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# Democratizing Credit: Examining the Structural Inequities of Subprime Lending

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# DEMOCRATIZING CREDIT: EXAMINING THE STRUCTURAL INEQUITIES OF SUBPRIME LENDING

Cassandra Jones Havard<sup>†</sup>

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### INTRODUCTION

The deregulation of the conventional home mortgage market created a new market for borrowers who were typically excluded from the traditional mortgage markets.<sup>1</sup> Borrowers whose credit is blemished, or whose income is limited, are excluded from the traditional home mortgage market because they represent an undue level of risk. The elimination of borrowing constraints by offering risk-based loans created the subprime lending market, and thus created more home financing opportunities.<sup>2</sup> Subprime lenders argue that they are contributing to the societal goal of greater access to credit by offering innovative mortgage products to traditionally excluded borrowers.<sup>3</sup> That argument ignores an arguably unintended consequence of the mortgage market's innovation: lenders target minority communities for exploitative lending practices by providing loans with terms and conditions that are not warranted by the risks posed to the borrowers.<sup>4</sup>

Numerous statistical studies now prove that there are racial disparities in lending in the primary and refinance markets.<sup>5</sup> The infusion of minority loan markets with products that are economically unjustified and financially harmful represents a perverse incentive for financial

1. See generally NORMAN STRUNK & FRED CASE, *WHERE DEREGULATION WENT WRONG: A LOOK AT THE CAUSES BEHIND SAVINGS AND LOAN FAILURES IN THE 1980S* (1988).

2. Joseph A. Smith, Jr., *The Federal Banking Agencies' Guidance on Subprime Lending: Regulation with a Divided Mind*, 6 N.C. BANKING INST. 73, 76-81, 105-07 (2002) (discussing the federal agencies' classifications of subprime and predatory loans).

3. Cathy Lesser Mansfield, *The Road to Subprime "Hel" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 527, 539-40 (2000).

4. In two cases alleging that the specific targeting of minority markets is a violation of the Fair Housing Act, courts have failed to recognize a cause of action. See discussion *infra* Part I.B. But courts are recognizing that there is reverse redlining through steering minority loan applicants to unjustifiably high loan products. See *Honorable v. Easy Life Real Estate Sys.*, 100 F. Supp. 2d 885, 892 (N.D. Ill. 2000). "Reverse redlining is the practice of extending credit on unfair terms to those same communities." *Id.*

5. See CALVIN BRADFORD, *CTR. FOR CMTY. CHANGE, RISK OR RACE? RACIAL DISPARITIES AND THE SUBPRIME REFINANCE MARKET* vii, 3-8, 87-106 (2002) (reviewing statistical data of subprime lending patterns in the mortgage refinance market for the 331 Metropolitan Statistical Areas in the United States) [hereinafter *RISK OR RACE?*], available at [http://www.communitychange.org/shared/publications/downloads/Risk\\_or\\_Race\\_5-02.pdf](http://www.communitychange.org/shared/publications/downloads/Risk_or_Race_5-02.pdf).

deregulation.<sup>6</sup> Thus, the benefits of deregulation to the financial industry and to lenders ought to be balanced against the costs that financial deregulation imposes on minority consumers.

The policy decisions to deregulate the mortgage markets are wrought with implications. Examining the application of these policies ferrets out the distribution of those benefits and the attendant costs. The same legal rules that support financial deregulation have created a socioeconomic hierarchy, which has produced a system that is hostile to the economic interests of minorities.<sup>7</sup>

Redressing the structural inequities in this economic scheme requires legislation that treats conduct targeting or improperly assessing the economic interests of minority homeowners as per se discriminatory. Thus, changes to the Fair Housing Act are in order.<sup>8</sup> The statute must be amended to (1) define risk-based pricing, (2) provide guidelines to lenders on when it is appropriate to use risk-based pricing and the specific disclosures required to be provided to consumers, and (3) provide an economic remedy when lenders fail to make the appropriate disclosures. Structural inequities that bar fair lending will result in grievous harms and will not be addressed without the needed changes.

#### I. FAIR LENDING AND ECONOMIC SUBORDINATION

The economic and racial mix of predatory lending and loss of home ownership requires scrutinizing subprime lending under theories of social justice and equality.<sup>9</sup> Lending and economic development in cities are inextricably mixed.<sup>10</sup> The hypersegregation that affects the inner city is a

6. *Id.* at 75.

7. See generally Chantal Thomas, *Globalization and the Reproduction of Hierarchy*, 33 U.C. DAVIS L. REV. 1451 (2000) (discussing the effects of economic globalization and the creation of socioeconomic hierarchies).

8. Fair Housing Act, 42 U.S.C. §§ 3601-3619 (2000).

9. Predatory lending creates racialized economic space. "Racial spaces" refers to the concentration of minorities in geographical locations primarily due to racial segregation and discrimination. See generally Anthony Paul Farley, *The Poetics of Colorlined Space*, in CROSSROADS, DIRECTIONS, AND A NEW CRITICAL RACE THEORY 97-158 (Francisco Valdes et al. eds., 2002). The demarcation necessarily serves as an identification of a legal and political reality about the allocation of power. Racialized economic space argues for explanation on biased outcomes given the supposed neutrality of economic principles. See *infra* text accompanying note 25. That explanation requires a parallel focus on the political structure and the inherent policy choices that converge. See Cassandra Jones Havard, *African-American Farmers and Fair Lending: Racializing Rural Economic Space*, 12 STAN. L. & POL'Y REV. 333, 340-42 (2001) [hereinafter Jones Havard, *Racializing Rural Economic Space*].

10. See generally WILLIAM JULIUS WILSON, *THE TRULY DISADVANTAGED: THE INNER CITY, THE UNDERCLASS, AND PUBLIC POLICY* (1987) (discussing the conditions that

critical factor to consider when assessing access to finance in these communities.<sup>11</sup>

Hypersegregation creates information barriers that make lending difficult.<sup>12</sup> Lenders that service hypersegregated communities tend to ration credit and require substantial collateral.<sup>13</sup> Recognizing this link provides the foundation for the inquiry into whether lending requirements in these communities are appropriate, or based on race.<sup>14</sup>

One question to answer regarding residential lending is why do information asymmetries produce risk barriers that lead to loans that are improperly characterized? Two issues become significant for the lender making the determination: (1) borrower creditworthiness (given hypersegregation and property location); and (2) appropriate risk assessment (given the accumulated equity in property used as collateral in refinance loans). The current statutory scheme prohibiting lender discrimination encourages economic subordination by vesting too much discretion in the lender to make unbiased credit determinations.

#### *A. The Equal Credit Opportunity Act*

The Equal Credit Opportunity Act (ECOA) is a lender-friendly statute that allows the lender to choose the method of evaluating borrower creditworthiness.<sup>15</sup> Lenders choose which factors to evaluate for a creditworthiness determination (such as credit history, length of

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contribute to persistent poverty, including the unavailability of a living wage).

11. See DOUGLAS S. MASSEY & NANCY A. DENTON, *AMERICAN APARTHEID: SEGREGATION AND THE MAKING OF THE UNDERCLASS* 74 (1993) (defining "hypersegregation" as a pattern of being segregated in all types or dimensions of segregation); Peter Dreier, *America's Urban Crisis: Symptoms, Causes, Solutions*, 71 N.C. L. REV. 1351, 1369-70, 1381-83 (1993).

12. Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197, 217 (2000).

13. *Id.* at 213-18 (discussing the informational asymmetries that lead to small business and housing disinvestment in urban cities); see also Reginald Leamon Robinson, *The Racial Limits of the Fair Housing Act: The Intersection of Dominant White Images, the Violence of Neighborhood Purity, and the Master Narrative of Black Inferiority*, 37 WM. & MARY L. REV. 69, 108 (1995) (describing the five dimensions of hypersegregation as: (1) uneven representation areas; (2) total segregation by race; (3) large, "tightly clustered" contiguous enclaves or scattered, "checkerboard" enclaves; (4) neighborhoods "concentrated within a very small area or settled sparsely throughout the urban environment;" and (5) neighborhoods "spatially centralized around the urban core or spread out along the periphery").

14. See Sheryll D. Cashin, *Privatized Communities and the "Secession of the Successful": Democracy and Fairness Beyond the Gate*, 28 FORDHAM URB. L.J. 1675, 1681-83 (2001).

15. Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691f (2000).

employment, and income), but are prohibited from discriminating based on specified factors.<sup>16</sup> Courts have uniformly rejected claims by borrowers who have challenged a lender's credit denial based on the lender's evaluation standard.<sup>17</sup>

Pursuant to the ECOA, the Federal Reserve Board issued "Regulation B,"<sup>18</sup> which governs the evaluation criteria that lenders may use. The regulation expressly states that creditors may not use facially neutral evaluation practices that have a discriminatory effect.<sup>19</sup> The regulation governs both statistical and judgmental scoring lending.<sup>20</sup>

The Interagency Task Force on Fair Lending Policy Statement has interpreted the ECOA to allow the lender to demonstrate that a challenged practice is a business necessity.<sup>21</sup> Consequently, a lender may use

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16. For a thorough description of the various stages in the credit evaluation process in mortgage lending, see RAYMOND T. NIMMER, *COMMERCIAL ASSET-BASED FINANCING* § 2:02 (1988) (explaining lenders' standard procedure of not making a loan where the probabilities indicate default).

17. Courts called upon to review a particular lender's creditworthy standards, and allegedly discriminatory violations under the ECOA, have refused to do so. See, e.g., *Gross v. United States Small Bus. Admin.*, 669 F. Supp. 50, 52-53, 56 (N.D.N.Y. 1987) (applying traditional Title VII test to prove credit discrimination and rejecting plaintiff's use of an alternative test for proving an ECOA violation); *Thomas v. First Fed. Savs. Bank of Ind.*, 653 F. Supp. 1330, 1340 (N.D. Ind. 1987) (declining to find "disparate impact" under FHA where plaintiff's evidence of discrimination was statistical disproportion); *Miller v. Elegant Junk*, 616 F. Supp. 551, 552-54 (S.D. W. Va. 1985) (granting summary judgment against credit applicant where applicant's husband was required to sign an application as co-debtor based on applicant's credit history); *Sayers v. Gen. Motors Acceptance Corp.*, 522 F. Supp. 835, 836, 841-42 (W.D. Mo. 1981) (awarding actual and punitive damages for technical violations of the ECOA, although plaintiff failed to make prima facie case of credit discrimination); *Cherry v. Amoco Oil Co.*, 490 F. Supp. 1026, 1030-32 (N.D. Ga. 1980) (rejecting plaintiff's ECOA challenge to a lender's use of zip codes as credit predictor indicator); *Carroll v. Exxon Co.*, 434 F. Supp. 557, 562-63 (E.D. La. 1977) (finding plaintiff failed to establish a prima facie case of discrimination under the ECOA).

18. 12 C.F.R. § 202.1-202.17 (2005). The ECOA does not impose on lenders a mandatory procedure for creditworthiness evaluation. Instead, the statute merely removes certain personal characteristics from the universe of factors that lenders may use to determine creditworthiness. See Timothy C. Lambert, *Fair Marketing: Challenging Pre-Application Lending Practices*, 87 GEO. L.J. 2181, 2196-97, 2199 (1999) (arguing that the ECOA ought to apply to lenders' pre-application targeted solicitation).

19. 12 C.F.R. § 202.6(a) & n.2.

20. See Sarah E. Burns, Note, *Credit Scoring and the ECOA: Applying the Effects Test*, 88 Yale L.J. 1450, 1453 (1979) (stating that creditors use a two step evaluation process: first, screening out high-risk applicants who would not be able to or would not repay the creditor; second, approving applicants determined to fall within the acceptable risk level). See Winnie F. Taylor, *Meeting the Equal Credit Opportunity Act's Specificity Requirement: Judgmental and Statistical Scoring Systems*, 29 BUFF. L. REV. 73, 73-74 (1980) (stating that most creditors choose a system for determining who will obtain credit based on the applicant's capability and desire to repay the debt).

21. Policy Statement on Discrimination in Lending, 59 Fed. Reg. 18,266 (Apr. 29,

evaluation methods with a disparate impact on minorities if the lender meets “a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact.”<sup>22</sup> As explained in the interpretive comments to Regulation B, creditors are allowed to use criteria that have a disproportionate impact on minorities as long as there is a “demonstrable relationship” between the criteria and creditworthiness for the level of credit involved.<sup>23</sup>

The statute gives no guidance to lenders on how to evaluate a borrower’s creditworthiness, or more importantly, how lenders can make decisions that protect borrowers from being exposed to prohibited practices. Individuals who sue to enforce fair lending criteria are hampered by laws that grant lenders broad discretion in establishing creditworthiness. When injured applicants or borrowers do not sue, or are unsuccessful in litigation because of the statute’s lack of specificity, lenders have less economic incentive to comply with the statute. The statute, policy, and regulations are ineffective because lenders are not provided with much incentive to avoid discrimination when the success of a lawsuit is minimal.<sup>24</sup> In this regard, the fair lending laws are ineffective as a policing mechanism for subprime lending violations.<sup>25</sup>

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1994). The Policy Statement on Discrimination in Lending was issued by ten federal agencies in April 1994. *Id.* at 18,266-67. It states that “the precise contours of the law on disparate impact as it applies to lending discrimination are under development.” *Id.* at 18,269. Efforts to amend the ECOA and FHA to require a higher evidentiary burden in housing and lending cases failed. The McCollum Amendment was a proposal approved in 1995 by the House Committee on Banking and Financial Services as an amendment to the Community Reinvestment Act of 1977, the Equal Credit Opportunity Act, and the Fair Housing Act. The McCollum Amendment proposed that there be an evidentiary showing of intentional discrimination in a housing or lending discrimination case. H.R. 1699, 104th Cong. §§ 3(c)(1), (4)(f) (1995).

22. 12 C.F.R. § 202.6(a)(2).

23. *Id.*

24. See generally Michael Selmi, *Subtle Discrimination: A Matter of Perspective Rather Than Intent*, 34 COLUM. HUM. RTS. L. REV. 657 (2003) (discussing the difficulties of proving subtle and intentional discrimination).

25. Three statutes should protect borrowers in the marketplace, but have proven to be ineffective in ameliorating abusive lending. The three statutes are the Truth in Lending Act (TILA), 15 U.S.C. §§ 1601-1667f (2000), the Home Ownership and Equity Protection Act of 1994 (HOEPA), amended by 15 U.S.C. §§ 1602(aa), 1639, 1641(d) (2000) (amending HOEPA), and the Real Estate Settlement Protection Act (RESPA) of 1974, 12 U.S.C. §§ 1831b, 2601-2610, 2614-2617 (2000).

HOEPA is triggered when the loan’s “annual percentage rate exceeds certain treasury securities by more than 8% for first lien loans, or if certain points and fees exceed 8% of the total loan amount.” See Elizabeth Renuart, *Toward One Competitive and Fair Mortgage Market: Suggested Reforms in a Tale of Three Markets Point in the Right Direction*, 82 TEX. L. REV. 421, 421-22 (2003). Renuart describes the three most significant limitations in HOEPA as: “(1) it does not in any way limit what the lender can charge as up-front costs to

### B. The ECOA and Structural Inequities

It is unwise to argue that lending is color-blind when lenders' conduct bespeaks bias and racial animus in identifying lending opportunities. The economic and financial consequences attendant in lending options reveal that oftentimes, financial eligibility is based impermissibly on race.

Economists argue that the laws of supply and demand are race neutral and "work to allocate capital to the highest value user across competing networks of markets according to competitive and comparative advantages."<sup>26</sup> If loans are made in a "color-blind" fashion, neither the location of the community nor the race of the applicant has a bearing on the rate of the loan.<sup>27</sup> The market directs capital in ways that will result in profit maximization.<sup>28</sup>

Decades of evidence of disinvestment in urban cities begs a different conclusion.<sup>29</sup> Actually, capital is allocated to communities according to a

the borrower or the amount of such fees that can be financed; (2) the interest rate trigger and the points and fees trigger in HOEPA are both too high, allowing many abusive lenders to avoid HOEPA strictures by making high cost loans just under the trigger; and (3) HOEPA does not apply to open-ended loans." *Id.* at 422 n.6.

TILA requires lenders to disclose the terms and costs of all loan plans. 15 U.S.C. § 1601(a) (2000). The statute's intent is to compare the cost of borrowing to paying cash, and compare the costs of borrowing from different lenders. §§ 1601, 1639. To ensure consumers can do that, the federal government mandates that lenders disclose certain costs and terms. See Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists under One Roof*, 1993 WIS. L. REV. 13, 38-41 (1993) (describing the Truth in Lending Act as having increased consumer understanding of credit costs, despite its providing for an overload of information).

RESPA protects consumers from abusive financing costs associated with buying a home by requiring disclosures about closing costs in advance of settlement. See George S. Mahaffey Jr., *A Product of Compromise: Or Why Non-Pecuniary Damages Should Not Be Recoverable Under Section 2605 of the Real Estate Settlement Procedures Act*, 28 U. DAYTON L. REV. 1, 7-8 (2002). Critics argue that the mandated RESPA disclosures occur too late in the settlement process to allow or encourage comparison shopping. See generally *id.*

26. Elizabeth M. Iglesias, *Global Markets, Racial Spaces and the Role of Critical Race Theory in the Struggle for Community Control of Investments: An Institutional Class Analysis*, 45 VILL. L. REV. 1037, 1037 (2000). See also Rachel F. Moran, *The Elusive Nature of Discrimination*, 55 STAN. L. REV. 2365, 2385 (2003).

27. See Iglesias, *supra* note 26, at 1037; Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 298-99 (1993).

28. Iglesias, *supra* note 26, at 1037; Macey & Miller, *supra* note 27, at 296-97.

29. As Professor John A. Powell explains:

What is ignored in [the] cultural analysis of the inner city . . . is the explicit role that the White majority and the government itself have played in creating and maintaining this racialized space, in creating a society where good neighborhoods are defined as White neighborhoods and in defining positive individual characteristics as White characteristics. White flight . . . has been fueled by racist



rather complex interaction of institutional structures that include private financial institutions and governmental regulations.<sup>30</sup> Access to capital and investment in communities is dependent on lenders' evaluation of creditworthiness.<sup>31</sup> Lenders' evaluations are in turn legitimized by the systemic function of economic theory that ratifies disinvestment.<sup>32</sup>

The complexity reveals yet another issue—the role of law in configuring relations of power and in marginalization of class structures.<sup>33</sup> When it comes to access to loan funds, the supposedly neutral economic criteria becomes racialized.<sup>34</sup>

Understanding how the actual processes affect the financial transformation of neighborhoods is critical. Policies that fail to address the inherent, subtle discrimination in the legal rules, norms, procedures, and institutions effectively deny individuals their economic rights.<sup>35</sup> The failure to critically examine the existing decision-making structures produces systems of economic subordination.<sup>36</sup> An alternative scheme must specifically eliminate the structural and conceptual inequalities that have created the status quo.<sup>37</sup>

fears and facilitated by a host of government policies . . .

John A. Powell, *The "Racing" of American Society: Race Functioning as a Verb Before Signifying as a Noun*, 15 LAW & INEQ. 99, 111 (1997).

30. David Scott Black, "Rational" Inner City Disinvestment: A Critique of Lenders' Negative Economic Rights and a Foucaultian Analysis of Creditworthiness Evaluation, 2 GEO. J. ON FIGHTING POVERTY 303, 304 (1995).

31. *Id.* at 304-05. "Segregated minority communities have been historically impoverished and politically powerless. Today's laws and institutions need not be explicitly racist to ensure that this state of affairs continues—they need only to perpetuate historical conditions." Richard Thompson Ford, *The Boundaries of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841, 1844 (1994).

32. Black, *supra* note 30, at 304-05; Ford, *supra* note 31, at 1848.

33. See Deborah Kenn, *Institutionalized, Legal Racism: Housing Segregation and Beyond*, 11 B.U. PUB. INT. L.J. 35, 46-48, 69 (2001).

34. Whether the price corresponds to actual gradation in the borrower's riskiness is not so easily resolved. A non-competitive price may indicate that the predatory lender, which is sometimes an affiliate of a federally insured financial institution, has been allocated that particular market share due to the lack of competition in the marketplace.

35. According to Professor Iglesias, "spaces, not per se in the differential access to legality enjoyed by rich and poor, but rather, in the manner in which law (understood broadly to include its substantive norms, procedures and institutions) operates in different ways to allocate differential power among competing groups across many institutional contexts." Iglesias, *supra* note 26, at 1040.

36. The ECOA prohibits discrimination based on "race, color, religion, national origin, sex or marital status, or age." 15 U.S.C. § 1691(a)(1) (2000). Challenges to banks' credit decisions are usually unsuccessful. See *McCain v. Pennbank*, 549 A.2d 1311, 1315 (Pa. Super. Ct. 1988).

37. See Keith Aoki, *Race, Space, and Place: The Relation Between Architectural Modernism, Post-Modernism, Urban Planning, and Gentrification*, 20 FORDHAM URB. L.J. 699, 701, 788-90 (1993) (describing white suburban demographics as a politically

Proponents of human agency argue that structural changes are unnecessary because the desire for economic freedom is deeply imbedded within every individual.<sup>38</sup> Agency proponents argue that the condition of economic subordination can be transformed by the hard work of individuals determined to escape poverty.<sup>39</sup> The arguments touting individual agency are akin to entrepreneurial theory, which views self-determination and markets free of governmental restraints as crucial to individual financial transformation.<sup>40</sup> To the proponents of agency theory, it is regulatory bureaucracy that robs individuals of economic power and freedom.<sup>41</sup> Agency theory requires a solid system of empowering contract and property rights in which individuals compete in the marketplace.

Under agency theory, the individual trying to combat predatory lending must be well-versed on the intricacies of mortgage financing. The individual also must be effective in detecting and policing the lenders' decision-making process. Unfortunately, few individuals have either the know-how or the wherewithal to accomplish this.<sup>42</sup> Even fewer will be successful, given the studies showing systemic discrimination in mortgage lending.<sup>43</sup> One of the numerous results of hypersegregation is that it is vastly more difficult for racial and ethnic minorities to mount a defense to the posited business justifications.<sup>44</sup>

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independent suburban "municipal sovereignty" that uses zoning powers to maintain residential segregation).

38. See generally Reginald Leamon Robinson, *Human Agency, Negated Subjectivity, and White Structural Oppression: An Analysis of Critical Race Practice/Praxis*, 53 AM. U. L. REV. 1361 (2004).

39. Professor Reginald Robinson challenges race consciousness to the extent that it does not require that an individual exercise personal responsibility. *Id.* at 1366-68, 1408.

40. See Audrey G. McFarlane, *When Inclusion Leads to Exclusion: The Uncharted Terrain of Community Participation in Economic Development*, 66 BROOK. L. REV. 861, 876-77, 880 (2001) (arguing that empowerment zones are a flawed answer to community development woes).

41. See, e.g., Toby Egan, *Critical Race Theory's Individual Flaw*, 67 U. MO. KAN. CITY L. REV. 661, 692-93 (1999).

42. See generally Mansfield, *supra* note 3.

43. See RISK OR RACE?, *supra* note 5, at 87-106 (reviewing statistical data of subprime lending patterns in the mortgage refinance market for the 331 metropolitan statistical areas in the United States).

44. Plaintiffs bringing a lending discrimination case are disadvantaged by the absence of a single standard among the federal circuit courts. Plaintiffs are dependent upon the courts' interpretation of the various evidentiary approaches, among them the burden-shifting, four-factor, and statistical approaches, and the various modifications depending on whether the parties are public or private. Those interpretations have been unclear and have generated concern about the appropriate standards that apply and plaintiffs' evidentiary burdens. Specifically, it is unclear under the ECOA whether evidence of a disparate impact, without evidence of an intent to discriminate, is sufficient to establish a violation; whether there should be a statutorily-imposed or court-imposed finding of discriminatory intent; and

Agency does not represent choice for individuals who are powerless. What it does represent is a perpetual marginality.<sup>45</sup> Contrary to notions of agency, individuals have little power to make sustaining transformations when the underlying structure is flawed. Community action has been instrumental in blocking mergers of banking institutions that failed to be accountable to neighborhoods.<sup>46</sup> Sustainable change to those neighborhoods requires usurping the legal construction of powerful institutions and understanding how the institutional arrangements produce structural inequities.<sup>47</sup>

The denial of economic rights creates racial spaces when policies fail to address the inherent, subtle discrimination in legal rules, norms, procedures, and institutions.<sup>48</sup> Understanding how these inequities have evolved with the support of the law requires identifying economic relationships. This inquiry begins with an examination of the economic ordering. Focusing on disinvestment, banks and mortgage companies operating in the private sphere are as culpable as government policies in perpetuating borrower inequities. Hierarchical decision-making results in policies and laws that exclude the group of persons who are powerless to oppose those laws and policies that are not in their best interests.

Subprime lending uses lending criteria that creates racialized space. In this context, racialized space refers to neutral rules that are applied in a race-conscious manner.<sup>49</sup> Lenders engage in “reverse” credit allocation by making subprime loans abundantly available while making access to prime loans unavailable.<sup>50</sup> There is little justification, other than the profits and fees the subprime loan will generate, for making a subprime loan to a borrower who otherwise qualifies for a primary loan.<sup>51</sup> Often, there is a lack of documentation and rationale as to why a borrower is given a risk-

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what standard of proof a defendant must satisfy to rebut a plaintiff's prima facie case of illegal lending discrimination based on disparate impact.

45. Iglesias, *supra* note 26, at 1042-43, 1051-52.

46. Christopher A. Richardson, *The Community Reinvestment Act and the Economics of Regulatory Policy*, 29 *FORDHAM URB. L.J.* 1607 & n.74, 1627-28 (2002).

47. See Ford, *supra* note 31, at 1845. Chief among these institution of powers that must be usurped regarding subprime lending are the arrangements between federally insured institutions and their affiliates which allow the affiliates to export interest rates and to shuffle the subprime and predatory loans to these non-regulated subsidiaries. See generally Cassandra Jones Havard, *To Lend or Not to Lend: What the CRA Ought to Say About Subprime and Predatory Lending*, 7 *FL. COASTAL L. REV.* 1 (2005) [hereinafter Jones Havard, *To Lend or Not to Lend*].

48. See Aoki, *supra* note 37, at 788; Iglesias, *supra* note 26, at 1040.

49. See Iglesias, *supra* note 26, at 1037-38.

50. See Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 *FLA. L. REV.* 295, 330-32 (2005).

51. *Id.* at 304-07, 330-32.

adjusted loan product. Instead, lenders are encouraged implicitly to make biased decisions about creditworthiness rather than decisions based on well-defined, rational sounds. The transparency of race becomes evident in this and many other contexts.

Although mortgage lending is subject to the ECOA, mortgage companies can hide many of their decisions.<sup>52</sup> The discrimination and compliance statutes create some accountability, but are unable to measure the indirect slights or unwillingness to share critical information. It is often the discretionary decision-making (for example, which loan product to offer to a client initially, or how much assistance to provide) that will make a client look more creditworthy. Within the subprime lending process, the structure should require the loan officer, the mortgage broker, or any number of persons who originate loans to make the process one that is fair, that invites informed decision-making, and that systemically operates to match the best product to the individual borrower. This kind of accountability is missing in legitimate risk-based lending. Reforms that encourage transparency, require disclosure, and place responsibility on the originating lender when appropriate should be the foundations of an economically efficient, risk-based pricing regime. To allow geographical boundaries to create and give license to an economic structure is to allow race to impact the market economy.

The democratization of economic power requires a demonstration that the affairs and interests of those who are politically vulnerable are protected. Otherwise, institutionalized powerless people are pushed to the economic margins and eventually become defenseless.

## II. MARKET STRUCTURE AS EXCLUSIONARY CONDUCT

The deregulation of the financial services industry and advances in technology have changed the way financial firms market products to their customers. Historically, mortgage interest rates were regulated by the states, not by the federal government.<sup>53</sup> In 1979, the deregulation of deposit interest rates occurred because savings and loan institutions were

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52. See Stephen M. Dane, *Eliminating the Labyrinth: A Proposal to Simplify Federal Mortgage Lending Discrimination Laws*, 26 U. MICH. J.L. REFORM 527, 548 (1993) (critiquing ECOA's limitations as ineffective because the statute is inapplicable to other significant participants not involved in the loan origination decision, "such as appraisers, homeowners, mortgage insurers, and secondary market participants").

53. The first federal mortgage rate regulations were in the Federal Home Loan Bank Act, 12 U.S.C. §§ 1421-1449 (2000), which set a federal usury limit, only if there were no applicable state usury limits. Mansfield, *supra* note 3, at 477-78.

unable to maintain profitable loan portfolios.<sup>54</sup> The fierce competition for customers in an era of record-high interest rates narrowed the profit margins of thrifts so that many began to lose their customer base to money market funds that were not so restricted.<sup>55</sup> The domino effect meant that savings and loans, with less funds on deposit, also had less funds available for mortgage loans.<sup>56</sup> The statute allowed savings and loans to earn more income by "allowing them to charge whatever interest they could on first-lien home mortgages,"<sup>57</sup> and to establish interest-bearing checking accounts.<sup>58</sup>

Specifically, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) preempted state usury ceilings for first-lien mortgages.<sup>59</sup> It required states to opt out of the mortgage preemption provision through specific state action within three years.<sup>60</sup> As a result of these federal statutes, subprime lenders "charge unlimited interest rates on nonpurchase money loans secured by the borrower's residence - regardless of the purpose for which the loan was made."<sup>61</sup>

Service markets have also changed with deregulation. Mortgages are no longer geographically confined.<sup>62</sup> Deregulation has created compatibility between economic policies and incompatible social policies. Provided that "the lender secures a first-lien position on the consumer's residential real estate," nothing presently "regulates the maximum interest rate for loans such as debt consolidation loans, home improvement loans, refinance loans, and loans made for the purpose of obtaining consumer

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54. Although market interest rates were in the double digits, state interest rate ceilings required lenders to make mortgage loans far below the prevailing market rates. Savings and loans made up to sixty percent of all mortgage loans until 1979. See 125 CONG. REC. 29,930 (1979) (statement of Sen. Morgan); Mansfield, *supra* note 3, at 494-95.

55. Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 §§ 511-512, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.), amended by Pub. L. No. 96-399, § 324(b), 94 Stat. 1614, 1648 (1980); Mansfield, *supra* note 3, at 497-98.

56. Mansfield, *supra* note 3, at 498.

57. *Id.* at 499.

58. *Id.*

59. *Id.* at 476, 493-94.

60. DIDMCA § 501(b)(2), 94 Stat. at 162. Congress also passed the Alternative Mortgage Transaction Parity Act (AMTPA) of 1982, 12 U.S.C. § 3803(c) (2000) (preempting state statutes from restricting the use of alternative mortgage transactions, such as variable rate loans, balloon payments, and negative amortizations). See also Mansfield, *supra* note 3, at 508-09.

61. Mansfield, *supra* note 3, at 542.

62. See generally Michael H. Schill, *The Impact of the Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269 (1999).

goods . . . .”<sup>63</sup> The security of the home investment is now mired with consumer debt.<sup>64</sup>

Deregulation has fostered exclusionary conduct. Exclusionary conduct does not refer to activities that are per se regulated under, or prohibited by, antitrust laws for impairing rival opportunities. However, it is necessary to analyze whether the operation of the mortgage markets, post deregulation, has impaired consumers by unnecessarily restricting rivals on some basis other than efficiency.<sup>65</sup> The structural inequity of subprime lending becomes more apparent after such analysis. When viewed from the consumer’s perspective, it is a disadvantageous congruence of market dominance, segmentation, and securitization.

Market dominance occurs because there is a lack of competition among subprime lenders.<sup>66</sup> Admittedly, the federal regulation of financial institutions narrows the lending opportunities that banks and thrifts can make to non-prime borrowers.<sup>67</sup> Yet, borrowers who *perceive* themselves as not having many options have asymmetric information regarding available lending opportunities and limit their choices. Subprime lenders offer opportunities to these borrowers who may have unnecessarily avoided the prime market.

Similarly, market segmentation is an outgrowth of market dominance. When lenders segment markets, the underlying presumption is that it is economically efficient to offer homogenous products to homogeneous markets. Again, borrower perception is key, because an uninformed borrower does not understand the value of initiating and exercising more choice.

A third market phenomenon is the securitization and sale of mortgages on the secondary market. The process of securitization indirectly shifts fair lending responsibility away from the primary lender who sells loans on the secondary market.<sup>68</sup> Recent statistical evidence indicating disparate impact treatment in loans eligible for sale on the

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63. Mansfield, *supra* note 3, at 542.

64. See generally Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095 (1996).

65. See Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2242-43, 2268-69 (2000).

66. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1297-98 (2002).

67. See generally Arthur E. Wilmarth, Jr., *The OCC’s Preemption Rules Exceed the Agency’s Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).

68. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 550-51 (2002).

secondary market underscores the unfavorable treatment of minorities by the secondary market.<sup>69</sup> Unbeknownst to most borrowers, negotiation of mortgages, which may include sale on the secondary market, encourages deceit by lenders who are able to cut off borrowers' claims of fraud and misrepresentation through the sale.<sup>70</sup>

These three practices affect access to credit and control over the distribution of capital. They hamper a borrower's ability to receive a product that is accurately priced for risk, is properly underwritten, and adequately reflects the borrower's ability to repay. Failure to account for and address the control that these phenomena have over the mortgage market further evidences how structural inequities rob individuals of economic choice.

#### A. MARKET DOMINANCE

Describing the landscape of predatory lending in terms of an antitrust principle of high-cost predatory and opportunistic pricing provides a basis for examining the impact of the banking regulatory structure on the competitiveness of the subprime market. The antitrust rules provide the backdrop for explaining the conduct that prime and subprime lenders use to segment customers and charge them exorbitant prices. The conflicting values of the lender and the borrower mask a deeper issue: the inability or unwillingness of the lender to make available the fairest and most economically efficient loan terms given the borrower's particular situation.<sup>71</sup> Although these practices are not a violation of antitrust principles, they provide a basis for understanding how predatory

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69. *Id.* at 551. HUD established an in-house team to review years of data for evidence of discrimination on the part of the Government Sponsored Enterprises. See Kathleen Day, *HUD Says Mortgage Policies Hurt Blacks*, WASH. POST, Mar. 2, 2000, at A1. The data represents mortgages for loans of \$227,150 or less. *Id.*

Mortgages to:	Minorities	Blacks	Hispanics	Asians
Total Market	15.3%	5.0%	5.2%	3.6%
Fannie Mae	14.0%	3.2%	4.9%	5.9%
Freddie Mac	12.2%	3.0%	4.4%	4.8%

*Id.* Fannie Mae challenged the accuracy of the data used in the article, contending that it did not include approximately 250,000 mortgages purchased with no racial identification. See Franklin Raines, *Fannie Mae's Credit History*, WASH. POST, Mar. 10, 2000, at A21.

70. See Eggert, *supra* note 68, at 520, 607-08.

71. This may be due in part to the use of mortgage brokers, who recommend loans to borrowers. See Siddhartha Venkatesan, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177, 185 (2003) (noting that the lack of fiduciary duty encourages mortgage brokers to recommend subprime and predatory loans to borrowers).

monopolization and capture of minority, low-income, and distressed markets is a legitimate concern.

The classic definition of predatory pricing calls for a sacrifice of profit in the short run for the purpose of driving competitors from the market.<sup>72</sup> The predator expects that competitors will exit the market, thereafter enabling the predator firm to raise prices and earn monopoly or “supracompetitive” profits.<sup>73</sup> While the predatory tactics may vary, below-cost pricing operates through some device that results in loss to the rival.<sup>74</sup> What must be shown is that the dominant firm’s conduct has affected the existence of some market power, making the rival’s entry into the market more difficult and costly, to the detriment of competition generally.<sup>75</sup>

Predatory lending is not a typical predatory tactic, so predatory lending cases do not fit squarely within the analytical framework for predatory pricing violations. Predatory lending is similar to predatory pricing in that it is a cost-effective tactic allowing the lender to challenge and dominate a market underserved by traditional financial institutions to the disadvantage of the borrower. If it can be shown that the predatory lender does not engage in accurate risk-based pricing, then arguably the cost, or price of the loan, is not properly set. The predatory lender, because of the traditional lender’s exclusion of certain demographic markets and geographical areas, becomes dominant in the market because the predatory lender is the only source of loan funds. The predatory lender does not have to mount a broad market challenge because of the lack of competition for this particular market.

The “rival” is a fair lender, sometimes a federally insured financial institution, that would accurately price the loan. The predatory lender’s dominance is not born of aggressiveness in trying to eliminate other lenders as much as it is born of a market that is non-responsive to both the predatory borrower and to the neighborhood in which the property is located. Regulatory restrictions control the ability of the federally insured financial institution to make loans to some subprime borrowers.<sup>76</sup> While these regulations may not specifically prohibit subprime lending, the federally insured financial institution may be unwilling to design the products that will provide the subprime borrower with access to lower cost

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72. Bolton et al., *supra* note 65, at 2242-43.

73. *Id.* at 2322, 2256, 2269.

74. *Id.* at 2267-69.

75. *Id.* at 2255-56, 2267-69.

76. Dan Niedzwiecki, Note, *The Massachusetts High Cost Home Loan Regulations: Is This the End of Predatory Lending in the Commonwealth?* 21 ANN. REV. BANKING L. 335, 341 (2002).



loan funds.<sup>77</sup> Moreover, historically, many federally insured financial institutions have put little effort into, and thus have had poor results in, lending in these economically distressed areas.<sup>78</sup>

In some instances, the identified “rival” is a cohort, not a competitor. Some subprime predation is arguably government subsidized. Subprime lenders finance their operations by borrowing funds at a favorable rate from federally insured financial institutions.<sup>79</sup> These lenders in turn sell the loan funds at a profit to the borrower, at a lower price than the traditional lender.<sup>80</sup> As a result, there is the classic predation model of selling a product for a low price to gain a dominant position.

There is real competition for the subprime borrower. The federally insured financial institution, if willing to offer credit to the subprime borrower, would calculate a higher cost for the credit to compensate for the presumably higher monitoring costs, including regulatory costs, that would accompany the loan.<sup>81</sup> To the extent that the non-federally insured subprime lender reduces the price of the costs of the loan, the federally insured financial institution is driven out of the market. The subprime lender’s access to lower cost funds from the federally insured institution allows the lender to gain dominance in the market because of the lender’s ability to price the loan below the product’s competitive cost level. Yet, subprime borrowers, in effect upon default, pay the same higher price that could have been avoided if legitimate competition had in fact been present. Market dominance alone would be injurious to subprime borrowers, but when joined with market segmentation, it is ruinous.

### *B. Market Segmentation*

More recently, business organizations, including financial institutions, are creating plans that will capture independent segments of a market. This type of sorting can be made according to a customer’s willingness to pay certain amounts for products.<sup>82</sup> Or as argued below, market segmentation

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77. *Id.* at 337-38; see JAMES H. CARR & JENNY SCHUETZ, FANNIE MAE FOUND., FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: FRAMING THE ISSUE, FINDING SOLUTIONS 18 (2001) (discussing that the innovative partnerships that banks and fringe lenders can engage in stem the high costs of subprime lending).

78. See generally Christopher A. Richardson, *The Community Reinvestment Act and the Economics of Regulatory Policy*, 29 FORDHAM URB. L.J. 1607 (2002).

79. Niedzwiecki, *supra* note 76, at 341-42.

80. *Id.* at 339-41.

81. *Id.*

82. Financial institutions can realize substantial profits when markets are carefully segmented. See Harry C. Katz, *Industry Studies of Wage Inequality*, 54 INDUS. & LAB. REL. REV. 399, 399-400 (2001).

may be based on impermissible criteria.<sup>83</sup> The sorting also leads to market dominance as a phenomenon of the deregulation of mortgage markets.

Savings and loans and banks are no longer the dominant lenders in mortgage markets. Efforts to get around the regulations imposed on financial institutions led banks to partner with more loosely regulated mortgage companies.<sup>84</sup> These affiliations are often unknown to customers who may be steered into a more costly loan product.<sup>85</sup> This may be especially true in minority and low and moderate-income markets where the markets have been historically plagued with concentrations of imperfect information.<sup>86</sup> The failure of lenders to invest more in evaluating the standards of creditworthiness often results in credit denial for fear of lack of profitability.

Businesses find it more efficient to sort the customer base by similarities such as customer income, product interests and preferences, and age.<sup>87</sup> By creating customer sets and subsets, implicit comparisons are made about customer preferences. Customer segmentation leads to more homogeneous markets.<sup>88</sup> Homogeneous markets can lead to targeting.<sup>89</sup> In matching customer demand to product offerings, there is arguably a more efficient delivery of services.<sup>90</sup> A differentiated market strategy for each homogeneous base dictates the characteristics of the service or product that a financial institution offers given the customer's preferences or

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83. Market segmentation may not be illegal, but it becomes suspect when based on impermissible criteria. See generally Ross D. Petty et al., *Regulating Target Marketing and Other Race-Based Advertising Practices*, 8 MICH. J. RACE & L. 335 (2003) (discussing race-based advertising practices).

84. Niedzwicki, *supra* note 76, at 341-42.

85. *Id.* at 342-45.

86. Petty et al., *supra* note 83, at 379-80.

87. *Id.* at 343. Market segmentation allows service providers to match customer demand to product offerings. The homogeneity of the market makes it more efficient and allows providers to group individuals according to demand characteristics. *Id.* at 342 n.29. Firms can also engage in "strategic" segmentation, which results in further customization and tailoring of preferences or quality. PHILIP KOTLER, *MARKETING MANAGEMENT* 264 (8th ed. 1994).

88. See Petty et al., *supra* note 83, at 342 n.29; Paul N. Bloom & William D. Novelli, *Problems and Challenges in Social Marketing*, 45 J. MARKETING 79, 81 (1981). Developing a target market requires dividing buyers into discrete categories. KOTLER, *supra* note 87, at 264. Homogeneous segments for mortgages might include (1) age, income, and religious preference; (2) housing condition; (3) geographic location; and (4) ethnicity. Lambert, *supra* note 18, at 2190-92.

89. See Bloom & Novelli, *supra* note 88, at 81; Petty et al., *supra* note 83, at 342 n.29. Market segmentation may be a form of discrimination when illegal demographic factors are used to determine which customers are solicited to receive the most favorable credit card and loan offers. Lambert, *supra* note 18, at 2184, 2203.

90. Lambert, *supra* note 18, at 2218.

willingness to pay for the offerings.<sup>91</sup> Creators of segmentation strategies would argue, therefore, that customer demand and product offerings can be more accurately met.

Authentic market segmentation should be distinguished from artificial market segmentation or market steering.<sup>92</sup> Grouping a customer base according to decided preferences should not be confused with denying a group of customers access to products based on demographic categories, including race and ethnicity. Instead of offering the product that best fits the borrower's needs, the borrower is offered the product that is the most profitable based on race or neighborhood demographics.<sup>93</sup>

Informational deficiencies are inherent within subprime lending.<sup>94</sup> An assumption of efficient markets is that lenders have perfect information on which to base credit decisions. When this information is insufficient or missing, lenders must incur information costs to determine the borrower's ability and willingness to re-pay the obligation.<sup>95</sup> Based on profit projections of loan performance, lenders determine the risk adverse selection effect and moral hazard effect of borrowers.<sup>96</sup>

A closer evaluation of creditworthiness standards reveals that although important, their importance has been misplaced. Using their predictive value to bridge the informational deficiencies requires recognizing the inherent bias in the creditworthiness evaluation as it relates to minorities.<sup>97</sup>

91. *Id.* at 2186-87.

92. C. Edwin Baker, *The Media That Citizens Need*, 147 U. PA. L. REV. 317, 374-80 (1998) (using the media to make distinctions between authentic and corrupt market segmentation).

93. Taiesha L. Cantwell, *Yield-Spread Premiums: Who's Working for the Borrower? HUD's Erroneous Regulation and its Bar on Plaintiffs*, 21 LAW & INEQ. 367, 375 (2003). See generally Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757 (2003) (reviewing CROSSROADS, DIRECTIONS, AND A NEW CRITICAL RACE THEORY (Francisco Valdes et al. eds., 2002), which discusses homogeneity in the employment context).

94. Michael S. Barr, *Credit Where it Counts: The Community Reinvestment Act and its Critics*, 80 N.Y.U. L. REV. 513, 534-35 (2005).

95. Immigrant and minority populations are especially vulnerable to information asymmetries. See Charu A. Chandrasekhar, *Can New Americans Achieve the American Dream? Promoting Homeownership in Immigrant Communities*, 39 HARV. C.R.-C.L. L. REV. 169, 172-73, 177-78 (2004).

96. Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 90 (1995).

97. Fred Galves, *The Discriminatory Impact of Traditional Lending Criteria: An Economic and Moral Critique*, 29 SETON HALL L. REV. 1467, 1473 (1999); Barr, *supra* note 94, at 534-35.

*1. Perfect Information*

Borrowers have information superior to that of banks concerning the borrower's ability to perform.<sup>98</sup> This handicaps banks because they cannot predict the borrower's future performance.<sup>99</sup> To compensate for the information deficit, financial institutions use interest rates as a screening mechanism. Higher interest rates will yield more income from successful projects on the possibility that the borrower will default and not repay the obligation.<sup>100</sup> The notion that credit criteria can determine who is a risky borrower may be flawed.<sup>101</sup> The underlying presumption of credit criteria is that past conduct is an accurate predictor of a borrower's future performance.<sup>102</sup>

Instead of charging higher interest rates to borrowers who would otherwise be denied credit, financial institutions simply choose not to extend credit to these "risky" borrowers. Credit rationing thus creates a gap in the market for credit.<sup>103</sup> The subprime lender counters the lack of information that causes adverse selection by imposing oppressive terms upon default.<sup>104</sup> The adverse selection phenomenon means that some lenders are willing to take on more risk while the risk adverse selection effect identifies the borrower who is the most at risk.<sup>105</sup> Correspondingly, the adverse selection borrower is one who is willing to pay a higher rate of interest because she expects the profits to increase with the risk.<sup>106</sup> Lenders who have limited credit opportunities regulate credit by screening out the borrowers who are willing to pay a higher interest rate for credit.<sup>107</sup>

The subprime lender has an incentive to identify the borrower who will engage in risky repayment behavior. While the traditional model is for the lender to view the moral hazard effect as a negative, the subprime lender views it as positive.<sup>108</sup> The moral hazard effect evaluates the

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98. Macey & Miller, *supra* note 96, at 90.

99. *Id.*

100. *Id.* at 77-81.

101. *Id.* at 90-91.

102. Galves, *supra* note 97, at 1473.

103. Barr, *supra* note 94, at 537-38.

104. *Id.*

105. *Id.*

106. *Id.*; Daniel S. Ehrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 117, 119-20 (2001).

107. Frank Lopez, *Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. ON POVERTY L. & POL'Y 73, 77 (1999) (describing the credit shortage as one of reverse redlining in credit-starved communities that have been shut out by traditional lenders).

108. Barr, *supra* note 94, at 536-38.

likelihood that the borrower will repay the loan once made.<sup>109</sup> The lender evaluates the project's potential for success and lends to the borrower at a higher rate of interest to protect against default.

Far too often, the marketing strategies of subprime lenders make no attempt to bridge information deficiencies.<sup>110</sup> Instead of instituting screening and monitoring mechanisms, subprime lenders base offers of interest rates and loan terms on race and geography.<sup>111</sup> There is little incentive to make adequate disclosures or present alternatives about risk-based products when the originating lender is able to sell the loans quickly on the secondary market.<sup>112</sup> While some may argue that regulating subprime lending will restrict credit opportunities for the less-than-prime borrower, it is important to require that those lenders engage in adequate screening and monitoring activities and are not unnecessarily passing along asymmetric information costs to borrowers.

The subprime lender views the information deficiency as an opportunity to make a more substantial profit. Knowing that the borrower is willing to pay a higher rate of interest for the loan, the subprime lender is not dissuaded by its lack of information. These lenders in fact thrive on limited information about borrowers to justify the high rates that they charge.<sup>113</sup> Indeed, there is little incentive for the lender to become privy to more information about the borrower and thus adjust either the amount of credit or the rate of interest.<sup>114</sup> Having identified these borrowers as risk-adverse and recognizing a benefit in foreclosure of the residential property, lenders benefit if the size of the loan is larger.<sup>115</sup> This leads the borrower to conclude that the loan is rational, when, in fact, it may not be.

## 2. Transaction Costs

Efforts for a borrower to secure her own financing are costly. Transaction costs affect the economic efficiency of a deal between the lender and the borrower. Transaction costs measure the costs of performance.<sup>116</sup> Transaction costs often interfere with credit availability as

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109. See Charles G. Hallinan, *The 'Fresh Start' Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 83-84 (1986); Barr, *supra* note 94, at 538.

110. Engel & McCoy, *supra* note 66, at 1286.

111. *Id.*

112. *Id.* at 1286-87.

113. Barr, *supra* note 94, at 535-36.

114. *Id.* at 535-37.

115. Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 119-20 (2002).

116. See Manuel A. Utset, *Producing Information: Initial Public Offerings, Production*

they can price a borrower out of the market because verifying borrower information and negotiating funds' availability with investors are costly functions.<sup>117</sup> In the most efficient bargains, the parties negotiate on who will bear these costs.<sup>118</sup>

The lender's job as a financial intermediary is to diversify risk, evaluate investments, and provide liquidity to the investors.<sup>119</sup> The lender must charge the borrower for the costs of acquiring and verifying information, as well as for the cost of searching for the funding of the loan.<sup>120</sup> The lender incurs the costs of identifying the investor who will finance the transaction and the borrower who needs the funds. The participation of the secondary market makes the subprime lender more like a financial intermediary that incurs costs for negotiating and verifying contracts.

Borrowers must pay the lender for finding an investor. In general, borrowers are unable to identify investors who are willing to take on the risk of funding an illiquid asset that spans fifteen to thirty years. The lender serves as an intermediary who must match the investor with the borrower's needs. Similarly, an intermediary's transaction costs will be less than those that an individual borrower may incur if she were to seek her own investors.<sup>121</sup>

The advantage of the subprime lender is that the subprime loans will be sold quickly on the secondary market. This substantially reduces the transaction costs of finding funding. In the context of subprime lending, the existence of the secondary market has a direct effect on transaction costs.<sup>122</sup> The secondary market substantially reduces the search costs for the average lender. As a readily identifiable source of funds, the secondary market creates liquidity in these assets. Conversely, the borrower who is trying to secure financing independent of traditional lenders will find

*Costs, and the Producing Lawyer*, 74 OR. L. REV. 275, 288-89 (1995).

117. See Barr, *supra* note 94, at 536-37.

118. See generally Scott R. Peppet, *Contract Formation in Imperfect Markets: Should We Use Mediators in Deals?*, 38 OHIO ST. J. ON DISP. RESOL. 283 (2004).

119. See Jeffrey S. Glaser, *The Capital Asset Pricing Model: Risk Valuation, Judicial Interpretation, and Market Bias*, 50 BUS. LAW. 687, 689-90 (1995) (discussing efficient portfolio diversification).

120. See Michael I. Swygert & Katherine Earle Yanes, *A Unified Theory of Justice: The Integration of Fairness into Efficiency*, 73 WASH. L. REV. 249, 272-74 (1998) (discussing the "ad hoc" and "definitional" approaches to transaction costs).

121. Mortgage borrowers are less disadvantaged in the credit economy than other types of borrowers because there is a ready source of funds for residential mortgages. Ann M. Burkhart, *Lenders and Land*, 64 MO. L. REV. 249, 278 (1999).

122. See generally Venkatesan, *supra* note 71 (comparing the transaction costs of the holder in due course doctrine with the borrower's right to recover from an assignee).

borrowing funds to be too costly.

### 3. Agency Costs

The agency costs, or the costs of managing the loan after the borrower receives the funds, also bear some significance to the lender's decisions of whether to make the loan and how to price it. Agency costs represent the lender's ability to assess the borrower's credit managerial skills.<sup>123</sup> A lender must evaluate the borrower's incentive to repay the loan and to engage in conduct or behavior that will maximize the benefits of the loan as well as refraining from conduct that will retard the loan's efficiency.<sup>124</sup> Basically, an agency cost is an assessment of the borrower's ability to repay.<sup>125</sup> The lender evaluates the borrower's credibility in promising to repay the debt by evaluating the borrower's present earnings, predicting future income streams, and reviewing past credit history.<sup>126</sup> Securitization allows the originating lender to avoid a critical evaluation of agency costs.

The need to accurately predict the borrower's ability to perform cannot be ignored. Far too often in subprime lending, the equity in the home and the availability of foreclosure are used as a proxy for this assessment. Instead of an adequate assessment of whether the borrower will conform her behavior to make the transaction a profit-maximizing one, subprime lenders wager on the borrower's equity. Thus, if the borrower fails to perform as expected, she loses by giving up the right of home ownership. The subprime lender has simplistically and inappropriately characterized many borrowers as high-risk. The subprime lender also predetermines that the subprime borrower will be an unreliable agent in monitoring, adjusting when necessary, and conforming to the terms of the loan.

The notion of agency becomes confused with free choice in subprime lending.<sup>127</sup> Assuming borrowers have neither accurate nor adequate information about their level of risk, they cannot be said to have acted rationally or with free choice in accepting a loan that was not in their best interests. Accepting an overpriced loan that can become onerous with any

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123. See James W. Lovely, *Agency Costs, Liquidity, and the Limited Liability Company as an Alternative to the Close Corporation*, 21 STETSON L. REV. 377, 379 n.9 (1992).

124. The lender needs to have the ability to minimize the borrower's moral hazard. Larry T. Garvin, *Credit, Information, and Trust in the Law of Sales: The Credit Seller's Right of Reclamation*, 44 UCLA L. REV. 247, 286-87, 341 (1996).

125. *Id.* at 309.

126. See Galves, *supra* note 97, at 1476 (arguing that employment stability is biased and is "really just a proxy for income stability").

127. See discussion *supra* Part I.B.

financial mistake or mishap cannot be equated with agency costs that justify a higher loan price. The offered product was flawed from the beginning. The effect of securitization cannot be overstated. The ability of the lender to sell the loan on the secondary market also permits the lender to short-circuit an evaluation of agency, or the borrower's ability to manage the loan, which would otherwise be critical. The inquiry should be whether the borrower has an ability to repay with sufficient residual income.<sup>128</sup>

Furthermore, if the subprime lender is required to look at alternative behavior, there are proxies that indicate the borrower's ability to manage the debt. If the lender's only behavior proxy is credit history as reported through the credit bureaus, the information may not be the most reliable and may result in unnecessarily high agency costs added to the price of the loan.

### C. Government-Sponsored Entities (GSEs)—The Secondary Loan Market

The secondary mortgage market provides money to originate mortgages by purchasing primary mortgages after origination.<sup>129</sup> Unlike the primary market, which has direct contact with individual borrowers, secondary market participants have an indirect relationship with the borrower.<sup>130</sup> Secondary market entities include government-sponsored agencies as well as depository institutions, mortgage companies, pension funds, and real estate investment trusts.

Secondary market institutions play a critical role in the residential lending market, and either support or exasperate the negative market segmentation and specialization that exists in the primary mortgage market. Recognizing the potential for discrimination that exists due to the purchasing and securitization activities that occur in secondary market institutions, Congress amended the Home Mortgage Disclosure Act ("HMDA"). The choice to live in an ethnically homogeneous neighborhood usually results in a decline in municipal services.<sup>131</sup> For

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128. See Cassandra Jones Havard, *Invisible Markets Netting Visible Results: When Subprime Lending Becomes Predatory*, 26 OKLA. CITY U. L. REV. 1057, 1076 (2001) (discussing the importance of taking residual into account income).

129. See generally Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 501-02 (1989).

130. See Ronald K. Schuster, *Lending Discrimination: Is the Secondary Market Helping to Make the "American Dream" a Reality?*, 36 GONZ. L. REV. 153, 156, 175-76 (2000-2001).

131. See Franklin D. Wilson & Roger B. Hammer, *Ethnic Residential Segregation and Its Consequences*, in URBAN INEQUALITY: EVIDENCE FROM FOUR CITIES 272, 273, 294 (Alice O'Connor et al. eds., 2001) (discussing that minorities pay a price for living in ethnically homogeneous neighborhoods).



example, such neighborhoods have fewer recreational areas (such as parks), less police protection, higher vandalism, poorer quality schools, and a "limited availability of retail and financial establishments."<sup>132</sup>

Regulations require mortgage lenders to disclose information on the race, income, and other characteristics of loan applicants.<sup>133</sup> However, each secondary market institution specifies the underlying criteria that loans must meet to be eligible for purchase or securitization by that entity.<sup>134</sup> Those variables, which include loan limits and underlying guidelines, affect the type and size of loans that the secondary market institutions will buy or securitize.<sup>135</sup> In this regard, the secondary market's inherent structural biases can go largely undetected and its discriminatory effects unpoliced.<sup>136</sup> An evaluation of GSEs' underlying criteria raises questions of whether secondary market GSEs can more fully promote "the availability of mortgage credit to low- and moderate-income households."<sup>137</sup> The question becomes what is the appropriate monitoring device to determine whether the secondary agencies are adequately promoting the availability of mortgage credit to low- and moderate-income minority households.

### 1. Background

The deregulation of the banking industry has changed the way in which mortgages are originated and what happens to them after origination. When Congress passed the Depository Institutions Monetary Control Act ("DIMCA"), the immediate response was an increased competition for deposits. Banks traditionally relied on deposits to raise capital. The competition for deposit dollars became fierce as capital-starved banks touted a "win big—lose nothing" attitude, knowing that if they failed their deposits were insured by the federal deposit insurance fund. The high interest rates for borrowing money that outpaced the performance of loans held in portfolio were especially disastrous to the traditional savings and

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132. *Id.* at 273.

133. Schuster, *supra* note 130, at 161 (discussing the HMDA requirement that lending institutions publicly disclose loan information and applicant characteristics).

134. Give current Fannie Mae and Freddie Mac guidelines and loan-limit sizes. (Effective 1/1/05, limit size is \$359, 650)

135. See Schuster, *supra* note 130, at 156-58.

136. *Id.* at 179 (discussing the secondary market's "ability to discriminate outside the scope of the legislative barriers").

137. Glenn B. Canner & Stuart A. Gabriel, *Market Segmentation and Lender Specialization in the Primary and Secondary Mortgage Markets*, 3 HOUSING POL'Y DEBATE 241, 295 (1992).

loan.<sup>138</sup>

The deregulation of the financial services industry also bolstered the modern secondary mortgage market by making the mortgage-backed security a routine way of financing the common home mortgage loan.<sup>139</sup> The mortgage-backed security requires mortgage originators to cater their lending to the loan's liquidity and the ability to sell the loan on the secondary market.<sup>140</sup> The result is a dynamic change in the once local mortgage real estate market. Investors dictate that the products of this market be uniform and predictable. Moreover, the market structure has evolved into various participants with each investing in only a discrete portion of the cash flow of the loan. Each set of investors has different expectations and risk tolerances, and thus, a different expected outcome. These differences are in some respects magnified when the loan fails and the divergent interests of the investors become competitive. Regulatory changes to the secondary mortgage market must be made with an understanding of these investor demands to avoid hampering the market's efficiency.<sup>141</sup>

## 2. Market Liquidity

Congress created the GSEs to ensure that homebuyers throughout the country have available mortgage funds.<sup>142</sup> The secondary mortgage

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138. See generally Cassandra Jones Havard, *Back to the Parent: Holding Company Liability for Subsidiary Banks—A Discussion of the Net Worth Maintenance Agreement, the Source of Strength Doctrine, and the Prompt Corrective Action Provision*, 16 CARDOZO L. REV. 2353 (1995) (discussing causes of past saving and loan associations' failures).

139. In a well-known article, two legal scholars defined securitization as:

[T]he sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.

Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1374-75 (1991).

140. Mortgage-backed securities are securities whose repayment is backed by a pool of mortgages. The pool issues securities; and payments on the securities are made from payments received on the mortgages. Paula C. Murray & Beverly L. Hadaway, *Mortgage-Backed Securities: An Investigation of Legal and Financial Issues*, 11 J. CORP. L. 203, 204, 207-08 (1986) (arguing that the local nature of mortgages created capital shortages that reflected a need for a secondary mortgage market).

141. Supporters of the secondary market tout that increased standardization has made the market more efficient, more liquid and thus, profitable and reduced mortgage costs for home buyers. See Quintin Johnstone, *Land Transfers: Process and Processors*, 22 VAL. U. L. REV. 493, 515-16 (1988).

142. See Robin Paul Malloy, *The Secondary Mortgage Market a Catalyst for Change*

markets, of which the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are significant players, provide greater liquidity in the mortgage markets.<sup>143</sup> With origins in New Deal legislation, GSEs serve two important purposes.<sup>144</sup> First, banks are able to resell their mortgages and in turn have more funds available to make mortgages and other investments.<sup>145</sup> Second, mortgage rates are stabilized throughout the nation's housing markets.<sup>146</sup> A process of securitization has evolved, which encourages a secondary market in mortgages and which arguably benefits from a significant government subsidy.<sup>147</sup> Securitization has the added benefit of reducing information costs, thus making it economically efficient for investors to participate in this particular market.<sup>148</sup>

GSEs, Fannie Mae, and Freddie Mac are quasi-governmental bodies with a unique charge and a special status.<sup>149</sup> The governmental charters

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*in Real Estate Transactions*, 39 Sw. L.J. 991, 992 (1986).

143. Murray & Hadaway, *supra* note 140, at 204-06. Congress created Fannie Mae in 1938. Originally, Fannie Mae was a government corporation with the purpose of purchasing and reselling FHA guaranteed mortgages in an effort to provide liquidity to financial institutions with limited access to national markets for capital. See U.S. DEP'T OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION 17-18 (1996) [hereinafter GOVERNMENT SPONSORSHIP]. Two subsequent Congressional authorizations in 1948 and in 1970 expanded Fannie Mae's purchasing power to include VA loans and non-conventional loans, respectively. *Id.* at 18-19. Likewise, Congress created Freddie Mac in 1970. Craig E. Marcus, Note, *Beyond the Boundaries of the Community Reinvestment Act and the Fair Lending Laws: Developing a Market-Based Framework for Generating Low- and Moderate-Income Lending*, 96 COLUM. L. REV. 710, 756 n.244 (1996). Congress created the Government National Mortgage Association (Ginnie Mae) in 1968 to take over the low-income housing programs previously run by Fannie Mae. Congress then restructured Fannie Mae to become a private corporation with ties to the federal government and with the authority to buy and sell conventional (non-federally insured) home mortgage loans. David J. Bleckner, Note, *Section 106 of the Secondary Mortgage Market Enhancement Act of 1984 and the Need for Overriding State Legislation*, 13 FORDHAM URB. L.J. 681, 687 n.42 (1985).

144. Murray & Hadaway, *supra* note 140, at 204.

145. Marcus, *supra* note 143, at 754-55.

146. *Id.*; Malloy, *supra* note 142, at 994. The financial crisis of the Great Depression created a need to both restore solvency to the nation's lending institutions and regulate and stabilize the money supply. Thus, the GSEs were created to sell mortgages within a "closed" market designed to regulate and stabilize the money supply. See Bleckner, *supra* note 143, at 683; Murray & Hadaway, *supra* note 140, at 204-05.

147. Malloy, *supra* note 142, at 992-99 (discussing the development of the secondary mortgage market in America). See also Michael Carroll, *Masters to Beltway Capitalism*, INSTITUTIONAL INVESTOR, July 1995, at 60.

148. See *supra* notes 94-97 and accompanying text.

149. Fannie Mae and Freddie Mac are accorded a special status as GSEs. They are exempt from paying state and local corporate income taxes, exempt from registering their securities with the Securities Exchange Commission, and borrow funds at a more favorable

creating them restrict their operation to the secondary market and require the GSEs to purchase target amounts of mortgages from underserved low, moderate, and very low-income households.<sup>150</sup> As purchasers of loans and not originators, the federal lending discrimination laws do not apply to the GSEs.<sup>151</sup> Accordingly, Congress requires Fannie Mae and Freddie Mac to review their operating procedures and underwriting standards for discrimination.<sup>152</sup>

The presence of securitization in the real estate mortgage market has created a market dominance that in effect sets the standards for mortgage loan originations and underwriting. The changes in the financial network trickle down to the local real estate market and its operations. The liquidity of the market means that financing is available from unlikely sources.

An assumption that promotes the continued government sponsorship of the secondary market is that the GSEs counteract lending discrimination in the primary market.<sup>153</sup> The argument is that by making lending liquid and profitable, credit is made more widely available to those to whom it has been historically denied.<sup>154</sup> Securitization combines liquidity and quality. Quality, however, has been defined in this instance only in economic terms that benefit the investor, invariably meaning how well the loan is expected to perform. While measuring the quality of the product inherently connotes compliance with regulatory and legal guidelines, the quality evaluation has not translated into any borrower protections vis-a-vis the original lender.

The GSEs have a ready market for their securities because they have

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rate. Schuster, *supra* note 130, at 156-57. See generally Bradley K. Krehely, Note, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519 (2002) (explaining the nature of the federal charter of the two GSEs and discussing the nature and extent of their power).

150. Additionally, the charters limit the amount of a single mortgage purchase to \$207,000. Schuster, *supra* note 130, at 156-57.

151. *Id.* at 156-57, 179. “[S]econdary market participants, like Fannie Mae and Freddie Mac, are not lenders or creditors as identified by the ECOA.” *Id.* at 179.

152. *Id.* at 156-57. Securitization benefits the homebuyer. Various studies have indicated that homebuyers realize a 25 to 50 basis point (.25% - .50%) decrease in mortgage rates as a result of the presence of the GSEs in the market. See A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 600 & n.121 (1995).

153. See GOVERNMENT SPONSORSHIP, *supra* note 143, at 57-58.

154. In a typical transaction, the GSEs purchase mortgages from mortgage originators and finance them by creating a mortgage pool and selling securities that represent an interests in that pool. The mortgage originator performs the tasks of processing the application, checking the borrower’s credit and securing the appraisal. The mortgages are uniform in their age, interest rate structures, and underwriting characteristics. The original lender continues to participate in the mortgage transaction usually by servicing the loan pool, for which it receives a fee. Schuster, *supra* note 130, at 156-57.

an implicit federal guarantee.<sup>155</sup> The full faith and credit guarantee correlates to tremendous cost savings for GSEs. They are not required to get credit enhancements for their securities.<sup>156</sup> Additionally, GSEs are exempt from some federal, state, and local taxes, as well as from the federal securities laws.<sup>157</sup> These advantages create substantial costs savings for GSE products.<sup>158</sup> The GSEs, however, were disadvantaged initially because they were not able to capture the niche product markets such as adjustable rate mortgages, jumbo or large dollar amount mortgages or lower quality mortgages.<sup>159</sup> Arguably, the GSEs, as the largest participants in the secondary market, are undermining the primary market for mortgage capital.<sup>160</sup> Fannie Mae and Freddie Mac dictate the conditions under which primary lenders can sell loans and primary lenders conform their own underwriting criteria to meet these specifications.<sup>161</sup> The effect of securitization is that lenders now make loan approvals based in large part on whether the loans can be sold on the secondary market.<sup>162</sup> As a result, the secondary market dictates how and why lending occurs in the primary market.<sup>163</sup> Therefore, greater scrutiny ought to be placed on the various ways in which the secondary market passively encourages abusive lending and can actively prohibit it.<sup>164</sup> Similarly, the GSEs receive

155. See Froomkin, *supra* note 152, at 559, 621 (arguing that GSEs have diminished market discipline thereby allowing private parties an opportunity to benefit at public expense with more rigid controls). See Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 583-85 (2005).

156. Froomkin, *supra* note 152, at 603-05.

157. Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1120 (1996).

158. *Id.*

159. The lower quality mortgages are represented by "B," "C," and "D" paper. *Id.* at 1121.

160. The secondary market has undergone tremendous growth since its inception. Schuster, *supra* note 130, at 156-58. The GSEs, Fannie Mae and Freddie Mac, hold about 34% of the four trillion dollars worth of outstanding mortgages for one to four family homes. *Id.* at 157. See also U.S. DEP'T OF HOUS. & URBAN DEV., STAGE 3: THE LOAN APPROVAL OR DISAPPROVAL DECISION, at <http://www.hud.gov/pressrel/newsconf/stage3.html> (last modified Sept. 8, 2000).

161. Today, the norm is that many primary mortgage loan applications mirror those that Fannie Mae and Freddie Mac use for the purchase of loans. Also, Fannie Mae has developed a software program called Desktop Underwriter, which allows a primary lender to get an immediate response from Fannie Mae regarding the purchase of a loan when the borrower makes the application. Schuster, *supra* note 130, at 158.

162. *Id.* at 157-58, 179.

163. *Id.* at 179.

164. The argument that the credit market is colorblind is not necessarily borne out by the statistics. A HUD investigation of discrepancies in lending systems using credit scoring was met initially with resistance by Fannie Mae, which declared that the absence of data on race in the underwriting systems indicated a lack of discrimination. *Id.* at 174. As one

a guarantee fee before passing the remaining portion of the monthly mortgage payments to the holders of the mortgage-backed securities for that loan pool.<sup>165</sup>

By contrast, federally insured depository institutions issue mortgage-backed securities,<sup>166</sup> and must meet capital adequacy requirements and pay deposit insurance premiums.<sup>167</sup> Securitization has the added advantage of allowing the seller to sell large volumes of loans and discounting them only slightly for sale.<sup>168</sup>

#### *D. Conclusion: How the Market Protects Subprime Lending*

Subprime lending occurs, in part, because there is a credit gap in the prime lending sector that is filled by subprime lenders. The lending activities of affiliates of federally insured institutions present an area of concern for policy makers because these organizations represent what one research organization has called the “dual mortgage market.”<sup>169</sup> A segmented system of consumer finance has evolved concentrating, it appears, higher-income homeowners as the main customers of the more highly-regulated banks and thrifts, and lower income and minority customers as primary customers of the unregulated banks and thrifts.<sup>170</sup> Information asymmetries between lenders and borrowers affect credit availability.<sup>171</sup> When a seller has market power, its dominance in the market excludes its competitors from serving disfavored customers. In turn, that imbalance can lead to “credit rationing”—the denial of loans to

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scholar has suggested, such an argument fails to account for the disparate impact of discrimination that occurs due to the factors that comprise the colorblind system. *Id.* at 173. Statistics reported by the Washington Post led however to a different conclusion. *Id.* at 174-75 (citing Kathleen Day, *HUD Says Mortgage Policies Hurt Blacks; Home Loan Giants Cited*, WASH. POST, Mar. 2, 2000, at A1).

165. A second way of financing the secondary market transaction is for the secondary market lender “to issue debt securities and retain the mortgage in the corporation’s portfolio.” *Id.* at 157.

166. Lisa M. Fairfax, *When You Wish Upon a Star: Explaining the Cautious Growth of Royalty-Backed Securitization*, 1999 COLUM. BUS. L. REV. 441, 448 (1999). Securities backed by mortgages receive favorable government treatment. *Id.* at 451-58 (discussing the benefits of securitization).

167. 12 U.S.C. §§ 1815-1816 (2000).

168. Fairfax, *supra* note 166, at 449-52.

169. See DANIEL IMMERGLUCK & MARTI WILES, WOODSTOCK INST., TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT i-ii (1999).

170. *Id.*

171. See Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1566-68, 1570-72 (1995) (discussing lender’s low incentive to invest in obtaining adequate information in low and moderate income communities).

would-be borrowers who are observationally indistinguishable from successful loan applicants.<sup>172</sup>

Financial institutions use interest rates as a screening mechanism. Although higher rates will yield more income from successful projects, the adverse selection phenomenon means that some lenders are willing to take on more risk because of the possibility that borrowers will default and not repay the obligation.<sup>173</sup> Instead of charging higher interest rates to borrowers who would otherwise be denied credit, financial institutions simply choose not to extend credit to these "risky" borrowers. Credit rationing thus creates a gap in the market for credit. The subprime lender counters the lack of information that causes adverse selection by imposing oppressive terms upon default.<sup>174</sup>

A byproduct of the information asymmetry is market segmentation that identifies populations of like-situated individuals with representative proportions of qualified minorities. True risk-based pricing bridges informational deficiencies and offers a more balanced process of obtaining information of those who may be creditworthy in low-income communities. The profit motive, outside of underwriting considerations, should not provide a basis for lenders who restrict their applicant pool so as to neglect minority populations. Conversely, it is unlikely that true risk-based pricing would include a high-risk applicant pool that consists only of minority applicants.

A dominant seller, such as a subprime or predatory lender, is able to achieve a high volume of sales in its market segments and, consequently, is able to lower its prices in its most competitive markets. For the predatory lender, the very access to markets underserved by primary lenders creates an advantage and prices the primary lenders out of the market.

A postured justification and economic assumption underlying subprime and predatory lending focuses on the lender's judgment and underwriting policies. Subprime lending theory presumes that the transaction and agency costs of lending are evenly calculated. A further presumption is that all borrowers are treated equally in terms of access to the application and submitting information that makes them look more "creditworthy."

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172. *Id.* at 1566; see STEFANIA COSCI, CREDIT RATIONING AND ASYMMETRIC INFORMATION 8 (1993).

173. COSCI, *supra* note 172, at 27. Some subprime lenders offer "special 'bottom-fishing models' to search for creditworthy candidates among the approximately fifty million individuals in the United States with credit scores normally too low to qualify for credit." Lambert, *supra* note 18, at 2223.

174. Barr, *supra* note 94, at 535-37.

The corollary to this presumption is that the lender treats all borrowers fairly, if not necessarily equally. Many recent studies on mortgage lending, that have made comparisons across racial lines find that by far, minorities have not fared as well in the loan application or approval process of mortgage lending. In the home equity context, the economic assumption of a fair lender with rational underwriting standards should integrate the collateral that secures the loan as a variable, thereby making rates and loan availability indicative of the borrower's actual creditworthiness rather than the lender's perceived judgments about the borrower's risk.

Although the dominant firm's goal may not specifically be to exclude rivals, its competitive edge allows it to set prices that serve its own objectives. Those prices are ultimately profit-maximizing for the dominant firm and the competitor is forced to follow them.

Lenders argue that subprime borrowers are riskier, and, therefore, there are higher delinquency and default rates. It is argued that this, in turn, dictates the high cost of subprime loans and justifies the cost. While subprime loans carry a high risk of default, it is unclear whether these risks are caused by the credit condition of the borrower before the loan is made, or by the loans themselves. This argument is particularly fallacious when the loan is actually secured by property owned by the borrower.

The most common credit product is the subprime refinance loan. Most borrowers who lose, or are under the threat of losing, their home already owned their home before taking the subprime loan. The tremendously inflated costs of the subprime loan has created most of the risk of default and foreclosure.<sup>175</sup>

### III. TOWARDS CREDIT DEMOCRATIZATION - ADDRESSING STRUCTURAL INEQUALITIES

Law and economics scholars are consistent in their condemnation when race impermissibly impairs economic efficiency.<sup>176</sup> Using risk-based pricing in inappropriate circumstances is yet another form of redlining.<sup>177</sup> Extending credit on unfavorable terms is always suspect. While the presumption is that the borrower is well informed and has the ability to

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175. See generally Joseph A. Smith, Jr., *Financial Literacy, Regulation and Consumer Welfare*, 8 N.C. BANKING INST. 77 (2004).

176. See generally Emily M.S. Houh, *Critical Interventions: Toward an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law*, 88 CORNELL L. REV. 1025, 1063-66 (2003) (critiquing race, law, and economics).

177. See Jones Havard, *Racializing Rural Economic Space*, *supra* note 9, at 341 n.106 (discussing lenders using high agency costs as reason to avoid lending in minority neighborhoods).



negotiate, this ability is dramatically curtailed in the present day environment of mortgage brokers.<sup>178</sup> Since mortgage brokers shop for loans for borrowers and presumably advise borrowers on the best product available to them, it is difficult to argue that borrowers are actually exercising free choice regarding the particular loan products because they are only being presented with “the best” available product.<sup>179</sup>

Furthermore, risk-based pricing founded on stereotypes lacks neutrality. Lenders making decisions about which products to offer a particular borrower should base that decision on an assessment of the loan’s performance and profitability. Unfortunately, most risk-based pricing takes on a decentralized nature instead of a presumed exclusive one.<sup>180</sup> The lack of specific determinants leads to lending disparities that could be alleviated if attention was more closely paid to individual predictors of performance.<sup>181</sup>

Unfortunately, the presence of the secondary market makes individual lenders calloused to the actual performance of the loan.<sup>182</sup> Securitization allows lenders to divert the costs of subprime loans to borrowers who are already economically at risk. The lender factors his or her prediction of the loan’s performance into the cost of the loan.<sup>183</sup> Unless and until the secondary market routinely rejects those lenders who have the highest rates of foreclosure, subprime lenders will be allowed to be unconcerned about loan delinquencies, or the costs and consequences of those delinquencies to individual homeowners.<sup>184</sup> Although borrowers have an incentive not to default because of the damage to their credit histories, subprime lenders are

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178. See Peppet, *supra* note 118, at 358.

179. See Eggert, *supra* note 68, at 555 (identifying California and Ohio as two states that have strengthened their regulation of mortgage brokers).

180. Courts have begun to recognize claims of “reverse redlining” under the ECOA and FHA. See, e.g., *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874, 886 (S.D. Ohio 2002); *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7, 20 (D.D.C. 2000); *Honorable v. Easy Life Real Estate Sys.*, 100 F. Supp. 2d 885, 886-87 (N.D. Ill. 2000); see also *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 537 (N.J. Super. Ct. App. Div. 2001).

181. Kenneth G. Gunter, *Computerized Credit Scoring’s Effect on the Lending Industry*, 4 N.C. BANKING INST. 443, 451-52 (2000) (discussing how supposedly neutral computerized credit scores can have a disparate impact).

182. See Eggert, *supra* note 68, at 534-35.

183. See Renuart, *supra* note 25, at 427.

184. Foreclosure data for FHA loans indicates that the rates are increasing. SARAH ROSEN WARTELL, MILLENNIAL HOUS. COMM’N, SINGLE-FAMILY RISKSHARING: AN EVALUATION OF ITS POTENTIAL AS A TOOL FOR FHA 11, 21 (2002), available at <http://govinfo.library.unt.edu/mhc/papers/wartell.doc> (discussing FHAs objective of providing finance for affordable housing in light of the conventional market’s expanding role in providing low- and moderate-income house financing).

actually given a competitive market advantage by targeting borrowers who may themselves perceive an offer for a risk-based product as their best option.<sup>185</sup>

Justifications of rigid subprime lending policies that disproportionately affect large numbers of minorities must be reckoned with. These policies are inflexible in that they accept flawed classical economic theory and render inefficient results when examined from the perspective of geography and race.<sup>186</sup> The aggregate gains of liberalized lending must be balanced against the negative effects that these policies have wrought on individuals and communities.<sup>187</sup> The failure to acknowledge, and thus, work at remedying why minorities and low- and moderate-income persons are disproportionately effected destroys the supposed neutrality.<sup>188</sup>

#### A. Informed Risk-Based Pricing

While subprime lending entangles marginal borrowers, admittedly it provides a source of credit. Regulating subprime and predatory lending arguably denies access to credit.<sup>189</sup> This is a foreseeable and acceptable consequence in many submarkets.<sup>190</sup> The differing perspectives regarding regulation raises an issue of social policy that is particularly appropriate for legislative consideration. Legislative intervention provides guidance to bank regulators, whose unfettered discretion leads to uneven results.<sup>191</sup> A specific law will also provide guidance to market participants who do not have any incentive to comply without guidance.<sup>192</sup> The questions become: what information should the market be required to divulge; what are the identifiable risk triggers; and what punishment should the business face if it provides inaccurate information, intentionally or otherwise?

185. See Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 731-32 (2005) (discussing groups towards whom subprime marketing is typically directed).

186. See Azmy, *supra* note 50, at 322-24, 351.

187. See generally Christopher Jordan Heisen, Comment, *Community Development Lite: An Economic Analysis of the Community Development Financial Institutions Act*, 39 HOW. L. J. 337 (1995).

188. *Id.*; Azmy, *supra* note 50, at 346-47, 358.

189. See generally Donald C. Lampe, *Wrong from the Start? North Carolina's "Predatory Lending" Law and the Practice vs. Product Debate*, 7 CHAP. L. REV. 135 (2004) (discussing the limitations imposed on mortgage lending by North Carolina law).

190. "[C]redit is . . . a privilege [not] a right . . ." Gail R. Reizenstein, *A Fresh Look at the Equal Credit Opportunity Act*, 14 AKRON L. REV. 215, 215, 237 (1980).

191. See generally Iglesias, *supra* note 26.

192. Mortgage brokers and real estate brokers are subject to state law regulation. See generally Murray & Hadaway, *supra* note 140.

### 1. *The Need for Meaningful Disclosures*

Contract law is based on the obligation to be bound once the parties voluntarily assent.<sup>193</sup> This legal premise is no less binding on subprime loans, notwithstanding the lender's use of standardized documents and the borrower's inability to understand them.<sup>194</sup> Standardized forms can become user-friendly and lending decisions transparent.<sup>195</sup> Requiring lenders to disclose more information about risk-based loans will help to remedy the informational deficiencies.<sup>196</sup> The trigger for the disclosure, as well as the nature and preciseness of the information, is crucial.<sup>197</sup> Arguably, consumers have the right to receive adequate information about the products that they are purchasing, including home mortgages.<sup>198</sup> One school of thought is that disclosures are the most efficient consumer protection because they address the information deficiencies.<sup>199</sup>

When the loan price exceeds the base price due to an identified or stated risk, the borrower needs to know and understand the variance in pricing. Evidence indicates that the high variance between the two is an indication that the substantial margin represents opportunistic behavior.<sup>200</sup> Pricing information on loans that should be available to consumers includes borrower, mortgage, and property components.<sup>201</sup> The borrower component should include credit score and history.<sup>202</sup> The property component should include estimates of the property's market value and a "range of mortgages that the individual may wish to assume," along with

193. E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §§ 1.1, 3.1 (3d ed. 2004). See Alvin C. Harrell, *Basic Choices in the Law of Auto Finance: Contract Versus Regulation*, 7 CHAP. L. REV. 107, 109-11 (2004) (arguing that contracts of adhesion do not bar consumers from negotiating significant terms).

194. Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 238-42 (2002).

195. *Id.* at 261-66.

196. See Susan Wachter, *Price Revelation and Efficient Mortgage Markets*, 82 TEX. L. REV. 413, 415 (2003)

197. See generally Jan Narveson, *Consumers' Rights in the Laissez-Faire Economy: How Much Caveat for the Emptor?*, 7 CHAP. L. REV. 181 (2004) (arguing that consumers are informed, competent, and the best judges of a transaction's net benefit).

198. *Id.* at 188-90.

199. See Michael S. Greve, *Consumer Law, Class Actions, and the Common Law*, 7 CHAP. L. REV. 155, 156-59 (2004) (stipulating that mandatory disclosures can be efficient depending on the circumstance).

200. Andrew L. Sandler, *Consumer Lending: The Next Fair Lending Enforcement Frontier*, in CONSUMER FINANCIAL SERVICES LITIGATION 613, 615-16 (PLI Corp. Law & Practice Course Handbook Series No. B4-7188, 1997), WL 989 PLI/Corp 613 (discussing cases in which risk premiums exceeded the risks presented).

201. Wachter, *supra* note 196, at 417 (suggesting further study of a price-revelation facility that would inform consumers on lenders' pricing determinants).

202. *Id.*

any information that is “transaction-specific” to the mortgage.<sup>203</sup> Revealing pricing information is in line with the current trends.<sup>204</sup> The need to convey this information to consumers in a way that will affect their behavior is also crucial.<sup>205</sup>

An identifiable risk is when a loan is subject to a yield spread premium.<sup>206</sup> The term should be broadly defined so that it captures those instances in which the borrower pays the broker to receive a loan at “the lender’s par rate or the lowest interest rate at which a lender will make mortgage loans without charging the borrower discount points.”<sup>207</sup> An alternative to regulating the disclosure would be to limit the activities in which mortgage brokers can engage.<sup>208</sup>

Moreover, secondary market purchasers should require more monitoring from lenders in the ordinary course of business.<sup>209</sup> The originating lenders should accurately assess the loan’s risk and verify the borrower’s ability to re-pay.<sup>210</sup> Performing this monitoring task, and requiring the lender to exercise due diligence as a standard operating practice, results in an appropriate level of insight by secondary

203. *Id.*

204. In revising Regulation “C,” the Federal Reserve Board requires lenders to “report the rate spread between the APR on a loan and the yield on Treasury securities with comparable maturity periods, for loan originations in which the APR exceeds the applicable Treasury yield by a percentage or threshold specified by the Board.” Home Mortgage Disclosure, 67 Fed. Reg. 7222, 7229 (Feb. 15, 2002) (to be codified at 12 C.F.R. pt. 203). Lenders must also report borrower characteristics, and the racial and ethnic composition and income level of the census tract in which the property is located. *Id.* at 7222. The reporting requirement is for home purchase loan originations, secured home improvement loans and refinanced loans. *Id.* at 7229.

205. As one commentator has said:

In a true risk-based pricing system, prices would either be graduated or display far smaller discontinuities between prime and subprime loans. The secrecy of subprime rate sheets and the complex, multipart pricing structure of subprime loans with their bewildering array of nominal interest rates, points, fees, and prepayment penalties are further evidence of price discrimination.

Engel & McCoy, *supra* note 66, at 443.

206. See *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing on 66 Fed. Reg. 53,052 Before the S. Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. 54-59 (2002) (statement of Professor Howell E. Jackson).

207. Brian A. Wahl, *Yield Spread Premium Class Actions Under RESPA: Confusion Predominates*, 19 REV. LITIG. 97, 107 (2000). Lenders determine the par rate daily and provide it to brokers on a rate sheet. *Id.* Brokers have little incentive to offer clients the best rates. *Id.* at 107-08.

208. Lampe, *supra* note 189, at 151 (calling for regulating abusive sale practices through regulations on broker activities). There is certainly the possibility that lenders will do an end around the regulations and “will compete on some other, less transparent margin.” Greve, *supra* note 199, at 161.

209. See generally Jones Havard, *To Lend or Not to Lend*, *supra* note 47.

210. *Id.*

purchasers.<sup>211</sup> Also, consequently, the secondary purchasers can disqualify for sale those originating lenders who do not meet the appropriate criteria.<sup>212</sup>

## 2. *The Remedy for Failure to Disclose*

When there is a failure to engage in informed risk-based pricing, it must be determined who has been advantaged by subprime lending. The borrower has economic interests that, when abused, can have a broad negative impact. It is important to remember, as already noted, that the borrower is not exercising choice or rationality if she has taken a high-risk loan based on deficient information. Thus, choice is not “autonomous decisionmaking” but “a function of the contexts in which people find themselves.”<sup>213</sup>

Borrowers who are harmed by inadequately sub-priced loans deserve remedies that compensate the full spectrum of their economic harm. Adequate protection of borrowers would require that they be allowed to pursue causes of action beyond common law remedies. At a minimum, the lender should have to disgorge the profits. This is consistent with what is done in other contexts for an overreaching injury, including the antitrust area.<sup>214</sup>

This call for unusual penalties is also justified in another way. Harmed borrowers help fill the enforcement void when they bring successful law suits.<sup>215</sup> When economic rights are violated, borrowers will only pursue claims if the possibility of a fair remedy exists. Thus, the public perception that the law is willing to both recognize and remedy such violations is enhanced.

Increasing available remedies to borrowers to include punitive

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211. *Id.*

212. *Id.*

213. Twila L. Perry, *Alimony: Race, Privilege, and Dependency in the Search for Theory*, 82 GEO. L.J. 2481, 2518 (1994) (discussing the “choice” of women who are homemakers to seek alimony in divorce proceedings).

214. In some areas of law (RICO and copyright infringement, for example), the resulting harm is considered so egregious that treble damages are awarded. One that is most closely akin to the violations discussed here is unfair trade practices under a state statute regulating landlords and tenants. Daniel B. Hill, *An Update on Contract Damages When the Landlord Breaches the Implied Warranty of Habitability: Surratt v. Newton and Allen v. Simmons*, 69 N.C. L. REV. 1699, 1713 (1991) (noting that treble damages can be appropriate if applied consistently to egregious circumstances).

215. See Greve, *supra* note 199, at 159-60 (discussing increased rewards for private enforcers as an option for enforcing prohibitions against unfair or fraudulent business practices).

damages might also be appropriate in these circumstances.<sup>216</sup> By punishing lenders for bad behavior, borrowers are remedied and other lenders are put on notice, thereby possibly deterring the speculative behavior.<sup>217</sup>

There is economic injury when the failure to inform a borrower results in an overpriced loan. But further development of this concept of injury from uninformed subprime lending is the nature of the social injury. While the law presently fails to compensate for the subtle, psychological injury that comes from societal oppression, there is a growing need to recognize that failure to do so is a denial of just compensation.

#### IV. TOWARDS A THEORY OF ECONOMIC JUSTICE—ROOTING OUT ECONOMIC SUBORDINATION

As has happened in other settings, subprime lenders are using economic criteria to construct political and social communities.<sup>218</sup> By defining borrowers by race and space instead of by objective criteria, subprime lenders make it unnecessarily more financially difficult for borrowers to manage their resources.<sup>219</sup> When it comes to access to loan funds, the supposedly neutral economic criteria becomes racialized.<sup>220</sup>

The absence of governmental intervention must also be considered. Ignoring structural inequities strengthens the economic subordination of

216. See generally Michael L. Rustad, *Punitive Damages in Cyberspace: Where in the World is the Consumer?*, 7 CHAP. L. REV. 39 (2004).

217. See *id.* at 101 (“Punitive damages are an efficient remedy to punish and deter intentional . . . torts . . . where ‘the probability of detection is very low and the probability of harm is very high.’”) (citation omitted).

218. Race-neutral principles have been constantly challenged in the context of political rights and voting. Lani Guinier, *No Two Seats: The Elusive Quest for Political Equality*, 77 VA. L. REV. 1413, 1421-23 (1991) (examining voting rights legislation as a remedy with twin objectives of political equality and empowerment, and positing that majoritarian collective decisionmaking must be restructured to ensure meaningful minority interest representation and participation in the political process). See James Thomas Tucker, *Affirmative Action and [Mis]representation: Part II—Deconstructing the Obstructionist Vision of the Right to Vote*, 43 HOW. L.J. 405, 440 (2000) (arguing that race-neutral political solutions create political subordination and defeat the purpose of the Voting Rights Act).

219. See generally Iglesias, *supra* note 26.

220. Whether the price corresponds to actual gradation in the borrower’s riskiness is not so easily resolved. A non-competitive price may indicate that the predatory lender, which is sometimes an affiliate of a federally insured financial institution, has allocated that particular market share due to the lack of competition in the marketplace. Curtailing predatory lending also calls for more regulation of non-bank lenders in the mortgage industry. See *All Current Proposals for Legislation on Financial Services Reform: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 25-26 (2004) (testimony of Ed Mierzwinski, Director of Consumer Protection, U.S. Public Interest Research Group, & Margot Saunders, Managing Attorney, National Consumer Law Center).

subprime borrowers. The unfettered discretion of subprime lenders to function autonomously in these markets is a great failure of the ideals of democracy because it allows the maintenance of a status quo that denies individual liberty in making economic decisions. Individuals who receive subprime loans when they are eligible for prime loans are denied the true power of economic choice. This power presumes that choices are unfettered and that individuals are allowed to make choices detached from institutional structures of inequality.<sup>221</sup>

Critical race theory marries legal theory to the actual lives of individuals.<sup>222</sup> The theory is premised on identity and the idea that the experiences and perspectives of the individual are relevant to legal analysis.<sup>223</sup> Critical race theory identifies these experiences and perspectives in order to address issues of subordination.<sup>224</sup> The issue of access to credit is an indisputable exemplar of economic subordination as addressed by critical race theory. The search for economic justice for borrowers who are vulnerable in the marketplace raises issues of economic and racial privilege.<sup>225</sup>

Critical race scholars have begun to develop a theory of economic wrong, and concomitantly, of economic justice to redress the structural inequities of race-based economic decisions.<sup>226</sup> The elimination of

221. As Beverly Balos states, “[t]his protection of individual liberty assumes that choices are made outside the relations of power within which individuals operate and are unconnected to institutional structures of inequality.” Beverly Balos, *The Wrong Way to Equality: Privileging Consent in the Trafficking of Women for Sexual Exploitation*, 27 HARV. WOMEN’S L.J. 137, 171 (2004).

222. See Peggy C. Davis, *Law As Microaggression*, 98 YALE L.J. 1559, 1565-68 (1989) (discussing the law’s inadequate response to the psychological effects of racial discrimination).

223. Charles R. Lawrence III, *The Id, the Ego, and Equal Protection: Reckoning with Unconscious Racism*, 39 STAN. L. REV. 317, 355-62 (1987) (discussing the law’s inadequate response to unconscious racism).

224. See generally John O. Calmore, *Random Notes of an Integration Warrior—Part 2: A Critical Response to the Hegemonic “Truth” of Daniel Farber and Suzanna Sherry*, 83 MINN. L. REV. 1589 (1999).

225. Professor Anthony Cook argues for alternative theories of justice. See generally Anthony E. Cook, *Beyond Critical Legal Studies: The Reconstructive Theology of Dr. Martin Luther King, Jr.*, 103 HARV. L. REV. 985 (1990); Anthony E. Cook, *The Spiritual Movement Towards Justice*, 1992 U. ILL. L. REV. 1007 (1992).

226. Critical race scholars have explored the intersection of race and class. See Cecil J. Hunt, II, *In the Racial Crosshairs: Reconsidering Racially Targeted Predatory Lending Under a New Theory of Economic Hate Crime*, 35 U. TOL. L. REV. 211, 279 (2003) (arguing that the economic loss of home equity by African-Americans through predatory lending is based on white privilege). See generally Regina Austin, *Black Women, Sisterhood, and the Difference/Deviance Divide*, 26 NEW ENG. L. REV. 877 (1992); Regina Austin, “*The Black Community, its Lawbreakers, and a Politics of Identification*,” 65 S. CAL. L. REV. 1769 (1992); John O. Calmore, *Racialized Space and the Culture of Segregation: “Hewing a*

economic subordination requires unearthing its ideology to dismantle the structures that privilege individuals and groups. The access to and distribution of credit is one such structure. Addressing and developing a system of fairness in economic matters requires defining what constitutes the process, outcome, and appropriate level of inquiry.<sup>227</sup> The work is important to reconciling the perceived divide between critical race theory and law and economics.<sup>228</sup>

One way of defining economic justice is by looking to institutional economics and its focus on the relationship of institutions to individuals.<sup>229</sup> Because neoclassical economics values efficiency, it focuses on the actions and choices of the individual.<sup>230</sup> The notion of the individual's rational choice obliterates any inquiry into whether the transaction is just or fair.<sup>231</sup> By definition, neoclassical economics also forbids inquiring into the impact of race on decision making because to do so would be irrational.<sup>232</sup>

*Stone of Hope from a Mountain of Despair*," 143 U. PA. L. REV. 1233 (1995); Phyllis Craig-Taylor, *Through a Colored Looking Glass: A View of Judicial Partition, Family Land Loss, and Rule Setting*, 78 WASH. U. L.Q. 737 (2000) (discussing partition statutes and land loss of African-Americans); Lisa C. Ikemoto, *The Code of Perfect Pregnancy: At the Intersection of the Ideology of Motherhood, the Practice of Defaulting to Science, and the Interventionist Mindset of Law*, 53 OHIO ST. L.J. 1205 (1992); Richard H. McAdams, *Cooperation and Conflict: The Economics of Group Status Production and Race Discrimination*, 108 HARV. L. REV. 1003 (1995); Beverly I. Moran, *Exploring the Mysteries: Can We Ever Know Anything About Race and Tax?*, 76 N.C. L. REV. 1629 (1998); Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751 (discussing the impact of the tax code on the economic rights of blacks).

227. Rudolph J. R. Peritz, *Introductory Remarks: An Analytical Framework for Thinking about Economic Justice*, 22 N.Y.L. SCH. J. INT'L & COMP. L. 361, 362 (2003). Professor Elizabeth Iglesias identifies the three crucial tasks that critical race theory must address in resolving issues of economic subordination:

The first task is to develop a compelling account of the way law constructs institutional class structures. Second, it must reveal the way these institutional structures demobilize and disorganize the collective political identities through which subordinated groups might otherwise seek to transform the political economy—for example, as community members, consumers, workers, racial minorities or welfare recipients. Third, Critical Race Theory needs to imagine the kinds of institutional arrangements that should replace them.

Iglesias, *supra* note 26, at 1051.

228. Iglesias, *supra* note 26, at 1051. See generally CROSSROADS, DIRECTIONS, AND A NEW CRITICAL RACE THEORY (Francisco Valdes et al. eds., 2002).

229. Charles R. P. Pouncey, *Institutional Economics and Critical Race/LatCrit Theory: The Need for a Critical "Raced" Economics*, 54 RUTGERS L. REV. 841, 844 (2002).

230. *Id.* at 847.

231. Pouncey, *supra* note 229, at 842. See Patricia Williams, *The Obliging Shell: An Informal Essay on Formal Equal Opportunity*, 87 MICH. L. REV. 2128, 2140 (1989) (positing that racial domination can come from supposed neutrality).

232. Pouncey, *supra* note 229, at 847.



Institutions, for this purpose, are “patterns of thought that impact the structure, operation, and consequences of all processes in societies.”<sup>233</sup> Just as racism is “a belief system about the way things are and the way things should be,”<sup>234</sup> institutional economics could support a system of economic justice that is premised upon the expansion of opportunity, and that takes into account the consequence of economic decision making for privileged and non-privileged people.<sup>235</sup> The opportunity to participate in the economy through rightful access to credit can be viewed not as an individual goal, but as a societal process, and as such, can take into account historical inequities and oppression.<sup>236</sup>

A distinguishing feature of this school of thought is a disavowal of “natural” markets.<sup>237</sup> The market is necessarily subject to influence and can be shaped by policy and preferences that result in benefits for some and burdens for others.<sup>238</sup> Contrasted to the predominant premise of institutional economics, in which property rights are expected to provide access to opportunity, is the neoclassical view that the optimal state of equilibrium is achieved through supply and demand.<sup>239</sup>

Another perspective on developing a critical theory of economic justice examines the legal and regulatory context of institutional economic power, and the way that institutional economic power creates classes of subordinated and marginalized persons.<sup>240</sup> An institutional-class analysis allows for an examination of how disinvestment and racial spaces are created through institutional and regulatory frameworks.<sup>241</sup> By identifying the affected interests inherent in institutional class conflicts, the legal distribution of power is allocated in a manner that perpetuates subordination.<sup>242</sup> Iglesias posits that what is needed are particular analyses of the way in which law creates racial spaces.<sup>243</sup> Because decisionmaking is so ingrained in the power structure, the established power allocations have become a legitimized hierarchy that is often unchallenged.<sup>244</sup>

To pretend that neoclassical economics is pure science negates the

233. *Id.* at 844.

234. *Id.*

235. *See id.* at 848.

236. *See id.* at 848-50.

237. *Id.* at 845.

238. *Id.* *See generally* Viet D. Dinh, *Forming and Reforming Wants*, 85 GEO. L.J. 2121 (1997).

239. Pouncy, *supra* note 229, at 846.

240. Iglesias, *supra* note 26, at 1051-52.

241. *Id.* at 1051.

242. *Id.* at 1052.

243. *Id.* at 1051.

244. *Id.* at 1052.

need to evaluate its oppressive and exclusive outcome.<sup>245</sup> Moreover, subprime lending that is not adequately priced is a form of economic subordination. Lenders use manipulative techniques to induce borrowers to accept over-priced loans or loans that lead to foreclosure.<sup>246</sup> There is the mistaken assumption on the part of borrowers that creditors are required to give them the lowest rate for which they qualify.<sup>247</sup> Yet, competition among lenders is nonexistent because borrowers do not have the information needed to make comparisons and creditors have no market incentive to charge less than borrowers are willing to accept.<sup>248</sup>

A theory of economic justice can benefit subprime borrowers. While all subprime borrowers are not minorities, all subprime borrowers are enveloped in a system of subordination and exploitation.<sup>249</sup> The whole notion of access to credit is an integral part of the search for economic justice.<sup>250</sup> The issue thus becomes not just one of discrimination, but, more importantly, of unearthing the attendant subordination. Especially in issues involving business law generally, and creditworthiness particularly, there is the tendency to argue that the neutral market dictates these results. Yet, to argue that credit is “color-blind” is to ignore the subtle ways in which the market fails to be either neutral or equal.<sup>251</sup>

Developing a theory of economic justice requires articulating a basis for harm that follows a violation. Again, institutional economics is helpful.

245. As Professor Pouncy states, “Consequently, neoclassical theory intervenes in society not just to preserve economic inequality, but to recruit the economically oppressed to cooperate in their own oppression.” Charles R. P. Pouncy, *Economic Justice and Economic Theory: Limiting the Reach of Neoclassical Ideology*, 14 U. FLA. J.L. & PUB. POL’Y 11, 25 (2002).

246. See Lauren E. Willis, *Decisionmaking & the Limits of Disclosure: The Problem of Predatory Lending* (Working Paper) (2005) 11 & n.40, at <http://law.bepress.com/alea/15th/art2>.

247. In her working paper on predatory lending, Professor Willis asserted: (1) borrowers do not understand the disclosures; (2) the disclosures come after the borrower is psychologically committed to the transaction; (3) the disclosures are too voluminous, creating an information overload (although the disclosures must be complex to fully reflect all price characteristics of the transaction). *Id.* at 17-19.

248. See *id.* at 25.

249. See Perry, *supra* note 213, at 2515 (discussing the need for a clearer intersection of feminist theory, alimony and critical race theory as it affects the rights of women of color and poor women).

250. See generally Angela P. Harris, *Race and Essentialism in Feminist Legal Theory*, 42 STAN. L. REV. 581 (1990) (positing a jurisprudence of reconstruction that evaluates the intersection of material relations of production and consumption).

251. See Iglesias, *supra* note 26, at 1037. See also Joan C. Williams, *Dissolving the Sameness/Difference Debate: A Post-Modern Path Beyond Essentialism in Feminist and Critical Race Theory*, 41 DUKE L.J. 296, 305 (1991) (arguing that problems of subordination require a transformation of the status quo).

It allows for the design of a system of belief that rewards the social, economic, and psychological harm to the individual. Societal racial oppression ought to be taken into account when there is an economic injury. To do so would be to recognize the societal racial pressures that continually keep minorities from making economic gains.<sup>252</sup> Economic harms affect the transmission of wealth.<sup>253</sup> Although not conventional to traditional legal analysis, the subtle injuries that are attendant to a system of subordination justify compensation.<sup>254</sup>

Similarly, the issue of choice must be reckoned with by those developing a theory of economic justice.<sup>255</sup> Choice makes reference to rationality and the notion that individuals make autonomous decisions, but choice may be dictated by circumstances and history.<sup>256</sup> Again, ingrained notions in minority communities about the unavailability of credit may have developed a perceived notion of access limitations that dictates behavior. Adapting present day concerns to historical realities is crucial for measuring harm and developing a theory of economic justice.<sup>257</sup>

#### CONCLUSION

Persistent disparities in the levels of subprime lending reveal a pattern of racial and ethnic differences in subprime lending. This type of lending discrimination challenges the unfettered discretion that lenders have in setting interest rates for home mortgages. The industry practices have resulted in discrimination that may not be explained by legitimate risk

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252. In 2000, Black families had less tangible income than white families as represented by a comparison of the median income. CARMEN DENAVAS-WALT & ROBERT W. CLEVELAND, U.S. CENSUS BUREAU, MONEY INCOME IN THE UNITED STATES: 2001 25 (2002). See generally Spencer Overton, *Racial Disparities and the Political Function of Property*, 49 UCLA L. REV. 1553 (2002) (examining the economic and social harm that results from racially discriminatory property laws).

253. I proposed a concept of economic loss when black farmers, denied access to federal loan funds, lost their land and livelihood. Jones Havard, *Racializing Rural Economic Space*, *supra* note 9, at 344-47.

254. See Patricia Williams, *Spirit-Murdering the Messenger: The Discourse of Fingerpointing as the Law's Response to Racism*, 42 U. MIAMI L. REV. 127, 139 (1987).

255. See generally Spencer Overton, *Voices from the Past: Race, Privilege, and Campaign Finance*, 79 N.C. L. REV. 1541 (2001) (examining minority campaign contributions and linking past racial discrimination with existing income, wealth, and poverty statistics to support the assertion that the distribution of property affects the value of political liberties).

256. See generally A. Mechele Dickerson, *Can Shame, Guilt, or Stigma Be Taught? Why Credit-Focused Debtor Education May Not Work*, 32 LOY. L.A. L. REV. 945 (1999) (discussing debtor education and credit abuse in the bankruptcy context).

257. W. Sherman Rogers, *The Black Quest for Economic Liberty: Legal, Historical, and Related Considerations*, 48 HOW. L.J. 1, 18-19 (2004).

factors, and moreover, is very difficult to detect. To avoid the structural inequality that is the inevitable by-product of such discretion, the law must require lenders to treat borrowers the same regardless of the race or ethnicity of the loan applicant, or the geodemographics of the loan. Without clear standards regarding risk-based pricing, structural inequalities among similarly situated borrowers will continue to occur.

Fair lending laws must address these structural inequalities. A theory of risk-based pricing would take into account the existing disparities based on race. Specifically, statutes ought to require lenders to apply uniform standards of risk-based pricing that can be validated and measured. Penalties, such as the ones suggested in this article, ought to be available for individuals who are able to demonstrate that the lender has failed to appropriately evaluate their level of risk. Without such standards, the subjectivity of the lending decision results in economic harm to borrowers who should be protected from race-conscious conduct.

Law and policy must also recognize how incongruent doctrines can be reconciled. There is a need for continued examination of the intersection of critical race theory and law and economics. Replacing the emphasis on neoclassical economics with institutional economics points the way for developing a belief system that values those marginalized and subordinated by structural inequities. In this instance, a theory of economic justice protects the interest of all subprime borrowers who are denied fair access to loan funds. This theory measures the economic harm, as well as the societal and psychological harm, which results from an unfair transaction. It is an ongoing task that requires careful thought and attention.

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