NATIONAL CONSUMER LAW CENTER

Expert Reports in Morgan Stanley Unsealed: A Case Study in Discriminatory Mortgage Financing

November 2014

Expert reports were submitted in July 2014 and unsealed in October 2014 in support of the allegations made in the case of ***Adkins v. Morgan Stanley*** pending in the U.S. District Court for the Southern District of New York. The lawsuit asserts that Morgan Stanley, by and with now-defunct mortgage lender New Century Mortgage Company, pursued securitization policies and practices that resulted in a pattern of discrimination against African-American borrowers in the Detroit metropolitan area in the lead-up to the collapse of the housing market in 2008. The findings presented in the expert reports are offered to show how the subprime mortgage boom of the early 2000s was simply the latest incarnation of discriminatory housing and lending policies that perpetuate decades-old patterns of racial segregation and inequality. This issue brief summarizes the expert reports in the case.

Adkins v. Morgan Stanley: Challenging racially discriminatory mortgage practices in Detroit, Michigan

The National Consumer Law Center, along with the American Civil Liberties Union, American Civil Liberties Union of Michigan, and the law firm of Lieff, Cabraser, Heimann & Bernstein, have brought a class action lawsuit under the Fair Housing Act against Morgan Stanley for engaging in loan purchasing, pooling, and securitization policies that purportedly had an adverse impact African-American borrowers in Detroit between 2004-2007. Plaintiffs allege that Morgan Stanley discriminated against African-American borrowers by requiring, as a condition of its lucrative business, that New Century Mortgage Company ("New Century") issue a high volume of toxic loans containing certain risk features that were profitable to Morgan Stanley, but devastating to borrowers. The complaint and the expert reports assert that these toxic loans were steered towards predominately African-American communities in Detroit, resulting in disparate impact discriminatory lending. The complaint asserts that these practices decimated communities already suffering from a history of segregation, discrimination, and inequality.

In mid-September 2014, four expert reports filed in the case were unsealed and released to the public. Using statistical, factual, and historical evidence, these reports are offered to substantiate Plaintiffs' claims and seek to starkly illustrate how the predatory lending practices pursued by subprime lenders, with the backing of major financial institutions like Morgan Stanley, disproportionately devastated the financial stability of African-American families in Detroit and throughout the country.

The Experts Weigh in on Morgan Stanley

PROFESSOR IAN AYRES
William K. Townsend Professor at Yale Law School; Professor, Yale School of Management

Professor Ayres analyzed Morgan Stanley's and New Century's loan-level data, using credible and generally accepted statistical methods, and found that African-American borrowers were more likely to receive Combined-Risk Loans and High-Cost loans than non-Hispanic white borrowers with similar credit-risk characteristics, both in the Detroit region and nationwide. *The Ayers Report is available at:* **http://www.nclc.org/issues/mortgage-securitization-discrimination-litigation.html**

PROFESSOR PATRICIA A. MCCOY
Liberty Mutual Insurance Professor of Law, Boston College Law School

Professor McCoy analyzed Morgan Stanley's subprime-mortgage business model and related financial practices, and concluded that Morgan Stanley blindly steered inherently risky and toxic loans into predominately African-American communities, while doing virtually nothing to guard against the adverse racial impact of its mortgage funding and securitization activities. *The McCoy Report is available at:* **http://www.nclc.org/issues/mortgage-securitization-discrimination-litigation.html**

ACCOUNTANT AND FINANCIAL SERVICES CONSULTANT GEOFFREY A. OLIVER
CPA and CEO of Hilltop Advisors, LLC

Mr. Oliver's Expert Report confirms that Morgan Stanley profited greatly from the funding, purchasing, and securitizing of New Century's Combined-Risk and High-Risk loans, which adversely impacted African-American borrowers. *The Oliver Report is available at:* **http://www.nclc.org/issues/mortgage-securitization-discrimination-litigation.html**

PROFESSOR THOMAS J. SEGRUE
David Boies Professor of History and Sociology at the University of Pennsylvania

Professor Segrue's Expert Report conveys the ways in which past discriminatory practices in real estate sales and home financing, as well as the persistent residential segregation by race that ensued, have laid the groundwork for predatory mortgage lending practices, like those fostered by Morgan Stanley, that target African-American homebuyers and African-American communities in metropolitan areas across the country, and, particularly, in Detroit. *The Segrue Report is available at:* **http://www.nclc.org/issues/mortgage-securitization-discrimination-litigation.html**

Key Findings of the Expert Reports

1. African-American borrowers who obtained a loan from New Century were far more likely to receive high-risk toxic loans than white borrowers with similar credit-risk characteristics, both in Detroit and nationwide. (See Ayers Report)

- **Morgan Stanley actively sought to finance and purchase toxic loans from New Century.** Toxic loans are loans that carry a high-risk of default. Morgan Stanley preferred to purchase and securitize the types of toxic loans that either imposed high costs on the borrower (High-Cost loans) or that contained two or more of the following high-risk features (Combined-Risk loans):

  - a debt-to-income ratio of over 55%;
  - a loan-to-value ratio of 90% or more;
  - an adjustable-interest rate (an "ARM");
  - an "interest only" amortization feature;
  - a negative amortization feature;
  - a balloon payment feature;
  - a prepayment penalty; or
  - the loan was issued based on stated income, rather than verified income.

- **Data shows that African-American borrowers had a statistically higher chance of being subjected to Combined-Risk loans and High-Cost loans.**

  - Nationwide, an African-American borrower was 1.231 times more likely to receive a Combined-Risk loan and 1.500 times more likely to receive a High-Cost loan than a non-Hispanic white borrower *with identical non-race characteristics*. These odds jump to 1.347 (for a Combined-Risk loan) and 2.119 (for a High-Cost loan) in the Detroit region.

  - An African-American borrower who obtained a loan from New Century that was securitized by Morgan Stanley had an 84.6% likelihood of receiving a High-Cost loan and a 57.4% chance of receiving a Combined-Risk loan nationwide. In Detroit, the likelihood rose to 94.2% for High-Cost loans and 85.5% for Combined-Risk loans.

- **Morgan Stanley continuously sought to increase the volume of Combined-Risk loans and High-Cost loans that New Century originated.**

  - Nationwide, more than 70% of all New Century loans purchased by Morgan Stanley between 2005-2007 were Combined-Risk loans, and more than 90% were High-Cost loans. During these same two years, nearly *all* the New Century loans that Morgan Stanley purchased in the Detroit region were High-Cost loans, and nearly 90% were Combined-Risk loans.

2. By pursuing polices with perverse financial incentives and ignoring due diligence, Morgan Stanley incentivized New Century to increase the volume of toxic loans it originated to African-American borrowers in Detroit. (See McCoy Report)

- **Morgan Stanley's business model produced a perverse financial incentive to encourage New Century to generate toxic loans to borrowers who were likely to default, which had an adverse impact on African-American borrowers in Detroit and across the country.** The emphasis on maximizing profits made Morgan Stanley demand as many loans as possible with the types of risk features that maximized cash flows. These were mainly loans with higher interest rates, adjustable-rate terms, and prepayment penalties, which increased the risk of default for borrowers. Morgan Stanley's ability to immediately book its profits from securitizing these loans reduced its incentive to care about the actual credit quality of the loans and the borrower's real ability to avoid default.

- **Morgan Stanley became New Century's most important financier, and in so doing, gained singular influence over New Century's operations.** Morgan Stanley was New Century's largest purchaser of whole loans. The company also provided New Century with the warehouse funding needed to originate loans and hold them pending securitization or sale, and it served as the underwriter on subprime Residential Mortgage Backed Securities issued directly by New Century.

- **Morgan Stanley used this financial leverage to cause New Century to generate increasingly higher volumes of loans with the types of risky loan features that maximized cash flow.** To meet Morgan Stanley's demands, New Century resorted to qualifying growing numbers of borrowers by reaching down lower into the credit spectrum to make subprime loans and by putting borrowers into two-year hybrid ARMs to create a constant need for refinancing within two years of a loan's origination.

- **Morgan Stanley undermined the effectiveness of its due diligence procedures in order to increase its purchases of ever-riskier loans from New Century.** Morgan Stanley did not perform due diligence on every loan in the loan pools that New Century presented to it for sale. Additionally, the company's Due Diligence team could not independently increase the sample size of the loans it reviewed and its requests for New Century documents were opposed. Senior Morgan Stanley officials pressured the Due Diligence team to reduce the number of loans rejected from New Century loan pools, in part by participating in the performance evaluations of the head of Due Diligence.

- **Morgan Stanley overrode its due diligence procedures in order to purchase excessively risky loans from New Century.** Morgan Stanley overrode recommendations by its Due Diligence team to reject loans from New Century's loan pools for credit problems or lack of legal compliance. Furthermore, Morgan Stanley independently raised the grades of loans that outside consultants had assigned the worst due diligence score.

- **Morgan Stanley continued to limit, override, and ignore due diligence even though it was aware of an increasingly alarming risk profile associated with New Century loans.** Beginning as early as 2004, senior Morgan Stanley officials received repeated, escalating warnings, via analysis of the rate of loans kicked out of the loan pool, that New Century's lending practices were deteriorating, to the detriment of borrowers. Among other problems, these officials were informed that New Century was ignoring its underwriting guidelines, inflating appraisals, and making increasing numbers of Combined-Risk loans to borrowers with weak credit scores. These warnings should have caused Morgan Stanley to ramp up due diligence or scale back purchases; instead, Morgan Stanley *increased* its purchases after 2005.

- **Morgan Stanley was barely cognizant of its fair lending compliance obligations, made no attempt to test for adverse disparate impact, and made barely any attempt to comply with state and federal fair lending laws.** The head of Morgan Stanley's credit and compliance due diligence group testified that he was not aware of any efforts to avoid racially disparate impact in its securitization practices, analyze the impact of its securitization practices on protected groups, or review its compliance with the Fair Housing Act and the Equal Credit Opportunity Act.

3. Morgan Stanley profited immensely from directing and funding New Century to originate greater and greater volumes of Combined-Risk and High-Cost loans. (See Oliver Report)

- **Morgan Stanley netted huge revenues at every stage of its operation to fund, purchase, and securitize loans that adversely impacted African-American borrowers.** Revenues came from:
  - Sale of bonds and the value of retained assets in the securitizations;
  - Sale of mortgage servicing rights;
  - Warehouse financing;
  - Whole loan interest income;
  - Other fees and revenues (i.e. for underwriting a security and the development and maintenance of financial investments).

4. Predatory lending practices imposed on segregated communities—like those that Morgan Stanley employed in Detroit—perpetuate entrenched patterns of racial segregation, discrimination, and inequality. (See Segrue Report)

- **Discriminatory housing and lending practices gave rise to residential racial segregation and laid the groundwork for predatory mortgage lending practices that have had an adverse impact on African-American communities.** The following interrelated and pervasive actions by government officials, financial institutions, local residents, and real estate firms reinforced residential segregation and discrimination.
  - **Racially Restricted Covenants.** Until 1948, the deeds of most houses in white neighborhoods contained restrictions on the race of the homeowner.

- **Real Estate Guidelines.** Until the 1960s, Real Estate Boards insisted that agents follow an industry guideline that black homebuyers would not be shown homes in white neighborhoods.

- **Federal Pro-Homeownership Programs.** The federal government ranked every American neighborhood based on the quality of the area's housing and residents on a scale of A through D. The ranking took the predominate race characteristic of a neighborhood into account. Areas that had a "Negro concentration" or were "developing as a Negro colony" were given the worst rating of "D," preventing most blacks from getting access to federally-backed loans and mortgages until 1968.

- **Redlining.** Neighborhoods ranked "D" were starved for credit as investors and lenders fled from these neighborhoods. This process of restricting access to credit in poor, predominately black neighborhoods was labeled "redlining." *All* areas with more than a handful of black residents were redlined. Redlining also incentivized white residents, real estate brokers, developers, and municipal governments to keep blacks out of their neighborhoods, lest their own rating—and access to financing—be jeopardized.

- **White Resistance.** Organized and individual acts of resistance by white opponents of integration further perpetuated racial separation.

- **Skirting Civil Rights Legislation.** The passage of major civil rights reforms helped eliminate some discrimination in housing rentals, sales, and lending but proving and enforcing anti-discrimination laws in housing and lending proved to be difficult.

- **Steering and Reverse Redlining After the Civil Rights Era.** The practice of directing white homebuyers to all-white communities and black homebuyers to predominantly black or racially transitional neighborhoods (called steering) endured past the 1960s. The practice of inundating credit-starved black communities with predatory and toxic loans (reverse redlining) increasingly took hold across the country.

➢ **These entrenched and interconnected processes of neighborhood segregation and disinvestment provided the ideal conditions for a rise in predatory lending beginning in the 1990s.** As the subprime market expanded, lenders were increasingly likely to target minority communities and minority borrowers. This practice resulted in the rise of a dual mortgage market. This type of toxic financing has stifled African-Americans' ability to develop long-term wealth and escape entrenched cycles of segregation and inequality.

➢ **The inability to finance home purchases has dire, self-perpetuating consequences.** African-American rates of homeownership are lower than those of whites. For example, in 2000, 67% of whites but only 53% of African-Americans in metropolitan Detroit were homeowners. As a consequence, African-Americans are less able to build equity, have less ability to get access to conventional credit which, in turn, constricts their ability to get access to better homes in better neighborhoods, to get access to home improvement loans, to refinance at beneficial terms, to pay for college tuition, and to pass on inheritances to their children. This cycle leaves residents of segregated neighborhoods particularly vulnerable to entrenched poverty, economic vulnerability, and predatory loans as the only available means of financing an attempt at social and economic mobility. For most Americans, a house is their most important asset. In 2003, the average household wealth of African-Americans was just one-tenth that of whites, in large part because of differential value of real estate holdings.

- **Segregation, lack of wealth, and incomplete access to conventional and government-backed mortgages have made African-American communities particularly susceptible to predatory lenders that take advantage of their plight.** Morgan Stanley financed and New Century administered highly toxic loans in segregated neighborhoods with less household wealth and less access to capital. These practices ensured that these loans would have an adverse impact on African-American borrowers who suffered financial instability and were at extreme risk of defaulting on their loans.

RELATED MATERIALS

To review the complaint, expert witness reports, and other materials on Adkins v. Morgan Stanley, please visit:
http://www.nclc.org/issues/mortgage-securitization-discrimination-litigation.html

RACIAL JUSTICE &
EQUAL ECONOMIC
OPPORTUNITY PROJECT
NATIONAL CONSUMER LAW CENTER

The **National Consumer Law Center's (NCLC) initiative on Racial Justice and Equal Economic Opportunity** addresses abusive and exploitive marketplace practices that have decimated the finances of communities of color. The initiative builds on NCLC's groundbreaking anti-discrimination litigation and provides high-impact advocacy on issues of significance to communities and individuals of color, litigation support (including amicus briefs), training, and other assistance to advocates on both the state and national level. **www.nclc.org/special-projects/racial-justice.html**