract provisions, due diligence, and monitoring, then the market for subprime mortgages arguably will self-correct.

In this article, we examine the contention that market discipline by the capital markets is sufficient to stop predatory lending. We begin by describing how information asymmetries in securitization create the potential for investors in mortgage-backed securities (MBS) to suffer some of the consequences of predatory lending. In the second section, we describe the major risks that predatory lending creates and securitization must manage; in the third, we describe the various techniques that securitization uses to do so. In the final section, we posit that none of these safeguards adequately curbs predatory lending and propose legislation that would require the secondary market to police predatory lenders.

Our basic argument is as follows:

1. Secondary market participants can insulate themselves from the risks of predatory lending without having to monitor loan originators.
2. To the extent that originators of predatory loans retain some risk, that risk is low and does not exceed the benefits of making predatory loans.
3. The secondary market should bear some of the risk in order to foster greater incentives for Wall Street to discipline predatory lenders.

Securitization of subprime home loans

Securitization—also known as “structured finance”—is the technology that permits global capital markets to fund and profit from subprime home loans. The process includes numerous actors performing an array of functions, beginning with the originators that make the loans and ending with the investors that purchase the securities backed by those loans. The number of actors and the disparate degrees of access each actor has to credit history and other salient information about borrowers give rise to information asymmetries and adverse selection problems that, without adequate protections, could work to investors’ detriment. Allaying those concerns is a central task of secu-

¹ In 2003, \$215.4 billion or approximately 66 percent of the outstanding subprime/home equity loans in the United States were securitized (Standard & Poor’s 2004a; Theologides 2004). That year, there were 223 U.S. subprime mortgage securitization deals (“Summary of Worldwide Securitization” 2003).

ritization, and the secondary market has devised numerous methods for reducing investors' risks. The question is whether the efforts to protect investors from the risks that arise from securitization also deter abusive lending.

The securitization process

Securitization takes bundles of assets, such as home mortgage loans, and sells asset-backed bonds that are engineered from the cash flows generated by those loans to outside investors (Frankel 1999, at 4–2). In a typical securitization, a lender (known as the seller or loan originator) bundles individual home loans and transfers the bundle to a special purpose vehicle (SPV), which is usually a wholly owned, bankruptcy-remote subsidiary of the seller. The SPV then sells the assets to an independent, bankruptcy-remote entity, which is often organized as a trust and is known as the issuer. This two-step process is designed to assure investors that the collateral for the bonds will be sheltered from creditors if the lender goes bankrupt. It also allows the senior tranches of the securitized issue to qualify for investment-grade ratings, irrespective of the lender's own rating (Blum and DeAngelo 1996, at 242–44; Davidson et al. 2003, at 20–21; Frankel 1999, at 4–4; McCall and Blum 1996, at 140; Roever 1998, at 4–6).

To allay investor concerns about the credit quality of the loans in a pool, an investment-grade rating is key to the success of the senior tranches in a securitized offering. One or more ratings agencies, typically Moody's and/or Standard & Poor's (S&P), will evaluate the credit risk of the loan pool and forecast its performance based on comparisons with historical data (Davidson et al. 2003, at 24–25; McCall and Blum 1996, at 142).² The ratings agencies then require the trust to add enough credit enhancements to the securitized offering to justify investment-grade ratings on tranches that will be sold to outside investors (Blum and DeAngelo 1996, at 252–53; Davidson et al. 2003, at 25–26; Kendall 1996, at 4; McCall and Blum 1996, at 140–41).

The investment bank representing the issuer then carves the cash flows from the loan pool into asset-backed securities, prices them, and sells them to investors.³ The actual loans are owned by the trust, which is their legal assignee (Davidson et al. 2003, at 20). If the offering is successful, the lender receives two forms of proceeds from the sale. First, it receives cash from the sale of a “par-coupon” security. Second, it acquires the right to “excess

² In the subprime industry, ratings agencies aim for “controlled delinquency levels,” not a zero default rate (Dear and Blum 1996, at 134).

³ Credit enhancements increase the cost and reduce the risk of the senior tranches.

spread,” that is, any interest payments on the loans over and above the interest paid to the investors who buy the asset-backed securities (McCall and Blum 1996, at 141–43).

In this article, our principal concern is with residential MBS (RMBS), specifically in the subprime market. RMBS consist of fractional interests in pools of whole single-family mortgages or bonds based on discrete income streams from bundled mortgages. In the former, known as mortgage pass-through securities, ownership of the loan pool passes collectively to the investors, who receive the interest and principal payments, minus servicing fees, every month.

Alternatively, issuers may sell bonds based on discrete income streams from mortgages in the form of mortgage-backed bonds (MBBs) or collateralized mortgage obligations (CMOs). Both are bonds that are collateralized by mortgages. MBBs are priced based on the liquidation value of the loans and require a high degree of overcollateralization. CMOs, by contrast, are priced based on the cash flow of the mortgages, not their liquidation value, and generally require less excess collateral. CMOs parcel out income streams into derivatives consisting of interest payments plus principal, interest-only (IO) residual strips, or principal-only (PO) residual strips (Brick 1987, at 26, 29–32; Davidson et al. 2003, at 185–87, 196, 206–08). Our principal concern in this article will be with pass-through securities and CMOs.

Generally, both pass-through securities and CMOs are divided into sequential tranches. This senior/subordinated structure is the “predominant structure of choice in subprime RMBS” (S&P 2004b; see also Davidson et al. 2003, at 331–33). Under that design, the senior tranche receives all of the principal payments from the mortgage pool until it is paid in full, after which the next senior tranche receives all of the principal payments until it, too, is retired. As each tranche is paid off, the next one receives all of the principal payments until all the tranches are paid (Blum and DeAngelo 1996, at 257; Brick 1987, at 31; Davidson et al. 2003, at 208–09, 333). This structure is designed so that the junior tranches are first to absorb losses and shield the senior tranches from possible payment shortfalls from loan defaults (Davidson et al. 2003, at 333; S&P 2004a). Accordingly, the senior tranches have the best credit risk and ratings because they are paid first; the bottom, subordinated tranches, by contrast, have higher credit risk and lower ratings (Bhattacharya and Fabozzi 1996, at 7, 10–11; Davidson et al. 2003, at 208–09, 333).

Securitization and information asymmetries

In years past, mortgage lenders typically performed all lending functions themselves. They located the applicants, originated and funded the mortgages, performed the servicing, and held the loans in portfolio to maturity. Because lenders previously bore the full risk of default, they had strong incentives to turn down observationally risky borrowers (Stiglitz and Weiss 1981).

Securitization unbundles the core functions of lending and parcels them out to a string of market actors. Today, a mortgage broker may locate the applicants, a lender may originate the loans, another specialist firm may provide the servicing, a trust may hold the loans, and outside investors may provide the funding.

With unbundling, securitization gives rise to a new problem—adverse selection—that it then must solve. Potential investors have reason to be concerned that lenders will try to pass off their poorly performing loans, the classic “lemons” problem posed by Akerlof (1970; see also Cutts, Van Order, and Zorn 2000).

A lemons problem occurs because securitization and unbundling spawn new information asymmetries that benefit lenders, to the detriment of investors, in the home mortgage market. From the lender’s vantage point, a loan’s prospects for repayment depend on both observable and unobservable characteristics. With regard to observable characteristics, the lender has direct access to the observable data on the probability of default and loss severity, but investors do not⁴ (Cutts, Van Order, and Zorn 2000). Investors never meet the borrowers face-to-face, do not conduct the appraisals, and rarely examine individual loan files. These information asymmetries are particularly severe in the subprime market, which by definition serves borrowers with blemished credit.

In turn, these asymmetries foster perverse incentives toward adverse selection. Knowing that they can recognize problem borrowers better than investors, lenders have an incentive to fob off their lemon loans on the secondary market and to keep their good loans in portfolio⁵ (Cutts, Van Order,

⁴ For purposes of simplification, we assume that the lender markets directly to consumers rather than using mortgage brokers. Where lenders use mortgage brokers, the latter may have even more information than the lender about observable characteristics of the borrower.

⁵ In 2003, approximately two-thirds of the outstanding subprime/home equity loans in the United States were securitized, while lenders held the remaining one-third in portfolio (S&P 2004a; Theologides 2004).

Akerlof commented on a similar problem affecting middlemen who tried to arbitrage between the cheap loan rates of banks in the central cities of India and the exorbitant loan rates of local moneylenders who had personal knowledge of the borrowers, observing: “The middleman who tries to arbitrage between the rates of the moneylender and the central bank is apt to attract all the ‘lemons’ and thereby make a loss” (1970, at 499).

and Zorn 2000). The more securitization allows lenders to collect profits up front while shifting some or all of the credit risk to other market participants, the more the problem increases. This ability to take the profits and run weakens the incentive for lenders to rigorously screen loans. In addition, because predatory lending can spawn borrower litigation, investors may purchase securities without knowing that borrowers have claims that could, if successful, reduce the value of those securities. Last, without investors' knowledge, lenders may engage in behavior that increases the prepayment risk at a cost to investors.⁶

These information asymmetries enable lenders to pass the loans with the greatest risks off onto investors⁷ (Barta 2001, at A1; Cutts, Van Order, and Zorn 2000; Passmore and Sparks 1997, at 7). If the bad loans drive out the good, the market for RMBS will be destroyed (Akerlof 1970). Solving these information asymmetries and the ensuing risk of adverse selection is one of the key challenges of securitization.

The risks of MBS

MBS investors face three main risks that are relevant to market discipline in subprime securitizations, particularly when loan pools contain predatory loans: credit, prepayment, and litigation risk.⁸ Credit risk is elevated when, for example, originators make loans that borrowers cannot afford to repay—a hallmark of predatory lending. Prepayment risk involves the chance that the mortgage will be paid off before maturity. In the subprime securitization market, prepayment risk is exacerbated by a predatory lending practice called flipping (refinancing loans quickly, over and over, to the borrower's detriment), which we will discuss later. Finally, when originators make predatory loans, the trusts that own those loans face the risk of lawsuits, which can adversely affect investors.

⁶ In the related context of Federal Housing Administration (FHA) home mortgages, Wachter has pointed out that FHA insurance fostered perverse incentives for lenders to foreclose on insured loans as soon as possible because the sooner the loans were prepaid, the greater the return (1980).

⁷ Possibly, this ability to exploit information asymmetries to the detriment of investors may affect the premise, first advanced by Lang and Nakamura, that economies of scale rise in neighborhood lending as lenders obtain more and more private information about neighborhoods and borrowers, whether through increased scale of operation or otherwise (Avery, Beeson, and Sniderman 1999; Harrison 2001; Lang and Nakamura 1993).

⁸ In addition, RMBS investors are concerned with liquidity risk (the risk of an illiquid resale market) and interest rate risk. These risks do not bear directly on the question of market discipline for predatory lending, and so we will not discuss either of them in this article.

Credit risk

Credit risk is the possibility that some or all of the mortgage loans backing the securitized pool will go into default. When borrowers default, RMBS investors face loss of full and timely repayment of principal and interest.

Investors have heightened concerns about the credit risks associated with subprime securitizations, in large part because borrowers with marginal credit are more likely to default (Pennington-Cross 2003b, at 7; Weicher 1997, at 76). These concerns mount because subprime loan pools may contain predatory loans to borrowers who could not afford to repay their loans under any circumstances.

Further, subprime securitizations are a fairly new phenomenon relative to their prime counterparts,⁹ meaning that the performance of subprime loan pools over time is not yet well understood. Subprime loan pools also display far more heterogeneity than their prime counterparts. While prime loan pools display some heterogeneity, they span a much narrower range of credit risk—containing only those mortgages with the best prospects for repayment—and that range has been empirically tested and verified over time. By contrast, subprime loan pools span a far greater range of credit risks, potentially covering the entire spectrum from A and A– borrowers down through the worst D borrowers (Weicher 1997, at 56–57 and table 4.1). Thus, the distribution of credit risks in subprime securitizations has a higher variance than in prime securitizations. Compounding the uncertainty is the fact that the true distribution of subprime credit risks may not be observable to the investor or the rating agency, particularly if a pool contains loans whose predatory nature is not apparent. Finally, the costs of foreclosure vary from state to state, depending on state laws, thereby complicating the assessment of default costs (Clauret and Herzog 1990; Schill 1991).

Prepayment risk

Prepayment risk stems from the fact that all residential mortgages have an embedded call option that the borrower can exercise. Under that option, homeowners can prepay their mortgage and stop future payments whenever they wish as long as the outstanding principal is repaid in full. Prepayment has two effects: It accelerates the return of principal and it cuts off the expected cash flow from interest for the remainder of the life of the loan. When interest

⁹Unlike prime mortgage securitizations, which took off in the late 1970s, subprime securitizations were uncommon until the early 1990s (Kelleher 2000).

rates fall below coupon, prepayment spells the end of interest payments at favorable rates; those investors who invest the prepaid principal will experience reduced returns for equivalent risk.¹⁰

All residential mortgages are subject to prepayment risk. The nature of that risk differs for the prime and subprime markets, however. In the prime market, numerous prepayments occur when interest rates fall below the coupon rate on individual mortgages. When interest rates fall low enough, many homeowners will refinance their mortgages to take advantage of the lower rates. Prepayments also occur for idiosyncratic reasons having nothing to do with interest rates, such as home sales, new jobs, divorce, or death (Boudoukh et al. 1997, at 406, 437; Cutts and Van Order 2003, at 3, 7).

By contrast, subprime borrowers on average are less sensitive to shifts in interest rates because they have greater difficulty qualifying for new loans. Thus, prepayments on subprime loans are not as sensitive to fluctuating interest rates. There are two distinct prepayment patterns in the subprime market, one that is voluntary and one that is not. Subprime borrowers who voluntarily prepay generally do so when their credit rating has improved enough that they can refinance into prime products; doing so reduces their payments if interest rates are at or below coupon and often even when they have risen (Cutts and Van Order 2003, at 7). Conversely, subprime borrowers involuntarily prepay when lenders engage in a typical predatory lending practice known as flipping, which, as noted earlier, entails refinancing borrowers' loans in quick succession. Predatory lenders create opportunities to flip by making loans to borrowers with significant equity in their homes, but on terms that borrowers cannot repay. When borrowers default, the lenders refinance (flip) the loans, ostensibly to avoid foreclosure, and charge steep fees that they finance and fold into the new principal, thus stripping the equity from borrowers' homes and earning fees in the process (Mehra 2000).¹¹ When predatory lenders, with an eye to future loan flipping, make loans that borrowers cannot repay, they perversely boost prepayment risk, which has the potential to reduce investors' returns during periods of declining interest rates.

¹⁰ Prepayment risk also arises when borrowers make partial prepayments, thereby reducing the number of future interest payments at favorable rates, but not bringing them to a halt. In the predatory loan context, this is rarely, if ever, a problem, if only because borrowers have difficulty making timely mortgage payments in the first place. For that reason, we will restrict our discussion of prepayment risk to situations in which mortgages are prepaid in full.

¹¹ Technically, default is not prepayment. But because default terminates the mortgage, the consequences are the same from the viewpoint of the security holder. Upon default, the trust forecloses on the collateral and pays the principal balance of the loan to the investors (Davidson et al. 2003, at 132–33). Accordingly, subprime home loans made with no regard to the borrowers' ability to pay can increase prepayment risk.

Litigation risk

Litigation risk is the possibility that borrowers will bring predatory lending claims or, when charged with nonpayment, raise predatory lending defenses against the trusts that own their loans. Successful lawsuits by borrowers can reduce the value of the loan pool and thus the returns to investors. This is particularly true if there are significant punitive damage awards. Similarly, anticipated income streams from loans may fall if borrowers successfully defend nonpayment on the grounds of predatory lending practices.

Aggrieved borrowers historically have brought claims solely against the originators or brokers of their loans. There are a number of reasons for this. The most obvious reason is that originators and/or brokers typically are the actors with the greatest culpability for predatory practices. Another reason stems from the fact that securitization of subprime home mortgages is a new phenomenon. Consumer attorneys have never had reason to look beyond originators for defendants because the originators historically retained ownership of the notes; there were no other parties who were involved in the transactions or who had an ownership interest in the notes.

In recent years, consumer attorneys have become more sophisticated in their understanding of the secondary market and are looking farther up the lending food chain to bring claims against the securitization trusts that own the loans. In legal parlance, the trusts are the assignees or holders of the loans. Some states and municipalities have also spurred such suits against trustees by passing legislation that holds assignees of loans liable for the predatory lending of originators.¹²

In this section of the article, we identify the types of predatory lending claims¹³ that can give rise to assignee liability and thus expose investors to litigation risk.¹⁴ Although we identify a number of avenues through which borrowers potentially can seek relief against originators and assignees, pursu-

¹²Debates are raging about the impact of these laws, with consumer advocates arguing that assignee liability is needed to deter predatory lending and secondary market actors claiming that assignee liability would make securitization too costly and, consequently, dry up the capital for subprime mortgages altogether (National Consumer Law Center 2003; S&P 2003b, 2003c). The ratings agencies have interposed themselves as the ultimate arbiters of these laws by refusing to rate subprime RMBS in jurisdictions whose assignee liability provisions they deemed too harsh (Fitch Ratings 2003; S&P 2003a, 2003b, 2003c, 2003d).

¹³It is difficult to determine the number of claims that borrowers alleging predatory lending have brought against lenders and/or assignees. Legal databases include only published decisions, which represent a fraction of all claims filed. Even when predatory lending decisions are published, there is a time lag between the filing of the cases and the published decision, which further complicates any attempt to assess the number of claims.

¹⁴For a fuller discussion of the types of predatory lending claims that borrowers can bring and the impediments to bringing them, see Engel and McCoy (2002).

ing predatory lending claims faces significant obstacles, which we will discuss later. Thus, the actual litigation risk to investors is not substantial.

Unfair and deceptive acts and practices (UDAP). Some, but not all, laws prohibiting unfair and deceptive acts and practices can be a source of relief to borrowers against assignees. UDAP claims can arise when lenders, for example, engage in fraud or fail to disclose material information to borrowers. The federal UDAP law, which falls within the Federal Trade Commission Act (14 U.S.C. §§ 41 *et seq.*), protects against fraud in or affecting commerce (14 U.S.C.A. § 45(a)(1)). By definition, it applies only to mortgage loans used to finance the sale of goods or services. There is no private right of action under the federal statute. Most state UDAP statutes do allow for private causes of action, although some preclude claims against banks or do not cover credit transactions in general.

The federal statute and a number of state UDAP statutes permit claims against assignees. For example, South Carolina's Consumer Protection Act permits borrowers to assert consumer credit claims offensively and defensively against assignees of their debts even if the borrowers were not financing the purchase of goods or services (Haynsworth 1984, at 7–10). Other jurisdictions allow consumer protection claims to go forward against assignees who played a direct role in a loan transaction by “promoting, underwriting and ultimately funding” the loan (*Cooper v. First Government Mortgage & Investors Corp.*, 238 F. Supp. 2d at 50, 65 (D.D.C. 2002)).

Fraud and unconscionability claims. Borrowers can also bring fraud and unconscionability claims against assignees of predatory loans that fail to qualify as holders in due course. Common law fraud claims arise when plaintiffs establish that originators affirmatively misrepresented the loan terms and that plaintiffs relied on the misrepresentations to their detriment (American Law Institute 1977, *Restatement of the Law Second, Torts*, §§ 537–545). To establish unconscionability, plaintiffs must demonstrate that they did not have a meaningful choice as to the terms of their loans and that the “contract terms [were] unreasonably favorable to the other party” (U.C.C. § 2–302(1); *Williams v. Walker Thomas Furniture*, 350 F. 2d at 445, 449 (D.C. Cir. 1965)).

Assignee liability for fraud and unconscionability claims depends on whether the assignee qualifies as a holder in due course. When assignees can establish that fact, they can escape liability for these claims. The requirements for holder in due course are that (1) the purchaser is the holder of a negotiable note and (2) the purchaser took the note for value, in good faith, and without notice of any defenses the borrower might raise to justify nonpayment (Summers and White 2000, § 14–2). To meet the definition of a “holder,” the assignee must have the note and it must be “issued or endorsed to him or to

his order or to bearer or in blank” (Summers and White 2000, § 14–3). A note that is made payable to a particular person or entity must be endorsed or it will fail the negotiability requirement needed to preserve the assignee’s status as a holder in due course (Summers and White 2000, § 14–3).

Borrowers have been able to defeat the holder in due course rule by using three main strategies. The first is demonstrating that the assignee did have notice of the originator’s wrongdoing.¹⁵ Assignees have notice if they (1) have actual knowledge of the defenses; (2) received notice of any defenses; or (3) “from all the facts and circumstances known to [them] at the time in question, [had] reason to know” that the defenses existed (U.C.C. § 1–201(25)). Where loan documents on their face reveal fraud or unconscionability, assignees have notice of potential claims.¹⁶ Similarly, when assignees aid and abet predatory lending, there is knowledge of claims and defenses.

In other situations, the relationship between the originator and the assignee of the notes establishes the knowledge element. For example, when the originator and the assignee bear a close relationship (*e.g.*, are overlapping entities) or the originator is acting as the assignee’s agent, the assignee may not be able to prove that it was unaware of potential fraud or unconscionability claims.

In a second strategy, some borrowers defeat assignees’ holder in due course status by establishing that their notes fail to qualify as negotiable instruments. This can arise when a note requires performance other than a promise to make the payments due or lacks the proper endorsements (Summers and White 2000, § 14–4). A note could be deemed non-negotiable if, for example, it required that borrowers make certain repairs to the property securing the note.

The final strategy applies to loans used to finance the purchase of services and goods. In 1975, the Federal Trade Commission (FTC) issued the FTC Holder Rule, permitting borrowers who financed the purchase of goods or services to assert any claims against the holders of their loans that they could have asserted against the people or entities that sold them the goods or services (16 C.F.R. § 433.2). The rule is narrow in its applicability to mortgage loans, but broad in terms of the potential liability of assignees. In the context of mort-

¹⁵ This is the theory under which Lehman Brothers was found liable for fraud based on First Alliance’s predatory lending activity (Reckard 2003).

¹⁶ Ironically, the holder in due course doctrine creates a disincentive for secondary market actors to engage in due diligence because to do so could reveal information that would defeat their status as holders in due course. This is because the more information the secondary market has about originators’ misdeeds, the more likely borrowers will succeed in claims against assignees.

gage loans, the Holder Rule applies only if borrowers used those loans to finance the purchase of goods or services. It does not govern mortgage loans that do not involve the sale and financing of goods and services, such as purchase money mortgages. Borrowers whose loans do fall within the Holder Rule can take advantage of broad assignee liability provisions. In fact, the Holder Rule permits borrowers to bring claims against any assignees that are “connected with the transaction, whether in tort or contract” (Office of the Federal Register 1976, 20024).

Truth in Lending Act violations. The federal Truth in Lending Act requires lenders to disclose finance charges and annual percentage rates to applicants for home mortgages (15 U.S.C. §§ 1601 *et seq.*). Assignees are liable for damages under the act only if the failure to make the required disclosures is “apparent on the face of the disclosure statement” (15 U.S.C. § 1641(a), (e)(2)).¹⁷ Conversely, assignees that could not have detected violations when reviewing Truth in Lending Act disclosures are not liable.

Even when assignees can escape liability for damages under the act, it is possible for them to suffer the consequences of originators’ liability. Among other remedies, the Truth in Lending Act permits borrowers with successful claims to rescind their mortgages for up to three years after closing. When borrowers seek and obtain this remedy, the assignees must return the loan to the originators for rescission, in which case the investors may lose the income stream generated by the loan.

Home Ownership and Equity Protection Act (HOEPA) violations. HOEPA, which is a subpart of the Truth in Lending Act, bans certain loan terms and lender practices for loans defined as “high-cost” under the statute (15 U.S.C. §§ 1602(aa), 1639). HOEPA explicitly provides for assignee liability unless “a reasonable person using ordinary due diligence” would not be able to ascertain that the loan was high-cost (15 U.S.C. § 1641(d)(1)). Thus, if the assignee, after due diligence, knew that the loans in question were high-cost, borrowers can seek relief from the assignee for any HOEPA violations by the originators.¹⁸

¹⁷In *Hays v. Bankers Trust Co.*, the court allowed a Truth in Lending claim to go forward against an assignee because the violations were apparent from the face of the documents (46 F. Supp. 2d 490, 499 (S.D. W. Va. 1999)). There is also a potential for claims against assignees under the Real Estate Settlement Practices Act (15 U.S.C. §§ 2601, *et seq.*) if the loans are table funded (24 C.F.R. § 3500.2(b)). See also Renuart 2004 (note 5) for a definition of table funding.

¹⁸In *Cooper v. First Government Mortgage*, the court required the defendant to demonstrate that a person with knowledge of the HOEPA requirements evaluated and analyzed the loan documents and disbursements to satisfy the due diligence requirement (238 F. Supp. 2d at 56).

Federal racketeering violations. The Racketeer Influenced and Corrupt Organization Act (RICO; 18 U.S.C. §§ 1961, *et seq.*) allows for sanctions against any entity or person who, through a pattern of racketeering activity or through the collection of an unlawful debt, violates certain laws while conducting or participating in an enterprise affecting interstate commerce (18 U.S.C. §§ 1961, *et seq.*). Thus, to the extent that assignees and originators act together to collect unlawful debts or to use the mail to defraud borrowers—a form of racketeering—borrowers may be able to prevail in RICO claims against assignees.¹⁹

Discrimination claims. The fact that predatory lenders disproportionately target people of color²⁰ can give rise to federal and/or state lending discrimination claims. The federal Equal Credit Opportunity Act (15 U.S.C. §§ 1691, *et seq.*) and its state analogues prohibit race-based credit practices. The law imposes liability on assignees when they participate in or have notice of originators' discriminatory actions (15 U.S.C. § 1691a(e)). Similarly, federal and many state fair housing laws provide a cause of action for discrimination in the financing of residential real estate on grounds of race. The federal Fair Housing Act (42 U.S.C. §§ 3601, *et seq.*) allows for claims against the assignees of loans if the purchasers “refuse to purchase” loans or “impose different terms or conditions” on the purchase of loans based on race, color, or other protected class status (42 U.S.C. § 3605; 24 C.F.R. § 100.125). Like the Equal Credit Opportunity Act, the Fair Housing Act limits assignee liability to situations where assignees are actively engaged in wrongdoing.

State and local predatory lending laws. Several states and municipalities have responded to predatory lending by enacting laws that allow borrowers to pursue civil remedies against originators and assignees of predatory loans. These assignee liability provisions vary a great deal. Some jurisdictions hold assignees liable for any predatory lending by originators, and others limit the situations in which assignees can be held liable. Arkansas, for example, tracks HOEPA and holds assignees liable for predatory lending unless the assignee, after exercising reasonable due diligence, could not determine that the loan was a high-cost loan covered by the statute (Arkansas Home Loan Protection

¹⁹ Borrowers can also bring civil conspiracy claims under state law. In *Hays v. Bankers Trust Co.*, the court denied summary judgment on a civil conspiracy claim against an assignee based on its alleged participation in fraudulent misrepresentations to the borrower (46 F. Supp. 2d at 497–500).

²⁰ Subprime and predatory lending is concentrated in neighborhoods with a high percentage of blacks. Recent evidence suggests that this pattern cannot be explained by risk alone (Calem, Gillen, and Wachter 2004). There is anecdotal evidence that predatory lenders also target older people, particularly women.

Act, 23 Ark. Stat. § 53–10 *et seq.*). When assignees are subject to liability under this law, borrowers are entitled to less relief against assignees than is available to them in claims against the originators of their predatory loans.

The Anti-Predatory Lending Ordinance of the City of Los Angeles (16 L.A. City Code §§ 181.00 *et seq.*) takes a broader approach, holding assignees liable for any predatory lending claims or defenses that borrowers could have raised against the originators (§ 181.07). New York banking law (New York Banking Law §§ 6–1 *et seq.*) takes yet another approach, disallowing affirmative claims against assignees, but allowing borrowers to raise predatory lending as a defense if assignees bring enforcement actions against them for nonpayment (Article 1, § 6–13).²¹

The credit, prepayment, and litigation risks associated with predatory lending could deter investors from purchasing securities backed by subprime loan pools. The challenge for the secondary market over the past decades has been to structure securitization deals to reduce these risks to investors.

How the secondary market manages securitization risks

Until the late 1970s, the capital markets lacked the technology to defray the risks just discussed to the satisfaction of investors. With advances in computing power, however, investment banks acquired the ability to conduct the intensive computations needed to analyze credit, prepayment, and litigation risk, thereby giving rise to the era of securitization through structured finance. To quote Akerlof, structured finance is the institution that arose “to counteract the effects of quality uncertainty” in the secondary market (1970, at 499).

Structured finance manages credit risk through credit enhancements and due diligence, while pricing is the principal means of managing prepayment risk. Structured finance circumvents litigation risk by designing deals to avoid assignee liability.²² Because these techniques are successful in defraying risk, independent investors, who normally restrict their purchases to the senior tranches, have little or no incentive to press for elimination of predatory lending practices.

²¹ The viability of these laws as a practical matter is an open question. Rating agencies have refused to rate loans that contain broad assignee liability provisions such as those adopted in Los Angeles (Bergquist 2003b). At least one state—Georgia—already has curtailed its assignee liability provisions in response to similar threats by rating agencies (Bergquist 2003a). On a parallel front, there is significant movement toward federal preemption of predatory lending laws (Davenport 2004; Heller 2004).

²² In the rare instances when assignee liability is a concern, credit enhancements serve to defray losses from litigation.

Managing credit risk

The secondary market uses numerous tools to defray credit risk in MBS offerings. The primary tool is credit enhancements, which are financial cushions designed to absorb losses that could, for example, arise from unanticipated levels of default. In addition, investors, rating agencies, investment banks, and other secondary market participants engage in limited due diligence to uncover and assess credit risks (Blum and Mattera 1999, at 53).

Credit enhancements. Credit enhancements are added to a securitization deal to boost the senior tranche to a top AAA/Aaa rating. Credit enhancements come in two types: internal and external. Internal credit enhancements are furnished by the issuer and are used to absorb credit losses. Entities that are not counterparties to specific securitization deals—for instance, insurance companies—may provide the external enhancements. Issuers typically have to adopt internal credit enhancements sufficient to bring the issue to a BBB-/Baa3 investment-grade rating before they can obtain any external enhancements (Blum and DeAngelo 1996, at 253; Hsu and Mohebbi 1996, at 278).

The most common internal enhancement is a senior-subordinated structure, which re-engineers the cash flows from mortgages into a variety of debt securities and assigns those securities to sequential tranches that are arrayed along the risk spectrum, ranging from highly safe investments to junk bonds (S&P 2004b). The tranches are structured so that outside investors buy the senior tranches while the originator's SPV typically retains the subordinated tranches. Any losses are absorbed by the subordinated tranches first, buffering the senior tranche-holders against most of the credit risk (Bhattacharya and Fabozzi 1996, at 10-11; Davidson et al. 2003, at 24–25). Because the originator or its SPV often holds the most junior tranches, there is some incentive for originators to attend to the quality of loans they make, since their SPVs hold the riskiest position (Davidson et al. 2003, at 332).

Other internal enhancements include overcollateralization, in which the principal balance of the mortgage loans in the pool exceeds the value of the securities, and excess spread accounts, which are reserve accounts funded by interest payments left over after investors have been paid and are intended to cover any higher-than-expected losses (Baron 1996, at 86–87; Brick 1987, at 29–32; Davidson et al. 2003, at 25–26, 333; Hsu and Mohebbi 1996, at 281–83).

In about half of all subprime RMBS deals, once internal credit enhancements have been added, external credit enhancements are layered on top to further boost the credit rating of the senior tranche. The most common external enhancement for subprime RMBS is bond insurance by a monoline insurer. External credit enhancements can also take the form of corporate guarantees

and letters of credit from banks (Baron 1996, at 86–87; Davidson et al. 2003, at 26, 333; Hsu and Mohebbi 1996, at 278–79; Kendall 1996, at 8; Silver 1998, at 71).

To the extent that investors may purchase securities backed by predatory loans, such enhancements effectively reduce the credit risks that these loans can generate. The enhancements do not, however, effectively deter predatory lending.

Due diligence and deal protections. In some cases, secondary market participants perform due diligence. However, it is usually cursory and, like credit enhancements, rarely affords borrowers any significant protection from predatory practices.

Under pressure from the Federal Reserve Board, some bank holding companies and their bank subsidiaries have conducted due diligence before investing in subprime private placements.²³ Their due diligence is generally confined to reviewing lenders' underwriting guidelines, processing procedures, and agreement forms for facial compliance with consumer lending laws (Chase Manhattan Corporation 2001; Citigroup Inc. 2001a, 2001b; First Union Corporation 2001; Mizuho Holdings, Inc. 2000).

Originators are also required to provide contractual representations and warranties, for instance, that they complied with and will continue to comply with consumer protection laws²⁴ (Chase Manhattan Corporation 2001; Citigroup Inc. 2001a, 2001b). If originators fall short of their representations and warranties, trusts can require that they repurchase any nonconforming loans (Blum and Mattera 1999, at 56). Likewise, the originators provide guarantees that, for example, obligate them to buy back nonperforming loans or deposit funds into reserve accounts to cover investors' returns in the event of revenue shortfalls (Watterson, Twerski, and Stein 1998).

This level of due diligence cannot determine, however, whether the loans in any given loan pool *in fact* comply with consumer lending laws and eschew other predatory practices. Only a handful of banks and bank holding companies actually require underwriters to sample loans on site for actual compliance with lenders' stated standards or warning signs of fraud or other

²³ Investors can purchase RMBS either through public offerings or through private placements whose marketing is largely limited by federal law to sophisticated institutional investors (Securities Act of 1933 (15 U.S.C. §§ 77a, *et seq.*)); Shivaswamy 2004).

²⁴ As such, representations and warranties are a mechanism that permits investors to limit risk by specifying a minimum quality standard for loans in a given loan pool (Cutts, Van Order, and Zorn 2000).

predatory practices (Chase Manhattan Corporation 2001; Citigroup Inc. 2001a, 2001b; First Union Corporation 2001; Mizuho Holdings, Inc. 2000). It is exceedingly rare for investors or other entities to require the unbundling of loan packages to pinpoint the risks associated with individual loans (Korell 1996, at 99–100), largely because this safeguard is labor-intensive and highly costly and might defeat the cost savings of securitization (Cutts, Van Order, and Zorn 2000).

Due diligence before closing is rarely able to detect fraud or predatory servicing, neither of which is usually apparent from the loan files but both of which come to light over time (Baron 1996, at 90). Post hoc monitoring would work better to catch fraud or predatory servicing. Nonetheless, investors rarely reserve the right to receive notification of predatory lending complaints or to perform special audits of lenders' subprime terms and practices when the warning signs of predatory lending crop up.

While due diligence has the potential to curb lending abuses, the current level at which it is performed is quite limited and does not provide borrowers with any appreciable protection. To the extent that due diligence does occur, it consists of reviewing lenders' policies for legal compliance. Such scant due diligence cannot detect most predatory practices; its only achievement is determining whether lenders complied with the law in word, not in deed.

Managing prepayment risk

Prepayment risk is an overriding concern in RMBS, particularly in the subprime sector, due to the commonly held belief that subprime prepayment speeds exceed those of prime borrowers. As we discussed earlier, loan flipping by predatory lenders contributes to faster subprime prepayment speeds and thus is of concern to investors.

Pricing is the main tool for managing prepayment risk in all RMBS, both prime and subprime. Mortgage industry representatives contend that pricing models are commensurate with the true level of subprime prepayment risk²⁵ (SMR Research Corp. 2000, at 24–38). In reality, models have not succeeded in accurately pricing prepayment risk. Furthermore, there are growing indications that subprime prepayment models result in supranormal profits, to the serious detriment of subprime borrowers.

²⁵ In the private-label secondary market (that is, the portion not served by government-sponsored entities such as Fannie Mae and Freddie Mac), investment banks are the institutions that generally develop prepayment risk pricing models.

Vagaries in pricing prepayment risk. Pricing prepayment risk is an inexact art in the prime market, and it is even more so in the subprime market. In the former, pricing models are the subject of a vast scholarly literature that has undergone intensive critique and refinement over the years. Indeed, the bulk of the finance literature on prime RMBS is devoted to improving pricing models for prepayment risk (Boudoukh et al. 1997, at 407). By contrast, pricing models for subprime RMBS are strictly proprietary and jealously guarded from public view.²⁶ Although the high degree of secrecy shrouding subprime models complicates any analysis of subprime pricing, prime models are instructive because numerous pricing problems are common to both markets.

There are two basic steps in pricing prepayment risk for RMBS. First, analysts must model the term structure of interest rates over the life of the mortgage, namely, possible future interest rate movements and their likelihood. Second, models must estimate the prepayment behavior of borrowers and the effect this behavior will have on the underlying cash flows from the mortgages (Boudoukh et al. 1997, at 409; Davidson et al. 2003, at 133, 234–68).

Modeling these issues, particularly prepayment behavior, has proven thorny. In recent years, option theory has been the predominant approach to estimating and pricing mortgage prepayment risk (Brennan and Schwartz 1985; Davidson et al. 2003, at 241–47; Dunn and McConnell 1981; Dunn and Spatt 1985; Johnston and Van Drunen 1988; Stanton 1992). Under this approach, investment banks calculate a price adjustment known as the option-adjusted spread or OAS, which is a metric designed to enable investors to compare the yields on RMBS versus the yields on bonds with dissimilar features (Davidson et al. 2003, at 249–68; Kochen 1996, at 113–14).

Option pricing has revealed itself to be an imperfect tool. Over the years, investment banks have experimented with a variety of simulation techniques to implement option pricing models, including Monte Carlo simulation, one-factor and multifactor models with fixed or time-varying parameters, and models incorporating martingale theory²⁷ (Chen, Maris, and Yang 1999, at

²⁶ One rare exception is the Salomon Smith Barney RFC HEL (Residential Funding Corporation subprime/home equity loans) fixed-rate prepayment model discussed in Gjaja 2001. Even though the Salomon Smith Barney model is publicly described, it is proprietary and outside researchers therefore do not know the precise coefficients of the model. (Van Order and Zorn 2001, at 17).

²⁷ Martingale theory models the stochastic processes that underlie a fair game. Having its origins in gambling, martingale theory now enjoys broad application in mathematical finance (Karlin and Taylor 1975, at 238–48).

34, 52; Zenios 1996, at 326, 334–42). To date, no technique has managed to accurately model prepayment risk without prohibitively costly computations.²⁸ More affordable simulation techniques have significant pricing errors that observable factors cannot explain (Boudoukh et al. 1997, at 408, 410, 434–43; Chen, Maris, and Yang 1999, at 36).

Apart from these unobserved sources of noise, researchers have identified several observable factors that distort the pricing of prepayment risk for prime RMBS. For one thing, historical prices of RMBS are prone to measurement error due to varying bid prices and bid-ask spreads among dealers. Moreover, structural market changes can further introduce errors into pricing models (Boudoukh et al. 1997, at 408, 410, 434–43; Chen, Maris, and Yang 1999, at 36; Davidson et al. 2003, at 135).

Other pricing problems in the prime market stem from difficulties in comparing the composition of loan pools. All of the estimation techniques described earlier depend heavily on analyzing historical data on past loan pool performance. But future and historical mortgage pools usually do not have the same composition, and data, particularly loan-level data, on historical mortgage pools may not be available (Davidson et al. 2003, at 133–36). Furthermore, MBS are often marketed on a to-be-announced (TBA) basis. In TBA offerings, the underlying mortgages have not yet been pooled, leaving the composition of the pool (including its age and prepayment history) to the discretion of the dealer (Boudoukh et al. 1997, at 410, 419). These vagaries make inferences from historical data necessarily imprecise.²⁹ For all of these

²⁸ Each of these simulation techniques represents some trade-off between accuracy and cost. Fixed-parameter models do not take into account the fact that parameters such as risk premiums and interest rate volatility often vary over time. Single-factor models assume perfect correlations between bond returns, although this assumption is undermined by the fact that securities with the same OAS display markedly different leverage ratios, volatility, prepayment risks, and responses to changing market conditions (Kochen 1996, at 113–14). More sensitive models, such as Monte Carlo simulations and multifactor time-varying parameter models, can account for these problems but require such intensive computations that they have spawned their own separate literature on cost-effective computing techniques (Chen, Maris, and Yang 1999, at 34, 52; Zenios 1996, at 326, 334–42). In an effort to bypass these methodological problems, other researchers have experimented with empirical models of prepayment behavior (Schwartz and Torous 1989; Waldman 1992) and nonparametric methods such as multivariate density estimation (Boudoukh et al. 1997). For further discussion of the trade-offs, see Davidson et al. 2003, at 144–52.

²⁹ These uncertainties impede the accurate pricing and hedging of mortgage pass-through certificates, IO strips, and PO strips generally (Gaberdiel 1995–96). In addition, IO and PO strips pose further pricing complications that make them more complex and volatile than mortgage pass-through certificates (Gaberdiel 1995–96; Marcus and Kling 1987, at 2–3, 9–12).

reasons, prime market models have not succeeded in accurately modeling prepayment risk.

These pricing errors also infect subprime RMBS models. As is the case in the prime market, option pricing forms the basis for prepayment risk models of subprime pools. The simulation techniques for option pricing in the subprime market must make the same trade-off between accurate results and cost-intensive computations that they do in the prime market. Furthermore, it is even more difficult to extrapolate from historical data for subprime loan pools. Not only is the makeup of these pools more diverse than that of their prime counterparts, the subprime market has less historical data on which to draw. Varying bid-ask spreads and structural market changes can distort subprime estimations as well (Gjaja and Hayre 2001, at 516–17).

Subprime prepayment pricing models have a further source of inaccuracy, which arises from the relatively crude method typically used to equate the yield on subprime RMBS with that on other investments. OAS, which is commonly used for prime RMBS, is a dynamic methodology that controls for changes in the timing of cash flows arising from the mortgage prepayment option. In the subprime industry, however, OAS is used much less often; instead, the convention is to calculate relative value through a more primitive method called static spread analysis. This kind of analysis, which depends on the difference between the yield of a specific subprime RMBS and the yield of the swap curve or the Treasury curve, does not account for volatility in cash flows because of the prepayment option (Davidson et al. 2003, at 109–26, 249–68, 334–35; Gjaja 2001, at 553 and note 26; Gjaja and Hayre 2001, at 516; New Century Financial Corp. 1999).

The unique prepayment behavior of subprime borrowers further complicates the pricing of prepayment risk. For example, unlike prime borrowers, who are more likely to prepay when interest rates fall below coupon, analysts report that subprime borrowers are less sensitive to interest rate movements (Davidson et al. 2003, at 331; Deng and Gabriel 2002, at 17; Pennington-Cross 2003a, at 292–94). Such differences in prepayment behavior inject an added degree of uncertainty into subprime pricing.

Ostensibly for this reason, the vast majority of subprime mortgages layer a second price component for prepayment risk, consisting of hefty prepayment penalties for borrowers, on top of the static spread or OAS.³⁰ Industry analysts

³⁰ Estimates of the percentage of subprime home mortgages with prepayment penalties have ranged from 64 percent to over 98 percent. By contrast, less than 2 percent of prime mortgages carry prepayment penalties (Brockman 1999; Farris, Richardson, and Shai 2003, at 4; U.S. Department of the Treasury and U.S. Department of Housing and Urban Development 2000, at 93).

justify these penalties as necessary to compensate for supposedly higher prepayment speeds in the subprime market. These analysts contend, moreover, that subprime borrowers are able to trade prepayment penalties for lower annual percentage rates (McCall and Blum 1996, at 141; Mehra 2000; Weicher 1997, at 69). As we discuss later, empirical data cast doubt on both contentions.

Examining the justifications for prepayment penalties. Mortgage industry analysts commonly justify prepayment penalties by asserting that subprime mortgage loans have higher prepayment speeds on average than prime mortgage loans (McCall and Blum 1996, at 141; Mehra 2000; U.S. Department of the Treasury and U.S. Department of Housing and Urban Development [HUD] 2000, at 28; Weicher 1997, at 69). However, in the words of one commentator, industry data to back up that claim have been “sparse” (Pennington-Cross 2003a). Essentially, such data have been limited to summary statistics provided by private companies such as University Financial Associates and the Mortgage Information Corporation (now Loan Performance, Inc.) (Pennington-Cross 2003a). For researchers outside the industry, access to those companies’ proprietary data, with rare exceptions, is prohibitively expensive or not available at any price.³¹

Other recent regression analyses suggest that the story is considerably more complicated. A 2003 study of five 2-year panels of data from the American Housing Survey found no significant difference between the prepayment speeds of non-low-income and low-income households. The authors also found that high loan-to-value (LTV) ratios significantly slowed the prepayment speed of lower-income households (Archer, Ling, and McGill 2003).

A second 2003 study, this time of A- and Alt-A fixed-rate 30-year purchase money mortgages originated between February 1995 and February

In the subprime RMBS market, prepayment penalties come in several types. Some consist of constant dollar amounts, while others are expressed as a percentage of the outstanding balance. Some last indefinitely, but 70 to 90 percent expire after five years (Cutts and Van Order 2003, at 8; Farris, Richardson, and Shai 2003, at 4). In other subprime mortgages, penalties decline in constant dollar or percentage terms over a stated number of years (e.g., stepwise from 5 percent to 1 percent annually over five years). Finally, some mortgages have yield maintenance provisions that expire in x years and essentially amount to noncallable bonds (Kelly and Slawson 1999, at 1–2).

³¹ That commentator said: “It is important to note that while private companies provide free of charge general characterizations of their results they do not provide actual estimates, econometric results, or the methodology used to estimate them. These details are presumably available to companies that use their services” (Pennington-Cross 2003a, at 300, note 1; see also Archer, Ling, and McGill 2003, at 135–37, note 1).

In addition, such databases suffer from selection bias because few if any of the participating lenders “have uniform lending coverage throughout the United States, and across the spectrum of housing values” (Archer, Ling, and McGill 2003, at 136, note 1).

1998 and purchased by two national secondary market participants, concluded that the lower the borrower's credit score, the lower the prepayment speed. Furthermore, nonprime prepayment speeds were slower on average than prime prepayment speeds for borrowers with FICO (Fair, Isaac & Company) scores below 700 (Pennington-Cross 2003a, at 280–81, 289, 291; see also Davidson et al. 2003, at 330–331; Hayre and Young 2001, at 162). Subprime borrowers are typically defined as borrowers with FICO scores below 650 (U.S. Department of the Treasury and HUD 2000, at 33). These studies call into question the summary industry statistics suggesting that average subprime prepayment speeds are faster.³²

A third study studied the relationship between default risk and prepayment speeds in Federal Housing Administration (FHA)–insured home loans, which tend to serve lower-income and minority borrowers with high debt burdens and poor credit histories (Deng and Gabriel 2002, at 11 and table 1). The study, which examined FHA home purchase loans from 1992 to 1996, confirmed that borrowers with lower FICO scores and those with higher LTV ratios had significantly lower prepayment speeds (Deng and Gabriel 2002, at 13, 17–19; see also Gjaja 2001, at 537). The study similarly found that borrowers with lower FICO scores are relatively insensitive to falling interest rates and thus have dampened prepayment speeds even when prepayment is “in the money” (Deng and Gabriel 2002, at 17; see also Gjaja 2001, at 537). It is important to note that the researchers found significantly lower average prepayment speeds for black, Hispanic, and single-female borrowers (Deng and Gabriel 2002, at 13–14, 17–18). Finally, the study broke ground by finding that in the aggregate, the reduced prepayment speeds of high credit risk borrowers substantially offset the increased default risk of those loans. According to the authors, “the substantially elevated default probabilities of higher credit risk FHA borrowers [were] more than offset by their damp[en]ed prepayment propensities, resulting in significantly lower loan termination probabilities overall” (Deng and Gabriel 2002, at 5).³³ In the opinion of these authors, “loans originated among high credit borrowers are relatively more profitable to the investor [than loans to prime borrowers], given their substan-

³² Possible explanations for the divergent results are that lenders captured in the industry statistics steer prime-eligible borrowers into subprime loans or else the borrowers in those pools had strong FICO scores and low-documentation Alt-A loans, which they later refinanced at cheaper rates (Pennington-Cross 2003a, at 292–94, 296–97, 300, note 6; see also Hayre and Young 2001, at 161–62).

³³ Specifically, “[f]or the investor in FHA-insured mortgage pools, the estimated 5-year cumulative probability of mortgage termination among high default risk and minority borrowers [was] only about three-fourths that of low-default risk and non-minority borrowers, respectively” (Deng and Gabriel 2002, at 22).

tially depressed overall termination propensities” (Deng and Gabriel 2002, at 20).³⁴

The reduced prepayment rates of minority borrowers and borrowers with lower FICO scores suggest that subprime prepayment risk is not as severe as mortgage industry analysts report and that the widespread use of prepayment penalties may not be justified by risk (Archer, Ling, and McGill 2003, at 135; Deng and Gabriel 2002, at 3, 5). Of equal import is the growing evidence that prepayment penalties result in rent-seeking. Researchers analyzing nationwide loan-level data on subprime mortgages have concluded, for example, that subprime prepayment penalties are positively correlated with an *increase* in interest rates, not a decrease, after controlling for other loan terms (Farris, Richardson, and Shai 2003, at 18). This undermines the claim that subprime prepayment penalties provide a trade-off against higher interest rates.

Similarly, brokers have perverse incentives to market subprime mortgages with prepayment penalties. Researchers have found that lenders pay brokers higher yield spread premiums³⁵ for selling loans that carry prepayment penalties (Goldstein and Son 2003, at 7). This incentive structure artificially boosts the supply of loans carrying prepayment penalty clauses independent of the demand for such clauses, either by investors or by borrowers (Jackson and Berry 2002, at 3).

Finally, in the subprime market, it is erroneous to assume that prepayment risk, if it materializes, necessarily results in net losses for investors. In thinking about this issue, it is crucial to bear in mind what prepayment risk is: the risk that prepayment will force investors to reinvest their funds at below-coupon interest rates. Subprime prepayments, however, are for the most part insensitive to falling interest rates. Indeed, a recent study concluded that “the average nonprime mortgage prepays when it is not in the money to refinance,” for example, when comparable interest rates exceed coupon (Pennington-Cross 2003a, at 292). Thus, when subprime borrowers do prepay, it is likely that investors can reinvest their principal for comparable risk at rates above what their original investments earned. Industry discussions of prepayment risk models for subprime mortgages are silent on this topic, however. (See, for instance, McCall and Blum 1996; Mehra 2000; Weicher 1997.) Similarly,

³⁴ A 2001 study of conventional 30-year fixed-rate mortgages originated from 1993 to 1997 and purchased by Freddie Mac echoed these results. That study found that, even after controlling for FICO scores and LTV ratios, black and Hispanic borrowers prepaid at significantly slower rates than white borrowers. The study further concluded that while low-income and minority borrowers had “higher default costs, the lower costs from exercising the prepayment option...about offset (perhaps more than offset) these [default costs] for our loan sample” (Van Order and Zorn 2001, at 23).

³⁵ Yield spread premiums also reward brokers for making higher-interest loans.

there is no evidence that subprime pricing models lower their estimates of prepayment risk to account for this dynamic. To the extent that downward adjustments do not occur, the pricing structure results in rent-seeking.³⁶

In sum, efforts to price prepayment risk in both the prime and the subprime markets have been inadequate to date. It is not at all clear that investors in subprime pools face any significant prepayment risk from B, C, or D borrowers. On the contrary, it appears that investors may benefit from prepayment by such borrowers even in the absence of penalties. Just the same, these penalties pervade the subprime market, and investors, as well as lenders, are the beneficiaries when lenders flip borrowers' loans. From the borrowers' perspective, the use of pricing to reduce prepayment risk in the secondary markets provides no protection and in fact can result in harmful rent-seeking.

Managing litigation risk

Costly litigation and significant judgments arguably could have an adverse impact on the value of a loan pool. The reality, however, is that the risk that a securitized loan pool will actually suffer losses from predatory lending litigation is quite small. This is because there are practical impediments to bringing predatory lending claims and also because securitization deals are intentionally structured to reduce such risk.

Practical limitations. Turning first to the practical impediments, consumer litigation is time-consuming and costly. Attorneys often have to gain highly specialized expertise and put in a tremendous number of hours on cases to obtain uncertain outcomes, particularly when attorneys have a heavy burden of proof (for example, establishing that assignees had notice of originators' discriminatory practices). In addition, as discussed earlier, sometimes the laws themselves preclude claims against assignees, as when the holder in due course defense applies. Other laws do not provide a private cause of action, in which case borrowers must rely on government entities to enforce their rights against assignees. Likewise, where laws, like some state UDAP statutes, apply only to certain types of loan transactions, the range of actionable claims is correspondingly reduced. Even when laws do contemplate claims against assignees, originators often write loans so that they do not trigger a statute's coverage, especially that of HOEPA.

³⁶ Rapid subprime prepayments can also cause RMBS to appreciate in value due to credit rating upgrades. In 2003, 107 subprime RMBS upgrades were due to rapid prepayments "that resulted in increased credit support" (S&P 2004a). For these issues, the increased credit support resulted from the fact that as borrowers prepaid principal, credit enhancements rose as a percentage of outstanding mortgage principal (S&P 2004a).

Structured finance. Although the practical obstacles to predatory lending claims against assignees are significant, they do not completely eliminate the threat that litigation can pose to the value of a loan pool. For this reason, securitization deals are structured to further reduce this risk by adding credit enhancements and by reducing or eliminating the risk of assignee liability.

Just as the credit enhancements and deal provisions we discussed in the context of credit risk help protect investors against the risk of default, they also protect against the costs of litigation. Insurance, the junior tranches, excess spread accounts, overcollateralization, guarantees, representations and warranties, and letters of credit serve to maintain the value of a loan pool if and when a trust experiences unanticipated losses as the result of successful predatory lending claims or defenses.

Since federal and state laws increasingly allow for some form of assignee liability for predatory lending, investment banks and rating agencies have paid particular attention to claims that could expose trusts to liability. The rating agencies are increasingly refusing to rate loan pools that would subject securitization trusts to assignee liability. For example, Fitch Ratings has refused to rate any loans in Los Angeles because its anti-predatory lending ordinance holds assignees liable for actions of originators (Bergquist 2003b). Similarly, S&P (2001) regularly refuses to rate pools that contain loans covered by HOEPA. As further assurance, securitization deals almost invariably contain representations that the assignees are holders in due course and that the pools do not contain loans that could subject the trust to assignee liability.

Creating incentives for the secondary market to police predatory lending

Incentives for investors to monitor originators

RMBS investors have little incentive to guard against predatory loan practices. Although investors face some credit, prepayment, and litigation risk from predatory lending, pricing, credit enhancements, legal hurdles, and deal provisions combine to reduce and defuse much of the risk that they would otherwise bear.

Theoretically, it is possible for investors in senior tranches to sustain credit losses that are caused by predatory lending and result in higher defaults. Practically speaking, this virtually never happens. The vast majority of borrowers with predatory loans do not default (New Century Financial Corp. 1999; SMR Research Corp. 2000, at 49; White 2004), and when they do, originators, junior tranche holders, and/or insurers, not senior tranche holders, bear the costs. This holds true even in years with record numbers of subprime

home loan defaults. In 2003, which set a record for such defaults, not a single class of subprime RMBS rated AAA or AA (the two most senior grades) by S&P suffered downgrades. That year, 26 junior classes of subprime RMBS did default because of poor collateral performance, thereby resulting in ratings downgrades. However, 15 of these defaults were attributable to one guarantor, Conseco Finance Corp., while the remaining 11 defaults were limited to more speculative classes, rated BBB or below.³⁷ By contrast, S&P upgraded 107 classes of subprime RMBS in 2003, all for improved collateral performance. That year, upgrades outnumbered downgrades by 4 to 1 (S&P 2004a). This remarkable performance is testament to structured finance's success in buffering senior tranches against credit losses.

As we discussed earlier, investors face little or no risk from flipping that creates faster prepayment speeds because they are still *slower* on average for borrowers with subprime loans. In fact, prepayments due to loan flipping profit investors when comparable interest rates are above coupon because investors can reinvest the proceeds at a profit. For these reasons, investors have scant reason to be on guard against loan flipping. Even when they are concerned because they believe flipping increases prepayment risk, they will demand a lower price rather than avoid buying profitable loans resulting from flips.

Finally, the risk of lawsuits does not pose any serious threat to investors. Whatever losses do arise can be absorbed by the providers of the credit enhancements or passed back onto the originators through deal provisions that require them to take back nonperforming loans or loans that were made in violation of the law.

Given that investors in securities backed by predatory loans are adequately protected by pricing, credit enhancements, legal hurdles, and deal provisions, they have little or no incentive to police originators through loan screening criteria and other techniques designed to halt predatory practices. Obviously, investors demand credit enhancements and these are embedded in the price. The effect, however, is to apportion risk after the fact, not eliminate it beforehand.

³⁷ In theory, if an originator made a significant number of predatory loans and then went into bankruptcy, a trust would have difficulty fully recovering any credit enhancements the originator retained within its corporate shell or enforcing the originator's representations and warranties in the ensuing bankruptcy proceeding. As the 2003 experience suggests, however, rarely do bankruptcies adversely affect senior tranches. Moreover, the one major instance to date of illiquidity in the subprime RMBS industry was of short duration and linked to global instability. During the Russian ruble and Asian flu crises of 1998–99, investors fled to safety, triggering a domino effect of subprime originator bankruptcies (Davidson et al. 2003, at 328–29; Harney 2002; SMR Research Corp. 2000, at 28–34). Despite those bankruptcies and the ensuing loss of investor confidence, liquidity returned to the subprime RMBS market after only a few months (SMR Research Corp. 2000, at 29).

Risks borne by originators

Originators who transfer loans to SPVs for securitization retain some of the risk of predatory lending. Deal provisions such as junior-senior tranches and representations and warranties explicitly force originators to retain some of the risk. The fact that predatory lending continues to flourish³⁸ suggests that for originators, the risks of engaging in it do not outweigh the gains. There are a number of possible reasons for this phenomenon. First, injured borrowers usually pay back their loans and rarely raise affirmative or defensive legal claims. In addition, securitization defuses the risk by spreading it among an array of market actors, from borrowers and originators to insurance companies. Also, up-front fees generate significant income for originators and may offset the risks they retain through deal provisions (White 2004). At the end of the day, it is borrowers, not originators or secondary market actors, who are harmed by abusive lending.

A proposal for assignee liability

We contend that investors should bear some of the burden of predatory lending; this would create an incentive for them to avoid investing in loan pools containing predatory loans. There are numerous justifications for imposing assignee liability. From an efficiency perspective, the secondary market is in a better position than unsuspecting borrowers to detect and protect against predatory lending.³⁹ Further, the various secondary market actors—investment

³⁸ A recent report by The Reinvestment Fund (2004) documents the incidence of predatory lending in home mortgage loan refinance transactions. Between 1998 and 2003, the Federal Trade Commission (FTC) prosecuted predatory lending cases against home mortgage lenders and brokers including Action Loan Co.; Associates First Capital Corp.; Barry Cooper Properties; Capital City Mortgage Corp.; Capitol Mortgage Corp.; CLS Financial Services, Inc.; Delta Funding Corp.; Fairbanks Capital Corp.; First Alliance Mortgage Company; First Plus Financial Group, Inc.; Fleet Finance and Home Equity U.S.A.; Granite Mortgage, LLC; Interstate Resource Corp.; LAP Financial Services, Inc.; Mark Diamond; Mercantile Mortgage Co.; NuWest, Inc.; Stewart Finance Co.; and Wasatch Credit Corp. (FTC 1999, 2000, 2002, 2003). In the spring of 2004, the FTC authorized additional predatory lending investigations. In a resolution dated April 8, 2004, the commission authorized its staff to conduct further “non-public investigations of various unnamed subprime lenders and loan brokers to determine whether there have been violations of certain consumer protection laws” (Bergquist 2004, 1). According to press reports and Securities and Exchange Commission filings, Aames Financial Corp. was one company under investigation at that time (Bergquist 2004). Concurrently, to eliminate alleged predatory servicing practices, the Office of Thrift Supervision entered into a supervisory agreement with Ocwen Federal Bank (Blackwell 2004). On May 27, 2004, Citigroup Inc. and its subprime mortgage subsidiary, Citifinancial Credit Company, agreed to a cease-and-desist order that was imposed by the Board of Governors of the Federal Reserve System and assessed a \$70 million civil money penalty for alleged predatory lending practices (Board of Governors of the Federal Reserve System 2004; O’Brien 2004).

³⁹ For a fuller discussion of the rationales for imposing assignee liability, see Venkatesan 2004.

banks and rating agencies, in particular—have the technology to police predatory lenders. From a fairness perspective, the holder in due course doctrine provides a unilateral benefit to investors to the detriment of borrowers. Holder in due course status increases the value of loans when they are sold because it erects a roadblock to borrowers' contract claims. By contrast, borrowers cannot restrict the sale of their loans and do not receive any remuneration from such a sale, yet the holder in due course rule restricts their ability to assert predatory lending claims and defenses.

Any assignee liability provision must strike a balance between creating incentives for secondary market actors to screen loan pools for predatory loans and police originators on the one hand and the need to continue the flow of mortgage capital to low- and moderate-income borrowers on the other. Unrestricted assignee liability could create such uncertainty that securitization would likely be limited to prime loans. This would have devastating consequences for a large segment of homeowners and potential home buyers who cannot qualify for prime mortgage loans. However, the absence of sufficient incentives for policing originators has created an environment in which predatory lenders exploit vulnerable borrowers with impunity, wreaking havoc on individuals and communities.

Our assignee liability proposal attempts to increase certainty by establishing bright-line rules that would enable assignees to predict the impact of their liability for any predatory lending claims. Our proposal divides assignees into two classes, those that adopt certain controls and those that do not. The latter would be subject to any and all common law and statutory claims and damages remedies that borrowers would have against originators. The former would be liable for the same common law and statutory claims, but the scope of their potential liability would be limited and thus more predictable.⁴⁰

The determination of the actual controls that assignees must adopt should be left to the discretion of a federal agency that can gather information from consumer advocates, originators, and secondary market actors in rulemaking proceedings to determine which methods best detect and deter predatory lending. At a minimum, the controls should include the following:

1. Specific⁴¹ purchase criteria designed to screen out predatory loans in all securitized loan pools

⁴⁰ To the extent that borrowers already have direct claims against assignees under current law (aiding and abetting originator fraud, for instance), assignees would not be able to take advantage of our proposed restrictions on liability.

⁴¹ The controls must contain precise requirements to reduce uncertainty. Some predatory lending laws and ordinances use vague terms that make it difficult for the secondary market to determine the scope of its exposure.

2. Examinations of originators' loan policies, underwriting guidelines, broker compensation policies, and loan contract forms for compliance with all relevant laws, including consumer protection and predatory lending laws
3. A computerized screening of loan-level data to determine whether the loans in the pool contain identified terms associated with predatory lending⁴² or other specified markers of it
4. A statistically valid sampling of loan documents to determine whether any contain predatory terms that could not be detected through computerized screening
5. Collection and review of all pre- and postsale complaints filed and regulatory actions taken against originators to determine whether they are engaged in predatory lending
6. Designated actions depending on the outcome of the review (Specifically, if the controls revealed evidence of isolated predatory lending, assignees would have to reject the offensive loans. If the review revealed more systematic predatory lending by an originator, the assignee would be obliged to reject all of the originators' loans in the pool.)⁴³
7. Ongoing monitoring of the performance of loans to identify and investigate originators whose loans are underperforming relative to the particular market to determine whether they are engaged in predatory lending and, if so, requiring the originators to buy back their loans

Trusts that complied with these provisions would be liable to the same extent as originators for any violations of state or federal laws, but they would not be subject to punitive damages. Trusts that failed to implement these controls would be liable for punitive damages as well as other damages.

⁴²Almost all predatory loan practices and terms, such as financed credit life insurance, can be easily detected through loan review. One exception is fraud, which can be based, for example, on misrepresentations to borrowers or inflated appraisals, neither of which would be easy for the secondary market to detect. There are, however, ways to detect and protect against fraud. The sampling of individual loans that we recommend could uncover some fraud. For instance, an appraisal that far exceeds the average appraisal in the area could be a sign of fraud that might require further investigation. In situations where fraud might be difficult to detect, credit enhancements and representations and warranties, coupled with the restricted liability, could provide investor protection.

⁴³As we discussed earlier, the contours of these and other provisions should be defined by the appropriate federal agency.

Conclusion

Predatory lending continues to thrive despite claims that the market will correct the problem. Investors, who because of information asymmetries could potentially absorb some of the risks of predatory lending, are protected by pricing and securitization deals and, therefore, have no incentive to police predatory lenders. In fact, it is increasingly clear that investors actually benefit from predatory lending through prepayment penalties. The social consequences of predatory lending and the ability of the secondary market to help police predatory lenders justify the imposition of assignee liability. Carefully crafted provisions can reduce uncertainty and thus enable the secondary market to calculate the cost of assignee liability into its pricing technology.

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