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Working Paper

Predatory Lending and Community Development at Loggerheads

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For decades, cities have invested in decaying neighborhoods, trying to revitalize blighted areas and stimulate economic growth. Where their efforts have been successful, homeowners have experienced appreciation in their homes, safer streets, and improved neighborhoods. Cities, in turn, have benefited from the increased affluence and tax revenues. Rising home values, and as a consequence increased homeowner equity, have made these neighborhoods prime targets for predatory lenders, who focus on financially unsophisticated homeowners with equity in their homes and no relationships with traditional lenders. Predatory lenders often make loans on terms that these borrowers cannot afford. Some borrowers lose their homes. Others forsake necessities such as heat in the winter, health insurance, or home repairs to avoid default and foreclosure. Neighborhoods that were once stable become littered with abandoned and neglected homes. As people lose their homes, cities experience increases in crime, greater demand for social services, and an array of other costs associated with economic decline. The reduction in home values and the abandonment of homes lead to a decrease in tax revenues. At the end of the day, predatory lenders have exploited borrowers' increased equity in their homes and thereby plundered city investments in neighborhoods, leaving abandoned and deteriorated properties in their wake.[1]

As predatory lenders exploit the benefits of community development and devastate neighborhoods, the question for policy-makers is: what can be done? In this article, we attempt to address this question. We begin by defining predatory lending.

[1] Community development groups that seek to rehabilitate these properties encounter an array of obstacles. These obstacles are particularly burdensome when lenders elect not to foreclose on the property. Oftentimes, there is a question of who actually owns the property. Recording errors and uncertain transactions can further cloud titles to property. Many of these problems could be resolved through the foreclosure process; however, the entities in the best position to foreclose on the property – the mortgage holders and the taxing authorities – may lack sufficient incentives to initiate foreclosure proceedings. Mortgagees, once they become owners through foreclosure, incur tax liabilities, are subject to housing code enforcement actions, and may have to defend nuisance claims. Taxing authorities may perceive that the immediate costs of foreclosure outweigh any benefits that could accrue from taking title to the property.

We then describe the forces that led to the rise of predatory lending in recent years. Lastly, we describe different approaches to redressing the problem of predatory lending.

II. Defining Predatory Lending

Abusive home loans primarily occur in the subprime market, which consists of high-cost loans designed for borrowers who cannot obtain prime loans, either due to poverty, credit blemishes, spotty documentation, or irregular income. [Board of Governors of the Federal Reserve System, 2001, p. 2; Board of Governors of the Federal Reserve System, 1999, p. 1; Department of the Treasury, 2000, p. 28; Predatory Mortgage Lending, 2000, pp. 308-19]. Subprime home loans are not necessarily predatory. But predatory home loans are usually subprime.

Attempts to define which subprime loans are predatory for purposes of statutory regulation have proven unsuccessful. Early forays usually resulted in detailed catalogues of individual loan abuses. [See, e.g., Sturdevant & Brennan, 1999]. While useful, those catalogues were ultimately unsatisfactory, both because the lists did not explain why terms or practices were abusive and because lenders could evade itemized lists by devising new forms of abuse. Eventually, the sheer inability to arrive at a working definition of predatory lending emerged as a major fault line in the public debates. Consumer advocates called for the regulation of high-cost loans, while skeptics rebuffed them with the retort, “How can you regulate something that can’t be defined?”

As current laws demonstrate, it is not necessary to devise a comprehensive statutory definition in order to regulate predatory lending. Anti-predatory-lending statutes take two approaches, both focusing on specific abuses. One approach (the more common) is to designate “high-cost loans” as the trigger for statutory protection, define high-cost loans in terms of quantitative interest rate spreads or points and fees, and then prohibit or regulate specific loan terms and practices in high-cost loans. The other approach (sometimes used in tandem with the first) is to identify loan terms or practices that are abusive in all home loans and regulate those abuses across-the-board. [Azmy, 2004, pp. 1-4, 62-63].

While a comprehensive statutory definition of predatory lending is not necessary, it is necessary to identify problem loan terms and practices that require regulation. That, in turn, requires determining whether specific loan terms or practices are abusive and, if so, why.

An examination of various catalogues of loan abuses reveals six underlying problems. Those problems form a syndrome of abusive loan terms or practices that together constitute predatory lending [Engel & McCoy, 2002, pp. 1259-70]:[2]

(A) loans structured to result in seriously disproportionate net harm to borrowers;

(B) rent-seeking;

(C) loans involving unlawful fraud or deception;

(D) other forms of lack of transparency in loans that are not actionable as fraud;

(E) provisions requiring borrowers to waive meaningful legal redress;

(F) exploitative servicing; and

(G) discrimination.

A. Loans Structured To Cause Seriously Disproportionate Net Harm To Borrowers

The subprime mortgage industry offers more flexible lending criteria than the prime mortgage market. While some of those criteria, when applied, work to the benefit of both borrowers and lenders, other subprime loans are structured to inflict seriously disproportionate net harm on borrowers. When the harm seriously outweighs the benefit of subprime loans to borrowers and society at large, such practices are predatory in

[2] Predatory lending can also involve pervasive lending discrimination on grounds of race, gender, age, and ethnicity. [Calem et al., 2004; Farris & Richardson, 2004; Goldstein, 2004; Lax et al., 2004].

nature. Examples include asset-based lending (loans based solely on homes' collateral value that are made to borrowers who cannot afford the monthly payments); loan flipping (frequent, repeated refinancings designed to allow lenders to extract cumulative, costly refinancing fees); shifting unsecured debt into mortgages in order to tap into the homeowner's equity; insisting on larger loans than customers desire; steering prime-eligible customers into high-cost loans; and refinancing subsidized mortgages (such as no-interest Habitat for Humanity loans) at high interest rates for no good economic reason. [Freddie Mac, 1996, ch. 5 & nn. 5-6; Mortgage Bankers Association, 2000, ¶ 6; Murray, 2000, p. 1C; Sturdevant & Brennan, 1999, pp. 37, 39-40].

B. Harmful Rent-Seeking

Subprime loans are high cost, either due to higher interest rates or fees or both. Some subprime loans may reflect legitimate risk-based pricing, i.e., prices carefully calibrated to higher risks. Risky borrowers pose higher probabilities of delinquency, default, and foreclosure. [Department of the Treasury, 2000, p. 27; Jaffee & Russell, 1976; Weicher, 1997, pp. 69, 74-88]. Origination and servicing costs for these borrowers may be higher due to the need for more intensive underwriting, lower approval rates, and higher servicing costs. [Department of the Treasury, 2000, pp. 28, 67; Weicher, 1997 pp. 56-57 & tbl. 4.1, pp. 69-70, 74-88]. However, when subprime lenders exert market power in order to charge higher-than-competitive rates, they engage in predatory lending. They extract rents by hiking prices above risk-adjusted levels and by steering naive prime-eligible borrowers to subprime loans. [Lax et al., 2004; Shroder, 2000, pp. 14-15 fig. 2, tbl. 4; Sturdevant & Brennan, 1999, pp. 38-39; White, 2004]. Double billing and fees for phantom services similarly serve to extract rents. [Sturdevant & Brennan, 1999, pp. 38-39]. Finally, unlike the prime mortgage industry (where any prepayment penalty results in a lower interest rate), the subprime mortgage industry generally assesses prepayment penalties on top of high interest rates. [Farris et al., 2003, p. 18].

C. Fraud or Deceptive Practices

Sometimes predatory lending involves classic, illegal fraud. While loan fraud appears in ever-changing guises, essentially it boils down to fraud that aims to deceive borrowers.[3] [Board of Governors of the Federal Reserve System, 2001, p. 10; Department of the Treasury 2000, pp. 24, 79-90].

D. Other Forms Of Nontransparency That Are Not Actionable As Fraud

It is possible and all too likely for other home loans that are not technically fraudulent to nevertheless be misleading. That occurs when subprime loans omit information of crucial importance to borrowers. Although in the home loan area, two federal disclosure laws – the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) – mandate the disclosure of specific loan terms and costs,[4] these statutes suffer from flaws that severely diminish their utility.

Other subprime pricing practices also hinder transparency. Subprime rate sheets are rarely publicly posted. Even when they are, prices vary according to a plethora of factors including credit scores, making it difficult for borrowers to ascertain the exact price they personally would be charged. [White, 2004]. The lack of standardized fees further impedes transparency. [Ibid.].

E. Loans Requiring Borrowers To Waive Meaningful Legal Redress

More often than not, subprime home loans contain mandatory arbitration clauses that require borrowers to waive judicial redress and class action participation. [Smith,

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[3] Predatory lenders also engage in fraud that is meant to deceive suppliers of capital. [Barta, 2001, at p. A1; Department of the Treasury, 2000, at pp. 21-22, 80; Sturdevant & Brennan, 1999, at p. 37].

4 For a fuller discussion of these statutes, see the text infra at pp. 29-31.

2001, pp. 1192-93]. Those subprime home loans that allow judicial redress often require borrowers to pay the lenders' attorneys' fees. [Department of the Treasury, 2000, p. 99].

F. Exploitative Servicing

Once a loan has closed, a company known as a servicer collects the loan payments. Some servicers engage in exploitative practices, such as charging unjustified fees, force-placing homeowners' insurance without cause, instituting foreclosure improperly, and failing to make property tax payments when due. [Eggert, 2004].

G. Discrimination

Lending discrimination is yet another type of predatory lending. There are lenders and brokers who target people of color, single women, and senior citizens with abusive loans. This targeting, especially when coupled with the marketing of loans with less burdensome terms to those outside these protected classes, violates anti-discrimination laws [Renuart 2003].

III. The Emergence of Predatory Lending

By the 1990s, an array of market and regulatory forces converged to create an environment in which predatory lending could flourish. These forces changed the home mortgage market from one in which the supply of capital was limited and only the most creditworthy borrowers could obtain loans to one that provided a steady flow of mortgage capital to borrowers representing almost every level of credit risk. The same forces enabled lenders to exploit vulnerable borrowers who lacked borrowing experience.

Historically, lenders had a set amount of capital they could lend to borrowers and, as a result, they made loans to borrowers who presented the lowest risk of default.[5] As a result, there was a queue of borrowers who desired but could not obtain loans,

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5 For a fuller discussion of the pricing of home mortgages, see Engel & McCoy, 2002(a).

either because lenders had exhausted their supply of capital or because the borrowers presented unacceptable risks of default. [Stiglitz & Weiss, 1981, p. 393]. The limited availability of mortgage capital had the greatest consequence for low- and moderate-income (LMI) borrowers.

Market changes that began in the 1980s spurred a dramatic increase in the availability of money for home mortgages. The government-sponsored enterprises, Fannie Mae and Freddie Mac, as well as private securitizers began bundling and securitizing home mortgages. Investors, looking for new investment vehicles, eagerly bought up securities backed by these bundles of mortgages. Securitization,[6] which in 2003 accounted for approximately two-thirds of subprime home loans [Standard & Poor's, 2004; Theologides, 2004], has enabled lenders to make loans and sell them on the secondary market, generating new funds to loan. By enabling lenders to have greater access to capital, securitization has virtually eliminated the problem of unmet demand.

Just as securitization has enabled regulated institutions to increase their lending activities, it also has opened the door for thinly capitalized nonbank lenders to enter the lending business. Lenders no longer need to be highly-capitalized, regulated financial institutions. Indeed, unregulated mortgage bankers and finance companies have captured a significant portion of the home mortgage market. Like banks, they originate loans (typically using a warehouse line of credit) and then sell the loans on the secondary market. [Brendsel, 1996, p. 24].

In the 1990s, simultaneous with mortgage capital becoming increasingly available, many LMI borrowers began to see their wages and their home values rise. [Kennickell et al., 1997, p. 5; Canner et al., 1998, p. 249; Hylton, 2000, p. 205]. The

6 For a fuller discussion of securitization, see Engel & McCoy, 2002(a) and 2004.

increased cash flow and equity of these LMI borrowers bolstered their creditworthiness and made them more attractive to lenders. Concomitantly, Congress liberalized many restrictions on loan terms. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)[7] granted state banks and thrifts the same favorable variable-rate ceiling enjoyed by national banks and preempted state usury caps for loans secured by first mortgages. As a result, the law gave high-cost lenders added incentives to refinance first mortgages at high APRs in lieu of home equity lines of credit and other junior mortgages governed by state usury laws. The Alternative Mortgage Transactions Parity Act of 1982 (AMTPA)[8] broadened the types of loans regulated institutions could make by permitting adjustable rate mortgages, balloon payments, and interest-only loans.

Other federal regulations and laws created incentives for lenders to market their products to LMI borrowers.[9] The Department of Housing and Urban Development (HUD) set new lending goals for Freddie Mac and Fannie Mae that included a significant increase in the number of loans the GSEs had to purchase from LMI households and from high minority and/or low-income census tracts. [Fannie Mae, 2000, p. 110]. In a parallel development, changes to enforcement of the Community Reinvestment Act (CRA) increased incentives for banks and thrifts to serve LMI neighborhoods. [Department of the Treasury, 2000, p. 106].

These market and regulatory changes have transformed the home mortgage market and inadvertently spawned predatory lending. Predatory lenders tend to focus

7 Pub. L. No. 96-221, 94 Stat. 164 (1980).

8 Pub. L. No. 97-320, 96 Stat. 1469 (1982).

9 Federal Housing Administration (FHA) insurance further reduces the costs associated with high-risk borrowers by reimbursing lenders for many of expenses they incur when borrowers default. Clauretie & Jameson, 1990, pp. 701-02.

on LMI communities and LMI borrowers, who, because of credit rationing, discrimination, and other forces, are relatively inexperienced in and unsophisticated about credit transactions. These borrowers and communities often have pent-up demand for home mortgages that securitization, by continually generating new capital, enables lenders to meet. High levels of demand are only one reason why predatory lenders focus on LMI borrowers. The CRA incentives to provide banking services in LMI neighborhoods and HUD's loan purchase goals for the GSEs make LMI borrowers particularly attractive to lenders. These borrowers also are attractive because rising home values have increased homeowners' equity. Inexperience is the final and perhaps strongest factor motivating predatory lenders to target LMI borrowers. Predatory lenders approach homeowners who do not understand the home mortgage market and "hard sell" them with complex loan products and false promises. Some of these borrowers actually qualify for prime loans but are not apprised of that fact, while others could not obtain a conventional loan on any terms.

The prevalence of predatory loans reflects inefficiencies in the legitimate home mortgage market. These inefficiencies arise because of information asymmetries that predatory lenders exploit.[10] Lenders have extensive information about loan products and terms that even the most experienced borrowers cannot match. For the typical victim of predatory lending, this information is impenetrable. Unlike the prime market, where fixed-rate mortgages predominate, subprime and predatory loans include a dizzying array of complex terms, from prepayment penalties and balloon payments to negative amortization and floating rates that are tied to the interest on T-bills. The complexity of terms prevents borrowers from knowing what their loan payments will be in

10 Lenders also exploit information asymmetries that exist between them and the various secondary market actors involved with the securitization of loans. For a discussion of this phenomenon, see Engel & McCoy 2002(a) and 2004.

any given month and whether they can afford to make their loan payments under various contingencies that could arise. In this situation, borrowers tend to grasp onto the information they can understand: the amount of the monthly payment at the time the loan is consummated. When it comes to the information they cannot comprehend, borrowers rely on lenders' assurances that they can afford the loan and that they are in good hands.[11]

Predatory lenders seek out unsophisticated borrowers who are unlikely to shop for loans. Such lenders do so knowing that many of these borrowers erroneously believe they are ineligible for loans and will jump at the opportunity to borrow regardless of the terms. Abusive lenders pinpoint communities that traditional lenders have not served,[12] typically LMI neighborhoods and neighborhoods with a significant percent of people of color. [Calem et al., 2003; Lax et al, 2000, p. 8]. It is easy for lenders to identify these neighborhoods by using Home Mortgage Disclosure Act data that reveal areas with low levels of lending activity and census data that shed light on the income levels and racial composition of neighborhoods.

Once they have targeted specific areas, predatory lenders identify which homeowners have significant equity in their homes and pressing financial needs. Lenders can readily obtain information on homeowners' equity through public records that document the assessed value of homeowners' property and any outstanding mortgages. In addition, through public agencies, lenders can learn which homeowners have unpaid tax bills or outstanding housing code violations. Foreclosure records, divorce dockets, and bankruptcy filings can reveal homeowners with significant non-

11 When borrowers later default, the lenders reappear on the doorsteps, eager to refinance the loans, which enable the lenders to reap additional fees. Treasury & HUD, 2000, p. 74.

12 There are borrowers who are vulnerable to predatory lenders for other reasons. For example, people who are infirm may not be able to venture from their homes to apply for loans with conventional lenders.

mortgage debt. Some unscrupulous lenders drive through neighborhoods looking for decrepit homes in desperate need of repair.

Rather than adopt the traditional persona of a bank loan officer, predatory lenders attempt to make victims feel comfortable and trusting. Their warmth and compassion for borrowers' financial plights make customers believe that the lenders represent their interests. The lenders also exude an aura of authority, which together with the intimacy they establish with the borrowers, intimidate borrowers from questioning the loans the lenders are peddling. As a result, the lenders are able to foist loans on these borrowers that are not in the borrowers' best interests.

Information asymmetries are not the sole source of market inefficiencies in the predatory loan market. Predatory lenders' marketing strategies and a lack of competition from legitimate lenders also contribute. When predatory lenders offer loans to potential borrowers, frequently they insist that the loans will expire if the borrowers do not commit immediately. [Treasury & HUD, 2000, p. 79]. Thus under the gun, the borrowers hasten to sign the loan applications and pay the application fees, becoming psychologically committed to the loan in the process. Lenders know that by using this strategy, borrowers will likely rebuff offers from any subsequent lenders who appear on their doorsteps.

Given the incentives for lenders to reach out to LMI borrowers and the demand for mortgages in LMI neighborhoods, one would expect regulated depository institutions and legitimate unregulated lenders to market their loan products to LMI borrowers. For a number of reasons, most banks and thrifts have not entered the subprime market.[13] Many banks and thrifts worry that if they begin serving borrowers with elevated default risks, they will reject more applicants, charge higher interest rates, and foreclose on more properties, all of which could spawn public outcry. Where rejection rates, high interest rates, or foreclosure are positively correlated with the race of borrowers, banks could face lawsuits, regulatory actions, and damage to their reputations. [Duca &

[13] There are banks that do engage in subprime and predatory lending through subsidiaries and affiliates that do not have the same names, which reduces the reputational risk to the banks. [Gilreath, 1999, p. 149; Garver, 2001, p. 4; Litan, 2000, p. 76]. Banks and thrifts also are complicit in predatory lending when they buy mortgage-backed securities, the underlying loans of which are predatory.

Rosenthal, 1994, p. 99]. In contrast, predatory lenders have reduced reputational concerns and can readily dissolve and incorporate as new entities if their activities tarnish their reputations. Similarly, lawsuits do not pose a serious threat because limited liability makes undercapitalized predatory lenders judgment-proof to a large degree.

Regulatory controls may create disincentives to banks and thrifts engaging in subprime lending. Regulations require banks to maintain loan loss reserves and sufficient capitalization. The amount of protection against losses that banks must retain depends, in part, on the risk propensity of their loans. Subprime lending by definition entails more risk. Conversely, unregulated nonbank lenders can lend without regard to capitalization or other "safety and soundness" requirements because they are exempt from federal loan loss reserve and capitalization requirements. [Weicher, 1997, p. 31; Board of Governors, 2001; Treasury & HUD, 2000, p. 18].

Thus, in contrast to banks and thrifts, abusive lenders are substantially less concerned about the level of risk borrowers present. These lenders sell their loans on the secondary market,[14] after reaping their profits from upfront fees. If their deals with purchasers include recourse provisions and borrowers default, the lenders can take back the loans and foreclose on the properties. If a significant number of loans go into default, triggering recourse provisions and threatening the lenders with insolvency, those lenders can dissolve, and escape legal claims by borrowers and secondary market investors. Nothing prevents them from later resuming lending as new entities.

Regulated lenders also lack the special expertise that is needed to serve LMI borrowers. Unlike their more affluent counterparts, the credit histories of LMI borrowers do not fit neatly within conventional lenders' underwriting guidelines. [Litan, 2000, pp. 87-88]. Some LMI borrowers function solely in the cash economy, receiving their wages

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14 For an in-depth discussion of how the secondary market protects investors from the risks associated with buying securities backed by predatory loans, see Engel & McCoy, 2004.

and paying their debts in cash. Others may be self-employed, for example as child care providers or gardeners, and may not report all their income to the Internal Revenue Service. To assess the creditworthiness of these borrowers, banks would have to retool their underwriting methods and identify alternatives to W-2s, bank statements, and credit reports to verify debt and income. This is an expensive proposition for banks and one that might not reap enough performing loans to justify the expense. [Weicher, 1997, p. 36; Klausner, 1995, pp. 1567-68; Avery, 1999, p. 287]. Similarly, banks and thrifts are less likely to have offices in LMI neighborhoods, reducing their access to potential customers and hampering their ability to identify promising borrowers and neighborhoods. [Avery, et al, 1997, p. 719; Hylton, 2000, p. 218].

Predatory lenders are better equipped to evaluate potential borrowers' credit risk. Unlike banks that provide an array of services to diverse individuals and entities, predatory lenders have only one task: making home mortgage loans to homeowners. They can target one neighborhood and learn about individuals within that neighborhood and the overall economic stability of the area.

Predatory lenders' intense focus on specific neighborhoods and personal contact with potential borrowers makes them unique. Legitimate subprime lenders, in contrast, use the Internet and other mass marketing vehicles to attract borrowers. Arguably, these lenders should be able to undercut predatory lenders' prices and drive them out of business. However, mass marketing techniques work best with borrowers who are actively seeking loans, believe they will qualify for a loan, and are willing to contact a remote lender. These methods often will not catch the eye of potential victims of predatory lending, who may not be actively looking for loans, may falsely believe they are ineligible for credit, and may feel uncomfortable dealing with an anonymous lender. As a consequence, the most sophisticated subprime borrowers obtain favorable subprime rates and the more vulnerable borrowers, who may in fact be eligible for prime loans, fall prey to predatory lenders.

The scant presence of conventional bank lenders and legitimate subprime lenders in LMI communities means that the only significant competition predatory lenders face is from other predatory lenders who permeate these underserved communities. The nature of competition among predatory lenders is unique. Rather than compete on price, they compete on access. Whichever lender gets to homeowners first and induces them to sign loan applications wins. The unsuspecting targets cannot believe their good fortune and sign on the line, worried that their opportunity to borrow will vanish if they hesitate. [Treasury & HUD, 2000, pp. 17-18].

IV. Combating Predatory Lending

In the past five years, the debate over predatory lending and its cure has evolved dramatically. As late as 2000, many lenders continued to deny that predatory lending was a problem. That year, then-Senator Phil Gramm, chairman of the Senate Banking Committee, voiced the subprime industry's view when he asserted: "As the regulators themselves admit, there is no definition of predatory lending. I don't know how we can hope to address the problem before we have decided what it is." [Heller & Garver, 2000, p. 1; see also News Conference With Senator Phil Gramm, 2001]. Concomitantly, the main focus of consumer advocates was on securing the passage of state and federal legislation to regulate conduct by loan originators and mortgage brokers.

Increasingly, advocates and policy-makers began investigating the role that the secondary market played in predatory lending through the financing of subprime loans. The debate surrounding whether and how secondary market actors should be held responsible for abusive lending by originators became robust and is still being played out in state anti-predatory-lending legislation.

Over the last few years, some states ushered in significant reforms to address predatory lending, while other states have remained passive in the face of mounting abuses. At the federal level, reforms have been incremental and administrative in nature. The Federal Reserve Board amended its rules implementing the federal anti-predatory-lending law (known as the Home Ownership and Equity Protection Act or HOEPA) to expand prohibited subprime practices. Although the rules expanded the number of covered loans, HOEPA still only covers a scant five percent of subprime home loans. [Federal Reserve Board, 2001, pp. 65,606–10]. Over the same period, the Federal Trade Commission brought a number of high-visibility enforcement actions against abusive mortgage lenders under the Federal Trade Commission Act. [Federal Trade Commission, 2003].

With the election of President George W. Bush in 2000 and Republican dominance in Congress, strong federal legislation became stymied and reformers turned their focus to states and municipalities with increased success. By November 2004, thirty-six states, the District of Columbia, three counties, and nine municipalities had enacted anti-predatory-lending statutes or ordinances of varying breadth and strength. Some of those jurisdictions impose damages liability on both lenders and assignees of predatory loans. [Butera & Andrews, 2004]. The state and local initiatives came under fierce assault, both before passage and afterwards. The mortgage lending industry filed lawsuits challenging the legality of numerous state and local provisions and lobbied Congress for a federal preemption statute. Standard and Poor's and other rating agencies refused to rate securitized subprime loan pools in states whose assignee liability provisions they deemed too harsh. The U.S. Comptroller of the Currency declared all state and local anti-predatory-lending laws federally preempted for national banks and their operating subsidiaries.

The efforts to combat predatory lending span many fronts, from consumer education to civil litigation and criminal enforcement. In this section of the paper, we canvass and appraise these various approaches. In addition, we propose a new vehicle for redressing predatory lending.

A. Industry Self-Regulation

Some sectors of the financial services industry – securities and life insurance in particular – have strong industry self-regulation. In the securities industry, self-regulation is mandatory and is subject to oversight by the Securities and Exchange Commission.[15] In the life insurance industry, over half of all life insurers participate in self-regulation on a voluntary basis.[16] While there are significant differences between the two models of self-regulation, both require members to comply with codes of conduct that are designed to protect consumers and monitor compliance with those codes through outside independent assessments or audits and enforcement mechanisms. [IMSA, 2004; 15 U.S.C. § 78(b)–(c); Loss & Seligman, 1990, pp. 2653–57, 2669–70, 2787–830].

In contrast, the subprime mortgage industry has resisted establishing a meaningful mechanism for industry self-policing. The only initiatives to date have been: (1) a code of ethics and best practice guidelines adopted by the National Home Equity Mortgage Association (NHEMA); and (2) subprime legislative guidelines adopted by the

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15 The securities industry has a long history of industry self-regulation, dating back to the Maloney Act of 1938. In the Maloney Act, 15 U.S.C. § 78*o*-3(b)(6), Congress directed the Securities and Exchange Commission (SEC) to register national securities associations that among other things promulgated rules "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade." Today, such associations are known in securities parlance as securities regulatory organizations or SROs and include the National Association of Securities Dealers, the New York Stock Exchange, and the other American stock exchanges.

16 Such self-regulation is carried out under the auspices of the Insurance Marketplace Standards Association (IMSA), a voluntary membership organization promoting high ethical standards in the sale of individual life insurance, long-term care insurance and annuity products. Insurers must earn IMSA membership by passing an independent assessment designed to ensure their compliance with IMSA's principles and code of ethical market conduct, which are designed to advance sound market practices. [IMSA 2004].

Mortgage Bankers Association (MBA). [Mortgage Bankers Association, 2000; National Home Equity Mortgage Association, 2004c].

NHEMA bills itself as "the only trade association solely representing the non-prime mortgage lending industry" and boasts membership of "approximately 250 mortgage lenders accounting for 80 percent of the $240 billion in outstanding non-prime mortgage loans." [National Home Equity Mortgage Association, 2004a]. Nevertheless, NHEMA's code of ethics and best practice guidelines are solely voluntary in nature. Indeed, the preamble to NHEMA's ethics code and guidelines denies that either has legal effect, stating: "the modification of or failure to adopt one or more of these voluntary guidelines shall not necessarily be taken to indicate that the lender has violated any law, duty or standard of care." [National Home Equity Mortgage Association, 2004c].

Similarly, compliance by MBA's members with the association's subprime legislative guidelines is purely voluntary and is not subject to independent outside assessment or enforcement.[17] In a 2003 report on predatory lending enforcement, MBA announced its future plans to fight predatory lending. In that report, MBA stated it planned to promote financial literacy, explore new funding for government enforcement, and commission a study on abusive lending practices. [Mortgage Bankers Association, 2003, pp. 7, 18]. Nowhere in the report, however, did MBA commit to strengthen compliance with and enforcement of its own subprime legislative guidelines. Furthermore, the report recited evidence that industry oversight was ineffectual and confirmed that binding best practices standards were not yet in place. [Ibid., pp. 11, 15-16].

17 Separately, MBA has instituted a general set of Best Practices. MBA members may, but are not required to, agree to conduct their businesses according to those standards. For the most part, the standards are general in nature and do not address the specific predatory lending practices that MBA's legislative guidelines address. [Mortgage Bankers Association, 2001].

B. Consumer Education and Counseling

One common proposal to stop predatory lending – championed by lender trade associations and the Federal Reserve Board – is consumer education and counseling. [Gramlich, 2003; Greenspan, 2001; Mortgage Bankers Association, 2003, p. 18; National Home Equity Mortgage Association, 2004b]. While the terms "education" and "counseling" can have varying meanings, here we use "education" to refer to general educational programs such as workshops or classes that are not transaction-specific and "counseling" to refer to sessions that are tailored to a particular home purchase or loan transaction. [See also Gwatkin & McCarthy, 2003].

Mandatory mortgage counseling remains the exception and not the rule. Counseling is mandatory for reverse mortgages supervised by the U.S. Department of Housing and Urban Development under the Home Equity Conversion Mortgage program and for high-cost home loans that are subject to anti-predatory-lending laws of Arkansas, Georgia, Illinois, Massachusetts, New Jersey, North Carolina, and South Carolina. Other states – notably New York and California – have optional counseling measures that require lenders to advise loan applicants in writing to seek loan counseling before closing and to provide a list of counselors. [Azmy 200, pp. 57-58, 72-73; Azmy & Reiss, 2004, p. 687; Department of the Treasury, 2000, pp. 92; Harkness, 2000, pp. 39-41]. Elsewhere, mandatory counseling proposals have failed, either due to lender opposition or cost. In the private and non-profit sectors, homeowner counseling programs have generally focused on first-time homebuyers and not on existing homeowners who are refinancing their home loans. [Hermanson & Wilden, 2003, pp. 1-2].

Non-profits and government agencies sometimes offer mortgage education and predatory lending awareness programs, but these programs are not statutorily mandated. Examples of such programs include the "Don't Borrow Trouble" campaigns found in several U.S. cities and homeowner education initiatives offered by Freddie Mac, Fannie Mae, the Federal Deposit Insurance Corporation, and the Neighborhood Reinvestment Corporation as part of affordable lending initiatives. [Gramlich, 2003; Gwatkin & McCarthy, 2003, pp. 5-6; Hermanson & Wilden, 2003; McCarthy & Quercia, 2000; Freddie Mac, 2005].

Whether borrower counseling alone would succeed in combating predatory lending is highly questionable. In an overview of research on the effectiveness of homeownership education and counseling programs, Alan Mallach concluded that the findings were “highly ambiguous” and had “serious limitations [which] severely compromise the value of such findings.” [Mallach, 2002, p. 5; see generally Hermanson & Wilden, 2003, pp. 3-5]. One study did find homeowner counseling effective in the pre-purchase context. Hirad and Zorn found that pre-purchase homeownership counseling required under Freddie Mac’s Affordable Gold program reduced 60-day delinquencies on average by 13 percent. The mode of delivery mattered: borrowers who received classroom instruction and one-on-one counseling were 23 percent and 41 percent less likely respectively to have a 60-day delinquency. Home study and telephone counseling programs, in contrast, resulted in virtually no improvement. [Hirad & Zorn, 2001, pp. 1-2].

There are reasons to doubt whether the same results would obtain in situations involving predatory lending. The borrowers studied by Hirad and Zorn were actively shopping for homes and were required under the Affordable Gold program to obtain homeownership counseling. In contrast, predatory lenders generally restrict their operations to the mortgage refinance market, where they pressure vulnerable victims who are not in the market for credit into taking out loans. [Engel & McCoy, 2002(a), pp. 1310 & n.235; Hermanson & Wilden, 2003, p. 6]. In the absence of mandatory counseling, those people who fall prey to high-pressure sales tactics are also unlikely to take the initiative to consult an independent housing counselor before the loan closing.

Even if borrower counseling had proven effective in the subprime refinance market, prospects for mandatory, universal borrower counseling would still be dim. Kathryn Gwatkin and George McCarthy have noted that homeowner education and financial literacy education generally "is a costly, labor-intensive, process." [Gwatkin & McCarthy, 2003, p. 13]. Cash-strapped borrowers may not be able to afford retaining a lawyer or credit counseling service. Government sponsorship of readily available credit counseling would be too costly.

From lenders' perspective, counseling is unnecessary and can be against their best interests. Many subprime lenders actively oppose borrower counseling, arguing that "the development of risk-based pricing techniques has made financial literacy education all but obsolete as a risk mitigation tool." [Ibid., p. 14]. To the extent that consumer counseling makes borrowers more savvy and more likely to engage in comparison shopping, abusive lenders have a decided disincentive to pay for counseling. Even if some advantages, e.g., reduced default rates, accrued to lenders who provided counseling, the benefits of the counseling could extend to external actors, who did not bear the cost of the counseling. For example, if a borrower took information obtained through credit counseling with one lender and used that information to secure a loan on better terms with another lender, the original lender would not benefit from the counseling. In this respect, credit counseling reflects a public goods problem. Putting cost considerations aside, there is further reason to doubt that mandatory counseling of subprime refinance applicants would really work, given the flaws in the current system of disclosures. In the ideal situation, loan counselors would be able to advise homeowners to shop for other loans before they sign loan applications and become psychologically committed to the loans. Short of that, at least loan counselors could review the final loan documents and disclosures several days before closing in order to provide meaningful advice. However, currently none of the loan documents except the HUD-1 closing cost disclosure is available before closing and at most the HUD-1 is available one day before upon request. [Engel & McCoy, 2002(a), p. 1269]. Even with adequate disclosures, as Alan White has powerfully demonstrated, the subprime home loan market structures pricing and advertising to impede comparison shopping. [White, 2004].

At bottom, relying on borrower counseling as a predatory lending stopgap is little more than "borrower beware" in new clothes. Borrower counseling depends on victims to protect themselves, rather than on perpetrators to stop abusive practices. Similarly, borrower counseling does nothing to redress the disparities in bargaining power that fuel predatory lending. For these reasons, borrower counseling may be a desideratum, but it is no panacea.

C. Community Reinvestment Act Oversight

There are a number of ways that banks can directly or indirectly engage in predatory lending. The most obvious is the brokering and originating of predatory loans either through the banks themselves[18] or through affiliates that are relatively shielded from scrutiny. Banks may steer borrowers who are eligible for prime rate loans to subprime products or their subprime affiliates may refuse to inform borrowers that they could obtain more favorable terms if they went to the affiliated bank. Banks also engage in predatory lending when they impose more onerous loan terms on people of color or members of other protected groups.

Banks provide indirect support for predatory lending when they purchase loans or buy securities backed by predatory loans. They enable predatory lenders by providing them with warehouse lines of credit and letters of credit. Likewise, when banks provide

18 As we discussed, supra, there are significant disincentives for banks to engage in predatory lending. The actual rates at which banks directly or indirectly are engaged making these loans is unknown, although anecdotal evidence reveals some banks are involved in abusive lending. [Day, 2001, p. E1].

services, such as underwriting, and act as trustees, registrars, or agents for loan securitizations involving predatory loans they facilitate predatory lending.

CRA provides a vehicle through which bank regulators can detect and sanction banks and thrifts that are involved in predatory lending. CRA mandates that federal banking regulators "encourage [federally insured depository] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions." [12 U.S.C. § 2901(b) (2001)]. Regulators review banks' CRA compliance during routine CRA exams and when banks seek to expand their activities.

During routine CRA compliance examinations, for banks of all sizes, regulators review the banks' lending activities ("lending test") to determine whether they are "meeting the credit needs of [their] entire communit[ies], including low-and-moderate-income neighborhoods." [12 U.S.C. § 2903(a)(1)]. Regulators scrutinize additional factors when evaluating the community reinvestment performance of medium- and large-sized banks. For banks with total assets of $250 million to $1 billion, regulators also examine their community development activities ("community development test"). And for large banks – with total assets of over $1 billion – regulators evaluate their investments in community development ("investment test") and the retail depository services they provide ("service test"). Following this review, banks can receive one of four CRA ratings, ranging from outstanding to substantial noncompliance. [12 U.S.C. § 2906(b)(2)].

When reviewing bank applications related to depository facilities,[19] bank regulators must consider the banks' CRA performance, including any publicly-lodged

19 These can include applications: (a) for a bank charter or deposit insurance; (b) applications to open or close a branch; (c) to relocate a home office or a branch; (d) for a merger, acquisition or consolidation; (e) to acquire another bank's liabilities; or (f) to acquire an insured bank. [12 U.S.C. §§ 2902(2)-(3), 2903(a)(2)].

complaints. If regulators conclude that the institutions have failed to meet their CRA obligations, they can deny or place conditions on approving the institutions' applications. Similarly, when regulated lenders apply to become financial holding companies and when financial holding companies and national banks seek to expand into new financial services, the regulators consider the institutions' CRA ratings and deny the applications if any of the holding company's banks or thrifts have ratings below satisfactory.

When banks participate in and provide support for predatory lending, they are not only failing to "meet the credit needs" of their communities, but also are contributing to the decline of already struggling neighborhoods. The regulatory agencies have begun to recognize the role banks may be playing in predatory lending and, in response, are increasing their scrutiny of banks' lending activities. One of the most important shifts has been including non-bank affiliates in examinations when banks apply for deposit facilities. Historically, subprime affiliates of insured banks were not subject to CRA scrutiny; however, in recent years, the Federal Reserve Bank has required lenders seeking approval for deposit facilities to adopt internal controls to detect and protect against abusive lending, including lending by subprime affiliates. [Engel & McCoy, 2002(b)].

Although the Federal Reserve Board and other bank regulators recognize the problem of predatory lending and have made some steps to address it, their enforcement has not been uniform or widespread. For example, although the Federal Reserve Board now requires banks that are applying for deposit facilities to review their loan applications for steering of prime borrowers to subprime loans [Engel & McCoy, 2002(b)], there is no parallel requirement that routine CRA examinations include review of loan applications to ensure that banks are not engaged in steering. Similarly, CRA examinations do not scrutinize purchases by banks of interests in predatory loans, regardless of a bank's size.

CRA is a powerful and underutilized vehicle for redressing predatory lending. Regulators should use CRA exams to detect predatory loans and, where there is evidence of predatory lending, issue CRA demerits. Likewise, where banks indirectly support predatory lending through financing and other arrangements without proper due diligence to detect predatory lending, they should receive ratings downgrades. Finally, affiliates of banks should be subject to CRA examinations without exception.

D. <u>Criminal Enforcement</u>

Numerous predatory loans are infected with fraud and thus are subject, at least in theory, to criminal prosecution. However, fraud prosecutions for mortgage abuses are the exception and not the rule. The relative rarity of criminal fraud cases in the mortgage arena is explained in part by the fact that only affirmative misrepresentations, not misleading omissions, are actionable as common-law fraud. [Restatement (Second) of Torts §§ 525, 537-45]. In addition, criminal fraud charges require proof of knowing or willful intent to deceive beyond a reasonable doubt, which is not necessarily easy to show. The high standard of proof needed for culpability can deter prosecutors from bringing criminal fraud cases.

Other pragmatic concerns hinder vigorous prosecution of predatory lending fraud. District attorneys or state attorneys general must be willing to file charges. State and local prosecutors have been slow to indict predatory lenders for fraud except in the most egregious cases. The model home mortgage antifraud program in the County of Los Angeles has been a notable exception [Potter, 2000], but it stands alone. In addition to the exacting proof that is needed to show common-law fraud, predatory lending transactions are often technical and complex, daunting prosecutors who lack financial know-how. The lack of systematic reporting requirements that would flag possible loan abuses for prosecutors is another impediment. Finally, severe budget constraints and other pressing priorities, including violent crime, drug use, and terrorism, cause many state and local prosecutors to place predatory lending fraud on the back burner. [Mortgage Bankers Association, 2003, pp. 6, 13-14].

E. Individual Relief

Borrowers can employ an array of tools for combating predatory lending, each of which has varying degrees of efficiency. Historically, usury laws protected borrowers from abusively high interest rates. These laws, which have been pre-empted, also restricted many borrowers from access to credit. The most widely used approach to redressing predatory lending entails bootstrapping laws and regulations that pre-date the emergence of predatory lending. The fact that these laws were written without predatory lending in mind makes them imperfect mechanisms for relief. Disclosure laws, some of which explicitly address predatory loan terms, fail to fulfill their promise because they are too narrow or are subject to evasion. Increasingly, municipalities and states are passing laws aimed specifically at predatory lending. The enforceability and effectiveness of these laws depends critically on their specificity, the breadth of practices they cover, and whether they are subject to preemption.

1. Originators and Brokers

a. Usury

Historically, usury laws served to curtail abusive lending by setting maximum interest rates. Several decades ago, the United States deregulated limits on mortgage rates, including passage of DIDMCA, which pre-empted state usury limits on first mortgages. With the advent of predatory lending, some policy-makers and consumer advocates have argued for re-imposition of usury laws. Interest rate restrictions, however, are imperfect methods for deterring predatory lending because they limit the amount of capital available to LMI borrowers and spur credit rationing. When interest rates are capped, lenders charge borrowers more in up-front fees and require larger down payments, both of which adversely affect people with limited resources. [Tansey, et al., 1981]. Similarly, limits on non-interest rate terms, such as restrictions on points and fees, lead lenders to reduce the number of loans they make and require higher down payments, which, like interest rate caps, impede lending to LMI borrowers. [Phaup, et al., 1981, p. 91].

b. <u>Fraud, Consumer Protection, and RICO</u>

Borrowers, who have been defrauded by lenders through misrepresentations, can bring claims under state consumer protection statutes and anti-fraud laws. Common law fraud allows recovery when borrowers make material misrepresentations on which borrowers rely to their detriment. Both federal and state consumer protection laws prohibit unfair and deceptive acts and practices.

Although claims based on misrepresentations hold a great deal of hope for borrowers, a number of forces deter and impede the filing of these types of claims. Fraud claims can be time-consuming and expensive, with minimal returns. As a result, borrowers may find it difficult to secure private representation to pursue these claims. The terms of UDAP statutes often present unique obstacles. Some preclude private lawsuits. Others exempt lending or other credit transactions from their coverage. Still others fail to include attorneys' fees provisions that would provide an incentive for lawyers to bring UDAP claims. [Engel & McCoy, 2002(a), pp. 1302-1305].

When lenders, by engaging in a pattern of racketeering activity, e.g., mail or wire fraud, or through collection of an unlawful debt, violate certain laws while conducting or participating in an enterprise affecting interstate commerce, they may be subject to claims under the Racketeer Influenced and Corrupt Organization Act (RICO) [18 U.S.C. §§ 1961 et. seq]. RICO claims can be even harder to prove than fraud claims. This is because in addition to proving the underlying fraud, borrowers must prove the other elements that are unique to RICO claims. [Engel & McCoy, 2002(a), p. 1303].

c. Unconscionability

Contract law enables borrowers to bring claims against lenders who enter into loans that are unconscionable. Unconscionability claims arise when borrowers are not given any meaningful choice as to the terms of contracts and the terms unreasonably favor the other party. [U.C.C. § 2-302(1)]. Borrowers have met resistance from the courts when pursuing unconscionability claims based on price terms. This is because the aggrieved borrowers are contesting prices that they knowingly accepted. In addition, it is difficult for plaintiffs to prove that a price is unfair. It is equally difficult for courts to draw the line between an unreasonably favorable and a reasonable favorable price. [Engel & McCoy, 2002(a), pp. 199-1301]. Thus, only those borrowers who contest non-price terms stand much chance of succeeding in unconscionability claims.

d. Discrimination

When predatory lenders impose more onerous loan terms on members of protected classes, e.g., people of color or seniors, they may be subject to state and federal lending discrimination claims. Lending practices that have a disparate impact on protected classes even in the absence of intent to discriminate can also give rise to discrimination claims. [Swire, 1995, p. 832].[20]

Victims of discrimination confront unique hurdles to successful resolution of their claims. [Dane, 1993, p. 549]. The first hurdle is the difficulty of determining whether a lender engaged in unlawful discrimination. Without knowledge of the lenders' internal processes, borrowers typically cannot deduce whether a loan rejection or loan terms are based on legitimate reasons or unlawful discrimination. Likewise, the lack of access to

20 The federal statutes that protect against lending discrimination are the Equal Credit Opportunity Act of 1974 (ECOA) [15 U.S.C. §§ 1601 et seq.], which prohibits lenders from discriminating against applicants for mortgages, and the Fair Housing Act (FHA)[42 U.S.C. §§ 3601-3619], which prohibits discrimination in the financing of residential real estate.

lenders' underwriting methods and information on other borrowers precludes borrowers from knowing whether they have claims based on disparate impact. Practical hurdles are as formidable as these informational hurdles. Private attorneys shy away from lending discrimination claims because they are costly to litigate, difficult to prove, and often result in low awards.[21] Enforcement, therefore, frequently depends on governmental agencies and non-profits that are sorely constrained by limited resources and other more pressing priorities.

e. Disclosure

Several federal laws require lenders to disclose features of loans to borrowers. RESPA[22] mandates the disclosure of real estate closing costs through two different mechanisms. First, lenders must provide loan applicants with a good-faith estimate of settlement costs (GFE) within three days after the loan application. Second, at the closing, the lender must furnish the borrower with a HUD-1 settlement statement listing all final closing costs that the borrower must pay. [Department of Housing and Urban Development, 1998, Executive Summary p. II]. RESPA's effectiveness is minimal because it does not provide any relief if the lenders made any errors in borrowers' GFEs or final accountings of loan closing costs. As a result, the information borrowers obtain from lenders is often unreliable and typically is presented at a time when borrowers are on the verge of signing the mortgage and note and, for a variety of emotional and financial reasons, may be unable to walk away from the loan.

21 For a fuller discussion of the obstacles to fair lending claims, see Engel & McCoy 2002(a) and Engel (1999).

22 Congress vested enforcement of RESPA in nine federal agencies [U.S.C. §§ 1607(a), (c)]. Borrowers can only pursue private claims for RESPA violations if the lenders failed to inform them that their loans could be transferred, received kickbacks, or steered them to title companies. [15 U.S.C. §§ 2605(f), 2607, 2608].

TILA mandates disclosure of finance charges and annual percentage rates. The finance charge portrays the cost of the loan as a lump-sum dollar figure after taking interest payments, points, origination fees, and private mortgage insurance into account. The APR converts the finance charge into an effective annual interest rate. When lenders violate TILA's provisions, they may be subject to criminal penalties [15 U.S.C. § 1611]. On the civil side, borrowers may pursue claims – either as individuals or as members of class actions – for actual damages, statutory damages and attorneys' fees [NCLC, Ch. 8]. In addition, in some situations borrowers have a right to rescind their mortgages for up to three years after closing [NCLC, ch. 6]. The goal of TILA was to standardize disclosures so that borrowers could easily compare the total cost of the credit lenders were offering. This standardization has failed because a multitude of closing costs are not included in the TILA calculations, which prevents borrowers from engaging in any meaningful loan comparison and shopping.

HOEPA, which is a subpart of TILA, mandates additional disclosures for loans that meet the statutory definition of a high-cost loan.[23] These disclosures include advance notice of the annual percentage rate and the dollar amount of the borrowers' loan payments, including any increases that could occur if the loans contain adjustable rates. HOEPA also requires that lenders inform borrowers that they have the right to refuse to enter into the loan agreement up until the time of the closing and that, by assuming the loan obligations, the borrowers could lose their homes. [Engel & McCoy, 2002(a)]. Like violations of TILA, lenders who violate HOEPA may be subject to criminal penalties. [15 U.S.C. § 1611]. Civil remedies include all the TILA remedies, expanded rights of rescission, and the amount of all finance charges and fees paid by the borrower. [15 U.S.C. §§ 1640(a)(4), 1635]. HOEPA suffers from its own limitations. Its

23 State attorneys general and the same agencies that have the power to enforce TILA and RESPA can enforce HOEPA [15 U.S.C. § 1640(e)].

application is limited to closed end, non-purchase loans that contain certain, specific "trigger" terms.[24] Lenders can evade HOEPA by making open-end loans or by setting the loan terms below the HOEPA triggers and compensating for the decreased revenue by increasing the charges that are excluded from the HOEPA points and fees calculation.

Tinkering with the TILA, RESPA, and HOEPA requirements will not solve the problem of predatory lending. As quickly as Congress improves these statutes, lenders will event new ways to evade them. Furthermore, given that most people do not understand the extant disclosures, crafting new and different disclosures will only add more confusion, especially if the disclosures are presented as part of high-pressure closings.

f. State and Local Anti-Predatory-Lending Laws

In 1999, a sharp rise in predatory lending along with perceived deficiencies in traditional remedies for lending abuses led North Carolina to enact the first comprehensive state anti-predatory-lending statute. [N.C. GEN. STAT. §§ 24-1.1E(a)(4), (a)(6), (1999)]. In the succeeding five years, thirty-five additional states, the District of Columbia, plus assorted counties and municipalities followed suit by enacting a wide assortment of anti-predatory-lending laws. [Butera & Andrews, 2004].

Some of the new state laws add relatively little protection, either because they only mandate studies (Hawaii), do not expand HOEPA's triggers to reach more loans (e.g., Connecticut and Florida), do not afford aggrieved borrowers a private right of action (e.g., Connecticut and Colorado), severely restrict or deny private relief to individual borrowers (e.g., Connecticut and Pennsylvania), or severely limit private relief

24 The triggers are that the annual percentage rate at consummation exceeds the yield on Treasury securities of comparable maturity plus 10 percent or the total points and fees exceed 8 percent of the total loan amount or $400 (subject to annual indexing), whichever is greater. [15 U.S.C. §§ 1602(aa)(1)-(aa)(4)].

against lenders as opposed to mortgage brokers (California). In contrast, other jurisdictions, following North Carolina's lead, enacted statutes that significantly increase state regulation of subprime practices and loan terms.

Vigorous state laws that track North Carolina's vary across a host of dimensions. To begin with, some statutes only regulate lenders and brokers, while others regulate both groups plus secondary market assignees of subprime loans. In this section, we discuss state regulation of loan originators; in a subsequent section, we discuss state assignee liability provisions.

Of the vigorous state statutes, some regulate high-cost home loans alone, while others regulate both prime and subprime home loans. Thus, the laws can be classified according to two different models. The first model tracks and often expands upon HOEPA by defining "high-cost" loans as loans with minimum numerical APR or points and fees triggers and regulating specific terms and practices in the resulting group of "high-cost" loans. The second model regulates terms and practices for home loans across-the-board, both prime or subprime, without regard to interest rates or points and fees. Some statutes take a hybrid approach, adopting the first model for some loan terms and the second model for others. [Azmy, 2004, pp. 62-63].

Among state laws that follow the first model, there are further variations. Some states, such as Pennsylvania, Connecticut, and Kentucky, set their numerical triggers at the same high level as HOEPA. A handful of other states, most notably Illinois, the District of Columbia, and New Mexico, lowered their APR triggers below HOEPA's (as low as 5 percent above the rate on comparable Treasury securities). At least ten states – including North Carolina, New Jersey, New Mexico, and New York – use lower points and fees triggers than HOEPA. Most of the latter states expand on HOEPA in two further ways: first, by defining "points and fees" to include added charges and second, by covering purchase mortgages and/or home equity lines of credit in addition to closed-end home refinance loans. [Azmy, 2004, pp. 65-66].

The vigorous state statutes, plus some state laws that mimic HOEPA's numerical triggers, prohibit certain types of loan terms and/or practices. Depending on the state, prohibited terms or practices include: negative amortization, acceleration clauses, advance payments, increased interest upon default, financing of single premium credit insurance, and lending without regard to ability to pay. Those same statutes subject other loan terms or practices to strict regulation. Such provisions include, depending on the state: balloon clauses, direct payments to home improvement contractors, prepayment penalties, and loan flipping. Some state statutes mandate additional disclosures to borrowers. [Azmy, 2004, pp. 67-72]. Scattered states cap or prohibit the financing of points and fees or outlaw steering of prime-eligible customers into subprime home loans. [Azmy, 2004, pp. 73-74].

Remedies among state anti-predatory-lending laws vary widely. Virtually all of the states that afford aggrieved borrowers private relief award reasonable attorneys' fees to successful plaintiffs and compensatory and statutory damages. Most of those states allow courts to strike down illegal loan provisions as void and to reform loans so that they no longer are high-cost. In those states, predatory lending violations commonly provide defenses to foreclosure. A smaller subset of states permits borrowers to rescind loans that violate their statutes. Some states provide defenses to lenders who cure violations in good faith. [Azmy, 2004, pp. 74-75].

g. Federal preemption

In January 2004, in one fell swoop, the U.S. Office of the Comptroller of the Currency (O.C.C.), which is charged with regulating national banks, made a bold countermove at banks' behest by eviscerating state anti-predatory-lending laws as those laws apply to national banks and their mortgage lending operating subsidiaries.[25] The Comptroller accomplished this objective by issuing a final rule preempting all state anti-predatory-lending laws to the extent those laws apply to national banks and their operating subsidiaries. The only exception to this broad O.C.C. preemption rule is where (1) Congress expressly incorporated state-law standards in federal statutes, or (2) a specific state law only has an "incidental" effect on national banks (i.e., is part of "the legal infrastructure that makes it practicable" for national banks to operate and does not "regulate the manner or content of the business of banking authorized for national banks"). [Office of the Comptroller of the Currency, 2004a; Wilmarth, 2004]. In a companion final rule also issued in January 2004, the Comptroller heavily restricted states' exercise of "visitorial powers" over national banks and their operating subsidiaries.

These two rules excuse national banks and mortgage companies that are operating subsidiaries of national banks from complying with all state anti-predatory-lending laws. Victims of predatory lending by those lenders cannot sue them for relief under state anti-predatory-lending laws. Nothing in the Comptroller's preemption rule affords a new cause of action to aggrieved borrowers to replace the ones that they have lost. Similarly, the rules bar states from examining national banks or their operating subsidiaries for predatory lending violations, from taking enforcement action against them for such violations, and from suing those entities in court to enforce the state laws. Although the Comptroller has cautioned the entities it regulates against certain abusive lending practices, for the most part, the O.C.C. has demurred from pronouncing specific practices illegal.

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25 Length does not permit description of the other types of broad-ranging and complex federal preemption of state mortgage laws. For a cogent description, see Renuart & Keest, 2000.

If the Comptroller's two rules are interpreted as a charter bid, they have already been successful. In 2004, J.P. Morgan Chase Bank swapped its New York state charter for a national bank charter to take advantage of the O.C.C. preemption rule. Increasingly, independent subprime mortgage companies are casting aside their independence to become operating subsidiaries of national banks for the same reason. Thus, by unilateral agency fiat, the Comptroller may eventually accomplish what many in the subprime home loan industry desire – the effective repeal of the state anti-predatory-lending laws.

h. Suitability Proposal

Vigorous state anti-predatory laws such as North Carolina's have much to recommend them. They require abusive loan originators and mortgage brokers to internalize the cost of harming victims. They make victims whole through a variety of techniques, including damages, reformation of loan terms, and defenses to foreclosure. Attorneys' fees provisions provide incentives to attorneys to bring meritorious claims. Often (but not invariably) the laws define predatory practices according to clear and objective standards. Finally, the wide variation among state laws creates a laboratory of state experimentation that will permit future researchers to evaluate the strengths and any unintended consequences of the various approaches.

These accomplishments are highly significant and should not be underestimated. At the same time, the lack of an effective uniform federal standard relegates injured borrowers in states with no anti-predatory laws or weak anti-predatory laws to more traditional remedies, which experience has proven are generally inadequate. Furthermore, most of the state laws patterned after North Carolina's are static in design. In other words, the laws do not provide a regulatory mechanism for expanding the list of prohibited and regulated practices as new abuses arise. Federal preemption rulings by the O.C.C. essentially have nullified the state laws, moreover, as those laws apply to national banks and their operating subsidiaries.

We would address these problems through enactment of a federal statute creating a uniform national duty of suitability in subprime mortgage lending. The duty of suitability is rooted in federal securities law, which provides that a salesperson "should recommend only securities that are suitable to the needs of the particular customer." [Loss & Seligman, (2001), pp. 1010]. In the subprime mortgage context, the statute we propose would enunciate a general duty of suitability and implement that duty by prohibiting or regulating the same practices that the state laws address, plus other emerging problems, such as servicing abuses. In addition, the law would authorize an appropriate federal agency such as the Federal Trade Commission to expand the duty of suitability by rule or adjudication to regulate any new abuses that arise. The federal statute would set a floor, not a ceiling, thereby allowing states to impose stricter limits on subprime lending abuses. Enforcement mechanisms would include a non-waivable private right of action for injured borrowers with broad-based remedies, federal prosecution, and agency enforcement.

2. <u>Assignee Liability</u>

Under the Uniform Commercial Code, investors who buy loans on the secondary market can cut off most claims and defenses to collection by borrowers under the holder-in-due-course rule. The rule empowers secondary-market purchasers to defeat "personal" defenses to non-payment if they satisfy the following requirements for a holder in due course: (1) the purchaser is the holder, (2) of a negotiable note, (3) who took the note for value, (4) in good faith, and (5) without notice of the defenses. Once a purchaser qualifies as a holder in due course, it can cut off the defense of unconscionability, as well as all other personal defenses to the loan agreement.[26] [White & Summers, (2000), §§ 14-1–14-7, 14-10].

Today, approximately two-thirds of all subprime home loans are sold in the secondary market through securitization. Thus, unless some other law abrogates the holder-in-due-course rule for subprime home loans, borrowers injured by predatory practices are barred from relief against any investors or securitized trusts who own their loans.

HOEPA was the first specific anti-predatory-lending law to repeal the holder-in-due-course rule for subprime home loans (but only for the costliest five percent of subprime mortgages).[27] Under that law, investors who buy HOEPA loans are subject to all claims and defenses a borrower could assert against the original lender unless the assignee can prove that "a reasonable person exercising due diligence" could not have determined that the loan fell within HOEPA. [15 U.S.C. § 1641(d)(1)].

North Carolina did not include an assignee liability provisions in its 1999 anti-predatory-lending law. However, some other states that passed laws modeled after North Carolina's did include assignee liability, including Georgia, New Jersey, New York, and New Mexico.

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25. Personal defenses include failure or lack of consideration, breach of warranty, unconscionability, and fraud in the inducement. Borrowers who are sued by secondary-market purchasers may still raise the "real" defenses of infancy, duress, lack of legal capacity, illegality of the transaction, fraud in the factum (i.e., fraud in which the plaintiff signed the wrong document and was not at fault), and discharge of the debtor through insolvency. Furthermore, duress, lack of legal capacity, illegality, and fraud in the factum only constitute real defenses for void contracts, which are extremely rare. Where a contract is simply voidable, not void, the latter four defenses are personal defenses and cannot be raised against holders in due course.

The Federal Trade Commission has a rule abrogating the holder-in-due-course rule, but this rule only applies to HOEPA loans and the financing of sales of goods or services secured by home mortgages. [White & Summers, (2000), § 14-9(b); 16 C.F.R. § 433.2].

27 For discussion of assignee liability provisions under other statutes that are not specific to the subprime mortgage context, see Engel & McCoy, 2004, pp. 723-27.

The earliest state law to impose assignee liability was Georgia's 2002 anti-predatory-lending statute. The 2002 version ignited a firestorm of criticism, with many interpreting the assignee liability provisions as imposing unlimited punitive damages and class action liability. When the specter of uncapped liability caused Standard & Poor's and its sister ratings agencies to refuse to rate numerous securitized home loan pools originated in Georgia, the Georgia legislature repealed the 2002 law and replaced it with a weaker assignee liability provision that the ratings agencies found acceptable. [Azmy, 2004, pp. 76-77].

Since then, a number of states, including New Jersey, the District of Columbia, Arkansas, Maine, Illinois, Massachusetts, New Mexico and New York have enacted assignee liability provisions patterned after the later Georgia law. Colorado and Florida have adopted HOEPA's assignee liability language, with provisions to cap damages liability. [Azmy, 2004, pp. 77-78]. Standard & Poor's rates securitized subprime loan pools from most of those states, but generally requires higher and in some cases enormous credit enhancements to rate those pools due to assignee liability concerns. As of this writing, Standard & Poor's has refused to rate some or all high-cost home loan pools originated in Indiana, Massachusetts, New Jersey, Oakland and Los Angeles, California, due to concerns that the damages risk to assignees cannot be quantified. [Standard & Poor's, 2004].

A federal assignee liability provision is essential, both to afford injured subprime borrowers meaningful relief and to create an incentive for Wall Street to stop funding predatory loans. In crafting such a law, it is crucial to strike a balance between devising a cost-effective method for screening out abusive loans from loan pools and maintaining the flow of legitimate mortgage loans to LMI borrowers. To achieve that balance, assignees should be rewarded for implementing adequate controls. Thus, we propose that assignees who fail to adopt adequate controls should be subject to all claims and defenses that borrowers could raise against loan originators with full damages liability, including punitive damages. In contrast, assignees that do institute effective controls would be subject to all claims and defenses by borrowers against originators, but damages would be limited to compensatory damages. Under our proposal, Congress would empower a federal agency to define “adequate controls,” on the condition that such controls would include, at a minimum, computerized screening of loan-level data to screen out predatory loans and ongoing monitoring of loan performance. [Engel & McCoy, 2004, 742-43]. Our proposal would provide rating agencies with the certainty they require to adequately assess the risks associated with loan pools so long as the assignees instituted our proposed controls. Thus, our approach rewards assignees that help to police predatory lending and creates a mechanism through which injured borrowers can be made whole, all the while permitting ratings agencies to rate securitized loan pools that contain subprime loans.

V. Conclusion

In the past fifteen years, cities have made impressive strides in revitalizing urban centers and helping renters to become homeowners and begin building wealth. Where urban planners tread, however, predatory lenders follow in their footsteps. The surge in home equity values in recent years attracted unscrupulous lenders who scheme to tap out equity by refinancing mortgages with high interest and fees, heedless of the toll to homeowners and the neighborhood from bankruptcies, abandoned houses, and foreclosures.

In combating predatory lending, this country finds itself at a crossroads. In two-thirds of the subprime mortgage loans, the holder-in-due-course rule bars borrowers from any meaningful relief against the owners of their loans. Even when loan originators continue to hold abusive home loans in portfolio, traditional remedies often fail to afford borrowers adequate relief. Some states have addressed these problems through new anti-predatory-lending statutes. The ratings agencies and the O.C.C. have undercut these laws however, by respectively declining to rate subprime securitizations in some states and by preempting the new state laws for national banks and their operating subsidiaries. In 2006, the controversy will move to the federal arena as Congress debates a national anti-predatory-lending bill. If Congress acts responsibly, it will prohibit subprime lenders from making unsuitable loans and reward loan assignees for refusing to finance predatory loans with damages caps. If Congress does not, predatory lending will mushroom to epidemic proportions. Homeowners – and their communities – stand in the balance.

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