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TO LEND OR NOT TO LEND: WHAT THE CRA OUGHT TO SAY ABOUT SUB-PRIME AND PREDATORY LENDING

Cassandra Jones Havard*

I. INTRODUCTION

Thirty years ago, Congress passed legislation to ensure that people living in racially segregated neighborhoods would have the economic advantages that access to credit provides.¹ Today, there is a dire need to scrutinize the broader economic and regulatory framework within which the mortgage lending markets operate. The new issue of predatory lending is both consistent with and diametrically opposite of the old problem of credit denials based on race and property locations.

Congress passed the Equal Credit Opportunity Act of 1974 (“ECOA”) after congressional hearings revealed that commercial and savings banks, private-mortgage companies, and savings and loan institutions were denying credit to legitimate consumers and small businesses, thereby hindering job creation and stable communities.² Two years later, Congress amended the Act based on the disturbing discovery that lenders often denied credit to consumers based on gender, race, color, national origin, marital status, religion, and age.³

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¹ See generally Equal Credit Opportunity Act of 1974, Pub. L. No. 93-495, 88 Stat. 1500 (1974) (codified as amended at 15 U.S.C. § 1691 (1994)). See also Equal Credit Opportunity Act Amendments of 1976, Pub. L. No. 94-239, 90 Stat. 251 (1976) (codified as amended at 15 U.S.C. § 1691 (1994)).

² Congress passed The Community Reinvestment Act as Title VIII of the Housing and Community Development Act of 1977, Pub. L. No. 95-128, 91 Stat. 1111 (1977) (codified at 12 U.S.C. § 2901(b) (1998)). The statute directs banks “to meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with [the] safe and sound operation” of the bank. *Id.*

³ During later hearings evaluating the statute’s effectiveness, evidence was presented

The overwhelming consensus now, however, is that liberal access to credit contributes to income and wealth disparities based on race. Predatory lending, an outgrowth of the sub-prime lending market, is a market response to risk-based pricing.⁴ In the sub-prime market, lenders make higher-priced loans to borrowers with less than prime credit records. Far too often sub-prime loans are made to borrowers who have been excluded from access to credit in traditional financial markets.⁵ Those borrowers could qualify for loans in the prime market and are unaware of the onerous terms of the sub-prime loan.⁶

Distinguishable from sub-prime lending, predatory lending practices range from unfair terms hoisted on unsophisticated borrowers to illegal and fraudulent loan provisions.⁷ In predatory lending practices, borrowers usually have overpriced loans and no legal recourse from the terms of those loans.⁸ Lenders who make predatory loans engage in unfair practices such as requiring credit insurance, high prepayment fees, and/or balloon payments. Predatory lenders also callously make loans without regard to the borrowers' ability to repay the loan. In addition, predatory lenders participate in fraudulent practices such as falsifying loan applications, forging borrowers' signatures, changing loan terms at closing, and misrepresenting loan terms.

showing that lenders were denying credit and loans to consumers on the basis of gender, race, color, national origin, marital status, religion, and age. See 15 U.S.C. § 1691(a) (1996).

⁴ See U.S. DEP'T OF TREASURY & DEP'T OF HOUS. & URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING (June 2000) [hereinafter HUD REPORT], available at <http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf> (noting that while there is not an official definition for predatory lending, it is widely accepted that the term describes abusive lending practices by creditors, brokers, or any seller of home financing, involving manipulation and deception).

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ This is because the original lender immediately sells the loan on the secondary market, thereby denying the borrower the ability to contest the loan's onerous provisions. See discussion *infra* Part III, B.

Specifically, in the home equity lending market, the absence of mainstream lenders in certain geographical and racial communities creates a ripe market for predatory lenders who target “house-rich, cash-poor,” and oftentimes elderly consumers.⁹ These lenders ignore a borrower’s income and cash flow as indicators of the borrower’s ability to repay a debt and instead make “asset-based” loans primarily based on the borrower’s home equity.¹⁰

Any analyses of access-to-capital, reverse red-lining practices, and disinvestment in capital-starved neighborhoods and communities reveal two passionately debated points: 1) the market segmentation represented by fringe banking activities – high-cost, high-risk lending that is predatory – is economically justified; and 2) fair lending laws will prevent lender abuses associated with mortgage reverse red-lining and discriminatory access to loans and credit.¹¹

It is highly questionable whether, as abusive sub-prime lenders claim, lenders servicing the sub-prime market are democratically providing credit by extending credit beyond the traditional borrower base.¹² The higher interest rate associated with these loans makes the loans less affordable and harder to manage for borrowers whose income-to-debt ratio is marginal. Moreover, current fair lending laws promote predatory

⁹ This “fringe banking” system functions as an equivalent of the prime banking system, offering check cashing and payment services and credit capacity. These include check cashing outlets, payday loan companies, rent-to-own stores, high-cost second mortgage companies, sub-prime auto lenders, and traditional and auto title pawn companies. The lending is expensive and the providers often argue that credit is not being extended as defined by the Truth in Lending Act. 15 U.S.C. § 1602(e) (1994); *see also* 12 C.F.R. § 226.2(a)(14) (1999). For an overview of the fringe banking sector, *see* Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 595-96 (2000). *See also* Cathy Mansfield Lesser, *The Road to Sub-Prime HEL Was Paved with Good Intentions*, 51 S.C. L. REV. 473, 524 (2000); JAMES H. CARR & JENNY SCHUETZ, FINANCIAL SERVICES IN DISTRESSED COMMUNITIES 5-7 (2001).

¹⁰ The distinctions between “sub-prime lending” and “equity-skimming” are often blurred. *See* Family Fin. Serv. v. Spencer, 677 A.2d 479 (Conn. App. Ct. 1996).

¹¹ *See* discussion *infra* note 22.

¹² HUD REPORT, *supra* note 4, at 27.

lending by failing to prohibit the sale of these loans on the secondary market.¹³

Two critical points highlight the debate regarding the public policy choices in the area of sub-prime lending. First, in recent years a macro-analysis marginalized (or even obliterated) concerns about particular consumer classes and has driven justification for certain practices.¹⁴ This economic view of lending is devoid of the non-economic factors that contribute to the dilemma of borrowers faced with equity-skimming lending. Presently, the utilitarian view of economics dominates, endorsing the political view that the free market operates without interference. Whether this is an informed viewpoint in the area of home-equity lending is debatable. Second, differences among individuals necessitate a diversified financial services industry, allowing consumers and providers to make fundamental decisions about the availability of financial services. This point is consistent with the overriding principle that access to funds is a fundamental premise of sub-prime lending.

The second point lays the groundwork for the argument that to protect financially vulnerable borrowers, it must be acknowledged that the integration of the banking regulatory system and the law's rule on commercial negotiation represents an essential tool to protecting sub-prime borrowers generally, and people of color particularly, from predatory lending practices. However, not all sub-prime lending is predatory. To some borrowers, sub-prime lending provides short-term financial benefits.¹⁵ Nevertheless, predatory lending is the result of market information failure that leads to an onerous type of borrower market segmentation. The question becomes how to regulate predatory practices

¹³ See generally Truth in Lending Act, 15 U.S.C. §§ 1601-1665 (1994).

¹⁴ Without calculating the costs of residential foreclosures, one estimate is that predatory lending costs borrowers \$9.1 billion annually. ERIC STEIN, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING: A REPORT FROM THE COALITION FOR RESPONSIBLE LENDING 2, available at <http://www.responsiblelending.org/pdfs/Quant10-01.pdf> (last visited Sept. 17, 2005).

¹⁵ As one law professor has argued in the context of providing health care access to the elderly, "[g]ood public policy cannot be made in this area by decision makers who are 'color-blind' or 'class-blind.'" See Frank M. McClellan, *Is Managed Care Good for What Ails You? Ruminations on Race, Age and Class*, 44 VILL. L. REV. 227, 234 (1999).

so that fairly-priced loans are made available to that segment of borrowers. The result will be to limit the loss of home ownership due to onerous lending terms.

Closer adherence to the rules of commercial negotiation would place more scrutiny on both the funding of predatory lenders by the primary market and the selling of predatory loans on the secondary market. In particular, the originating lender's failure to engage in a due diligence analysis, which examines factors such as an adequate ability to repay determination, the inclusion of financially onerous terms, or the effect of the foreclosure on an economically distressed community, is the type of relevant misconduct that ought to be the basis for a denial of assignment and negotiability under the holder in due course doctrine. In this regard, restricting the capital supply of predatory lenders is critical to eliminating the sharp practices presently sanctioned by law.¹⁶

This article has five parts. Part II discusses the Community Reinvestment Act ("CRA")¹⁷ and why the current statutory scheme is inadequate. Part II also describes the current validation of utilitarian policy-making, which serves as a back-drop for illustrating, in Part III, how a more integrated federal regulatory scheme could control such opportunistic behavior. Part III discusses the relationships between sub-prime lending, the CRA, and federally-insured lending institutions. That discussion serves as a backdrop to explain why a more integrated federal regulatory scheme should control this type of opportunistic behavior. Part IV discusses how the practices of brokering, purchasing, and steering loans justify limiting the holder in due course doctrine. It goes on to argue why that doctrine ought to be limited by restricting assignee liability. Finally, Part V outlines the regulatory reforms needed to limit abusive lending and illustrates that ineffective fair lending laws aid lenders in concealing abusive behavior. To better protect borrowers, the policies underlying the

¹⁶ Professor Eggert's excellent body of work discusses in detail how the secondary markets have financed predatory lenders and effectively transferred the risk of loss from the lenders to homeowners. See Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002).

¹⁷ The Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901-2907 (1994) [hereinafter CRA].

prohibited practices that result in unfairness must be policed and corrected. Part VI concludes by placing the issue of predatory lending within the larger issue of economic justice. There is a need to develop a paradigm that ensures that economic freedoms *are* protected.

II. THE ENFORCEMENT VOID

Congress passed the CRA to require banks to lend in the communities in which the banks are located.¹⁸ The CRA is silent about sub-prime lending because sub-prime lending was virtually nonexistent when the statute was enacted. More recently, Congress amended the Home Ownership and Equity Protection Act of 1994 (“HOEPA”),¹⁹ a companion statute to the Truth in Lending statute, to address some issues of abusive lending. Still, how lenders fund abusive lending or use the loans to receive CRA credit has not been addressed.

A. HOEPA

Congress passed HOEPA in 1994 to stem the growth of certain predatory lending practices.²⁰ HOEPA amended the Truth in Lending Act (“TILA”) and provides special protections for consumers in certain non-purchase, high-cost loans secured by their homes.²¹ In loans covered by HOEPA, the lender must give the borrower certain disclosures, in writing, at least three business days before closing.²² This information includes a notice that the consumer could lose her home and any money put into it, if she does not satisfy her loan obligations.²³ The notice also requires disclosure of the annual percentage rate, amount of payments, and certain

¹⁸ See, e.g., S. REP. NO. 95-175, at 33 (1977) (commenting that “[T]he Committee is aware of amply documented cases of red-lining, in which local lenders export savings despite sound local lending opportunities. Only recently, under the constraint of a lawsuit by civil rights groups and two highly critical oversight reports by this Committee, has the Federal Home Loan Bank Board begun to adopt an anti-red lining program”).

¹⁹ 15 U.S.C. § 1602(aa) (2000).

²⁰ *Id.* See also 12 C.F.R. § 226.32(a) (2000).

²¹ 15 U.S.C. § 1602(aa)(1) (2000); 12 C.F.R. § 226 (2000).

²² 12 C.F.R. § 226.31(c)(1) (2000).

²³ 12 C.F.R. § 226.32(c)(1) (2000).

applicable variable rate information.²⁴ The law also bans from high-rate, high-fee loans such terms as balloon payments due in less than five years, increasing the interest rate at default, and most prepayment penalties.²⁵ These disclosures are in addition to the other TILA disclosures that must be made no later than the closing of the loan.²⁶ Lenders are also prohibited from engaging in a pattern or practice of lending based on home equity, without regard to the consumer's ability to repay loans, and making direct payments to home improvement contractors.²⁷ HOEPA amends the TILA and addresses certain deceptive and unfair practices in certain home equity lending.²⁸ However, these acts do not cover loans to buy or build a home, reverse mortgages, or home equity lines of credit.

While HOEPA was intended to curb predatory lending practices, such protections must be extended in order to address current trends.²⁹

²⁴ See 12 C.F.R. § 226.32(c)(1)-(4) (2000).

²⁵ See 12 C.F.R. § 226.32 (d)(1)-(6) (2000).

²⁶ HOEPA prohibits the following practices: all balloon payments, except for bridge loans of less than one year used by consumers to buy or build a home; negative amortization; default interest rates higher than pre-default rates; rebates of interest upon default calculated by any method less favorable than the actuarial method; a repayment schedule that consolidates more than two periodic payments that are to be paid in advance from the proceeds of the loan; most prepayment penalties, including refunds of unearned interest calculated by any method less favorable than the actuarial method; a due-on-demand clause. See 15 U.S.C. § 1639. Creditors also may not make loans based on the collateral value of property without regard to ability to repay the loan. The prohibition also applies to assignees holding or servicing the loan. *Id.* at § 1639(h).

²⁷ 12 C.F.R. § 512(b) (2002).

²⁸ A loan is covered by the law if it meets the following tests:

[F]or a first-lien loan, that is, the original mortgage on the property, the annual percentage rate (APR) exceeds by more than eight percentage points the rates on Treasury securities of comparable maturity; for a second-lien loan, that is, a second mortgage, the APR exceeds by more than 10 percentage points the rates in Treasury securities of comparable maturity; or the total fees and points payable by the consumer at or before closing exceed the larger of \$499 or eight percent of the total loan amount . . . Credit insurance premiums for insurance written in connection with the credit transaction are counted as fees.

Federal Trade Commission, *High-Rate, High-Fee Loans (HOEPA/Section 32 Mortgages)*, at <http://permanent.access.gpo.gov/websites/www.ftc.gov/bcp/conline/pubs/homes/32mortgs.htm> (last visited Sept. 17, 2005).

²⁹ Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial*

First, HOEPA does not limit the amount of the lender's up-front charges and costs, or the points and closing costs, which are financed in the loan. The excessive fees found in closing costs, credit insurance premiums, and points deplete the equity in the home. A lender who re-finances a home repeatedly receives these fees and costs immediately upon the loan's closing. Second, HOEPA's interest rate trigger and the points and fees trigger are too high, allowing many abusive lenders to avoid HOEPA strictures by making high-cost loans just under the trigger.³⁰ The weakness of the statute is also illustrated by the lender's ability to circumvent the law by transforming the transaction. Finally, open-end credit provides an opportunity for mortgage abuse. Since HOEPA's passage in 1994, the mortgage finance environment has changed dramatically. Without restrictions on open-end loans, a lender has an incentive to make loans that are not legally restricted, but that are against the spirit of the law.³¹

Actions, 6 N.C. BANKING INST. 111, 129 (2002). Cf. Michael J. Pyle, *A "Flip" Look at Predatory Lending: Will the Fed's Revised Regulation Z End Abusive Refinancing Practices?*, 112 YALE L.J. 1919 (2003) (discussing the antiflipping amendment to Regulation Z as an ineffective change because it will be over-enforced).

³⁰ Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1307-08 (2002) (recommending suitability as a means to curb predatory lending while encouraging beneficial market activity).

³¹ Two other statutes serve a policing function for consumers, indirectly and directly. The Home Mortgage Disclosure Act (HMDA), enacted by Congress in 1975 and implemented by the Federal Reserve Board's Regulation C, requires lending institutions to report public loan data. Data collected under HMDA are used to help the public determine if lending institutions are meeting the housing credit needs of their communities, to help public officials target community development investment, and to help regulators enforce fair lending laws. The HMDA data collection requirements include mortgage lenders not affiliated with depository institutions or holding companies and also requires reporting of data regarding the disposition of applications for mortgage and home improvement loans, in addition to data regarding loan originations and purchases and requires most lenders to identify the race, sex, and income of loan applicants and borrowers. See 12 U.S.C. §§ 2801 to 2804 (1975).

Another statute, the Real Estate Settlement Procedures Act (RESPA), a consumer protection statute passed in 1974, covers loans secured with a mortgage placed on a one-to-four family residential property. These include most purchase loans, assumptions, refinances, property improvement loans, and equity lines of credit. RESPA requires that borrowers receive disclosures at various times. Some disclosures spell out the costs associated with the settlement, outline lender servicing and escrow account practices, and describe business relationships between settlement service providers. RESPA also

B. *The CRA*

The CRA requires depository institutions with assets over \$10 million to report mortgage lending totals in metropolitan areas aggregated by census tract.³² The law directs federally-insured depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations.³³ To evaluate compliance, federal banking regulators evaluate an institution's lending, service, and investment activities.³⁴

The criticisms surrounding the CRA from various housing advocates are numerous, including allegations of vagueness and burdensome paperwork by bankers,³⁵ unprofitable lending neighborhoods,³⁶ inadequate enforcement, and failure to raise the actual lending in low-income and minority communities.³⁷

In response to some of the criticisms, Congress, in 1999, amended the CRA in the Gramm-Leach Bliley Financial Modernization Act

prohibits certain practices that increase the cost of settlement services. 12 U.S.C. §§ 2601-2603 (1974).

³² See Community Reinvestment Act of 1977, 12 U.S.C. § 2901 (2000). See also Gramm-Leach-Bliley Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified at 15 U.S.C. §§ 6801-6809) (1999) [hereinafter GLBA].

³³ See 12 U.S.C. § 2901(b) (2000). The CRA is implemented by Regulations 12 C.F.R. parts 25, 228, 345, and 563e.

³⁴ See 12 U.S.C. §§ 2906(b)(1)(A), 2906(b)(2) (2005); 12 C.F.R. § 25.28 (2005) (Office of the Comptroller of the Currency) [hereinafter OCC]; 12 C.F.R. § 228.28 (2005) [hereinafter FRB]; 12 C.F.R. § 345.28 (2005) (Federal Deposit Insurance Corporation) [hereinafter FDIC]; 12 C.F.R. § 563e.28 (2005) (Office of Thrift Supervision) [hereinafter OTS].

³⁵ The seminal work in the field remains that of Professors Macy and Miller. Jonathan R. Macy & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 298 (1993); see also Gary M. Swidler, *Making the Community Reinvestment Act Work*, 69 N.Y.U. L. REV. 387, 390-94 (1994).

³⁶ Vincent M. Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium*, 71 U. COLO. L. REV. 51, 76 (2000).

³⁷ Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, but Strengthened Federal Enforcement Is Needed*, 20 FORDHAM URB. L.J. 293 (1993).

(GLBA).³⁸ GLBA mandates that depository institutions must have satisfactory CRA ratings before the institution, or its holding company, affiliates, or subsidiaries, can engage in any of the expanded financial activities permitted under the law.³⁹ The GLBA's sunshine provision requires that agreements entered into by depository institutions and community organizations or other entities, in fulfillment of CRA obligations, must be publicly disclosed.⁴⁰ The GLBA also changed the frequency of small banks' exams.⁴¹ However, all banks remain subject to CRA review at the time of any application for merger, to open or close a branch, or at the discretion of regulators for reasonable cause.⁴² Instead, the acquiring institution and the protesting community group or responsible regulatory agency generally reach a settlement. Though the forms of settlements may vary substantially, institutions are usually required to make substantial CRA commitments.⁴³

As a result of the federal regulator's authority to review an application for merger or branch closure, the public has become knowledgeable about a lending institution's obligation to the communities that it serves and the industry has become increasingly responsive.⁴⁴ CRA

³⁸ GLBA, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (mainly codified at 12 and 15 U.S.C. (2005)).

³⁹ See GLBA § 711, 113 Stat. 1465 (codified at 12 U.S.C. § 1831y(a) (2000) and implemented by 12 C.F.R. § 25.29 (2005) (OCC), 12 C.F.R. § 228.29 (2005) (FRB), 12 C.F.R. § 345.29 (2005) (FDIC), and 12 C.F.R. § 563e.29 (2005) (OTS)).

⁴⁰ GLBA § 711, 113 Stat. 1465 (codified at 12 U.S.C. § 1831y(a) (2000)). At least one commentator has argued that the sunshine provisions have a "chilling effect" on CRA activities. Deborah Goldberg, *Remarks of Deborah Goldberg*, 17 N.Y.L. SCH. J. HUM. RTS. 67, 69 (2000).

⁴¹ Small banks with an outstanding rating are subject to review once every five years, every four years for those with a satisfactory rating, and as deemed necessary for institutions whose last rating was less than satisfactory. GLBA § 712, 113 Stat. 1469 (codified at 12 U.S.C. § 2908 (2000)).

⁴² 12 C.F.R. § 25.29(a) (2005) (OCC); 12 C.F.R. § 228.29(a) (2005) (FRB); 12 C.F.R. § 345.29(a) (2005) (FDIC); 12 C.F.R. § 563e.29(a) (2005) (OTS).

⁴³ Joseph Moore, *Community Reinvestment Act and Its Impact on Bank Mergers*, 1 N.C. BANKING INST. 412, 427 (1997).

⁴⁴ Earlier research indicated that profitability of CRA loans lagged behind that of overall home purchase and refinance loans. Vincent Di Lorenzo, *Financial Services Modernization Provides an Opportunity For Increased Responsiveness to Community Needs*, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 177, 185 (2001).

enforcement remains an issue. The challenges do not usually result in the denial of a merger application, although it is a relevant factor in the assessment of a proposed transaction.⁴⁵ The Act does not, and never has, provided a private right of action. Regardless, regulators are giving substantially more attention to CRA records and agreements and whether they are being upheld after the merger.

III. ECONOMIC UTILITARIANISM

The economic and racial mix of predatory lending and loss of home ownership requires scrutinizing the results under theories of social justice and equality. The argument that lending is color-blind is flawed when lenders' conduct bespeaks bias and racial animus in identifying lending opportunities.⁴⁶ The economic and financial consequences attendant in lending options reveal that economic decisions are at times based impermissibly on race. The industry must recognize that such discriminatory conduct is not legitimate in the economic order.

The concern with the social consequences of segmentation is that the segmentation is based on a utilitarian economic perspective and in that regard denies the value that individuals place on home ownership. This particular view also undercuts the ability and sanctity of the individual to negotiate terms that are critical to good pricing of a loan.

A. *Utilitarianism Defined*

Arguably, what has occurred in the financial services industry is regulatory lending policy that has become utilitarian in nature. In the consumer lending area, the policy that supports predatory lending treats the consequences as more important than the individual dignity of the borrower.⁴⁷

⁴⁵ See generally Joseph Moore, *Community Reinvestment Act and Its Impact on Bank Mergers*, 1 N.C. BANKING INST. 412 (1997).

⁴⁶ 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 (2003).

⁴⁷ Mark S. Campisano, *Ordinary Observing and Utilitarian Policymaking in the Internal Revenue Code*, 55 S. CAL. L. REV. 785, 827 (1982).

Utilitarianism is defined as sacrificing individual autonomy, for the maximization of good.⁴⁸ Utilitarianism ignores the expectations of any one individual if the satisfaction of the group can be achieved. The decision that produces the greatest good or utility is the right one.⁴⁹ The expectations of individuals or inconsistencies regarding the outcome of a particular policy are ignored so long as the economic interests or material ends have been met.⁵⁰

The utilitarian economic view evaluates harm in terms of the risk to the affected group. The concerns of an individual are measured in light of the probability of harm and the magnitude of loss to others who are either identically or similarly situated.⁵¹ Inherent within this school of thought is the free-market regulatory paradigm that the market will achieve optimal results and will not support inefficient ones. The corollary is that there should be no market interference through external regulation.⁵²

Proponents of this approach argue that any market regulation should be tested under a cost-benefit analysis.⁵³ This is in part due to the supposition that regulators act outside of the market and may hamper

⁴⁸ See J.J.C. SMART, UTILITARIANISM IN THE ENCYCLOPEDIA OF PHILOSOPHY (Paul Edwards ed., 1969) (discussing the history and critical analysis of utilitarian thought). See also JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION, Ch. X (1996).

⁴⁹ Lawrence B. Solum, *To Our Children's Children's Children*, 35 LOY. L.A. L. REV. 163, 191 (2001).

⁵⁰ "The utilitarian policymaker accords no special value to 'lay expectations,' which may well be founded on outdated custom or simple ignorance and which are often muddled or inconsistent with one another. Rather, he evaluates the goodness or propriety of a proposed legal rule by reference to his own comprehensive philosophical system, utilitarianism." Campisano, *supra* note 47, at 788.

⁵¹ M. Stuart Madden, *Selected Federal Tort Reform and Restatement Proposals Through the Lenses of Corrective Justice and Efficiency*, 32 GA. L. REV. 1017, 1045 (1998).

⁵² See Thomas O. McGarity, *The APA at Fifty: The Expanded Debate Over the Future Of the Regulatory State*, 63 U. CHI. L. REV. 1463, 1492 (1996) (discussing the preferability and efficiency of the free market over regulated markets). See also Barry J. Rodger, *Competition Policy, Liberalism and Globalization: A European Perspective*, 6 COLUM. J. EUR. L. 289, 299 (2000) (discussing that state inaction can steer the economy towards desired goals).

⁵³ John S. Applegate, *The Taming of the Precautionary Principle*, 27 WM. & MARY ENVTL. L. & POL'Y REV. 13, 47 (2002).

market efficiencies. Market efficiency is synonymous with satisfying individual wants. A risk-based system of regulation substitutes protectionist oversight with a cost-benefit analysis. This analysis is a surrogate market discipline on regulators to ensure that the consequences do not hamper market efficiencies. By identifying the intended and expected consequences, a systematic approach reveals areas of concern and matches those areas with data which determines the future course of action.

B. Sub-Prime Lending as a Utilitarianism Lending Policy

Analyzing predatory lending under a utilitarian economic approach requires considering two equally important components. One component evaluates the consequences for the individual and the other evaluates the aggregate measure of the good.⁵⁴ Using utilitarianism, the first component asks whether the borrower has made a consequential analysis of the decision to enter into a high interest rate loan. The second component evaluates the purpose and function of the default rules in terms of producing utilitarian conduct. The main function of the foreclosure rules is to re-capture the lender's investment in the transaction.

The two components yield independent results, justifying and negating, in tandem, the use of the theory. A central tenet of traditional utilitarian philosophy is that property rights should be exercised in such a way as to promote happiness.⁵⁵ This tenet explains that homeowners ought to make complex financial decisions in their own best interest at the given time, therefore making a balancing of the lender's harm with the borrower's injury appropriate. The borrower's harm is contingent on whether the lender's conduct is legally sanctioned as an acceptable social norm. In this regard, the economic perspective sanctions the lender's wealth-maximizing conduct regardless of the injurious behavior. The lender's behavior, when and if it is discovered, is justified as a legitimate

⁵⁴ Kenneth W. Simons, *The Puzzling Doctrine of Contributory Negligence*, 16 *CARDOZO L. REV.* 1693, 1719 (1995).

⁵⁵ See Kojo Yelapaala, *Owning the Secret of Life: Biotechnology and Property Rights Revisited*, 32 *MCGEORGE L. REV.* 111, 179 (2000) (discussing the central tenet of traditional utilitarian philosophy is unattainable in the case of biotechnological inventions).

cost of doing business.

A prevalent assumption of sub-prime lending is that the borrower is at fault for making an economically poor decision to enter into the transaction. This economic rationalization denies the lender's fault based on the borrower's judgment to enter into the transaction. More pointedly, the criticism is that a doctrine protecting borrowers is paternalistic.⁵⁶ That argument asserts that the borrower makes an economic decision that is in her best interests. Another perspective to consider is that the increased participation in the sub-prime market by mainstream financial institutions is a result of the deregulation and the freedom that exists in the consumer credit market. Lenders are able to design products that conform to regulation and then "export" the consumer credit regulation, strict or lenient, from the state in which they are located to all other states where they have customers.⁵⁷

Utilitarian economic policy, which rationalizes, and in some cases disregards, the effect of policies on the individual harm, best explains the choice for failing to monitor this industry. Legitimate risk-based pricing bridges the informational deficiencies and offers a more balanced cost of obtaining information in low- and moderate-income communities as to who may be creditworthy.

IV. CRA AND PREDATORY LENDING

Predatory lending manifests itself in several ways, directly and indirectly, as it relates to the activities of federally-insured financial institutions. The involvement of banks may result in the banks receiving CRA credit under the CRA lending and investment tests. The question is whether the current regulatory scheme adequately polices the involvement of banks, directly or indirectly, and effectively imposes some type of sanction on federally-insured institutions and their affiliates for this

⁵⁶ See Kurt Eggert, *Striking a Balance: Basic Questions About Consumer Protection Law*, 7 CHAP. L. REV. 1, 2 (2004) (arguing that too much consumer protection could lead to a paternalistic restriction of consumers' autonomy).

⁵⁷ Elizabeth R. Schultz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending*, 88 MINN. L. REV. 518, 522 (2004).

behavior. What follows is a discussion of how the CRA and predatory lending often overlap in various settings.

A. *Brokering Loans*

Predatory lending is not sanctioned by the federal regulatory regime. Whether banks engage in originating predatory lending may or may not be detectable by banking regulators.⁵⁸ By brokering loans, banks fund and then assign loans to the originating lender, holding them briefly. Yet serving as a mortgage broker allows a bank to receive CRA credit under two of the three CRA tests: lending and service. When banks briefly fund loans, assign them to the originating lender, or perform settlement functions, the banks receive credit under the CRA lending test. The settlement function and the acceptance of applications as a broker, may qualify for CRA credit under the service test. In addition, banks may also support predatory lending indirectly by purchasing the loans as an investment, financing non-bank sub-prime loans, or by participating in the securitization process; again, CRA credit may be received.

B. *Purchase of Loans*

The purchase of predatory loans, or loans by another lender, may meet lending test criteria under the CRA. The purchase of mortgage-backed securities backed by predatory loans made to low- and moderate-income borrowers may qualify for the CRA investment test credit. It is noteworthy that the indirect financing of predatory lending occurs when banks finance non-bank lenders through working capital loans and loan guarantees.⁵⁹

⁵⁸ Banks engaging in predatory lending activities are engaging in high-risk lending and therefore pose a higher risk of loss to the insurance fund. See U.S. GEN. ACCOUNTING OFFICE, GAO-02-419T, BANK REGULATION: ANALYSIS OF THE FAILURE OF SUPERIOR BANK, FSB, HINSDALE, ILLINOIS 8 (2002), available at <http://www.gao.gov/new.items/d02419t.pdf>.

⁵⁹ Dan Reynolds, *Predatory Lending in Oregon: Does Oregon Need an Anti-predatory Lending Law, or Do Current Laws and Remedies Suffice?*, 83 OR. L. REV. 1081, 1100 (2004) (citing reputational risks among the reasons that federally regulated institutions do not make sub-prime loans). In 2001, the FTC named Citigroup Inc. and CitiFinancial Credit Company, successor to the Associates, as defendants in a predatory lending action. Press Release, Federal Trade Commission, FTC Charges One of Nation's Largest

C. *Steering to Non-Bank Affiliates*

Finally, a more common problem that only the most sophisticated borrower recognizes is the steering of prime borrowers to sub-prime and predatory lenders. Benefiting from the incentive payments of yield spread premiums, loan officers encourage would-be prime borrowers to accept higher interest rate loans. Banks themselves may steer customers into the bank's in-house sub-prime products; however, banks may also steer customers to the bank's sub-prime non-bank affiliates.⁶⁰

D. *Limiting the Holder in Due Course Doctrine*

1. The Doctrine

The holder in due course doctrine historically has increased the transferability and liquidity of negotiable instruments.⁶¹ Purchasers of negotiable instruments are protected by the holder in due course doctrine,

Subprime Lenders with Abusive Lending Practices: Associates First Capital Corporation and Its Successors Citigroup Inc. and CitiFinancial Credit Company Named in Complaint (Mar. 7, 2001), at <http://www.mbaa.org/industry/news/01/0307a.html> (last visited Sept. 17, 2005).

⁶⁰ Federally-insured banks are not themselves able to make sub-prime loans but often use their affiliates to participate in the sub-prime market. 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, 313 (2004).

⁶¹ This doctrine is currently found in U.C.C. § 3-302 (2005), which defines a holder in due course as the holder of an instrument if:

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

which allows them to limit risks.⁶² The doctrine protects the purchasers from the claims of any other parties and from the defenses that a borrower may assert.⁶³ An instrument that appears valid on its face allows a purchaser to reasonably conclude that the obligation is a valid one. Thus, an assignee claiming the rights of a holder in due course may begin foreclosure payments when a homeowner fails to make timely payments. The doctrine turns a negotiable instrument into a replacement for currency by relieving the purchaser of any claims and defenses that the maker may have.⁶⁴

In the home mortgage context, the holder in due course doctrine protects both the originator and the assignee of the negotiable instrument. By passing the risk on to the secondary market purchaser or assignee, the original lender is able to escape the consequences of making an overreaching loan. The assignee, as a bona fide purchaser, protects itself from the borrower's defenses, which could have been raised against the originator. Thus, the doctrine provides no protection for a borrower against an assignee outside of the traditional defenses.

The Federal Trade Commission ("FTC") realized that consumers were being abused in retail and consumer goods transactions, so it changed the applicability of the holder in the due course rule.⁶⁵ Prior to the era of securitization, the doctrine was inconsequential to homebuyers who needed to challenge the originator. The dominance of the secondary market has not only resulted in originators selling those mortgages to investors, but also has the concomitant effect of protecting those investors from any claims that the borrowers might have against the originator. As Eggert

⁶² The doctrine of negotiability is subject to much debate recently. Some scholars argue that the doctrine is now arcane. See Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951 (1997).

⁶³ U.C.C. § 2-305 (1998). Defenses which can be asserted against a holder in due course include the lack of the maker's capacity to execute the instruments, duress, illegality of the instrument, misrepresentation of the essential character or terms of the contract, fraud that induced the obligor to sign the instrument or fraud with neither knowledge nor reasonable opportunity to learn its character and essential terms. *Id.*

⁶⁴ Kurt Eggert, *Held Up in Due Course: Codification and the Victory of the Form Over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 366 (2002).

⁶⁵ Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 509-10 (Nov. 18, 1975).

argued, predatory loan investors have been protected to the detriment of borrowers.⁶⁶

The preservation of fair lending standards requires that the doctrine of negotiability be used to police the abuses of sub-prime lending. There must be a balancing of the interest of investors who purchase beneficial interests in loans with the interests of homeowners whose rights are forfeited. An underlying policy of fairness dictates that originators ought to be required to buy back any notes that do not meet the underwriting standards of the purchaser.

2. The Equity Argument for Limiting the Doctrine: The Historical Context of Federal Policy Encouraging Lending Inequity

In discussing the lending inequities and loss of home ownership through predatory lending practices, commentators of late have described a dual mortgage market.⁶⁷ Unfortunately, that duality has long existed in the federal government finance programs designed to promote home ownership.⁶⁸

The federal government's home-ownership programs, the most significant being the Federal Housing Administration ("FHA") mortgage insurance program, encouraged a white suburban demography away from the lower property values of the minority occupied inner-cities.⁶⁹

⁶⁶ Eggert, *supra* note 64, at 424-26.

⁶⁷ Engel and McCoy describe the market as a tri-partite, consisting of a "prime market, [a] legitimate sub-prime market and a predatory market." Engel & McCoy, *supra* note 30, at 1277.

⁶⁸ Joshua L. Farrell, *The FHA's Origins: How its Valuation Method Fostered Racial Segregation and Suburban Sprawl*, 11 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 374, 379-81 (2002).

⁶⁹ It is important to point out that FHA policy explicitly recommended racially restrictive covenants in appraisal standards and advised that property in which the presence of "inharmonious racial or nationality groups" made a neighborhood's housing undesirable for insurance and stated that "[in order for] a neighborhood . . . to retain stability, it is necessary that properties shall continue to be occupied by the same social and racial classes . . ." Florence Wagman Roisman, *Teaching Important Property Concepts: Teaching About Inequality, Race, and Property*, 46 ST. LOUIS U. L. J. 665,

Reinforced by the lower earning capacity of its residents, inner-city neighborhoods continued to represent lower property values and consequently the attendant measures of property control and home ownership. These include income, wealth, and the peculiar economic value of home ownership.⁷⁰ Consequently, the attendant measures of property value, such as income and wealth, affect the value of home ownership.⁷¹

Home ownership represents wealth accumulation.⁷² Minority residential patterns have been shaped explicitly and implicitly by the federal governmental financing programs.⁷³ The FHA policies that encouraged suburban home purchases and made federally-insured and federally-guaranteed mortgage loans available predominately to whites caused the confinement of minorities to inner-cities.⁷⁴ Private developers

677-78 (quoting DOUGLAS S. MASSEY & NANCY A. DENTON, *AMERICAN APARTHEID* 54 (1993)). See also John O. Calmore, *Spatial Equality and the Kerner Commission Report: A Back-To-The-Future Essay*, 71 N.C. L. REV. 1487, 1509 (1993).

⁷⁰ See generally MELVIN L. OLIVER & THOMAS M. SHAPIRO, *BLACK WEALTH/WHITE WEALTH: A NEW PERSPECTIVE ON RACIAL INEQUALITY* 38, 114 (1995) (discussing the wage disparity among minority workers and the failure of minority workers to benefit from social welfare programs designed to aid workers because of the disparities in income).

⁷¹ Although homes in predominately minority neighborhoods have less property value, for minorities, home value represents their greatest financial asset. Nancy A. Denton, *Are African-Americans Still Hypersegregated?*, in *RESIDENTIAL APARTHEID: THE AMERICAN LEGACY* 49 (Robert D. Bullard et al. eds., 1994).

⁷² David E. Cohn, *The Community Reinvestment Act--Asset or Liability?*, 75 MARQ. L. REV. 599, 619 (1992) ("[T]he mortgage gap between African Americans and whites is alarming because home ownership is a principal method of increasing wealth in the United States. Consequently, barriers to home ownership as well as to funds for commercial development only serve to prevent upward economic mobility for African Americans").

⁷³ See CHARLES ABRAMS, *FORBIDDEN NEIGHBORS: A STUDY OF PREJUDICE IN HOUSING* 229-37 (1955). "FHA adopted a racial policy that could well have been culled from the Nuremberg Laws." *Id.* at 234.

⁷⁴ One researcher has reported that between 1946 and 1959, less than two percent of the housing financed with federal mortgage assistance went to African Americans. MARK I. GELFAND, *A NATION OF CITIES: THE FEDERAL GOVERNMENT AND URBAN AMERICA 1933-1965* 221 (1975). It was President Kennedy who abated the FHA and VA practice of excluding minorities from participating in the government-sponsored home ownership programs by issuing an executive order prohibiting the continued practices of excluding

followed the FHA's mandate of racial exclusion in order that the developers newly developed housing stock would meet the insurance program's eligibility requirements.⁷⁵

The historical treatment of land and African-Americans shows how federal policy has had a deleterious effect on the ability of African-Americans to accumulate wealth.⁷⁶ The value of property is directly affected by its location. The pervasive segregation of minority neighborhoods has significant reverberations on property values, regardless of whether the homeowner is black or not. This so-called "color-coded" process,⁷⁷ whereby minorities control less property and have less access to financing, has the ripple affect of curtailing access to education and parlaying home value into business and capital development.⁷⁸

3. Originating Lender and Assignee Liability

Congress can regulate the circumstances under which sub-prime loans thrive. Protecting borrowers requires circumscribing the protections that originating lenders and assignees rely upon when making loans with unnecessarily high rates of interest, excessive fees, and costs. More

minorities from such programs. See Executive Order 11063, 27 Fed. Reg. 11517 (Nov. 24, 1962).

⁷⁵ Cheryll D. Cashin, *Middle-Class Black Suburbs and the State of Integration: A Post-Integrationist Vision for Metropolitan America*, 86 CORNELL L. REV. 729 (2001).

⁷⁶ The myth of neutral, fair, and objective decision-making in federal governmental policies and the importance of taking race into account has been argued for by numerous academics of color in numerous settings. Two such noteworthy perspectives are Neil Gotanda, *A Critique of "Our Constitution is Color-Blind,"* 44 STAN. L. REV. 1, 16 (1991) (contending that governmental policymakers use the premise of colorblindness to actually create racially discrimination policies); and Jerome McCristal Culp, Jr., *Colorblind Remedies and the Intersectionality of Oppression: Policy Arguments Masquerading as Moral Claims*, 69 N.Y.U. L. REV. 162, 162-63 (1994) (arguing against neutrality of race in fashioning both forward-looking and remedial policies, commenting that "to assume that ignoring race in making social policy will bring about justice or achieve morality is legal fantasy").

⁷⁷ Camille Zubrinsky Charles, *Processes of Racial Residential Segregation*, in URBAN INEQUALITY: EVIDENCE FROM FOUR CITIES 217, 265 (Alice O'Connor et al. eds., 2001).

⁷⁸ See OLIVER & SHAPIRO, *supra* note 64, at 8 (finding that "[t]he lower values of black homes adversely affect the ability of blacks to utilize their residences as collateral for obtaining personal, business, or educational loans").

specifically, Congress should limit the circumstances in which originating lenders and assignees of high-cost mortgage loans may use the holder in due course doctrine.⁷⁹

a. Restricting Assignability

A borrower who has a contract dispute with a lender may refuse to pay on the contract, thereby offering the borrower some leverage to resolve the dispute to her satisfaction, unless the instrument is freely assignable. The negotiability of an instrument allows a third party, who purchases the instrument from the originating lender, to claim ignorance of the onerous circumstances surrounding the instrument. The negotiability of the instrument denies the mortgage borrower the legal right to refuse to pay for excessive fees and costs.

Purchasing lenders engage in voluntary due diligence practices. This process, designed by the individual lender's standards and secondary market dictates, ensures that the loans for sale are creditworthy and that the standards set for the legal, financial, and reputational risks are adequate.⁸⁰ A purchaser elects to perform some loan review of the originating lender's process in order to lower the risks of loss. Additionally, there should be a process for the purchaser to determine that the originator is reputable and financially sound. Lenders who purchase broad categories of loans that are not well-defined may in fact purchase poor performing and illegal high-costs loans. When there is a sub-prime borrower, the purchasing lender should significantly consider whether the originating lender has performed adequate due diligence to determine whether the borrower has the ability to repay the loan.⁸¹ Limiting the doctrine would allow the borrower to have

⁷⁹ The Federal Trade Commission regulates consumer transactions by restricting negotiability. The FTC's Preservation of Claims and Defense Rule, 16 C.F.R. § 433 (2005), limits the applicability of the holder in due course doctrine in consumer transactions.

⁸⁰ See Kathleen Engel & Patricia A. McCoy, *The Community Reinvestment Act: Twenty-Five Year Anniversary: The CRA Implications of Predatory Lending*, 29 *FORDHAM URB. L.J.* 1571, 1596-97 (2002) (discussing due diligence safeguards that can protect purchasers of sub-prime loans).

⁸¹ The creditor analyzes: 1) the applicant's desire to pay, 2) the applicant's ability to pay, and 3) the applicant's financial strength. See Gail R. Reizenstein, *A Fresh Look at the*

some protection from excessive costs and fees and to raise all claims and defenses against the assignee which would have been available for the borrower to raise against the originator.⁸²

There is a need for clear, concise, uniform standards of assignee liability. Loan purchasers must have defined standards of due diligence that will reveal upon review of the documents whether there are violations of representations, warranties, and/or conditions that are necessary for secondary market. Determining the quality of the loans and their expected performance is part of the issuer's review process.

Accordingly, the purchaser should be able to rely upon the accuracy of the originating lender's documentation. Therefore, assignee liability should occur only when the lending violations can be detected from the face of the loan documents.

Loan purchasers should be responsible for policing the quality of the loan pools that they purchase. Secondary market purchasers arguably have access to a myriad of information about the loans, e.g., loan-to-value ratios, debt-to-income ratios, and FICO scores. An examination of loan documents will reveal whether the originating lender is in compliance with the loan restrictions. An examination of the loan files also reveals problem lenders that include balloon payments, prepayment penalties, and unnecessarily high fees in their transactions.

One of the benefits of securitization and pooling is that the secondary market is very well protected from risks of default by borrowers. Purchasers have some information advantages about the originating lender that borrowers do not have.

Purchasers of loans can determine if the originating lender makes loans with high fees and interest rates, onerous loan terms, or if the borrowers regularly default. Purchasers invest in the loan pools, expect

Equal Credit Opportunity Act, 14 AKRON L. REV. 215, 237 (1980).

⁸² Another recommendation is that Congress expand the HOEPA definition of a high-cost loan. Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 129 (2002).

their funds to be repaid, and receive a return on the funds; therefore, the burden of reasonably measuring the risks and accurately predicting the performance of loan pools ought to be placed on them. It is unfair to expect the individual consumer to be able to identify and measure such risks.

Assignee liability properly places the tension between the originating lender and the purchaser instead of between the purchaser and the borrower. Inherent within this focus is that loans are originated by traditional lenders and brokers, as well as from non-traditional parties such as home improvement contractors. These parties, who have received financial benefit from the loan origination, also have a duty to make loans based on responsible lending criteria. Collecting accurate loan data, ensuring that loan documents are consistent with laws and regulations, and screening loan files for a review of the documentation of the mortgage are duties of the originating lender. After completing a due diligence review, the purchaser is able to reject those loans in which the default rates of loan originators are high, the loan fees and costs are high, and those loans from geographical areas identified as hot-beds of predatory lending. Lending violations that cannot be detected in a review of the loan documents will ultimately limit sub-prime borrowers' access to credit.

b. Assignee Liability is Efficient

Assignee liability establishes the market force that will limit investments in predatory lending. Assigning liability to the secondary market is fair when purchasers, as market participants, are able to observe and detect bad elements of loans. Assignee liability puts the onus on the secondary market participants to determine which loans are predatory. Only when secondary market entities are accountable for the violations of the originating lenders will the assignees be forced to implement due diligence standards.

Furthermore, fairness dictates that the borrower be allowed to pursue the purchaser that currently holds the loan. The borrower, unaware of the workings of the secondary market, is most likely uninformed that the loan will be sold shortly after it is made. Without assignee liability, the borrower may not bring a private right-of-action against a lender who

originates violating loans. Assuming the originating lender is solvent and well-capitalized, the borrowers should be spared the expense of litigation against the originator when foreclosure is threatened. Moreover, the borrower is most likely unaware that the originator may be defunct by the time the borrower learns that the loan terms are problematic.

Assignee liability, when well-defined, is a prudent safeguard against sub-prime mortgage lending abuses. Equally important to the notion of limiting free transferability, when there is evidence of sub-prime lending abuse, is the limitation of monetary damages. It is important that assignee liability provisions predetermine the monetary exposure. Only if the amount of financial exposure is known will the rating agencies be able to calculate the damages and adequately rate the transaction.⁸³

A national standard of assignee liability is efficient and cost-effective. A single federal statute should replace the myriad of state and local laws passed to combat sub-prime lending abuse.⁸⁴ Unlike many existing regulations that use subjective standards, there is a need for an objective determination of when assignee liability is enforceable. These measures of predictability ultimately protect the market that is serving this particular borrower segment.

V. THE REGULATORY REFORMS

Homeowners cannot always avoid foreclosure by refinancing. Faced with making a *non-performing loan* into a *performing loan* often requires losing some of the accumulated equity during the transaction. The

⁸³ Standard and Poor's considers whether the seller is selling a loan with unlimited assignee liability when rating a lender's secured loans for sale. Compliance with the applicable state statutes, including anti-predatory lending statutes therefore may result in loans receiving a less favorable rating. See Press Release, Standard and Poor's, Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. RMBS Market (Oct. 7, 2003), at <http://www.mbaa.org/industry/news/03/1007a.html>.

⁸⁴ As of June 2005, there were at least 129 varying state laws addressing issues having to do with predatory lending. Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 61-68 (2005) (arguing that federalism supports the differing predatory lending legislations of states and municipalities).

high failure rate of the sub-prime and predatory markets indicates that market forces are ineffective in halting this economic abuse. Revising the policy structure will stop the predatory and sub-prime industry from operating in such an unbridled manner.

Banking regulators can help to ameliorate the problem of predatory lending by expanding fair lending regulation and enforcement to develop a more rigorous means of evaluating the pricing and terms of loans to determine how costly the loans are. What banking regulators can do to change some of the operational issues that result in predatory lending is discussed below. Specifically, the CRA ought to be amended to require regulators to examine these lending practices more closely.

A. Banking Affiliates and Sub-Prime Lending

To help regulate what has become an abusive market, federally-insured financial institutions should not knowingly finance the operations of predatory lenders as a part of ordinary business operations. Specifically, the purchasing of loans on the secondary market, the direct purchase of loans for CRA credit, and the activities of affiliates or subsidiaries of federally-insured institutions should all be more closely monitored.

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.”⁸⁵ 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.⁸⁶ This dual finance system has increased the potential for abuse in the marketplace as less sophisticated homeowners are identified and approached by these types of lenders.

⁸⁵ See generally DANIEL IMMERGLUCK & MARTI WILES, WOODSTOCK INST., TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING AND THE UNDOING OF COMMUNITY DEVELOPMENT (1999).

⁸⁶ “The practice of steering prime borrowers to high-cost lenders is an example of pricing that is designed to extract harmful rents.” Engel & McCoy, *supra* note 30, at 1266.

These routine business financing transactions have the unwitting effect of stripping equity from low- or moderate-income homeowners. Although funded as an ordinary business transaction, loans from federally-insured financial institutions to sub-prime and predatory lenders begin the vicious cycle of abusive lending. Banks find it beneficial to grant these loans because they receive credit for their statutory obligation to grant loans to persons in low- and moderate-income communities without having to directly make or service those loans themselves. Failure to halt the practices and to give CRA credit deters banks from actually managing a portfolio of low- and moderate-income loans. Information asymmetries and credit gaps will continue to exist in contradiction to the CRA's explicit statutory purpose.

The practice of steering customers along racial or geographic lines to mortgage companies that are not examined by bank and thrift regulators contradicts the CRA's implicit and explicit purpose. Lenders active in white middle- and upper-income communities tend to be much less active in lower-income and minority communities. Conversely, many of the dominant lenders in lower-income areas tend not to compete heavily for business in more affluent areas, in part because their products are not competitive in that segment of the market.⁸⁷

Moreover, the Federal Reserve Board should use its authority to monitor the activities of bank holding companies to examine the non-bank subsidiaries that engage in sub-prime lending for compliance with consumer financial services and fair lending laws.⁸⁸ Financially insured institutions that are affiliated with sub-prime lenders could be required to "upstream" borrowers into the best loan product offered by the depository institution for which the borrowers are eligible.⁸⁹ Many depository

⁸⁷ The principal regulator of mortgage companies is the Federal Trade Commission (FTC), which enforces Truth in Lending regulations and fair lending rules. 15 U.S.C.A. §§ 41 et seq. (2005).

⁸⁸ The Federal Reserve Board supervises bank holding companies and approves bank merger applications and arguably has jurisdiction to review the direct lending activities of banks and non-bank subsidiaries owned by bank holding companies. 12 U.S.C.A. § 1842(B) (2005).

⁸⁹ Deregulation has resulted in banks finding competition in different product lines and in

institutions will refer customers who do not qualify for a loan “downstream” to a sub-prime lender owned by or affiliated with the depository institution. Since half of sub-prime borrowers could qualify for conventional financing, these sub-prime affiliates or subsidiaries should be required to refer qualified borrowers to the best loan product offered by the depository institution.⁹⁰

B. Underwriting Review of Predatory Loans

The growth of the mortgage and asset-backed securities industry that funds high-risk lending has played a role in the growth of the sub-prime and predatory lending markets. The ability to securitize and sell sub-prime portfolios at a profit while retaining the servicing rights has made sub-prime lending attractive to a large number of institutions, further increasing the number of sub-prime lenders and loans. The question is whether current underwriting techniques provide an adequate basis for the measurements of discrimination in mortgage lending activity in order to distinguish the difference in treatment in the segment of marginally qualified borrowers.

In both instances, whether funding or purchasing, the federally-insured financial institution should have to conduct a due diligence review to determine that their participation is not abusive. Specifically, the Federal Reserve can adopt regulations that prohibit federally-insured financial institutions from making loans to or purchasing loans from a lender when that lender cannot show evidence of the borrower’s capacity to repay. Similarly, using the HOEPA limitations, any lender who engages in high-end interest rate loans, also should be restricted from engaging in business transactions with federally-insured institutions. The direct effect will be to channel funding for sub-prime lending to those lenders who are responsible and engaging in risk-based pricing.

the traditional banking cluster market becoming more fragmented. *See generally* Tim McCarthy, *Refining Product Market Definition in the Antitrust Analysis of Bank Mergers*, 46 DUKE L.J. 865 (1997).

⁹⁰ This analysis calls for a more informed borrower, one who is knowledgeable about credit scores and the differences in loan products. *See* Cassandra Jones Havard, *Democratizing Credit:—Examining the Structural Inequities in Sub-Prime Lending*, 56 SYRACUSE L. REV. ___ (forthcoming Winter 2006) (manuscript on file with the author).

C. The Fair Lending Evaluation

As a part of the annual fair lending evaluation that banking authorities conduct, regulators should review and analyze the institution's underwriting guidelines to determine whether the guidelines are quantitatively related to default. This assessment determines if the predetermined underwriting guidelines are fairly applied. Additionally, this assessment should apply to loans that are originated at the institution as well as those that are purchased on the secondary market. Further, affiliate mortgage companies' lending should be considered when evaluating the fair lending practices of federally-insured financial institutions. Moreover, a more focused inquiry must be made by regulators awarding credit under the CRA's investment, service, and lending tests. Only by having a synergistic approach can both the statutory intent and the spirit of this law be enforced.

Each sub-prime loan should be designed to eventually turn it into prime paper. A firm which creates a competitive market in which to make loans to non-prime borrowers, by channeling borrowers to the sub-prime market without identifying possible off-setting risks elements, is not competing on the merits, but rather engaging in behavior that may properly be called predatory or abusive. Although a firm may offer higher priced loans in order to accommodate the risk of the transaction, some practices of high-risk lenders abuse high-risk borrowers.

D. Creating A Secondary Market for Sub-Prime Loans

Congress should authorize funding for Fannie Mae and Freddie Mac to securitize some sub-prime loans.⁹¹ When the government-sponsored enterprises encourage certain types of lending through credit support, credit availability increases for sub-prime borrowers who would

⁹¹ GSEs serve important functions since, by reselling mortgages to them, banks are able to make more funds available for other investments purposes. Also, making more mortgage funds available stabilizes mortgage rates throughout the nation's housing markets. Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519, 521 (2002) (discussing the history of the housing GSEs).

otherwise not be able to obtain a loan. There is the added benefit that sub-prime loans would have a ready market for participation in the securitization market and reduce the market's reluctance to accept sub-prime loan pools.

As with the residential mortgage markets, when the government-sponsored entities have developed programs for new markets, those programs have been well-received in the private markets. Once the GSEs have begun to successfully securitize these assets, it is probable that there will be substantial development of private pooling of sub-prime residential loans. The credit support should be a revolving loan fund that is available to originating lenders who want to reduce their exposure to the risks of selling a sub-prime loan on the secondary market.

E. Definitions and Disclosures

Congress must also re-define the sub-prime loan. The focus of the re-definition should be done with an eye towards making the sub-prime borrower move into the prime market. If the sub-prime loan is described as one that is greater than two, but no more than three points over prime, and secured by a residence, such a definition would capture equity loans secured by a residence that currently escape the HMDA's protections.

Congress should require specific disclosures regarding yield spread premiums when the home loan is secured by a residence.⁹² Yield spread premiums are commissions paid to brokers who sell a loan at a higher interest rate than the rate for which the borrower qualifies.⁹³ The amount is based on a percentage of the up-charge, but the average borrower does not understand that she is making an unnecessary payment and that she could qualify for a lower-interest rate loan. If yield spread premiums, as represented by loan origination fees, are definitively broken down, a borrower will understand all of the screening fees that she is being asked to

⁹² See generally Taneisha Cantwell, *Yield-Spread Premiums: Who's Working For the Borrower? HUD's Erroneous Regulation and Its Bar on Plaintiffs*, 21 LAW & INEQ. 367 (2003).

⁹³ See Prof. Howell E. Jackson, Testimony before Senate Banking Committee, at http://banking.senate.gov/02_01hr/010802/jackson.htm (last visited Sept. 17, 2005).

pay. This breakdown should be a statement of how much money is distributed to the originator, the processor, and the underwriter.⁹⁴ In this way, the borrower is in fact informed and capable of making a rational decision. Closing the credit gap requires mandating disclosures that balance the exchange of information between borrower and lender.

VI. THE ECONOMIC JUSTICE PARADIGM

Abusive lending occurs, in part, because there is a credit gap in the prime lending sector that is filled by sub-prime lenders. Information asymmetries between lenders and borrowers affect credit availability.⁹⁵ When a seller has market power, the seller's 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 would-be borrowers who are observationally indistinguishable from successful loan applicants.⁹⁶

The information asymmetries play out rather dramatically in minority neighborhoods. Properties in minority neighborhoods unquestionably have lower values.⁹⁷ Social services are limited and crime rates are higher.⁹⁸ Consequently, there is little incentive for non-minorities to invest in minority neighborhoods by purchasing homes. The financial consequences of discrimination based on race and geography are significant. Home ownership represents shelter, wealth accumulation, and

⁹⁴ This would also clear up issues about whether these up-charges are subject to mandatory disclosures under TILA. See *Gibson v. Bob Watson Chevrolet/Geo, Inc.*, 112 F.3d 283 (7th Cir. 1997).

⁹⁵ See generally Amy C. Bushaw, *Small Business Loan Pools: Testing the Waters*, 2 J. SMALL & EMERGING BUS. L. 197, 209 (1998).

⁹⁶ STEFANIA COSCI, CREDIT RATIONING AND ASYMMETRIC INFORMATION 25 (1993).

⁹⁷ See Oliver & Shapiro, *supra* note 70, at 8. "The lower values of black homes adversely affect the ability of blacks to utilize their residences as collateral for obtaining personal, business, or educational loans." *Id.*

⁹⁸ The choice to live in an ethnically homogeneous neighborhood usually results in a decline in municipal services, e.g., fewer recreational areas, such as parks, less police protection and higher vandalism, poorer quality schools and limited availability of retail and financial establishments. See Franklin D. Wilson & Roger B. Hammer, *Ethnic Residential Segregation and Its Consequences*, in URBAN INEQUALITY, at 272, 273 (Alice O'Connor et al. ed., 2003).

stability in neighborhoods. It also represents a significant source of wealth accumulation for middle-class persons.⁹⁹ The value of the home, its appreciation, and its accumulated equity determine the homeowner's ability to access additional financing.¹⁰⁰

Lenders working exclusively in a predominately segmented market should be required to value *the human community*, which should take into account human capital characteristics. The benefits and burdens of a loan transaction vary significantly with the socioeconomic, cultural, racial, age, and economic status of individuals; therefore, predatory lenders should not be allowed to escape the harm that is caused by transactions that are specifically designed to be financially injurious.

Valuing the human community can require lenders to document the effect of a foreclosure of the subject property on the surrounding community. This projection, based on an evaluation of the neighborhood demographics, ought to establish loans that do not increase foreclosures because the lender is made more aware of the need to offer the borrower a product that is evenly priced. Valuing the human community may also require that lenders commit to trying to work-out the defaulting loan instead of foreclosing it when there is borrower default. This commitment could survive negotiability or the sale of the loan on the secondary market.¹⁰¹ Subsequent purchasers must also commit to having and pursuing a borrower work-out plan in order to protect the borrowers who may find themselves in default.

Moreover, regulatory agencies examining the lending practices of

⁹⁹ See Oliver & Shapiro, *supra* note 70, at 6. "[H]ome ownership makes up the largest part of wealth held by the middle class, whereas the upper classes more commonly hold a greater degree of their wealth in financial assets." *Id.* at 8.

¹⁰⁰ Wiley E. Rice, *Race, Gender, "Redlining," and the Discriminatory Access to Loans, Credit, and Insurance: An Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts, 1950-1995*, 33 SAN DIEGO L. REV. 583 (1996).

¹⁰¹ Although beyond the scope of this article, a revolving loan fund dedicated to predatory loan work-outs might be beneficial both for lenders who have purchased the loans, after doing due diligence, as well for buyers who have committed to the loans, also in good faith.

financial institutions must eschew some consideration for the socioeconomic factors of neighborhoods, e.g., geography, race, and age, when evaluating the reasonableness and desirability of practices and policies adopted by sub-prime lenders. Only then can fair lending policy both protect borrowers and allow sub-prime lending to realize its tremendous potential to improve the availability of credit to underserved markets, such as the low- and moderate-income homeowners.

This consideration of non-economic factors is fair because economic justice for minorities is at stake.¹⁰² In this regard, if economic justice is viewed from the perspective of a meaningful opportunity to participate in the economy, what is necessarily required is an examination of the rules which prevent that. Instead of concluding that the credit-impaired borrower made the most efficient choice, it is possible to assign a value to the immeasurable rights of home ownership – the pride, respect, and self-worth of home ownership and to protect the tangible and valuable evidence of the homeowners’ hard work and life savings. Employing this paradigm that is not static allows for a fairer realization of the economic rights and opportunities of all individuals.

VII. CONCLUSION

Advocates of low- and moderate-income housing urge home ownership as an asset. Despite fair lending laws, policies that support the expansion of affordable housing for low- and moderate-income persons must be reconciled with those policies that undercut the sustainability of home ownership for those persons. Homeowners who cannot avoid foreclosure or refinance to make a *non-performing* loan a *performing* loan, losing some of the accumulated equity during the transaction, are trapped by abusive mortgages. The high failure rate of the sub-prime market indicates that market forces are ineffective in halting this economic abuse. The policies that permit the sub-prime industry to operate in an unbridled manner must be revised.

¹⁰² Professor Charles R.P. Pouncy defines economic justice as “the absence of impediments or barriers to the rightful access to assets, resources, and opportunities.” Charles R.P. Pouncy, *Economic Justice and Economic Theory: Limiting the Reach of Neoclassical Ideology*, 14 J. L. & PUB. POL’Y 11, 24 (2002).

Although there is a need for a sub-prime market, there is also a need for rules preventing sub-prime lending abuse. Care in formulating the rules will ensure that a narrow definition of the unfair practices will not materially deter legitimate, competitive loans. To remedy the deficiency, an approach explicitly based on the commonplace strategies to finance these operations should be taken. Allowing limited assignee liability is one way to regulate the funding of predatory lending. Purchasers who buy loans without an appropriate due diligence review to ensure that there is an accurate analysis of the borrowers ability to repay, and that disclosures regarding risks and pricing have been made, should not be able to freely negotiate those loans.

The proposed reforms are critical to ensure that sub-prime lending does not undermine the progress made in the economic development of communities. Identifying sub-prime lending practices as policy choices that affect credit availability leads to the conclusion that failure to regulate some aspects of this industry will result in a lack of protection for the unsophisticated borrower, whose economic condition may be further exacerbated by unfair credit terms.