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THE LAW AND ECONOMICS OF REMEDIES FOR PREDATORY LENDING

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Introduction

Over the past decade, there has been a significant increase in the phenomenon known as "predatory lending." In a forthcoming paper,[1] we argue that predatory lending emerged when market incentives that historically led lenders to engage in credit rationing gave way to a market where lenders could easily exploit unsophisticated borrowers. Our specific focus is on the home loan market, *i.e.*, closed-end mortgages secured by first or subordinate liens on borrowers' homes.

This executive summary of the paper proceeds in three parts. In the first section, we identify six problems associated with various lending practices that have been characterized as predatory. We define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of these six problems.

In the second part, we describe information asymmetries that formerly led to credit rationing. We then identify how changes in the financial services market have altered the conventional home mortgage market. In particular, we argue that an increase in the amount of capital available for mortgages, increased incentives for lenders to specialize in lending to low-and moderate-income borrowers, and opportunities for deception — a result, in part, of securitization — have enabled predatory lenders to thrive.

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In the final part, we evaluate remedies for predatory lending, including the effect of proposed and extant remedies on the availability of capital for home mortgages. In conclusion, we propose that the federal government draw on the suitability requirement that applies to the sale of securities and impose a similar obligation on lenders and brokers. We argue that suitability achieves the balance between the need to curb predatory lending and the need to encourage beneficial market activity.

"Predatory Lending" Defined

Predatory lending is a direct outgrowth of the emergence of the subprime loan market in recent years. In an overwhelming number of cases, predatory loans form a subset of subprime loans, which are loans with higher interest rates and fees designed for borrowers with impaired credit, who cannot qualify for loans in the prime market.

To date, predatory lending has not been adequately defined. Arriving at a definition of predatory lending is important for two distinct reasons. First, legitimate subprime loans play a crucial role in expanding credit to low- and moderate-income borrowers. To avoid impinging on legitimate credit, the dividing line between legitimate subprime loans and predatory loans must be defined. Second, any serious attempt to formulate remedies for predatory lending must be able to describe the loans that require redress.

To date, predatory lending most often has been described as a catalogue of onerous lending practices, which are targeted at vulnerable populations and often result in devastating personal losses, including bankruptcy, foreclosure, and the loss of one's home. (*e.g.*, Sturdevant and Brennan). When these practices are examined, six basic problems emerge. We can thus define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of the following six problems:

(1) loans that violate common loan underwriting norms to the detriment of borrowers;

(2) loans that result in no net benefit to the borrower;

(3) loan terms designed to earn supranormal profits;

(4) loans involving fraud or deceptive practices;

(5) loans involving other misleading nondisclosures that are nevertheless legal; and

(6) loans that require borrowers to waive meaningful legal redress.

Predatory loans involve at least one of the above six factors. In contrast, legitimate subprime loans do not display any of the six markers of predatory loans.

Market Segmentation and Predatory Lending

What explains the rapid growth in predatory lending? As we will now describe, changes in the financial services market and incentives for increased lending to low- and moderate-income (LMI) borrowers have altered the conventional home mortgage market. We argue that a surfeit of capital available for mortgages, new incentives for specialized LMI lending and opportunities for deception — resulting from a surge in securitization and a new class of naive borrowers — have made it possible for predatory lenders to thrive.

The Conventional Theory of the Market for Home Mortgages

In a market with full information, we would expect that the price of a loan would reflect the risk presented by the borrower. The reality, however, is that lenders do not have full information about the risk that borrowers will default, the costs of foreclosure if they do default, and the net amount recoverable in the event of foreclosure. As a result, lenders cannot accurately identify borrowers who present the greatest risk and cannot price loans accurately based on risk.

Twenty years ago, Stiglitz and Weiss (1981) recognized that this lack of information creates an adverse selection problem that prevents the market for mortgages from clearing. The key to this adverse selection problem is that high interest rates deter borrowers who are less risky and more risk-averse and attract the less risk-averse and riskier borrowers. Thus, if lenders raise interest rates, the proportion of loan applicants who present elevated risks of default will rise.

Given that lenders cannot identify less risky borrowers and that high interest rates will deter the very borrowers whom they seek to attract, lenders set the price of loans below the market-clearing rate. Lenders further reduce their risk by limiting the amount that borrowers can borrow; this has the effect of deterring risky borrowers. As a result of this credit rationing, the demand for loans exceeds the supply and not all creditworthy applicants can obtain loans (Brueckner 2000).

Changes in the Financial Services Market

Until the late 1980s, the home-mortgage market behaved as Stiglitz and Weiss predicted: there was essentially one market for home mortgage loans and demand exceeded supply. Beginning in the 1980s, several changes in the financial services market led to a significant increase in the supply of capital available for lending and spurred the emergence of lenders who were willing to lend to people who, historically, had been credit-constrained.

One of the most dramatic changes in the financial services market has been the advent of the securitization of home mortgages. Securitization is the process of converting packages of home mortgages into securities and selling the securities to investors. Widespread securitization began in the 1980s and by 1993, 60 percent of home mortgage loans were securitized. It is now routine for lenders to originate loans and sell them on the secondary market, which provides a steady stream of capital to lend.

In addition to generating additional capital for lending, securitization created opportunities for nonbank lenders to enter the home mortgage market. Lenders no longer need to be large financial institutions with significant deposits and capitalization. Rather, mortgage bankers, finance companies, and home improvement contractors with minimal assets can originate loans for sale on the secondary market.

Many of these new lenders specialize in subprime lending to low- and moderate-income borrowers. There are a number of reasons for this. First, prime lenders do not have a significant presence in LMI neighborhoods, so there is less competition. Second, LMI borrowers historically have had limited access to mortgage capital because of credit rationing. Hence, there is unmet demand in LMI neighborhoods. Third, many homeowners in LMI neighborhoods, just as in the rest of the country, experienced a rise in the value of their homes, and, therefore, their equity in the 1990s. Fourth, there has been an increase in homeownership among people with lower incomes.

Another factor that encouraged subprime lenders to focus on LMI lending was the 1992 Federal Housing Enterprise Financial Safety and Soundness Act, which authorized the Department of Housing and Urban Development to establish affordable housing lending goals for Freddie Mac and Fannie Mae. The 1996 to 1999 goals issued pursuant to the Act required that 42 percent of Freddie Mac's and Fannie Mae's loan purchases come from low- and moderate-income households. The goal for 2000 was 48 percent and for 2001, it was 50 percent.

Additional goals require that Fannie Mae and Freddie Mac significantly increase their purchases of loans from high minority and/or low-income census tracts.

Two other pieces of legislation — the Alternative Mortgage Transactions Parity Act (AMTPA) and the Community Reinvestment Act (CRA) — encouraged lending in LMI neighborhoods. AMTPA expanded the types of products that lenders could offer, thus making it possible for LMI borrowers to obtain loans with terms that meet their credit needs. The CRAprovides incentives for banks and thrifts to purchase subprime loans containing predatory terms in order to improve their CRA examination ratings and prospects for merger approval. In addition, the Federal Housing Administration (FHA) insurance creates incentives for lending in LMI neighborhoods by reducing the cost to lenders of default.

The changes in the financial services market, including the incentives for lending in low- and moderate-income communities, furthermore have created opportunities for deception by market participants. Securitization makes deception possible because the various entities involved in lending and securitization do not share the same knowledge about borrower's risk nor the same commitment to accurate risk assessment. This enables lenders and brokers to withhold information to the detriment of other participants.

Nonbank lenders who sell loans on the secondary market often use mortgage brokers to market and arrange loans. These brokers have little incentive to insure that borrowers are creditworthy because they do not bear the risk of loss in the event of default. Brokers do, however, have an incentive to deceive lenders regarding borrowers' ability to pay. This is because lenders typically compensate brokers only for loans that the lenders approve, based on the size or interest rate of the loans. When lenders do not have accurate information regarding borrowers' credit risk, they may agree to loan terms that borrowers cannot afford, which ultimately can result in default by the borrowers.

Principal-agent problems also arise because lenders have greater access than securitizers to information about borrowers' creditworthiness and securitizers rely on lenders' assurances about credit quality. Given that lenders' earnings are based on fees and not interest, their incentives to maintain credit quality are low relative to those of the securitizers. This information asymmetry and reduced commitment to creditworthiness creates incentives for lenders to approve loans and include loan terms that generate fees without regard to the risk that the borrowers will default.

Finally, separate information asymmetries occur between LMI borrowers and lenders and brokers. Lenders and brokers have extensive knowledge about mortgage products and loan terms. In contrast, LMI borrowers, many of whom have been excluded from the home mortgage market because of credit rationing, are relatively unsophisticated. Thus, LMI borrowers may not be aware of alternative sources of capital and may not be able to comprehend the information that brokers and lenders provide them regarding loan terms.

Disincentives for Legitimate Lenders and Brokers to Engage in Predatory Lending

The costs to banks and thrifts of predatory lending are significant and clearly exceed the costs that predatory lenders incur. Banks and thrifts are community institutions with valuable reputations that may not be worth sacrificing to pursue predatory lending. They may perceive that even legitimate subprime lending and the consequent increase in foreclosure rates could damage their reputations.[2] In contrast, predatory lenders are less concerned about their reputations because they can readily dissolve and reincorporate under different names.

Banks and thrifts, for the most part, do not have a significant presence in LMI neighborhoods. As a result, they have limited opportunities to develop relationships with LMI borrowers at retail sites or to obtain valuable information on the social capital in LMI communities. If banks wanted to target customers for predatory loans, they would need to establish or, in some cases, re-establish branch banks in LMI neighborhoods. The cost of establishing new offices likely would outweigh any profits they could realize from predatory lending. In contrast, predatory lenders do not have the same brick and mortar costs. They can operate out of storefronts or solicit borrowers door-to-door without the need for retail office space.

Banking regulations that mandate loan loss reserves and require adequate capitalization create further obstacles to banks that want to expand into predatory lending. If banks and thrifts begin charging LMI borrowers high interest rates, bank examiners likely will view the loans as a risk to safety and soundness and will require the banks to increase their loan loss reserves. In addition, federal banking regulators have tightened capital requirements for subprime loans and they are expected to tighten those requirements even further. Nonbank predatory lenders, in contrast, are not subject to federal loan loss reserve or capitalization requirements.

Banks are also less able to develop the special underwriting expertise that LMI lending requires. LMI borrowers often present elevated

risks of default and are less likely than more affluent borrowers to have credit histories that fit neatly into banks' underwriting standards. As a result, lenders who want to serve LMI borrowers need special expertise in evaluating their creditworthiness. Banks and thrifts are ill equipped to develop this expertise because their function is to provide diverse services, from deposit taking to commercial and personal lending. This diversification makes it unlikely that banks and thrifts profitably could develop an expertise in predatory lending. In contrast, predatory lenders can afford to specialize. By focusing on one class of borrowers — higher-risk borrowers — predatory lenders can better develop methods for obtaining and evaluating credit information on this group of borrowers.

The racial composition of the neighborhoods that predatory lenders target is disproportionately people of color. To the extent that banks have an aversion to lending to people of color that outweighs any market incentives, they will refuse to lend in these areas. In contrast, predatory lenders target people of color precisely because discrimination, as well as credit rationing, have prevented these borrowers from having access to capital.

Finally, banks and thrifts are reluctant to lend in neighborhoods that are economically unstable. Predatory lenders are less concerned about economic stability because they are willing to pursue foreclosure aggressively, which enables them to recover their investments before prices drop too far.

Competition Among Predatory Lenders

Although credit risk explains the market segmentation that has given rise to the prime and subprime markets, it does not explain the segmentation of the subprime market into legitimate and predatory lending. Arguably, competition among predatory lenders should result in loans with the same terms that legitimate subprime lenders would offer. This has not happened. Our hypothesis is that predatory lenders target LMI borrowers who, for reasons discussed below, do not "shop" for alternative sources of mortgage capital and do not negotiate over terms. If this is true, then predatory lenders compete with each other solely for access to the borrowers whom they target. We thus posit that the market for predatory loans is characterized by spatial, monopolistic competition. (Frank 1991).

Many LMI borrowers may not be aware of the increased availability of mortgage capital for LMI lending. This lack of awareness, when

coupled with pent-up demand because of credit rationing, makes them easy prey for predatory lenders who can readily convince them that their opportunity to borrow is fleeting. These borrowers, unaware of other options, desperate for money and fearful that the prospective loans will disappear, will not "shop" for other loans. Predatory lenders and brokers can take advantage of this false urgency and move quickly to commitment and closing on predatory loans.

Some LMI borrowers are simply unable to explore all their lending options. They may be infirm or feel that it is not safe to venture far from their homes. They may not have phones or, even if they have them, may find it difficult to understand people over the phone. Likewise, they often lack transportation to the offices of legitimate lenders. Predatory lenders, who solicit potential borrowers with phone calls and door-to-door solicitations, have ready customers among people who are isolated. They endear themselves to these borrowers with charm and solicitude that mask their guile and convince the borrowers that they can meet their lending needs.

LMI borrowers are further handicapped by their lack of experience with legitimate mortgage lenders. They may find it difficult to understand the terms of loans, especially predatory loans, which are notorious for lack of transparency. They may not know where to seek help in understanding loan documents and identifying the important questions to ask lenders. Predatory lenders can take advantage of their lack of sophistication and insert loan terms that would be unacceptable to more experienced borrowers. In the end, borrowers sign documents without a clear sense of the terms of the contracts, how much they borrowed, what they have purchased, or the repayment terms.

Predatory lenders identify potential borrowers by reviewing statistical data and public records and by familiarizing themselves with the neighborhoods that they intend to target. Predatory lenders can use Home Mortgage Disclosure Act (HMDA) data to identify areas in which there is minimal or no lending activity by prime lenders. They can also use census data to find neighborhoods with high percentages of people of color and LMI residents, who historically have been rationed out of the market and may desire to borrow money.

Municipal offices are sources of individual level information about residents. Predatory lenders can learn the names of homeowners from registries of deeds. Title records will also reveal any mortgages and the dates that they were recorded. From this information, predatory lenders can surmise how close homeowners are to paying off any outstanding

mortgage debt and, therefore, the likelihood that there is equity in their property to tap. From the local tax office, predatory lenders can obtain information on the appraised value of properties and learn the identities of any homeowners who owe outstanding taxes and, therefore, may be in the market for loans. In communities that have ordinances requiring homeowners to maintain the exteriors of their homes, predatory lenders can learn who has been cited for violations and, thus, may be in need of money for home repair loans. They can drive through neighborhoods and identify homes with sagging porches, aged roofs and peeling paint. Armed with the names of homeowners, the amount of equity they have in their homes, any outstanding tax bills or housing code violations they have and the conditions of their homes, predatory lenders approach the borrowers and offer their services. The borrowers, eager to take advantage of what appears to be a "dream come true," look no further.

Remedies

Neither the states nor the federal government (with the exception of North Carolina and to a lesser extent Illinois, Massachusetts and New York) have comprehensive laws to redress predatory lending. Rather, victims of predatory lending currently must rely on a loose assortment of statutes and common law that were not designed to require predatory lenders to internalize the costs of the harm they cause. Under the current stable of remedies, predatory loan contracts are generally enforceable except in the case of discrimination or where fraud or nondisclosure has operated in some way that is inimical to free will. Barring discrimination, fraud or nondisclosure, however, the law normally does not question the substance of predatory loan terms.

Remedies Under Contract Law and the Uniform Commercial Code

Because predatory loans are contracts in the form of promissory notes and security agreements, contract law might be expected to provide recourse for victims of predatory loans. Various contract law doctrines, however, make it difficult for borrowers to challenge their loan agreements as void.

Most defenses to enforcement of contracts go to defects in the formation of assent, not to disparities in bargaining power or the fairness of substantive terms. The most important exception to that rule, for purposes of predatory lending, is the defense of unconscionability. In the seminal case of *Williams v. Walker-Thomas Furniture Co.*, the

United States Court of Appeals for the District of Columbia Circuit defined unconscionability to mean “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”

The doctrine of unconscionability has limited utility, however, for victims of predatory lending. Courts have been reluctant to condemn excessive price terms as unconscionable. Furthermore, most courts only recognize the doctrine as a defense to suits for contract enforcement. Consequently, borrowers may not sue lenders affirmatively for damages or other relief based on unconscionable provisions in their loan agreements. Finally, under the Uniform Commercial Code, secondary market purchasers of predatory loans can cut off the defense of unconscionability (and many other contract defenses) where they qualify as holders in due course. Thus, when applicable, the holder in due course doctrine permits secondary market purchasers to evade responsibility for most misconduct by loan originators and eliminates an important incentive for the secondary market to police loan originators.

Antifraud Laws

Numerous predatory loans are the result of some form of fraud. Nonetheless, the limited scope of common-law fraud often precludes redress, either civilly or through criminal prosecution. Common-law fraud requires proof of affirmative misrepresentations and thus does not protect against misleading omissions or manipulation. In addition, for victims who want to press charges, criminal fraud prosecutions depend on the district attorney's willingness to prosecute. For victims who seek civil redress, mandatory arbitration provisions and inadequate attorneys' fee provisions often raise insuperable barriers to suit. Finally, the need to prove individual reliance in fraud cases often makes it difficult to bring class actions.

In response to these inherent limitations in common-law fraud, Congress and the states passed unfair and deceptive acts and practices (UDAP) statutes. However, the federal counterpart, the Federal Trade Commission Act, does not afford a private right of action. State UDAP statutes do provide private rights of action, but some state UDAP statutes exclude credit transactions. Other state UDAP statutes have weak attorneys' fee provisions that discourage the private bar from bringing state UDAP claims.

Disclosure

Several federal statutes, including the Truth in Lending Act (TILA), the Real Estate Settlement Practices Act (RESPA) and the Home Ownership and Equity Protection Act (HOEPA), mandate the disclosure of standardized price information on loans. All three statutes, however, are flawed in what they require and the relief that they provide. TILA has not lived up to its goal of standardizing disclosures as to the total cost of credit. RESPA suffers from deficient private enforcement and poorly thought-out provisions on the timing of disclosures. HOEPA's advance disclosure provisions are better crafted, but HOEPA's narrow coverage makes it easy to evade.

Fine-tuning federal disclosure provisions is no panacea. Most victims of predatory lending already find the current set of disclosures complicated and confusing. For naïve borrowers, piling on more disclosures would not help. The high-pressure nature of loan closings only exacerbates this confusion, by discouraging borrowers from reading loan documents at closing or asking questions when they do. Thus, more disclosure is not the answer.

Consumer Education and Consumer Counseling

Consumer education and/or counseling are another proposed response to the problem of exploitative loan terms. Currently, however, government-sponsored credit counseling is virtually non-existent and consumer education programs are in their infancy. There are serious questions about the efficacy of counseling, particularly for consumers with educational or cognitive deficiencies. There is a more basic problem with relying on education and counseling: education and counseling mistakenly put the onus of avoiding predatory loans on potential victims, rather than on the perpetrators.

Price Regulation

Usury limits for residential mortgages in the United States were largely deregulated through federal legislation in the 1980s. More recently, predatory lending has fueled calls to reimpose usury limits on interest rates and points and fees. Numerous studies, however, including studies by Bowsher (1974), Jaffee and Russell (1976), McNulty (1979), Nathan (1980), Ostas (1976), and Phaup and Hinton (1981), have concluded that price controls hurt the very individuals they are designed to serve by restricting the flow of legitimate credit. Accordingly, any attempt to regulate predatory lending should avoid price controls.

Antidiscrimination Remedies

Two federal statutes — the Equal Credit Opportunity Act of 1974 and the Fair Housing Act of 1968 — prohibit lending discrimination on prohibited grounds, including race, color, national origin, and gender. Both statutes authorize private damages actions. Only a paucity of private cases has been litigated under either statute, however, due to the high standards of proof, costly expert statistical analysis and low damages awards. Furthermore, federal lending discrimination laws are necessarily tangential in their approach, because they address discriminatory treatment rather than abusive loan terms *per se*.

Suitability

In contrast to the remedies previously discussed, which have limited utility in terms of stemming predatory lending, we propose taking a direct approach that goes to the heart of predatory lending - *i.e.*, abusive loan terms and practices.

Given the shortfalls in the current set of remedies, an effective remedy must accomplish several things. It must create effective disincentives to refrain from predatory loans and must force predatory lenders and brokers to internalize harm. It must outlaw predatory practices in such a way that the law is understandable, violations can be easily proven, and lenders and brokers cannot evade the law. It must avoid price regulation and other constraints on legitimate subprime loans. It must compensate victims for losses and grant loan reformation. And it must furnish the private bar and victims with adequate incentives to bring predatory lending claims.

In devising such a remedy, we take a leaf from the suitability doctrine in federal securities law. In its general form, a duty of suitability in mortgage lending would have three components. Under that duty, lenders and brokers would be prohibited from selling subprime loans:

(1) that exceeded individual customers' risk thresholds;

(2) to borrowers who qualified for prime rates; and/or,

(3) that contained oppressive mandatory arbitration clauses.

If the duty of suitability is appropriate for financial instruments that have been the traditional province of the affluent and the middle class,

it is appropriate for financial instruments that are peddled to the poorest rung of society. Such a duty would counteract the current financial incentives of lenders and brokers to exploit information asymmetries among market participants. In essence, a duty of suitability would provide the disincentive to predatory lending that credit rationing historically provided before the rise of the subprime market.

To avoid impinging on legitimate credit, we recommend vesting the Federal Trade Commission with authority under Section 5 of the Federal Trade Commission to define the precise requirements of the duty of suitability through regulation. To ensure adequate enforcement, we further recommend amending Section 5 to add a private right of action for predatory lending, in addition to the Federal Trade Commission enforcement that now exists.

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Notes

[1] The Law and Economics of Remedies for Predatory Lending (latest draft available at http://www.law.csuohio.edu/handbook/predatorylending.pdf).

[2] Ironically, depository institutions may have a veiled presence in the predatory lending market. Some banks and thrifts, whose direct lending is legitimate, have subsidiaries or affiliates that engage in predatory lending. Although the disincentives to engaging in predatory lending are greatest for banks and thrifts, several of the disincentives, including reputational concerns, also apply to legitimate subprime lenders.

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