Testimony
before the

Subcommittee on Housing and Community Opportunity

and

Subcommittee on Financial Institutions and Consumer Credit

at Joint Hearing regarding

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

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Introduction

I am Kurt Eggert, an Associate Professor of Law at Chapman University School of Law in Orange, California, where I teach real estate transactions and elder law. I have written several articles on predatory lending, and have frequently spoken on this subject in panels at the American Bar Association's annual meeting, the Association of American Law Schools, and several symposiums and conferences.

My testimony today will focus on the importance of having assignee liability for residential mortgages. Although my testimony today will focus on this one aspect of the predatory lending problem, I will also be putting into the record the entire text of a full law review article I authored entitled Held Up In Due Course: Predatory Lending, Securitization, and the Holder In Due Course Doctrine, which appeared in volume 35 of the Creighton Law Review in April, 2002. In that article, I describe the securitization of home mortgages and discuss how that securitization has fostered predatory lending in the United States by giving

unscrupulous lenders a ready secondary market for their overpriced loans. I discuss the interaction of securitization and the holder in due course doctrine, which prevents a homeowner from bringing most of her defenses or claims regarding the origination of a loan against the assignee of a loan and so prevents assignee liability in many cases. Much of my testimony today is based on that article.

In my testimony today, I will propose a definition for the term "predatory lending" and then describe common tactics used by abusive lenders. Next, I will address how the securitization of residential mortgages, pooling them and selling securities based on the pool on Wall Street, has led to a dramatic increase in subprime and predatory loans. Then I discuss a solution to this securitization-driven epidemic of abusive lending: force the investors who buy interests in the loan pools to bear the risk of predatory loans in those pools. If investors bear this risk, then they will demand that the securitizers of those loans ensure that the originators of the loans have abstained from predatory behavior and are creditworthy enough to repurchase any predatory loans. I argue that securitizers, with their greater market savvy and informational advantages, are better equipped than borrowers to recognize predatory lending and to refuse to deal with the abusive lenders that engage in it. Denied access to the capital markets that have purchased their loans and financed their activities, unscrupulous lenders will have difficulty funding loans.

I hope to dispel several myths about predatory lending, such as the notion that predatory lending has not been or cannot be defined, and until it is defined, no action should be taken to prevent it. Another myth is that the secondary market and other assignees cannot easily tell which loans are predatory and that individual borrowers are better able to prevent predatory lending. I would also like to dispel the notion that the securitization of mortgages is an unadulterated benefit for borrowers and must be preserved at all costs, even at the risk of having individual borrowers lose their homes because of predatory lending. Instead, it appears that securitization may not lower mortgage costs for subprime borrowers and may even increase those costs.

I will also discuss the current battle over assignee liability, during which the lending industry is claiming that assignee liability makes it difficult, if not impossible, to securitize residential mortgages. Rather than making such securitization impossible, assignee liability will, if designed correctly, cause ratings agencies to scrutinize the origination practices and creditworthiness of the originators of loans. This increased scrutiny will help deter originators that depend on securitization to fund their lending from engaging in predatory practices. Ensuring the creditworthiness of the lenders will help ensure that if the lenders do engage in predatory behavior, they will have sufficient assets to repurchase the affected loans, so that the borrower will be able to sue them directly without concern for the cutting off of any of their defenses. In addition, originators that are creditworthy are less likely to declare bankruptcy and so borrowers who have been defrauded are more likely to be able to recover their damages against the originator.

"Predatory Lending": Definition and Techniques

While predatory lending has been the focus of many hearings, articles, laws, and regulations, there has not yet been one generally accepted definition for this term. Opponents of laws attacking predatory lending assert that in the absence of a clear, generally accepted definition of predatory lending, any such efforts are premature. However, I believe that a clear, concise definition of predatory lending is possible. Clearly, predatory lending implies some abusive process whereby lenders take advantage of borrowers, and some definitions focus on the exact methods the lenders use. However, a more accurate definition should focus on both the coercive process and the detrimental effect of the lending, weighing one with the other to determine whether the lender has gained an unfair advantage over the borrower. Therefore, I offer this definition:

"Predatory lending" is the use by lenders of deceptive, manipulative, or coercive practices in order to induce borrowers to accept loans that (1) have interest rates or fees significantly above the current market rate given the risk profile of the borrowers or other terms significantly worse than the market norm offered by legitimate lenders, or (2) which leave the borrowers worse off than they would have been without any new loans, or (3) both. These factors should be balanced against each other so that a loan with grossly excessive interest rates or fees, given the risk characteristics of the borrower, would need less in the way of lender deception, manipulation, or coercion to be considered predatory.

A loan may affirmatively harm a borrower whether or not the loan is overpriced where, for example, the borrower is likely to be unable to repay the new loan and will lose her house as a result, or where it refinances existing loans with interest rates below the current market rate. Most loans that significantly increase the chances of foreclosure, for example, would likely be predatory regardless of their price, because foreclosure is so harmful to borrowers. However, the primary goal of predatory lenders is to convince or coerce borrowers to obtain loans that cost more than the market rate given the borrowers' risk characteristics.

Common methods of inducing borrowers to pay higher than market interest rates or fees or accept affirmatively harmful loans include:

1) Loan Flipping: The rapid refinancing of borrowers' loans, adding new fees and costs to each refinancing so that the lender bleeds dry the equity in the house. Flipping appears to be widespread in the subprime market for loans to elder borrowers.

2) High Prepayment Penalties: These fees for paying loans off early are rare in the prime market, but run rampant in the subprime market. Many subprime lenders charge prepayment penalties as high as five percent of the loan if borrowers prepay their loans.

3) Equity Stripping: The process of convincing homeowners to enter into loans that

cause them to lose their homes when they cannot pay the loans.

4) Packing: The process of increasing the amount of loans by adding unnecessary charges for products, such as credit insurance, that the borrower does not need, want, or often even realize that she is purchasing.

5) Steering: The process by which loan brokers direct borrowers to lenders who will provide high-cost loans, even though the borrowers would qualify for much lower interest rates. Steering by brokers is so effective that perhaps thirty-five to fifty percent of borrowers induced into accepting subprime loans could have qualified for much less expensive prime rate loans.

6) Balloon payments: The requirement that the borrower pay the entire loan amount before the monthly payments would have gradually paid off the loan. Some abusive lenders include this requirement to ensure that their borrowers, who rarely can make such a large lump-sum payment, must refinance their loans, offering a new opportunity for the lender to charge points and fees, thus increasing the amount of the loans.

7) Fraud or Deception: Outright deception is the most blatant form of predatory lending and may occur either through express statements or by concealing information from borrowers that would reveal the true cost or effects of the loan.

Predatory lending harms not only its victims but also their communities. Its victims are burdened with overpriced mortgages and, even if they are able to pay these loans, they feel the financial loss for years afterward. This direct cost was recently estimated at $9.1 billion annually. This figure, high as it is, does not include the much greater and separate harm of foreclosure suffered by those unable to pay their loans.

While abusive lending has always existed, there seems to have been an explosion of particularly virulent lending abuses in the 1990s. In case after case, a new or small lender would suddenly grow at an enormous rate, while accusations of the lender's abusive practices would grow at the same time. Then, even more quickly than it grew, the lender would disappear, filing for bankruptcy protection and leaving the victimized borrowers to fend for themselves against the current holders of their mortgages. These current holders could argue that, as innocent assignees of the notes, they should hold the notes free of almost all defenses that the borrowers had against the original lenders, including most fraud claims.

How these lenders could grow so quickly beginning in the 1990s is no mystery. Wall Street investment bankers discovered they could profit greatly from subprime loans, by lending money to subprime lenders and by taking sizeable fees for securitizing the resulting loans. With this ready flow of capital from Wall Street, subprime lenders could grow dramatically, lending far more each year than they might have had they held their own notes or tried to sell the notes individually to private investors.

The Process of Securitization

To understand Wall Street's role in the growth of subprime and predatory lending, one must first understand the process of securitization. Securitization is the method of aggregating a large number of notes secured by deeds of trust, or other illiquid assets, in a large pool, and then selling securities backed by those assets. These securities trade on an open market and allow investors to buy interests in the pool of notes without the paperwork or risk of purchasing individual notes. The resulting securities are highly liquid and easy to trade. Securitization has transferred the source of capital for mortgage funding from the savings industry to the capital markets and institutional and other investors. The process of securitization is designed to isolate the notes from the entity that originated them or acquired them, so that the notes are legally completely independent from their former owner and as free as possible from bankruptcy or liability risks of the originator.

A typical securitization of a loan secured by a residence might proceed as follows. The borrower negotiates with a mortgage broker for the terms of the loan. Mortgage brokers may originate the loans in their own names in three ways: (1) by using "table funding," money provided by the pre-arranged buyer of the loan used to close the loan in the originator's name; (2) by access to a warehouse line of credit; or (3) by supplying the broker's own funds. Alternatively, the mortgage broker may close the loan in the name of the lender providing the money. Whether the broker closes the loan in his or her own name or in the name of the lender, the broker typically almost immediately transfers the loan to a lender. This lender quickly sells the loan to a different financial entity, which pools the loan together with a host of other loans in a mortgage pool. The loans in the pool may all come from one lender or from a multitude of lenders.

The assignee of the loans then transfers them to another entity, typically a limited liability company or wholly owned corporate subsidiary. This entity (known as the "seller" because it will sell the securities that result from the securitization process) then transfers the loans to a special purpose vehicle (an "SPV"), a business entity that has the sole purpose of holding the pool of mortgages, and in return the seller receives the securities issued by the SPV. SPVs can be trusts, corporations, limited partnerships, or more specialized business entities, though a trust is considered the most common. However, the set of fiduciary duties that trust law would normally impose are by and large replaced by the trust agreement's minutely detailed provisions.

The securities that the SPV transfers to the seller are carefully packaged to maximize their appeal to purchasers. There are a multitude of ways in which these securities can be packaged, as different aspects, or "strips," of the loans are divided up and sold separately as securities. A relatively simple, straightforward division of ownership rights in the pooled loans is for one group of securities to represent the interest that will be paid on the loans

(interest-only strips), and a second group to represent the repayment of principal on those same loans (principal-only strips). If interest rates drop, the prepayment rate of the loans in the pool normally increases, shrinking the income of the holders of interest-only strips, since there will be fewer loans to pay interest, while swelling the returns of the principal-only strips, as they receive the payments on principal years before the payments might have been expected. The pool of mortgages can be cut into much more complex strips of mortgages, depending on what the creator of the SPV thinks may be most easily sold. The strips, or classes of securities, are also called "tranches," which is French for "strips."

Working with the seller to package the loan pool and its resulting securities is an underwriter, which, together with a rating agency, examines the loans assembled in the pool, sets specific requirements of loss probability for the loans, and discards loans that do not meet the risk standards set for the pool, returning them to the originator. The intermediaries who pool mortgages, however, have been too reluctant to undertake any significant diligence in their own examination of the loans or the borrowers and instead have excessively relied, for the most part, on detailed representations by the originators of the loans.

Most pooling agreements give the intermediaries the right to force an originator to take back any loan that did not actually qualify for the loan pool, the inclusion of which would cause a breach of the originator's representations. Therefore, the originator of the loans may be forced to take back a loan if the borrower defaults. Once the securities are rated by the rating agency, they can be sold to investors. This sale is typically accomplished by private placements or by public offerings, and an underwriter is involved in all public offerings and most private placements. The buyers may include mutual and pension funds, insurance companies, other institutional investors, and private individuals.

Securitization and its Discontents

The lending industry claims that securitization is an unqualified boon to borrowers as it lowers their interest rates and allows the free flow of money to home mortgages. While the government sponsored entities (GSEs) that securitize loans, such as Fannie Mae and Freddie Mac, claim that their securitization has led to lower interest rates, a recent analysis by the Federal Reserve Board suggests that securitization may not decrease interest rates. Instead, falling interest rates may lead to increased securitization by GSEs, rather than the other way around, and the liquidity premium that securitization creates may not be passed along to the borrower.[1]

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[1] See Andrea Heuson, Wayne Passmore, & Roger Sparks, Credit Scoring and Mortgage Securitization: Do They Lower Mortgage Rates? Federal Reserve Board Paper 2000_44, Dec. 12, 2000, at http:// www.federalreserve.gov/pubs/feds/2000/200044/200044abs.html. Unsurprisingly, the GSEs have attacked the Heuson, Passmore and Sparks paper, arguing that it is based solely on a model of "a hypothetical mortgage market based on a flagrantly unrealistic assumption," and "contains not one shred of data or evidence." Mike Sorohan, Securitization Does Not Lower Rates, Fed Report Says, Real Est. Fin. Today, Dec. 12, 2000, 2000 WL 8249712.

Another analysis of the effects of securitization concluded that, rather than decreasing the costs of borrowing, securitization may actually increase those costs, so long as the originators of loans have better information regarding the actual risk characteristics of the borrowers than do the securitizers of the loans and the securitizers have a comparative advantage in guaranteeing loans. This price increase would be due to the "lemon effect," the fact that securitizers may fear that originators will transfer their worst loans (the "lemons") to the securitizers while retaining their best loans (the "cherries") for the originators' own portfolios. Originators may doubt whether the risk characteristics of the possible lemons is as good as claimed by originators, and so demand a higher interest rate from the borrowers than they would if they had more perfect knowledge of the risk characteristics of the loans. Also, securitizers may offer a higher guaranteed rate of return across the boards for the loans to induce the originators to sell all of their loans, "cherries" as well as "lemons."[2]

Securitization might not only increase subprime borrowing costs, it may cause other harms to borrowers. First of all, securitization has encouraged the decline of stringent underwriting. Careful underwriting reduces foreclosure against borrowers by deterring lenders from making loans to borrowers unable to repay the loan.[3] As originators immediately sell their loans and so face less risk of loss even if a borrower defaults, the originators naturally will spend less time and effort screening potential loans for default, thus increasing the risk of lending money to borrowers with a high level of default risk. Securitization reduces the amount of individual, lender-driven underwriting and instead depends on systemic controls that can be objectively verified, such as automated underwriting systems. 98 percent of mortgage companies now use some form of automated underwriting, according to a 2001 survey.[4] In this way, banks step away from their great strength, which was the effectiveness and efficiency of their information gathering and regulation systems, in both selecting which loans to make and controlling those loans once

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[2] See Wayne Passmore & Roger Sparks, Putting the Squeeze on a Market for Lemons: Government_Sponsored Mortgage Securitization, 13 J. Real Est. Fin. & Econ. 27 (1996) (arguing that where there is information asymmetry between the originator and the securitizer, the securitization process may actually increase interest rates). In their later study, Heuson, Passmore, and Sparks assume that new credit scoring approaches have largely eliminated this information asymmetry in the prime market, though originators still have the "first mover advantage" of deciding what loans to securitize. However, in the subprime market, automated credit scoring has not been as universal or as efficient. Because subprime borrowers are more heterogeneous than prime borrowers, automated scoring systems are faced with a greater variety of potential risk characteristics. This, with the additional element of originator fraud, which is more common in the subprime market, preserves the information asymmetry between the originators and the securitizers, despite the advent of automated credit scoring.

[3] Edward L. Pittman, Economic and Regulatory Developments Affecting Mortgage Related Securities, 64 Notre Dame L. Rev. 497, 546 (1989).

[4] Chris De Reza, Fannie Mae, Freddie Mac Agree to Common AU Standard, Real Est. Fin. Today, Elec. Ed., July 23, 2001, at 1, 2001 WL 8193092.

made, and in using their long-term relationships with borrowers.[5] With less lender supervision, borrowers are more likely to default on their loans and risk foreclosure, though the default and foreclosure would likely occur after the original lender has assigned the loan.

Securitization and the "Atomization" of the Residential Loan Industry

Securitization has accomplished what is known as the unbundling of the loan industry, disassembling the lending process into its constituent elements, and allowing a separate entity to undertake each element. Traditionally, lenders performed all of the functions of a loan, finding the borrowers, preparing the documentation for the loan, funding the loan, holding the mortgage during the course of the loan, and servicing the loan throughout its life. Securitization has, in the words of Michael G. Jacobides, "atomized" this process, so that one distinct entity, more often than not a mortgage broker, originates the loan, while another, perhaps a mortgage banker, funds the loan, and another may securitize the loan and sell it to investors.[6] These investors, through their ownership of securities issued by the SPV holding the mortgage in trust with a pool of other mortgages, claim the capital represented by the mortgage, while a separate set of entities, such as a master servicer and subservicer, under the trustee's direction, services the loan, accepting the mortgage payments and foreclosing if necessary.

This separation of the mortgage process confers on each entity in the chain a plausible deniability of the actions of the others. The securitizer can claim to be unconnected to the broker and unaware of any of his activities, however improper. The SPV and the owners of its securities can claim to be holders in due course and protected from any accountability for the fraud of the mortgage broker, through their ignorance of any such fraudulent behavior. The mortgage broker can accurately claim, once the loan is out of his hands, that he can no longer help the borrower if the servicer wrongfully attempts to foreclose.

Before the rise of securitization, borrowers dealt with large finance companies, which funded their own loans and held the loans in their own portfolios. Because these lenders continued to hold the borrowers' paper, were closely regulated, and were required by regulators to hold sizeable assets, the finance companies had diminished incentive to commit outright fraud against the borrowers, as borrowers retained any defenses they had to the loans and the borrowers could also seek damages against the finance companies. With the rise of securitization, the origination of mortgages has largely been turned over to mortgage brokers,

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[5] Elisabetta Montanaro, Efficient Risk Management in Financial Systems: Universal Bank or Securitisation, in The Recent Evolution of Financial Systems 128 (Jack Revell ed., 1997).

[6] Michael G. Jacobides, Mortgage Banking Unbundling: Structure, Automation and Profit, Mortgage Banking, Jan. 1, 2001, 2001 WL 11398425. Jacobides writes, "The mortgage banking industry is one of the most fascinating examples of vertical disintegration and reconfiguration in modern business history." See Tamar Frankel, Securitization: The Conflict Between Personal and Market Law (Contract and Property), 18 Ann. Rev. Banking L. 197, 202 (1999) for the stages of the securitization process.

who now originate over sixty percent of all residential loans in the United States. Mortgage brokers are less regulated than finance companies and less constrained, since they may have few assets, either in their company or individually and rarely continue to hold the loans they originate.

While mortgage brokers themselves have very little direct interaction with the secondary market, the brokers often originate loans for the wholesale lenders, who then sell them onto the secondary market. A wholesale lender might purchase loans from a thousand different independent brokers and bankers from around the country. This use of brokers may lead to higher fees charged to borrowers, as brokers could be tempted to seek out the lenders that provide the greatest payments to brokers rather than the best rates to borrowers. Also, because brokers' fees are commonly a percentage of the total loan, brokers have an incentive to encourage the borrowers to take out as large a loan as possible, to maximize the brokers' commissions, even if a smaller loan would be more appropriate for the borrowers. The use of brokers has hastened the growth of subprime lending. Some brokers have steered borrowers who would qualify for conventional loans into subprime loans, since the brokers make greater fees from subprime than prime loans.

The securitization process allows even someone with almost no capital or financial services to exploit this lack of regulation and become a lender or otherwise originate loans. A mortgage broker could easily be judgment-proof in the states that do not require them to be bonded or to maintain a minimum capital. Such mortgage brokers are free to disappear if they are sued. Disreputable brokers have been known to declare bankruptcy, move to another state, and begin business anew under assumed names. Furthermore, since mortgage brokers rarely hold a borrower's notes in their own portfolios, they have too little reason to be concerned about any defenses the borrower might have to the note.

Securitization removes one sometimes potent weapon in the hands of a borrower who needs to have her loan restructured. When loans were held by regional or local banks, those banks were susceptible to bad publicity and might be loath to foreclose on the home of, for example, an elderly borrower, especially one who was the victim of fraud. Banks have locally recognizable brand names, so that borrowers can threaten to picket a bank or bring discredit to the brand name unless the bank acts reasonably in helping borrowers resolve their problems. Banks also might have some interest in keeping their customers satisfied, with an eye to obtaining repeat business from the customer or new business from referrals.

Securitization, on the other hand, has allowed the markets to be unbundled, atomizing the mortgage origination and collection process. When a mortgage broker solicited the borrower, an SPV holds the loan, and a servicer collects the payments, who would a defrauded borrower picket in order to obtain a loan forbearance? The originator may be long gone, as many subprime lenders have in recent years declared bankruptcy and gone out of business. The SPV is a business entity whose sole purpose is to hold a mortgage pool, and is

completely immune from any threats to its good name, which is often something like "Security Pool #351." The servicer is similarly immune to threats or pleading, as it serves solely at the direction of the trustee. The servicer little depends on the happiness or good will of the homeowners who make payments to it, since the homeowners have no choice whatsoever regarding which servicer collects the payments on their loans. Servicers have so taken advantage of borrowers on occasion of late that the term "predatory servicing" has been added to that of "predatory lending." The trustee also does not need to keep the good will of the borrowing public, since it gets its business from originators, not the borrowers. A reputation as a particularly ruthless collector of debts might well aid the trustee or servicer in gaining new originator clients. Furthermore, the trustee and servicer can always claim to be bound by the foreclosure criteria contained in the initial offering of the securities and absolve themselves of any responsibility to exercise discretion in dealing with a desperate homeowner.

The parties to the securitization who may most be affected by bad publicity are the underwriters, large Wall Street firms that should want to avoid tying their firms' valuable reputation to predatory lending. While Wall Street firms might avoid individual firms linked to predatory lending (though their support of predatory finance companies throws even that supposition into doubt), they did continue to participate in the securitization of residential loans without attempting to root out fraudulent lenders despite widely publicized hearings in 1994 and 1998 that documented how many lenders were taking advantage of unsophisticated borrowers and that the problem was growing dramatically.

The Holder in Due Course Doctrine and the Need for Assignee Liability

One pernicious effect of securitization is that it encourages the most rapid creation of an assignee with holder in due course status by causing the originator of the loan to sell the loan almost immediately. The holder in due course doctrine provides that if one who is assigned and holds an instrument is not chargeable with knowledge of or participation in certain wrongful acts, then most of the defenses that the maker of the note (the borrower) had to the original beneficiary of the note (the original lender) cannot be used against the new holder (the assignee). The cutting off of defenses upon transfer to a holder in due course has long been considered the central element of negotiable instruments. The holder in due course doctrine prevents assignee liability, which is the liability that the current holder of a note would have toward a defrauded or otherwise victimized borrower based on the actions of the original lender on the note.

The holder in due course doctrine does not cut off all defenses that a borrower or maker of the negotiable instrument, such as a promissory note, might have. The few defenses that remain to the maker of the instrument are the so-called "real defenses," which include infancy, duress, lack of legal capacity, illegality of the transaction, discharge of the obligor through bankruptcy, and fraud causing the drawer of the instrument not to know, for reasons

that were not her fault, the nature of the instrument she was signing. The "real defenses" are rare and fairly difficult to prove. Among the defenses that are cut off when a note is transferred to a holder in due course, called the "personal defenses," are the more common and easier to prove claims, such as: (a) that the borrower, while not completely incompetent, was less than fully competent; (b) that while she knew that she was signing a note and deed of trust, misrepresentations were made to her regarding its terms or effects or other conditions; (c) that undue influence had been used to coerce her into signing the note.

The holder in due course doctrine historically had two primary functions, both of which can now be better performed by other means. One function was to create a currency substitute, greatly needed in the seventeenth and eighteenth centuries when there was insufficient currency and inadequate means to transport that currency for the economy of the day. The usefulness of negotiable instruments as a currency substitute disappeared by the mid-nineteenth century.

Another function of the holder in due course doctrine was to make negotiable instruments more easily transferrable by removing a great barrier to their transferability, the fear that the maker of a note would have a defense to it. The holder in due course doctrine is intended to increase the liquidity of notes and thus their usefulness to commerce. This function of the holder in due course has, at least as far as residential or consumer loans, been taken over by the securitization of those loans, which provides greater liquidity than did the holder in due course doctrine. The holder in due course doctrine lives on in residential loans, those secured by the residences of the borrowers, long after its legitimate purposes have disappeared or been replaced by other tools.

Before the days of securitization, when lenders often held the notes they originated for the life of the loans, the holder in due course doctrine and the question of assignee liability were not as important, as there were far fewer assignees of notes. Gone, however, are the days when a lender would normally hold the loan for its full term. Instead, lenders might hold the loan for a few weeks, assigning it almost immediately either to a GSE or to another securitizer. Often, the loan will be sold before the first payment is even due, so that if the homeowner/borrower learns that her payments are much larger than had been represented to her, that defense has already been cut off as to the current holder of the note by the holder in due course doctrine. This combination (initial loan made by a thinly capitalized, poorly regulated lender who immediately negotiates the loan to a securitizer, so that the investors in the securities can claim holder in due course status) is a recipe for irresponsible and unethical lending, if not outright fraud.

The Secondary Market is Better Equipped to Minimize Predatory Lending Than Are Borrowers.

Both the borrower and the purchaser of the loan can take precautionary steps: the borrower can refuse to respond to subprime lenders' advertising, try to deal only with reputable loan brokers and to read all of the documents presented for her signature, refusing to sign those that she does not understand or agree to, or that do not correspond to the oral representations she has received. The purchasers of loans or securities backed by residential mortgages can investigate the brokers and lenders from whom they buy loans, insisting on dealing only with reputable brokers and lenders and ones with sufficient capital to cover sizeable losses. They can also monitor the complaints and default rates of loans that they have already purchased, and refuse to deal further with brokers and lender where there have been problems.

On the surface, it appears that the borrowers' precautionary measures, because they are so direct, would be more effective at less cost. If a potential borrower refuses to sign an unfair or fraudulent loan then, absent forgery, the loan would not exist to begin with. If a loan securitizer refuses to purchase an unfair loan from a dishonest originator, that securitizer's action does not prevent the originator from attempting to sell the loan elsewhere or attempting to collect on the loan itself.

On closer examination, however, it is clear that the borrowers' attempts at precaution might be feeble at best, while the buyers of loans on the secondary market can take inexpensive yet effective measures to reduce the general incidence of unfair loans. A subprime borrower's efforts to avoid deceptive loans by dealing only with large, reputable lenders, could easily come to naught, as some of the largest subprime lenders have been charged with fraud and deception in making subprime loans. Nor are the borrower's efforts to avoid deception by reading the loan documents carefully likely to bear fruit, as the documents are so complex and confusing for the borrower that an unscrupulous lender can easily insert unfair terms in the loan agreement without the borrower's knowledge. While some blame this complexity on the mandated mortgage disclosure forms, much of the complexity of the transaction is inherent in any loan secured by real property, as the presence of a security interest necessarily complicates the transaction well beyond the understanding of most residential borrowers. While the rare borrowers so sophisticated that they understand all the terms of the loan may escape, their escape will not prevent unscrupulous lenders from moving on to their next victims.

By comparison, the secondary market can take effective, long-term, precautionary measures simply by refusing to deal with originators who develop a reputation for sharp practices or deception. If such lenders lose their access to the secondary market and are forced to keep their loans themselves and attempt to collect from their own, often angry, borrowers who retain their defenses to the loan, these unscrupulous originators would have a much harder time growing or even staying in business. The cost to the secondary market of such monitoring would be two-fold. First of all the costs of acquiring information about which brokers and other originators are suspected of illegal or improper practices, and

secondly the cost of foregoing the profits to be gained by buying predatory subprime loans that have interest rates above the market rate. This latter cost is not one that even Wall Street is likely to publicly decry. The former cost can be spread out over the entire market. More importantly, the cost of monitoring brokers is already being incurred to good effect by some members of the mortgage industry, and the fruits of that labor can be easily shared with little net cost to the entire lending industry. Therefore, the secondary market has by far the most cost effective means of precaution at its disposal and for this reason should be assigned more of the risk of loss than the borrower.

Clearly, lenders and investors in securitized loans are better able than borrowers to determine the assignment of risk caused by the holder in due course doctrine. Lenders have attorneys, extensive and detailed manuals regarding the law of lending, and their own experience in the lending business. Investors in securitized loans are given detailed disclosure statements that should lay out the risks inherent in their investment.

The typical borrower, especially the typical subprime borrower, on the other hand, is unlikely to be familiar with even the basics of the loan process, which may be the most complicated financial transaction the borrower will ever experience. Unethical brokers target the elderly and undereducated, looking for those even less likely than the average borrower to understand the effects of the loan. Subprime borrowers rarely have the help of an attorney in negotiating a loan secured by residential property, as such advice might cost thousands of dollars. Unscrupulous lenders attempt to separate the borrowers from those who might provide valuable advice, and thus prevent borrowers from becoming more knowledgeable about the loan. Therefore, if the holder in due course doctrine were to assign risk efficiently to the party most likely to discover that assignment of risk and act on it, clearly it should assign such risk to the assignee.

Lenders and investors in securitized loans not only have infinitely greater understanding of the holder in due course doctrine than borrowers, they also have far more information regarding the magnitude of the risk of loss. Lenders can easily determine the going rate of foreclosure among subprime loans, which is one of the primary harms caused by predatory lending.[7] The firms that rate loan securitizations have finely calibrated methods to determine the risk of loss in the pools of loans and disclose that risk to the investors. Servicers can build web pages that allow investors to obtain default rates and other loan performance information. Servicers can give investors access to the information that would help investors detect one of the primary signs of predatory lending, borrowers paying more than market price for loans given their risk profile. Investors can track most of the information on a loan by loan basis they need in order to determine whether the loans are overpriced. They can obtain information such as the credit scores of borrowers, the loan to

[7] See Harold L. Bunce, et al., Subprime Foreclosures: The Smoking Gun of Predatory Lending? at http://www.huduser.org/publications/polleg/hpcproceedings.html.

value ratio of the property, the income of the borrowers. Lenders and underwriters can use sophisticated databases that track fraud and other suspicious activity in residential mortgages, identifying questionable brokers by name.[8] They can identify specific "hot zones," neighborhoods that contain an unusually high incidence of residential foreclosures and are likely breeding grounds of predatory lending. Lenders and underwriters have the help of federal regulators to advise them how to discern warning signs of predatory lending.[9] They can conduct complex analysis of loan pools to see which loans and which lenders are likely predatory.[10] Participants in the secondary market can review loans for signs of potentially abusive terms, including excessive fees and interest rates, balloon payments or prepayment penalties with no corresponding decrease in interest rates for borrowers, and adjustable rate loans that only increase.[11] Because the essence of predatory lending is charging above the market rate for loans, given the credit risk of the borrower, the secondary market participants can spot evidence of predatory lending by comparing the borrowers' credit scores with the loan costs to see if the borrower was overcharged. The secondary market can also monitor the creditworthiness of originators, which decreases the chance that a fly-by-night operation will make numerous predatory loans, then close shop when borrowers begin to sue it.

By comparison, an individual borrower has little comparable access to information on the risk of fraud or whether an individual mortgage broker might be likely to commit fraud. Loan counseling for borrowers has been demonstrated to significantly affect the likelihood that a borrower will become delinquent on their loans. However, the provision of such counseling is uneven and inadequate, and faces further budget cuts. For all these reasons, assigning the risk of fraud to purchasers of mortgage-backed securities would do far more to deter fraud than assigning that risk to borrowers. Lenders and the underwriters and ratings agencies who analyze risk for the investors are much better equipped to determine the risk of

[8] Beginning in 1995, for example, the Mortgage Asset Research Institute (MARI) has provided a national proprietary database known as the Mortgage Industry Data Exchange (MIDEX) which collects reports of alleged fraud and suspicious incidents and the companies and individuals involved identified by law enforcement or regulators as acting illegally or improperly. See Michele M. Walczak, Mortgage Industry Turns Up Heat on Fraud Artists, Sec. Mortgage Mkts. Online, Oct. 1997, at http:// www.freddiemac.com/finance/smm/oct97/html/oct97.htm. See also Robert Julavits, Industry Stepping Up Efforts to Thwart Loan Fraud, Am. Banker, Feb. 13, 2001, at 11, 2001 WL 3909474. The Mortgage Bankers Association has contracted with MARI for the use of this database. See Predatory Mortgage Lending: The Problem, Impact and Responses: Hearing Before the Senate Comm. On Banking, Housing and Urban Affairs, 107th Cong. (2001) (testimony of John A. Courson, President and CEO, Central Pacific Mortgage Co., on behalf of the Mortgage Bankers Association), available at http://banking.senate.gov/01_07hrg/072701/courson.htm.

[9] See Draft Memorandum from the FDIC Staff, How to Avoid Purchasing or Investing in Predatory Mortgage Loans (November 2000), at http:// www2.fdic.gov/epc/predlend/.

[10] [FN586]. See generally Balvinder S. Sangha & Anne Kerttula, Fair Lending and Predatory Analytics for Lenders, 83 The RMA Journal 66 (2000).

[11] See Comments of the National Consumer Law Center and Consumer Federation of America to the FDIC on Predatory Mortgages, at http:// www.nclc.org/predatory_lending/fdic.html.

that fraud and to minimize that risk by refusing to deal with the unscrupulous mortgage brokers and loan originators likely to engage in fraudulent activities.

The Battle Over Assignee Liability

Both federal and state laws designed to cure predatory lending have recognized the need for assignee liability. However, the lending industry is currently conducting a rear guard action to overturn or limit assignee liability where it can. The federal law which has served as a template for state regulation, the Home Ownership and Equity Protection Act of 1994 (HOEPA), attempts to limit the holder in due course doctrine in high cost loans. Under HOEPA, any assignee of a high cost loan is subject to all of the claims and defenses the borrower could assert against the original creditor, unless the assignee demonstrates that a reasonable person using ordinary due diligence could not determine, based on the required documentation, that the mortgage was a high cost loan.

Some states have followed this pattern, mandating assignee liability for high cost loans. However, this approach has not been universal. California's anti-predatory lending legislation, for example, explicitly provides that it does not impose any liability on holders in due course. And, where states have enacted laws mandating assignee liability, those laws have often been weakened by subsequent legislation or preempted for many lenders by federal regulators. For example, Georgia's predatory lending legislation was greatly weakened by reducing the liability of assignees, amid industry claims that assignee liability would prevent Georgia loans from being securitized. Ratings agencies had refused to rate loans in Georgia, fomenting this legislative change, and appear to be prepared to use the same tactic in other states.

Ratings agencies can rate loan pools even where law provides for assignee liability, however, so long as the laws that create assignee liability do so in a way that allow the ratings agencies to discern the level of risk to assignees that must be disclosed to investors. This ability by ratings agencies to determine the level of risk is affected by how clearly the legislation creating assignee liability delineates which loans are affected by the legislation and how well the ratings agency can determine the size of the potential claim against the assignee of the loan.

Most importantly, once a ratings agency determines that it can rate a loan pool with loans bearing assignee liability, the possibility of such liability causes the ratings agency to increase the diligence of its examination of the seller and its origination activities. At least one ratings agency has announced that it will review originators' compliance procedures to ascertain whether the loan originator can identify loans subject to assignee liability and loans that are predatory, by which the ratings agency means those that violate legislation designed to prevent predatory lending. The ratings agency will also review the creditworthiness of the loan originator to ensure that the originator can repurchase any predatory loan that is discovered in the loan pool. The ratings agency also stated that its review assumes

"increased significance" where loans subject to assignee liability are included in the pool and its requirements will be "considerably more stringent" for such pools where there is the increased risk of assignee liability for predatory loans. In other words, the presence of assignee liability, far from harming borrowers, causes the securitizers of loans to guard against the inclusion of predatory loans in their loan pools. If loan securitizers refuse to securitize loans with predatory terms, they will reform the lending practices of originators that depend on securitization of their mortgages.

The newest arena in the battle over assignee liability is that of preemption. Federal banking regulators have argued that states' predatory lending laws should be preempted as to federally regulated banks. Some in the industry have sought federal law that would preempt this state law for all lenders. However, this preemption effort is, at best, premature. New state laws have been drafted all over the country to combat predatory lending. These laws should be given some time to see which work most effectively. In this way, the states' laws can be used as a means to find out what system of regulation most protects borrowers without cutting off valuable access to credit. Stepping in with federal preemption at this early stage will not only trample on the states' interest in protecting their consumers, but will also prevent policy makers from discovering useful lessons from the states' experience. Even in the long term, federal preemption prevents states and locales with a greater incidence of abusive lending from providing increased protection. Thus, cities like Chicago or Oakland, California, which have been hard hit by predatory lending, would not be able to take the additional protective measures their citizens need that those who live in small towns in Kansas might not require.

Conclusion

The securitizers of residential mortgages and other secondary market participants are far better at detecting and deterring predatory lending than are borrowers, and therefore they rather than the borrowers should bear the risk of predatory behavior. To accomplish this transfer of risk requires that assignees be liable for the predatory behavior of the originators of loan and that the holder in due course doctrine be abrogated for residential mortgages. This assignment of risk will cause those market participants best able to prevent abusive lending to use the means already at their disposal to prevent it.