

SQUARING THE PREDATORY LENDING CIRCLE: A CASE FOR STATES AS LABORATORIES OF EXPERIMENTATION

*Baher Azmy**

I.	INTRODUCTION	297
II.	THE HOME EQUITY GOLD RUSH	303
	A. <i>The Explosion of the Subprime Lending Market</i>	304
	1. Subprime Loans	304
	2. The Explosion	307
	B. <i>Financing the Gold Rush: Securitization and Transformation of Consumer Credit</i>	308
	1. The Transformation of Demand for Consumer Credit	308
	2. Securitization and Mortgage Lending Supply	311
	a. Brokers, Contractors, and Finance Companies	312
	b. The Force of Securitization	315
III.	PREDATORY BEHAVIOR IN THE SUBPRIME MARKET	319
	A. <i>Excessive Rates and Fees: The Myth of Subprime Efficiency</i>	320
	1. The Rate-Risk Disparity	321
	2. Financing Excessive Points and Fees	326
	3. Disproportionate Impact on Racial Minorities	328
	B. <i>Unfair and Abusive Lending Practices</i>	332
	1. Aggressive and Misleading Marketing and Sales Techniques	333
	2. Predatory Lending Practices	335
	a. Loan Flipping	335
	b. Lending Without Regard to a Borrower's Ability to Repay	337
	c. Home Improvement Contractor Abuse	338
	C. <i>Unfair Loan Structures</i>	338
	1. Prepayment Penalties	338
	2. Balloon Payments, Default Interest Rates, Call Provisions, and Advance Payments	340
	3. Negative Amortization	341
	4. Financing Unnecessary Single Premium Credit Insurance (SPCI)	342

* Associate Professor, Seton Hall University School of Law. B.A., University of Pennsylvania; J.D., New York University School of Law. The author would like to thank the following people for helpful comments on earlier drafts: Kathleen Boozang, Linda Fisher, Kurt Eggert, David Reiss, and Charles Sullivan. The author would also like to thank Jason Pozner, Jonathan Needle, and Vanessa Verduga for their excellent research assistance.

	D. <i>Predatory Impacts: Explosion of Residential Foreclosures</i>	343
IV.	THE INSUFFICIENCY OF PRE-EXISTING REMEDIES	345
	A. <i>Market Responses</i>	346
	B. <i>Disclosure Regimes: TILA and RESPA</i>	350
	C. <i>Direct Limitations on High-Cost Loans: HOEPA</i>	352
	D. <i>Consumer Education</i>	356
	E. <i>Fraud and Antidiscrimination</i>	357
	F. <i>Federal Regulatory Activity</i>	358
	G. <i>Role of Securitization and the Holder-in-Due-Course Rule</i>	360
V.	STATE LEGISLATIVE RESPONSES AND THE MOVE TO PREEMPT THEM	361
	A. <i>Rapid and Experimental State Responses</i>	362
	1. <i>The Aggressive States: Variations on a North Carolina Theme</i>	363
	a. <i>Broader Coverage than HOEPA</i>	364
	b. <i>Core Lending Prohibitions: Moving Toward a Definition of Predatory Lending</i>	365
	i. <i>Categorical Prohibitions</i>	366
	ii. <i>Variations on Core Prohibitions</i>	367
	c. <i>Additional, Innovative Proposals</i>	371
	2. <i>Remedies and Assignee Liability</i>	373
	a. <i>Remedies Against Loan Originators</i>	373
	b. <i>Assignee Liability Provisions</i>	374
	3. <i>Supplemental and Hesitant States Approaches</i>	376
	B. <i>Assessing the Preliminary Results of State Experiments</i>	378
	C. <i>The Premature Move Toward Federal Preemption</i>	382
	1. <i>Regulatory Preemption</i>	383
	a. <i>OTS Preemption</i>	383
	b. <i>OCC Preemption</i>	385
	2. <i>Congressional Preemption</i>	388
VI.	THE VALUE OF STATE EXPERIMENTATION IN THE FEDERAL SYSTEM	390
	A. <i>A Happy Incident of Federalism: States as Laboratories of Experimentation</i>	391
	1. <i>Innovation and Experimentation</i>	394
	a. <i>Filling in Gaps and Staying Ahead</i>	395
	b. <i>Responding to Local Needs</i>	397
	c. <i>Eventual Adoption at the Federal Level</i>	398
	2. <i>Without Risk to the Rest of the Country</i>	399
	B. <i>The Countervailing, but Insufficient, Value of Uniformity</i>	400

I. INTRODUCTION

Like obscenity, “predatory lending” in the home-mortgage market eludes a precise or uniform definition; the phenomenon instead frequently evokes an “I know it when I see it” understanding among consumer advocates, responsible lenders, and concerned regulators.¹ As a result, accelerating debates about predatory lending between opposing sides—consumer groups and banking industry representatives—have focused on what sorts of lending behavior should be considered predatory and how to isolate or value predatory lending’s alleged impact on borrowers, particularly those in low-income communities.² In addition, as government institutions and market actors have begun to respond in varying degrees to various constituencies, an important new contest has emerged regarding which locus of regulatory power—federal or state—is best suited to comprehensively reform a problem as significant, complex, and not yet fully understood as predatory lending. In the last four years, twenty-six states have enacted predatory lending legislation in varying forms;³ thus far, federal regulators and legislators have allowed these legislative experiments to flourish, but federal preemption of this remarkably vibrant and evolving legislative process is looming. This Article argues that the promise of such state-by-state innovation has important implications for regulatory development beyond the home loan market, revealing in a concrete, measurable way the virtues of our federal system of government.

Reports of predatory lending emerged first anecdotally, as a shadowy practice of a particularly unscrupulous set of mortgage brokers and finance companies to manipulate vulnerable low-income, elderly, and minority homeowners into accepting mortgage products that would quickly and

1. Ellen Seidman, the former director of the Office of Thrift Supervision, has said “[y]ou tend to know predatory lending practices when you see them, but trying to come up with a neat definition is difficult.” Ellen Seidman, *Strategies for Combating Predatory Lending in Our Neighborhoods*, Remarks Before the Neighborhood Reinvestment Training Institute (Feb. 23, 2000) (transcript available at <http://www.ots.treas.gov/docs/8/87073.pdf>); see also Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 511-13 (2002) (noting difficulty among commentators and regulators in describing and understanding predatory lending).

2. Allen Fishbein & Harold L. Bunce, *Subprime Market Growth and Predatory Lending*, in U.S. DEPT. OF HOUS. & URBAN DEV., HOUSING POLICY IN THE NEW MILLENIUM CONFERENCE PROCEEDINGS 273, 280 (Susan M. Wachter & R. Leo Penne eds., 2001) (“Although there is broad public agreement that predatory lending should have no place in the mortgage market, there are differing views about the magnitude of the problem and even how to define practices that make a loan predatory.”), available at http://www.huduser.org/publications/pdf/brd/13_fishbein.pdf.

3. See *infra* Part V.A.

inevitably result in devastating home foreclosures.⁴ Only around the end of the 1990s did community groups and consumer advocacy organizations begin to compile these stories and recognize persistent, core patterns among them. They then demanded legislative reform to address what they contended was an exploding problem that could not be remedied by the federal and state consumer protection laws then on the books.⁵

Some regulators and legislators initially balked at attempts to regulate an area as broad, complex, and important as the residential mortgage market to ameliorate a problem they believed could not even be defined or an impact that could not be precisely evaluated.⁶ More recently,

4. See, e.g., Lynn Bonner, 'Predatory Lending' Problem is Severe, Senators Are Told, NEWS & OBSERVER (Raleigh, NC), June 4, 1999, at A3; Julie Johnsson, *As Economy Booms, So Do Foreclosures: Home Loan Defaults Go Through the Roof in Cook County*, CRAIN'S CHI. BUS., Sept. 20, 1999, at 1; Glenn J. Kalinoski, *NY Focuses on HEL Fraud*, NAT'L MORTGAGE NEWS, Sept. 13, 1999, at 1; Myron Levin, *Hitting Home: Critics Say California's Lax Regulation of Loan Firms Is Allowing Unscrupulous Businesses to Prey on Unwary Homeowners*, L.A. TIMES, July 26, 1998, at D1; Joan McQueeney Mitric, 'Predatory' Lending Practices Target Elderly; Homeowners Short of Cash Are Warned of Risks in Using House as Collateral, WASH. POST, Apr. 14, 1998, at Z22; Ted Sickinger, *Paying the Price for a Loan: Minorities Fill Financial Void by Turning to Subprime Lenders, Often at a Higher Cost*, KAN. CITY STAR, Mar. 1, 1999, at A1; Richard W. Stevenson, *Spending It: Focus on Home Equity Loans—Predatory Lending; How Serial Refinancings Can Rob Equity*, N.Y. TIMES, Mar. 22, 1998, § 3, at 10; Editorial, *Wrap up Predatory Lending; It's Time for Florida's Legislators to Stop Those Who Are out to Take Advantage of Poor Consumers by Lending Them Money at Ridiculously High Rates of Interest*, ORLANDO SENTINEL, Dec. 24, 1999, at A12.

5. See, e.g., DANIEL IMMERGLUCK & MARTI WILES, WOODSTOCK INST., TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT (1999) (documenting rise of abusive home lending practices, called predatory lending, and their contribution to the explosion of foreclosures in vulnerable communities); NAT'L TRAINING & INFO. CTR., PREYING ON NEIGHBORHOODS: SUBPRIME MORTGAGE LENDING AND CHICAGOLAND FORECLOSURES 5 (1999) [hereinafter PREYING ON NEIGHBORHOODS] (correlating dramatic rise of foreclosures in metropolitan Chicago area to increase in "subprime" and abusive lending), available at <http://npa-us.org/preying/preying.html>; see also ASS'N OF CMTY. ORGS. FOR REFORM NOW, SEPARATE AND UNEQUAL: PREDATORY LENDING IN AMERICA (2004) [hereinafter SEPARATE AND UNEQUAL] (describing series of typical practices that constitute predatory lending and the impact of those predatory practices on low-income, minority, and elderly homeowners), available at www.acorn.org/fileadmin/Community_Reinvestment/Reports/S_and_E_2004/separate_and_unequal_2004.pdf; CAL. REINVESTMENT COMM., STOLEN WEALTH: INEQUITIES IN CALIFORNIA'S SUBPRIME MORTGAGE MARKET (2001) (documenting the rise of predatory lending in California and correlating it to high incidence of residential foreclosures), available at <http://www.calreinvest.org/publications/CRC-StolenWealthReport.pdf>; RICHARD D. STOCK, CTR. FOR BUS. & ECON. RESEARCH, PREDATION IN THE SUB-PRIME LENDING MARKET: MONTGOMERY COUNTY (2001) (documenting the rise of predatory lending in Montgomery County, Ohio and correlating it to high incidence of residential foreclosures), available at <http://www.myfairhousing.com/cber/>; KEN ZIMMERMAN ET AL., N.J. INST. FOR SOC. JUSTICE, PREDATORY LENDING IN NEW JERSEY: THE RISING THREAT TO LOW-INCOME HOMEOWNERS (2002) (documenting the rise of predatory lending in New Jersey and correlating it to high incidence of residential foreclosures), available at http://www.njisj.org/reports/predatory_lending.pdf.

6. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY,

however, a variety of definitions, or core features, of predatory lending have emerged. Some focus on the excessive cost of credit extended to borrowers;⁷ others identify certain abusive or extortionate loan terms or practices that collectively make a loan predatory.⁸ Framing the problem through the lens of law and economics, Professors Engel and McCoy define predatory lending with reference to both unreasonable cost and abusive practices.⁹ Definitions are particularly elusive because the

WORKING PAPER, ECONOMIC ISSUES IN PREDATORY LENDING 6 (July 30, 2003) [hereinafter OCC WORKING PAPER] (noting that “disagreements over the definition of predatory lending have often served to confuse the debate over this issue” and that “without a precise definition, many of the published figures on predatory lending abuses become less convincing”), available at <http://www.occ.treas.gov/workingpaper.pdf>; STAFF OF SENATE COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, 106TH CONG., PREDATORY LENDING PRACTICES: STAFF ANALYSIS OF REGULATORS’ RESPONSES (2000) (recommending that no additional regulations of predatory lending should be undertaken because no adequate definition exists to describe the practice), available at <http://www.banking.senate.gov/docs/reports/prelend/prelend.htm>.

7. See ROBERT E. LITAN, THE BROOKINGS INST., A PRUDENT APPROACH TO PREVENTING “PREDATORY” LENDING 1 (2001) (stating that predatory lending “has come generally to refer to mortgages extended under terms that are more onerous to borrowers than if they were more fully informed about the loans themselves and the alternative sources of finance that may be open to them”), available at <http://www.aei-brookings.org/admin/authorpdfs/page.php?id=126>; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP’T OF THE TREASURY, ADVISORY LETTER 2003-3, AVOIDING PREDATORY AND ABUSIVE LENDING PRACTICES IN BROKERED AND PURCHASED LOANS 2 (2003) [hereinafter OCC ADVISORY LETTER 2003-3] (“[A] fundamental characteristic of predatory lending is the provision of credit to borrowers who simply cannot afford the credit on the terms being offered.”), available at http://www.namb.org/government_affairs/front/2003_occ_advisoryltr.pdf.

8. See Press Release, Woodstock Institute, Report Finds Dual Market in Refinance Loans: Subprime Lenders Dominate Lending in Minority Neighborhoods (Nov. 15, 1999) (“Predatory lending practices include but are not limited to fraudulent, high-pressure, or misleading marketing; the ‘packing’ and financing of unnecessary fees; and ‘flipping’ or overly frequent refinancing with fees being repeatedly rolled into the loan.”), available at <http://woodstockinst.org/document/2stepsback.html>; U.S. DEP’T OF HOUS. & URBAN DEV. & U.S. DEP’T OF THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 2-12 (2000) [hereinafter HUD-TREASURY JOINT REPORT] (declining to establish precise definition of predatory lending but identifying set of mortgage lending practices that are unreasonable and should be regulated), available at <http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf>; U.S. GEN. ACCOUNTING OFFICE, REP. NO. GAO-04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 18 (2004) [hereinafter GAO REPORT] (noting that predatory lending has “no universally accepted definition” but attempting to highlight core practices that may constitute predatory lending), available at <http://www.gao.gov/new.items/d04280.pdf>; ZIMMERMAN ET AL., *supra* note 5, at 2 (“Predatory lending refers to a wide array of practices that disproportionately affect low-income, elderly, and minority homeowners and result in unjustified increased payments, inability to refinance loans, and, in too many cases, equity stripping and foreclosure.”).

9. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1260-61 (2002). They suggest that predatory behavior includes loans that: (i) are structured to result in seriously disproportionate net

classification of lending behavior as predatory or fair depends invariably upon context. Any definition, therefore, must be flexible and accommodate context and not only should identify core objective criteria but also should focus on the intent of the lender as well as the impact on the victim.¹⁰ Likewise, any attempt to regulate this vague practice should be mindful of a potentially negative impact—what one banking industry representative has referred to as “unintended consequences”—on the residential mortgage market. Specifically, the lending industry is concerned that regulation may hurt precisely those financially vulnerable populations that the legislation is meant to help by driving up the cost of and drying up access to both legitimate and illegitimate credit.¹¹

In spite of these classification difficulties, reform has recently arrived, and it has arrived quickly. The most aggressive response, however, has not been at the national level, as some might have expected, but in a flurry of

harm to borrowers; (ii) engage in rent seeking; (iii) involve fraud or deceptive practices; (iv) lack transparency; and (v) require borrowers to waive meaningful legal redress. *Id.* at 1260.

10. Engel and McCoy’s five-part criteria certainly fit this flexible framework. The California Mortgage Brokers’ Association recently adopted a definition of predatory lending, more sweeping than other industry organizations had been willing to suggest, which incorporates deceptive intent of the lender, absence of legitimate economic justification, and impact on a victim. *See Don Jergler, Brokers Clarify to Save Consumers: Group Defines Predatory Lending to Control Any False Practices*, LONG BEACH PRESS-TELEGRAM, Aug. 6, 2004, at A16 (reporting adoption of definition of predatory lending by California Mortgage Brokers’ Association as a practice of “intentionally placing consumers in loan products with significantly worse terms and/or higher costs than loans offered to similarly qualified customers in the region for the primary purpose of enriching the originator and with little or no regard for the costs to the consumer”). Relying in part on a definition adopted by a recent New Jersey court decision, I would define predatory lending as a set of loan terms or practices, engaged in by lenders, mortgage brokers, and home improvement contractors, usually through aggressive or deceptive sales tactics, that are so disadvantageous or abusive that the borrower is subjected to an unreasonable risk of default or foreclosure. *See Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 536-37 (N.J. Super. Ct. App. Div. 2001); *see also* Baher Azmy & David Reiss, *Modeling a Response to Predatory Lending: The New Jersey Home Ownership Security Act of 2002*, 35 RUTGERS L.J. 645, 649 n.10 (2004) (adopting same definition). I will attempt to define those practices and loan terms that constitute predatory lending in Part II.B. of this Article.

11. ROBERT E. LITAN, UNINTENDED CONSEQUENCES: THE RISKS OF PREMATURE STATE REGULATION OF PREDATORY LENDING 3 (2003), *available at* <http://www.aba.com/NR/rdonlyres/D881716A-1C75-11D5-AB7B-00508B95258D/28871/PredReport200991.pdf>; *see also* Seidman, *supra* note 1, at 3. The Director of the Office of Thrift Supervision indicated her concern regarding this issue:

I want to emphasize the importance of stepping carefully in this area. Often, in the effort to put a halt to one problem, another may be inadvertently created. For example, in our zeal to declare some practices illegal, we must avoid overreaching and chilling the operations of the legitimate sub-prime market.

Id.

state and local legislative initiatives.¹² In 1999, North Carolina became the first state to pass comprehensive legislation to regulate the terms and conditions of high-interest-rate mortgages.¹³ Since then, twenty-five other states and eleven localities have passed laws intended to address, in some way, the practices associated with predatory lending.¹⁴ The subsequent state responses have been varied, reflecting the relative perceived seriousness of the predatory lending problem in their jurisdictions, the respective demands and strengths of local community groups and banking representatives, and a host of other local conditions and variations among jurisdictions. Some states have tweaked North Carolina's aggressive approach by regulating secondary market actors who frequently finance predatory behavior without fear of liability; others have more modestly built upon the floor set by federal residential mortgage regulations; and others have simply chosen not to regulate residential mortgages at all, perhaps because lending abuses have not been as prevalent in those states or because those states are hesitant to overregulate the sensitive residential mortgage market dynamic.

Although I hope to make the substantive case that an aggressive legislative response to predatory lending is necessary, an important corollary proposition of this Article is, in a sense, procedural. I believe that the regulatory response is currently occurring at the correct locus of public policy decisionmaking in our federal system—the state legislature. Indeed, the current state and local legislative response appears to be an exemplary manifestation of what Justice Brandeis has famously identified as a chief virtue of federalism: allowing states to serve as laboratories for experimentation with public policy.¹⁵

Scholars have long posited that state governments enjoy the advantages of responsiveness, flexibility, and innovativeness and that they can maximize local preferences without consequence to the rest of the nation by tailoring reforms to local conditions.¹⁶ Thus, state predatory lending legislation would appear to be a good empirical test of these hypotheses. Regulatory responses—or “experiments”—to predatory lending are

12. See discussion *infra* Part V.A.

13. See *infra* note 350 and accompanying text.

14. See *infra* Part V.A.

15. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (“It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”).

16. See, e.g., DAVID L. SHAPIRO, *FEDERALISM: A DIALOGUE* 84-95 (1995); Deborah Jones Merritt, *The Guarantee Clause and State Autonomy: Federalism for a Third Century*, 88 COLUM. L. REV. 1, 5-7 (1988); Andrzej Rapaczynski, *From Sovereignty to Process: The Jurisprudence of Federalism After Garcia*, 1985 SUP. CT. REV. 341, 352-53; Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1493-94 (1987) (book review).

particularly appropriate at the state or local level because: (i) the problem is both immature and difficult to define; (ii) its economic and social costs on borrowers are hard to isolate or evaluate; and (iii) the positive or negative effects of any particular regulatory strategy are thereby hard to quantify abstractly or in isolation; rather, they require empirical assessment. As a result, the recent efforts by federal regulators to preempt some aspects of state predatory lending legislation and emerging congressional attempts to more broadly preempt this legislation are at a minimum premature, and they may even be counterproductive.

My Article thus proceeds on eventually intersecting tracks. It depends almost as much on a defense of the experimentation rationale for federalism as it does on an analysis of predatory lending practices. In recent years, scholars have lamented the merely abstract defenses of federalism reflected in recent Supreme Court jurisprudence and have called for efforts to understand how federalism really works and how its purported benefits should be valued.¹⁷ In this Article, I attempt to offer a partial answer to those questions by demonstrating that the federalist legislative response to predatory lending is a concrete example of the value of federalism. At the point of this intersection, I urge federal regulators or legislators,¹⁸ as well as scholars, to observe this valuable example of federalism in action and to forebear on imposing a federal solution in the name of uniformity.

In Part II of this Article, I offer a comprehensive description of the residential subprime lending market from which predatory lending emerges, and I chart its explosive growth. I describe the interrelated forces that have driven the subprime market's growth, including the changing consumer credit demand; the emergence of alternative, under-regulated lending institutions; and that market's reliance on the powerful, new financial tool of mortgage securitization—a process which both provides the subprime market with enormous liquidity and insulates it from the risks associated with predatory behavior. A full understanding of the subprime market is critical because a countervailing goal of any sensible predatory lending reform is to ensure that access by consumers to legitimate subprime credit is not unnecessarily diminished in the fervor of reform.

In Part III, I demonstrate the ways in which the subprime market is not efficient. This analysis suggests, contrary to industry analysis, that

17. See Barry Friedman, *Valuing Federalism*, 82 MINN. L. REV. 317, 324 (1997); Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485, 1490 (1994).

18. The role of courts is not relevant to this argument since I am not addressing interpretation of whether a particular congressional enactment was intended, explicitly or implicitly, to preempt state law. The question I am interested in is whether or to what extent policy makers should exercise their discretion to avoid intentionally preempting state efforts.

carefully tailored legislative restrictions on some aspects of the market will not diminish the availability, cost, or profitability of subprime lending. I describe how these inefficiencies allowed predatory lending to emerge from the subprime sector and detail some practices and loan terms that, depending on context, can fairly be classified as abusive. In Part IV, I describe the failure of pre-existing consumer protection laws, regulatory efforts, or the market itself to respond to this new complex problem. In Part V, I describe the remarkable, perhaps unprecedented, emergence of state reforms in twenty-six jurisdictions as an interactive and innovative process and offer a rough taxonomy of the state experimentation. These state laws isolate a core set of abusive lending practices and terms, offering an encyclopedia of predatory lending and suggest that the variations among them require observation and assessment. As a result of this experimentation and early empirical studies of state efforts, I argue that emerging attempts by regulators and federal legislators to preempt state laws in the name of uniformity are premature and potentially misguided.

Finally, in Part VI, I place this process within the broader debate on the value of federalism generally and the state experimentation rationale for preserving state autonomy in particular. I deconstruct arguments supporting the virtues of state experimentation to test whether the state responses to predatory lending validates them. I conclude that states should enjoy independence, free from federal preemption, to experiment with solutions to predatory lending and certain other economic or social problems in order to advance what I believe is a preeminent value of federalism—producing good public policy.

II. THE HOME EQUITY GOLD RUSH

Predatory lending is a recent phenomenon that has emerged from a contemporaneous explosion of subprime home mortgage lending. The remarkable increase in the availability of subprime credit should generally be regarded as a positive development, to the extent that it has allowed a broader segment of the population, including low-income and minority borrowers, access to financing to purchase a home or collateralize its value for extra, necessary cash.¹⁹ Although subprime loans are by no means

19. Fishbein & Bunce, *supra* note 2, at 274.

The growth in subprime lending over the past several years has benefited credit-impaired borrowers, including those who may have blemishes on their credit record, an insufficient credit history, or nontraditional credit sources. Subprime lenders have allowed these borrowers to access credit they could not otherwise obtain in the prime credit market.

Id.

predominantly or even typically predatory,²⁰ virtually all predatory loans are subprime. The difficulty in devising a regulatory response to predatory lending lies in balancing the impulse to protect vulnerable borrowers from its devastating effects against the potential of disabling the complex and dynamic subprime market, which can help those same borrowers in need of legitimate credit.²¹

A. *The Explosion of the Subprime Lending Market*

1. Subprime Loans

A subprime loan provides funds to a borrower whose credit risk is assessed to be too high to merit a conventional loan carrying lower costs—a prime loan.²² When extending credit, subprime lenders generally assess a prospective borrower's ability to repay the loan, a process called "underwriting," although, unlike lenders in the prime market, subprime lenders subscribe to no uniform underwriting standards.²³ Rather, a

20. See *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing Before the Senate Special Comm. on Aging*, 105th Cong. 2 (1998) [hereinafter *Equity Predators Hearing*] (opening statement of Senator Charles Grassley, Chairman, Senate Special Committee on Aging) ("Most subprime lending institutions operate in an appropriate, ethical, moral, compassionate and legal manner. They provide a vital service to those borrowers who may be unable to take advantage of traditional lending institutions because of such things as poor credit and insufficient income."); see also SMR RESEARCH CORP., *THE SUBPRIME LENDING INDUSTRY AND ALLEGATIONS OF PREDATORY PRACTICES* 3 (2000) (distinguishing the vast majority of subprime lending from predatory lending practices).

21. See Seidman, *supra* note 1, at 3 (warning that anti-predatory lending legislation must not chill "the operations of the legitimate sub-prime market. The flow of responsibly delivered credit to underserved markets is critical to their survival and any legislative or enforcement solutions . . . must proceed with this caution in mind"). The subprime lending industry has repeatedly expressed concern about possible "unintended consequences" of good faith legislative efforts—taking away credit and thereby hurting the low-income and minority borrowers who predatory lending regulations are meant to help. See ROBERT E. LITAN, *A PRUDENT APPROACH TO PREVENTING "PREDATORY" LENDING* 11 (2001); Donald C. Lampe, *Wrong from the Start? North Carolina's "Predatory Lending" Law and the Practice vs. Product Debate*, 7 *CHAP. L. REV.* 135, 143-46 (2004).

22. See JOHN C. WEICHER, *THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT* 29 (1997). Banking regulators generally designate a subprime borrower as having one or more of the following: two or more thirty-day delinquencies in the last twelve months; judgment, foreclosure, repossession, or charge off in the past twenty-four months; bankruptcy in the last five years; and a high default probability measured by a "FICO" credit score of below 660 out of a possible 950. See OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., *EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS* 2-3 (2001). A conventional loan is one that is not guaranteed by a government agency, such as the Federal Housing Administration (FHA) or Veteran's Administration (VA). THE *HANDBOOK OF MORTGAGE—BACKED SECURITIES* 3 (Frank J. Fabozzi eds., 5th ed. 2001).

23. See *infra* note 126. This lack of uniformity, however, and lack of competitive pricing in

subprime lender employs its own underwriting matrix that designates a borrower as subprime after evaluating a credit score based on the Fair Isaacs & Company (FICO) scoring system, income and asset level as compared to level of debt, and anticipated stability of the borrower's employment.²⁴ The lender assigns the borrower a letter grade of A-, B, C, or D, representing correspondingly increased risk; the lender then charges more for loans it considers riskier.²⁵

Legitimate subprime loans carry interest rates or origination charges higher than conventional prime loans in order to compensate for generally greater risks and loan servicing costs.²⁶ Specifically, lenders demand higher interest rates to compensate them for the increased servicing costs they believe are associated with subprime borrowers' higher risk of delinquency, default, and, ultimately, foreclosure.²⁷ In addition, subprime

the subprime market contribute significantly to borrowers' vulnerability to abuse. See GAO REPORT, *supra* note 8, at 21; *infra* Part III.A.1.

24. WEICHER, *supra* note 22, at 34-35; see also James D. August et al., *Survey of Finance Companies*, 1996, 83 FED. RES. BULL. 543, 549 (1997) ("Subprime loans include those with more lenient underwriting standards (such as high loan-to-value ratios), those made to borrowers with blemished credit histories, and those with both characteristics.").

25. HUD-TREASURY JOINT REPORT, *supra* note 8, at 33-34. Borrowers will usually qualify for A credit if they achieve a FICO score of 650 or greater out of 850. *Id.* at 33. According to the National Home Equity Mortgage Association, the majority of subprime borrowers—sixty percent—who may have minor payment delinquencies are assigned an A- underwriting grade. *Id.* at 34. Thirty percent are classified as B credit, nine percent as C credit, and only one percent as D credit. *Id.* A more recent analysis published in *Inside B&C Lending* states that A- loans represent 78% of all subprime loans, B loans represent 7.5%, C loans represent 5.4%, and D loans represent 8.8%. *Brokers Continue Domination of Subprime Market at Midway Mark*, INSIDE B&C LENDING, Sept. 15, 2003, at 1, 2.

26. Office of Thrift Supervision, U.S. Dep't of the Treasury, *What About Subprime Mortgages?*, MORTGAGE MARKET TRENDS, June 2000, at 1, 8 ("While subprime mortgages may have higher default probabilities, they also have higher interest rates, which should compensate for their higher credit risk and administrative costs."); HUD-TREASURY JOINT REPORT, *supra* note 8, at 27-28; OCC WORKING PAPER, *supra* note 6, at 10 ("In order to offset the greater risk, as well as the higher servicing and other costs associated with subprime lending, providers charge higher interest rates. In fact, according to traditional investment theory, subprime lending should provide higher expected returns than prime lending specifically due to the higher risk.").

27. WEICHER, *supra* note 22, at 67, 69 (describing higher origination costs and higher servicing costs associated with increased rates of delinquency and foreclosure). Delinquency and foreclosure rates do appear to be empirically higher for subprime loans. According to the HUD-TREASURY JOINT REPORT, between January 1998 and September 1999, subprime delinquency and foreclosure rates averaged 13.5% and 2.6%, respectively, compared to prime delinquency and foreclosure rates which averaged 2.8% and 0.24%, respectively. HUD-TREASURY JOINT REPORT, *supra* note 8, at 34-35. Serious delinquency rates (loans that are ninety days past due or in foreclosure) for subprime mortgages in the aggregate were 10.44% for subprime borrowers in 2002 as compared to a 0.55% comparable rate for prime borrowers. OCC WORKING PAPER, *supra* note 6, at 9. Delinquency and foreclosure rates are much closer, however, when high-rated, A- subprime borrowers are compared to A rated prime borrowers. HUD-TREASURY JOINT REPORT, *supra* note

lenders believe they are entitled to origination charges—costs assessed as points on the balance of the loan, up-front fees, a higher interest rate, or all three—for higher origination costs associated with subprime loans. These higher origination costs result from more intensive reviews of credit histories, higher loan rejection rates, and greater fixed costs such as appraisals and marketing.²⁸

In the absence of comprehensive data on the subject, Professor Cathy Lesser Mansfield's study of interest rates of the larger subprime lenders revealed that the median interest rate for a cross-section of subprime refinance loans examined between 1995 and 1999 fell between 2.20 and 4.06 percentage points higher than conventional prime mortgage rates.²⁹ A study of other subprime lending rates conducted in August 2003 demonstrates a spread of almost two percent in interest rates of the weighted average of all subprime loans over prime loans.³⁰ Other estimates suggest an even bigger spread.³¹ It does not appear that recent studies also have attempted to trace the spread in points and fees paid by subprime borrowers as compared with those paid by prime borrowers, though there is consensus that the difference is significant. One frequently cited study estimates that 2.5 times as many subprime borrowers as prime borrowers report paying two or more points on their loans.³² Consumer advocates

8, at 35. As discussed in detail below, it remains important but difficult to isolate whether subprime loans accurately reflect an inherent market risk of default associated with their borrowers or whether overly-costly subprime rates are what push borrowers unnecessarily over the brink of default or foreclosure. *See infra* Part III.A.

28. HUD-TREASURY JOINT REPORT, *supra* note 8, at 28. Moreover, because subprime loans tend to be issued in smaller amounts (averaging \$58,000 to \$85,000 for subprime versus \$133,000 for prime), origination costs represent a greater proportion of overall subprime loan values. *Id.*

29. Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C.L. REV. 473, 536-37 (2000); *see also* WEICHER, *supra* note 22, at 16 (reporting that subprime loans are on average three percentage points higher than prime loans, but that large variations, between two to six percent, exist among grades of subprime loans).

30. CTR. FOR RESPONSIBLE LENDING, COMMENTS ON OCC WORKING PAPER 14, (Oct. 6, 2003) [hereinafter CRL COMMENTS ON OCC WORKING PAPER]. According to this study, the spread between the prime rate and A- rates was 1.71%; between the prime rate and B rates was 2.28%; and between the prime rate and C rates was 3.17%. *Id.*

31. *See id.* at 14 n.43 (citing unpublished analysis of Mortgage Information Company data which estimates the spread to be 420 basis points, or 4.2 percentage points); John Hechinger, *Home Bound: Nasty Surprise Haunts Some Folks' Mortgage: A Prepayment Penalty*, WALL ST. J., Aug. 1, 2001, at A1 (stating that subprime loans carry on average interest rates that are three to six percentage points higher than prime rates).

32. Howard Lax et al., *Subprime Lending, an Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 540 fig. 3 (2004). These figures do not account for fees associated with prepayment of loans. Because prepayment fees or penalties are assessed on refinance loans by subprime borrowers much more frequently than on prime borrowers, estimates of the extent of points and fees in the subprime market are necessarily conservative. *See infra* Part III.C.1.

have claimed that points and fees in some subprime loans “routinely” reach between five and ten percent.³³

2. The Explosion

The size of the subprime lending market has been hard to track with precision, in large part because the Home Mortgage Disclosure Act (HMDA)³⁴ does not require lenders to designate their loans as subprime or otherwise list loan criteria, such as interest rate or points and fees, that would identify a loan as subprime.³⁵ Nevertheless, all estimates document a stunning expansion of the subprime lending market both in absolute dollar values and as a percentage of the overall home lending market. In 1983, subprime lending represented only 1.4% of the national mortgage market, a rate that remained steady through the 1980s and into the early 1990s.³⁶ By 1994, subprime lending amounted to \$35 billion and represented less than 5% of all mortgage originations.³⁷ The rate of subprime growth increased steeply thereafter: from 1995 to 1996 alone, subprime lending grew approximately 50%, from \$65 billion to \$96 billion, approaching 10% of the overall mortgage market.³⁸ By 1999, subprime loans had increased to \$160 billion, representing a 13% share of the mortgage origination market.³⁹ The growth of the subprime market has not since abated. Subprime lending grew to an estimated value of \$173 billion in 2001 and in 2002 to over \$200 billion.⁴⁰ The market grew almost another 50% in 2003 alone, to \$330 billion, and it shows strong signs of continued expansion for the near future.⁴¹

33. SEPARATE AND UNEQUAL, *supra* note 5, at 47.

34. Home Mortgage Disclosure Act of 1975 (HMDA), 12 U.S.C. §§ 2801-10 (2000).

35. See Harold L. Bunce et al., *Subprime Foreclosures: The Smoking Gun of Predatory Lending?*, in U.S. DEP'T OF HOUS. & URBAN DEV., *supra* note 2, at 257, 260, available at <http://www.huduser.org/publications/pdf/brd/12bunce.pdf>; PREYING ON NEIGHBORHOODS, *supra* note 5, at 10 (determining the subprime market is not straightforward). HUD has used a combination of industry trade publications and HMDA data to identify lenders who predominantly originate subprime loans, and most estimates of the increase in subprime lending reflect assessment of expansion of subprime lenders themselves. Bunce et al., *supra*, at 260.

36. Mansfield, *supra* note 29, at 527.

37. Bunce et al., *supra* note 35, at 257.

38. WEICHER, *supra* note 22, at 37. In 1997, the subprime market continued to grow at an annual rate of approximately twenty-five percent. *Id.* According to an estimate, between 1995 and 1997 subprime lenders “more than tripled their market share” of the mortgage origination market. PREYING ON NEIGHBORHOODS, *supra* note 5, at 6.

39. Bunce et al., *supra* note 35, at 257.

40. LITAN, *supra* note 11, at 4.

41. *Subprime Lenders Shatter Records in '03 and Get Set for More in '04*, INSIDE B&C LENDING, Feb. 9, 2004, at 1; *Subprime MBS Rings in the New Year on the Heels of a Record '03*, INSIDE B&C LENDING, Jan. 12, 2004, at 1.

B. *Financing the Gold Rush: Securitization and Transformation of Consumer Credit*

A dynamic involving many interrelated demand and supply factors has driven the subprime lending explosion. These factors include an increase in residential property values which has offered a bountiful source of equity to be collateralized for cash; changes in the tax code that incentivize consolidation of consumer debt into home equity; the rapid emergence of new mortgage service providers; and the mammoth growth of the process of securitizing mortgage products, which has supplied billions of dollars to subprime mortgage lenders. The availability of large sources of subprime credit is generally desirable; however, this gold rush for subprime home equity presents commensurate opportunities for abuse. For example, the transformation of consumer credit has frequently left financially unsophisticated borrowers confused about the consequences of their borrowing; the predominant suppliers of subprime credit have been largely underregulated; and, the securitization process, to a large extent, has insulated mortgage service providers and secondary mortgage note holders from liability for abusive lending practices.

1. The Transformation of Demand for Consumer Credit

Despite its higher costs, subprime lending is often praised on the grounds that it provides access to credit for borrowers who otherwise would not be able to access it because of a credit blemish.⁴² It is also said that subprime lending provides an opportunity for previously excluded borrowers to improve their credit rating and eventually refinance—or “graduate”—to a prime loan.⁴³ As a consequence, some argue that subprime lending also has led to a growth in home ownership among low-income and minority groups.⁴⁴ While the rate of minority and low-income

42. See *Predatory Lending Practices: Hearing Before the House Comm. on Banking and Fin. Servs.*, 106th Cong. app. at 379 (2000) [hereinafter *Predatory Lending Practices Hearing*] (prepared statement of Professor Cathy Lesser Mansfield) (reading into record text of letter inviting her to testify, which read, “[a]n essential element of the continued growth of the U.S. economy is the democratization of credit of which subprime lending is an important part. Subprime lenders provide credit to borrowers who do not qualify for a prime rate due to poor credit history or low incomes”); HUD-TREASURY JOINT REPORT, *supra* note 8, at 27.

43. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 95, 105, 106 (recommending proposals that would permit subprime borrowers to move into low cost conventional loans or “graduate” over time).

44. Federal Reserve Governor Edward M. Gramlich, Remarks at the Community and Consumer Affairs Department Conference on Predatory Lending (Dec. 6, 2000) (transcript available at <http://www.federalreserve.gov/boarddocs/speeches/2000/20001206.htm>) (stating that access to subprime lending “gives people from all walks of life a shot at the American dream—owning a home and getting capital gains”).

home ownership has increased in the past decade, it is far from clear that such increase is significantly attributable to the growth of subprime lending.⁴⁵ In fact, the vast majority of subprime loans are not used to purchase homes but are in the form of home equity loans collateralized by first liens on already-owned homes. According to data from the mortgage industry, eighty-two percent of subprime borrowers used their loans for refinancing an existing loan rather than to purchase a house.⁴⁶ Studies conducted by the Department of Housing and Urban Development (HUD) and studies involving communities in Chicago and New Jersey confirm the vast predominance of non-purchase lending in the subprime market and the remarkable growth of non-purchase subprime lending as compared to non-purchase prime lending;⁴⁷ this conclusion is confirmed by studies of communities in Chicago and New Jersey.⁴⁸ Of the subprime refinance

45. In his remarks praising the growth of minority home ownership, Federal Reserve Governor Gramlich cites only to statistics demonstrating an increase in conventional—not subprime—home-purchase lending of seventy-five percent for low-income borrowers and ninety-five percent for African American borrowers in the period from 1993 to 1999. *Id.* Professor Mansfield further explained that

discussions and comments about subprime mortgage lending start with the assumption that the credit product being discussed is one of two kinds: the subprime purchase money loan—in other words a loan used by the borrower to become a homeowner; or the second mortgage used primarily for needed home repairs. These are most certainly the credit products needed by lower-income borrowers. Unfortunately, neither of these products is the primary product being offered by subprime mortgage lenders.

Predatory Lending Practices Hearing, supra note 42, app. at 379 (prepared statement of Professor Cathy Lesser Mansfield).

46. HUD-TREASURY JOINT REPORT, *supra* note 8, at 31 (citing estimates from the Mortgage Information Corporation). This data would therefore suggest that only eighteen percent of subprime mortgages are used to purchase a home.

47. HUD analysis demonstrates that nonpurchase (home equity) loans steadily represented 80% of all the subprime lending in the country and, overall, increased more than 880% between the years 1993 and 1998. DEP'T OF HOUS. & URBAN DEV., UNEQUAL BURDEN: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING IN AMERICA (2000) [hereinafter UNEQUAL BURDEN]. Specifically, the total number of subprime loans increased from 104,000 loans in 1993 to 997,000 in 1998. *Id.* The number of subprime home equity loans increased from 80,000 in 1993 to 790,000 in 1998, indicating that subprime home equity loans consistently represented a proportion of approximately 80% of all subprime loans in each of those years. *Id.*

48. A study of the subprime lending market in the Chicago area records a 1524% increase in subprime home equity (or nonpurchase) lending (rising from 3137 loans in 1991 to 50,953 in 1997) compared to a 14.6% increase in non-subprime home equity loan origination. PREYING ON NEIGHBORHOODS, *supra* note 5, at 4, 17; see also IMMERGLUCK & WILES, *supra* note 5, at 5 (estimating that, between 1993 and 1998, the number of subprime nonpurchase loans in Chicago metropolitan area increased by 890%). In New Jersey, between 1993 and 2000, subprime lenders' market share of loans increased from 0.5% to 5.5% (totaling 5958 loans in 2000) for home

loans, fifty-nine percent were “cash out” home equity loans, where the borrower obtained funds to consolidate unsecured debt (usually credit card balances), to finance home improvements, or to make purchases unrelated to the property.⁴⁹ Indeed, subprime lenders often aggressively market home equity loans as debt consolidation products⁵⁰ or “upsell” a borrower into progressively larger and unnecessary loan products.⁵¹

Non-purchase loans can be a useful way for homeowners to leverage otherwise illiquid home equity for cash.⁵² The passage of the 1986 Tax Reform Act, which eliminated the federal income tax deduction of consumer interest for all purposes except home mortgages, made mortgage debt more attractive to consumers to fund expenditures previously funded

purchases, 25.3% to 41.8% (totaling 4899 loans in 2000) for home improvement loans, and from 1.14% to 26.6% (totaling 14,546 loans in 2000) for refinance loans. ZIMMERMAN ET AL., *supra* note 5, at 6. In New Jersey, thus, home-purchase loans represent only 23% of the overall subprime market. *See id.*

49. HUD-TREASURY JOINT REPORT, *supra* note 8, at 31 (citing estimates from Mortgage Information Corporation).

50. Glenn B. Canner et al., *Recent Developments in Home Equity Lending*, 84 FED. RES. BULL. 241, 249 (1998) (“Subprime home equity loans are commonly marketed as bill-consolidation loans, particularly as a means to pay off credit card debt.”). Subprime lenders have seized upon higher incidence of consumer debt, access to credit cards, and decreased personal savings of many borrowers, rather than upon an interest in home ownership. *Id.*; *see also infra* Part III.B.2.6 (describing predatory practice of “asset-based lending” or lending based on an individual’s equity in a home without regard to the borrower’s ability to make repayments).

51. *Predatory Mortgage Lending: The Problem, Impact, and Responses: Hearing Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. 57 (2001) [hereinafter *Predatory Mortgage Lending Hearing*] (prepared statement of Thomas J. Miller, Attorney General, State of Iowa). Miller noted:

Consumers who buy household goods with a relatively small installment sales contract are moved up the “food chain” to a mortgage loan by the lender to whom the retailer assigned the contract; door-to-door contractors come by unsolicited with offers to arrange manageable financing for home improvements; telemarketers offer to “lower monthly payments” and direct mail solicitations make false representations about savings on consolidation loans. Another aspect . . . is “upselling.” (“Upselling” a loan is to loan more money than the borrower needs, wants, or asked for.)

Id.; *see also* CAL. REINVESTMENT COMM., *supra* note 5, at 22 (reporting survey of subprime borrowers in which 37.9% responded that the idea to take out a loan secured by their home came from a solicitation by the lender or broker); STOCK, *supra* note 5, at 24 (reporting data from study of subprime borrowers in foreclosures proceedings in Dayton, Ohio, in which 42% of respondents were encouraged to borrow more money than they intended).

52. Canner et al., *supra* note 50, at 241; *see also* 147 CONG. REC. S15470 (2003) (statement of Sen. Sarbanes) (“Homeownership has been the path to building wealth for generations of Americans, wealth that can be tapped to send children to college, pay for a secure retirement, or simply work as a reserve against unexpected emergencies.”).

by credit cards or personal loans.⁵³ In the years immediately following the Tax Reform Act, prime home equity loans were financed as second mortgages; in recent years, however, seventy-five percent of all home equity lending has taken the form of a first-lien mortgage.⁵⁴ The demand side of the mortgage market has thus been significantly transformed: the vast bulk of subprime loans are used as if they were consumer loans but are secured by primary residences. Lenders hold an interest not just in consumer debt, but also in a secured interest in a home, with far graver consequences for a borrower should the borrower default. This transformation has been of major significance for the poor and minority constituencies who disproportionately access subprime lending.⁵⁵

The consequences associated with this transformation are exacerbated when one acknowledges that a significant premise supporting arguments for a vibrant unregulated subprime market—that higher cost loans are accurately calibrated to higher credit risk—is not entirely sound.⁵⁶ Indeed, as described below, a substantial proportion of these home equity loans are predatory; that is, they are more costly than is justified by the borrower's financial situations, they impose abusive terms that impede the borrower's ability to fulfill repayment obligations, or they are otherwise unnecessary to fulfill a borrower's credit needs.⁵⁷ Thus, the optimistic picture suggested by the subprime market's contribution to greater home ownership or by allowing poor credit risks to graduate to prime loans is incomplete: a significant portion of subprime lending either is unrelated to securing financing for home purchases or, much worse, strips equity from homeowners and contributes significantly to avoidable foreclosures.⁵⁸

2. Securitization and Mortgage Lending Supply

A subprime loan typically does not involve a borrower's trip to the local bank. The subprime market exists in a metaphorical pipeline, through one end of which borrowers receive money arranged by mortgage brokers or home improvement contractors and lent by finance companies, mortgage bankers, or insured depository institutions.⁵⁹ Those lenders are supplied by commercial and investment banks who, in turn, pool and securitize many similar mortgage loans and sell them to private or

53. Canner et al., *supra* note 50, at 242 (discussing Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.)).

54. HUD-TREASURY JOINT REPORT, *supra* note 8, at 30-31; Mansfield, *supra* note 29, at 522-23.

55. *See infra* Part III.A.3.

56. *See infra* Part II.A.1.

57. *See infra* Part III.B.

58. *See infra* Part III.D.

59. HUD-TREASURY JOINT REPORT, *supra* note 8, at 37-40.

institutional investors such as mutual and pension funds.⁶⁰ These investors supply billions of dollars of mortgage financing for subprime borrowers. Any solution that attempts to limit the abuses of the subprime market and predatory lending should attempt to comprehend and account for this complex process.

a. Brokers, Contractors, and Finance Companies

Prior to the 1990s, mortgages were almost exclusively originated and financed by heavily regulated, traditional bank-and-thrift depository institutions.⁶¹ Indeed, the increased federal regulation of thrift institutions after the savings and loan crisis in the late 1980s caused most banks and thrifts to cease holding risky subprime loans in their portfolios.⁶² By 1990, this change created a significant market opportunity for nondepository institutions to finance subprime loans.⁶³ Since 1990, mortgages, including the majority of subprime mortgages, increasingly have been arranged by mortgage brokers and funded by nondepository institutions such as mortgage bankers and finance companies, particularly for home equity lending.⁶⁴ In 2001, HUD estimated that there were 178 institutions that *primarily* engaged in subprime loan originations. Of that group, fifty-nine percent were independent mortgage companies (mortgage bankers and finance companies), twenty percent were nonbank subsidiaries of bank holding companies, only ten percent were federally regulated banks and thrifts, and the remaining ten percent were “other types of financial institutions.”⁶⁵ Today, those new financial institutions, as well as mortgage

60. *Id.* at 37.

61. Federal thrift (savings and loan) institutions and their subsidiaries are regulated by the Office of Thrift Supervision. GAO REPORT, *supra* note 8, at 30 n.1. Federal banks and their subsidiaries are regulated by the Office of the Comptroller of the Currency. *Id.* National Credit Unions are regulated by the National Credit Union Association. *Id.*

62. WEICHER, *supra* note 22, at 42-43.

63. *Id.* at 43-44.

64. Mansfield, *supra* note 29, at 526 (documenting rapid growth of nondepository lenders in the 1990s and stating finance companies “are now the most active group of subprime, nonpurchase money lenders”).

65. See GAO REPORT, *supra* note 8, at 22. HUD used data available as of November 2003 as the basis for these statistics. *Id.* at 22 n.4. Another analysis suggests that twenty of the top twenty-five subprime lenders are nondepository institutions such as finance companies that are not regulated by federal agencies. DEBBIE GOLDSTEIN & STACY STROHAUER SON, WHY PREPAYMENT PENALTIES ARE ABUSIVE IN SUBPRIME HOME LOANS 2 (Ctr. for Responsible Lending, Policy Paper No. 4, 2003), available at http://www.responsiblelending.org/pdfs/PPP_Policy_Paper2.pdf. The implications from this estimated dispersal, which suggest a very limited role of banks and thrifts in subprime and predatory lending, have been controversial. The OCC, in announcing that it will preempt state regulations of subprime lending by national banks and their state-chartered subsidiaries, has claimed that, as only ten percent of the total subprime market, banks and thrifts have an insignificant role in predatory or abusive lending practices and that, therefore, such state

brokers and unscrupulous home improvement contractors who often act as their intermediaries to borrowers, are far less regulated than banks and thrifts.⁶⁶ Accordingly, they are frequently the source of abuses in the subprime industry.

In particular, the rapid growth of subprime lending has heavily relied on mortgage brokers, who now account for approximately half of all subprime loan originations.⁶⁷ A mortgage broker's role is to arrange financing for borrowers with loan providers such as finance companies and mortgage bankers, as well as with banks, thrifts, and credit unions.⁶⁸ Mortgage brokers rarely provide their own funds for loans.⁶⁹ Instead, brokers will either close the loan in the name of the lender, use "table funding" provided by a prearranged buyer of the loan, or access a line of credit from a nondepository institution.⁷⁰ Brokers typically make money by charging the borrower for services provided in the form of direct fees or percentage points off the total loan amount.⁷¹ In addition, brokers often

regulations are unnecessary. *See infra* Part V.C.1.b. The OTS has similarly preempted the application of state predatory lending laws to national thrifts and their state-chartered subsidiaries. *See infra* Part V.C.1.a. Critics of this analysis suggest that banks and thrifts and their subsidiaries are significantly engaged in subprime lending. *See, e.g.*, CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 7-10. Specifically, a leading participant in the debate over subprime lending, The Center for Responsible Lending, contends first, that these HUD statistics only account for institutions that primarily engage in subprime lending and that numerous banks and thrifts nonetheless are still heavily engaged in the practice, *id.* at 7-8 & n.19, and, second, that OCC does little to regulate the twenty percent of nonbank subsidiaries of banks and thrifts, which are admittedly primarily engaged in subprime lending, *id.* at 10. In any event, there is little current regulatory oversight over the majority of finance companies, mortgage bankers, and brokers who originate subprime loans. *See infra* note 66 and accompanying text.

66. GAO REPORT, *supra* note 8, at 48 (noting that nondepository lending institutions do not face the regular inspection and reporting requirements imposed by federal regulators on banks, thrifts, or credit unions); IMMERGLUCK & WILES, *supra* note 5, at 40 (commenting that the "shift of mortgage lending from depository institutions to mortgage companies has drastically reduced the proportion of home lending being examined by bank and thrift regulators").

67. *Predatory Mortgage Lending Hearing*, *supra* note 51, at 255 (statement of Neill A. Fendly, CMC, Immediate Past President of National Association of Mortgage Brokers).

68. HUD-TREASURY JOINT REPORT, *supra* note 8, at 39.

69. *Id.* at 39 n.42.

70. Eggert, *supra* note 1, at 538.

71. HUD-TREASURY JOINT REPORT, *supra* note 8, at 40. The mortgage broker industry claims the work brokers do is substantial, value added, and highly rewarding. *Predatory Mortgage Lending Hearing*, *supra* note 51, at 255 (statement of Neill A. Fendly, CMC, Immediate Past President of National Association of Mortgage Brokers). Fendly stated:

Mortgage brokers often do an amazing amount of work on [subprime] loans. . . . They work with borrowers to help them understand their credit problems, work out problems with other creditors, clean up their credit reports when possible, and review many possible options for either purchasing a home or utilizing [their] existing home equity as a tool to improve their financial situation.

negotiate with the lenders to obtain a “yield spread premium” on the loan, representing the marginal difference between the lower loan value the lender offered to the broker for the loan and the actual rate the broker entered into with the borrower.⁷² Mortgage brokers contend that the availability of yield spread premiums gives them the flexibility and personal financial incentive to offer borrowers advantageous “no cost” or “low cost” loans—loans with no or low fees or points assessed at closing.⁷³ A perverse incentive provided by yield spread premiums, however, is to steer a borrower to a higher-priced loan not correlated to the borrower’s real credit risk. The empirical reality of such spreads in the subprime market is that brokers do not discount their up-front fees, let alone adequately inform borrowers about them.⁷⁴

Indeed, as described more fully below, brokers frequently engage in aggressive and misleading techniques to solicit and induce vulnerable borrowers to enter into unnecessary and unfavorable loans, engage in outright fraud and manipulation in loan processing, and generally contribute significantly to the predatory lending problem.⁷⁵ Brokers are unregulated at the federal level, and states have only recently begun to require of brokers licensure and compliance procedures.⁷⁶ Another prominent facilitator of lending for subprime borrowers is a home improvement contractor, who can arrange financing for a borrower either independently or through a cooperating lender.⁷⁷

Id. (statement of Neill A. Fendly, CMC, Immediate Past President of National Association of Mortgage Brokers). Brokers do all of these things “primarily because they enjoy helping people.” *Id.* at 340 (prepared statement of Neill A. Fendly, CMC, Immediate Past President of National Association of Mortgage Brokers).

72. HUD-TREASURY JOINT REPORT, *supra* note 8, at 40.

73. *Predatory Mortgage Lending Hearing*, *supra* note 51, at 341 (prepared statement of Neill A. Fendly, CMC, Immediate Past President of National Association of Mortgage Brokers) (responding to criticism over yield spread premiums, by contending that they allow borrowers to receive tangible benefits in the form of low upfront costs).

74. In a comprehensive study of yield spread premiums, which looked at the variation in pricing between loans in which yield spread premiums were present and those in which they were not, the authors concluded that “[t]his price dispersion strongly suggests that yield spread premiums are not simply another form of mortgage broker compensation, but rather that the payments constitute a deceptive device that the mortgage broker industry employs to extract unnecessary and excessive payments from unsuspecting borrowers.” HOWELL E. JACKSON & JEREMY BERRY, KICKBACKS OR COMPENSATION: THE CASE OF YIELD SPREAD PREMIUMS 9 (2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf.

75. See *infra* Part III.B.1.

76. Eggert, *supra* note 1, at 554 (describing generally the underregulation of mortgage brokers). In addition, because so many brokers are heavily undercapitalized, they are judgment proof even if they violate the law and their abuses are caught. *Id.* at 612-13.

77. See *infra* Part III.B.2.c.

b. The Force of Securitization

A critical part of the dynamic process fueling the growth of subprime lending has been the enormous sums of financing created by securitizing mortgages. Put simply, securitization involves pooling many residential mortgages and issuing a security to be sold to investors (with an interest rate corresponding to a class of risk associated with a particular pool) backed by the collateral in the loans.⁷⁸ The government-sponsored entities (GSEs) of Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) spearheaded the securitization process in the 1970s by purchasing thousands of high-quality loans “conforming” to set criteria, packaging them in pools, and selling interests in the pools as securities in the secondary market with a federal government-backed guarantee of financial security.⁷⁹ Soon after, the private sector began securitizing mortgages, aided by investor confidence in credit ratings issued by private agencies for mortgage-backed securities.⁸⁰ Purchasers of these Wall Street-issued securities—including institutional investors—have come to dominate the residential mortgage industry, funneling enormous sums of money to finance the growth of prime and subprime loans and to support the enormous increase in new mortgage service providers.⁸¹ As Professors Engel and McCoy observe, the securitization of private loans has “single-handedly transformed the financial-services market.”⁸²

Securitization is a multi-step process. A lender—finance company, mortgage banker, or depository institution that originates a loan or is assigned a loan by a mortgage broker—assigns the loan to a “special purpose vehicle” (SPV), typically assuming the form of a trust, which holds a pool of mortgages of various risk classes.⁸³ The transfer is meant

78. MITCHEL H. KIDER & DON J. HALPERN, *SECONDARY MORTGAGE MARKET GUIDE* § 4.02 (2d ed. 2004); see also Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 *TEX. L. REV.* 1369, 1373-82 (surveying a variety of types of asset securitizations).

79. Shenker & Colletta, *supra* note 78, at 1383-88 (describing government efforts to securitize loans and create a secondary market in order to finance growing home-purchase market).

80. *Id.* at 1388-93.

81. Engel & McCoy, *supra* note 9, at 1273-74. In 1999 “[t]he top eight Wall Street underwriters of subprime securities accounted for three-fourths of all subprime issues.” HUD-TREASURY JOINT REPORT, *supra* note 8, at 43. In 1999, leading Wall Street firms resold \$60 billion of subprime mortgages. James H. Carr & Jerry Schuetz, *Financial Services in Distressed Communities: Framing the Issue, Finding Solutions*, in FANNIE MAE FOUNDATIONS, *FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: ISSUES AND ANSWERS* 14 (2001).

82. *Id.* at 1273.

83. Eggert, *supra* note 1, at 539.

to separate risks associated with the originator from the asset.⁸⁴ The SPV then packages and issues the mortgage-backed securities.⁸⁵ The securities are sold to an underwriter, typically a Wall Street investment bank, which underwrites the pooled loans, obtains a loan rating from a credit rating agency, sets the price of the securities, and sells them to investors.⁸⁶ The task of managing the loans that make up the pool—collecting loan payments and distributing income to investors—is typically assigned by the SPV to third parties, known as servicers.⁸⁷

A necessary component of this process is participation of credit-rating agencies—most prominently Standard and Poor's (S&P) and Moody's Investors Service, Inc. (Moody's)—who evaluate the credit risk of mortgage-backed securities based on an evaluation of prospective cash flow, loss probability, and loss security and who assign a credit rating to the securities.⁸⁸ Investors and issuers rely heavily on credit ratings to set the prices of securities and determine minimum acceptable returns on investment.⁸⁹ Indeed, credit rating agencies have driven much of the debate over recent state predatory lending regulatory efforts, expressing concern that extending liability to secondary market mortgage noteholders would render the securities too risky to be rated.⁹⁰ For example, after the Georgia Legislature passed an aggressive anti-predatory lending ordinance in 2002, which credit rating agencies perceived would impose uncertain extreme and overly-based liability on secondary-market financing of residential mortgages, rating agencies refused to assign a risk rating to virtually all residential mortgages originating in the state. In response to the resulting threat by the mortgage industry to stop issuing any mortgages in Georgia, the legislature amended the law to ameliorate the rating agencies' concerns.⁹¹

Securitization has played the dominant role in the growth of the subprime lending industry. The volume of securitized subprime loans has increased from \$11 billion in 1994 to \$83 billion in 1998, while the proportion of subprime loans that were securitized and sold to the

84. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994).

85. *Id.*

86. *Id.*; see also David Reiss, *Strangled by an Invisible Hand: How Rating Agencies Kill State Predatory Lending Legislation 15-19* (Jan. 21, 2004) (unpublished manuscript, on file with author).

87. KIDER & HALPERN, *supra* note 78, § 4.03[4].

88. See Shenker & Colletta, *supra* note 78, at 1401 & n.150.

89. Schwarcz, *supra* note 84, at 136.

90. See *infra* Part V.A.2.b.

91. See Kelly K. Spors, *Subprime Bill Aims to Mute State Laws: Republican's Proposal to Police Predatory Lending Would Set Weaker National Standards*, WALL ST. J., Feb. 14, 2003, at A4.

Figure 1
BOX GOES HERE

secondary market to unsecuritized subprime loans increased from thirty-two percent to fifty-five percent in those years, respectively.⁹² In 2002, sixty-three percent of new subprime mortgages, representing a volume of \$134 billion, were securitized; and in 2003, securitizations of subprime mortgages continued their rapid expansion, reaching \$203 billion.⁹³

The relationship between the secondary market and subprime lending players is reciprocal. On the one hand, securitization has driven the concomitant growth in subprime lending and nontraditional mortgage service providers,⁹⁴ giving such loan originators quick access to enormous capital resources from public or private institutional investment markets.⁹⁵ By securitizing loans, lenders can obtain an immediate cash infusion, which reflects the value of the loan, from the sale of the security pools; unlike in the traditional savings and loan mortgage process, securitized lenders need not wait for long-term returns from periodic payments from the borrower on the mortgage note.⁹⁶ Likewise, such originating lenders no longer need the vast depository reserves that a bank possesses; even undercapitalized companies can originate subprime loans, sell them on the secondary market, and finance another loan organization.⁹⁷ At the same time, the secondary market institutions funding this process benefit from the growth of subprime lending because secondary market noteholders prefer the higher rates of return associated with subprime loans.⁹⁸

92. HUD-TREASURY JOINT REPORT, *supra* note 8, at 41.

93. See GAO REPORT, *supra* note 8, at 72-73; *Subprime MBS Rings in the New Year on the Heels of a Record '03*, *supra* note 41, at 1.

94. HUD-TREASURY JOINT REPORT, *supra* note 8, at 41 (“The securitization of subprime mortgages was a major reason for the rapid growth of finance companies and new entrants into the [lending] industry during the mid-1990s.”).

95. Engel & McCoy, *supra* note 9, at 1274.

96. Eggert, *supra* note 1, at 546.

97. *Id.*; see also Canner et al., *supra* note 50, at 249 (“Most subprime lenders place heavy reliance on securitization of their loans to fund their operations.”). As Professor Eggert has described, “[t]hrough securitization, the source of capital for mortgage funding has been transferred from the savings industry, which used deposits to fund loans, to the capital markets and the portfolios of institutional investors.” Eggert, *supra* note 1, at 536. In addition to providing a great source of liquidity for nondepository lending institutions, securitization of subprime loans has created other obvious efficiencies. See Shenker & Colletta, *supra* note 78, at 1400 (describing benefits of securitization generally in mortgage markets). Securitization makes mortgage-backed securities attractive to investors because of their diversified risk and should, in theory, drive down rates for borrowers either as a result of the increased supply of lenders offering subprime products or because the trend toward uniformity generally caused by securitization should decrease lender origination costs. Engel & McCoy, *supra* note 9, at 1274.

98. LITAN, *supra* note 11, at 1 (explaining that a reason for the growth of subprime lending “is that many loans are now ‘securitized’, [sic] or sold to investors in the capital markets, who are accustomed to demanding higher interest rates on securities backed by loans that carry greater risks”); see also Office of Thrift Supervision, *supra* note 26, at 11 (“All in all, subprime lending should have higher expected profits than prime lending because of its higher risk.”); OCC

Much of what is attractive about securitization to lenders and investors, however, masks its great danger. Securitization's chief economic virtue is that it separates the owner of the asset from its originator and thereby insulates the noteholder from liability.⁹⁹ In particular, the operation of the holder-in-due-course rule protects good-faith purchasers of a note from liability for any wrongdoing by the loan originator and precludes the borrower in foreclosure from asserting against the secondary market note holder claims or defenses the borrower could have asserted against the originator.¹⁰⁰ The separation creates dangerous incentives. Lenders can feel free to originate loans with abusive terms or without regard to whether the borrower can afford the loan because the lender can quickly sell it off and shift costs of foreclosure to the secondary market; brokers, who understand that a loan will eventually be sold by the originating lender, can similarly deceive borrowers in order to get up-front fees or make loans that carry an unreasonable risk of default.¹⁰¹ At the same time, the secondary market's isolation from liability eliminates incentives that might otherwise exist to police abusive terms and practices engaged in by originating lenders; instead, lenders can collect all of the profits from predatory loans with little risk of legal or financial consequence.¹⁰²

III. PREDATORY BEHAVIOR IN THE SUBPRIME MARKET

Predatory lending has emerged from the complex dynamic fueling the expansion of subprime lending. Though the vast majority of subprime loans cannot be characterized as predatory, virtually all predatory loans are subprime. What transforms a subprime loan into a predatory one is of course at the heart of the definitional question,¹⁰³ and any attempt to

WORKING PAPER, *supra* note 6, at 10. Similarly, to the extent that brokers rely on the liquidity that securitization provides brokers and other mortgage originators, brokers have a strong incentive to satisfy investor demand by originating higher cost loans.

99. See Eggert, *supra* note 1, at 536 ("At the center of the process of securitization is the isolation of a specific group of assets from the organization that owned them, so that the assets are legally completely independent from their former owner and free of any bankruptcy or liability risks of the former owner."); Lynn M. Lopucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996) (noting that "the asset-securitization strategy puts ownership of the company's valuable assets in an entity separate from the one that is at risk for liability" and describing asset securitization as "a powerful new strategy for judgment proofing"); see also GAO REPORT, *supra* note 8, at 76 (suggesting that this separation can complicate efforts to combat predatory lending).

100. See *infra* Part IV.G.

101. See *infra* text accompanying notes 131-38.

102. See *infra* text accompanying notes 131-38.

103. See Donna Tanoue, Remarks at the Annual Conference of the National Congress for Community Economic Development (Oct. 13, 2000) (transcript available at <http://www.fdic.gov/news/news/speeches/archives/2000/sp13Oct00.html>) ("There is room for legitimate debate on how best to differentiate between subprime and predatory lending. At the same

describe predatory lending comprehensively or categorically will inevitably fail. Though the answer to this question depends heavily on context, certain core features can be identified: (i) credit is provided when it is not needed or on terms not justified by a borrower's credit risk or in order to exact rents; (ii) there is a subjective intent of a broker or lender to mislead, deceive, or exploit a financially unsophisticated borrower; and (iii) the terms of the credit or practices of the lender put a borrower at unreasonable risk of default or foreclosure.¹⁰⁴ In this section, I will attempt to highlight some of the market inefficiencies and opportunities for rent-seeking in the subprime lending market (including the disproportionate impact of subprime lending on minority communities) and describe sets of unfair practices and loan terms that are typically attributed to predatory lending and that unfairly push borrowers toward foreclosures. One estimate has suggested that predatory lending practices such as those that I describe cost borrowers over nine billion dollars annually.¹⁰⁵

A. *Excessive Rates and Fees: The Myth of Subprime Efficiency*

Subprime lenders contend that higher rates and fees appropriately compensate them for costs associated with higher risk of default, delinquency, and foreclosure (as well as for higher origination and mortgage servicing costs) that subprime borrowers create.¹⁰⁶ While lenders should, of course, be compensated for the increased credit risk of a particular borrower, evidence suggests that subprime underwriting criteria are so vague and discretionary that subprime rates and fees are not efficiently calibrated to borrower risk and can often be set at levels that greatly exceed the appropriate risk premium.¹⁰⁷ Indeed, data may even suggest a different causal connection: instead of higher subprime borrower rates of default, delinquency, and foreclosure driving up rates and fees for those borrowers, subprime borrowers' higher rates of default, delinquency, and foreclosure may actually be driven too high by inflated costs, unreasonable loan terms, and by steering borrowers to inappropriately priced loans.

time, there is no question that predatory lenders are doing a brisk—and profitable—business among vulnerable segments of the population.”)

104. See *supra* notes 7-10 and accompanying text (defining predatory lending).

105. ERIC STEIN, COALITION FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 2 (2001), available at <http://www.responsiblelending.org/pdfs/Quant10-01.pdf>.

106. See *supra* text accompanying notes 27-28.

107. See *infra* Part III.A.1.

1. The Rate-Risk Disparity

A subprime loan is predatory when it includes costs and fees that far exceed reasonable market return for the credit risk associated with that borrower or when it erects barriers that limit the borrower from accessing lower-priced conventional loans in the prime market.¹⁰⁸ As previously described, subprime residential mortgage rates are significantly higher than conventional rates, and of course, vary across subprime borrower grade.¹⁰⁹ Estimates suggest that rates on subprime loans, on average, are at least two percentage points higher than prime loans;¹¹⁰ other estimates suggest the difference is significantly higher.¹¹¹ All estimates, moreover, acknowledge a wide interest rate range depending upon borrower grade.¹¹² This variation in mortgage pricing is enormously significant for low-income borrowers in particular. For example, a three percent point spread (nine percent compared to six percent) in a loan with \$200,000 principal and thirty-year maturity will cost a borrower an additional \$148,000 in interest, or approximately an additional \$400 per month of the life of the loan.

Nevertheless, regulators should hesitate to undertake reforms that will affect pricing in the subprime market if the market is operating efficiently—that is, if loan prices are accurately calibrated to borrower credit risk. On the other hand, if traditional market failures, such as information asymmetries and predatory or rent-seeking behavior, prevent an efficient matching of borrowers and lenders, reforms are justified without fear of counter-productive effects on the market. Because numerous factors strongly indicate that the subprime market is not operating efficiently, legitimate subprime regulation would not necessarily drive up mortgage prices or drive out credit.

108. See LITAN, *supra* note 7, at 6; OCC ADVISORY LETTER 2003-3, *supra* note 7, at 2-3; ZIMMERMAN ET AL., *supra* note 5, at 3; *see also* Eggert, *supra* note 1, at 514 (describing excessive rates and fees as the “heart” of predatory lending).

109. See *supra* Part II.A.1.

110. See CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 14 (weighted average of two percentage points higher); Mansfield, *supra* note 29, at 537 (at least 2.2 percentage points higher).

111. See CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 14 n.43 (citing unpublished analysis of Mortgage Information Company data which estimates the spread to be 420 basis points, or 4.2%); WEICHER, *supra* note 22, at 16 (stating that subprime loans are, on average, three percentage points higher than prime loans); Hechinger, *supra* note 31, at A1 (subprime loans carry on average interest rates that are three hundred to six hundred basis points higher than prime rates).

112. See SEPARATE AND UNEQUAL, *supra* note 5, at 47 (those with “perfect credit are regularly charged three to six points higher than market rates”); WEICHER, *supra* note 22, at 16 (range of two to six percentage points); Mansfield, *supra* note 29, at 537 (range of 2.2 to 4.06 percentage points); Hechinger, *supra* note 31, at A1 (range of three to six percentage points).

First, studies have demonstrated that many subprime borrowers are priced into loans that do not reflect their actual credit risk. The Chairman of Fannie Mae, Franklin Raines, estimated in 2000 that up to half of borrowers of A- subprime loans could have qualified for a lower-cost conventional mortgage.¹¹³ In 1996, Freddie Mac estimated that between ten and thirty-five percent of borrowers in subprime market could have qualified for a conventional mortgage.¹¹⁴ In the same year, an industry-sponsored poll conducted of fifty of the then most active subprime lenders found that up to fifty percent of their subprime borrowers could have qualified for prime loans.¹¹⁵ Moreover, a 2004 study by Fannie Mae economists demonstrated that non risk factors significantly affect pricing of high-grade subprime loans.¹¹⁶ Specifically, the study compared a group of A- prime loans purchased by Freddie Mac and a pool of privately-owned A- subprime loans and determined that one percent of the price difference between the two sets was attributable to noncredit risk factors, such as race, financial sophistication, and age.¹¹⁷ The finding that non risk

113. Franklin D. Raines, Remarks to New York Society of Security Analysts (Oct. 11, 2000) (transcript available at http://www.fanniemae.com/media/speeches/speech.jhtml?repID=/media/speeches/2000/speech_138.xml&p=Media&s=Executive+Speeches&counter=5). In a 2004 speech, Chairman Raines echoed this assessment. See Franklin D. Raines, Remarks to Fifth Annual Fair Lending Conference (Sept. 29, 2004) (transcript available at http://www.fanniemae.com/media/speeches/speech.jhtml?repID=/media/speeches/2004/speech_246.xml&p=Media&s=Executive+Speeches&counter=4) (stating that half of subprime borrowers are “a notch” away from accessing conventional loans).

114. FREDDIE MAC, AUTOMATED UNDERWRITING: MARKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA’S FAMILIES (1996), available at <http://www.freddiemac.com/corporate/reports/moseley/chap5.htm>; see also Office of Thrift Supervision, *supra* note 26, at 10 (noting that sixteen percent of A- borrowers had high credit scores, above 680, which suggests that they could have qualified for prime loans).

115. *Half of Subprime Loans Categorized as ‘A’ Quality*, INSIDE B&C LENDING, June 10, 1996, at 7.

116. Lax et al., *supra* note 32, at 564.

117. *Id.* The study compared the interest rates on sub prime loans rated A- by subprime lenders with the interest rates on loans purchased by Freddie Mac and rated A- by Freddie Mac’s underwriting model. *Id.* Despite the same A- rating, the loans originated by subprime lenders bore interest rates that were 215 basis points higher. *Id.* In order to account for differences in credit risk, the study assumed that default rates for subprime borrowers were four times higher and that the higher servicing costs of subprime loans would account for a twenty-five basis point difference. *Id.* Even accounting for those risk factors, the study concluded that one hundred basis points, or one percentage point of the difference in price for A- loans, could not be attributed to risk. *Id.* The OCC Working Paper focuses on this study, perhaps recognizing the significance of its findings in the literature of predatory lending, and attempts to minimize its conclusions. See OCC WORKING PAPER, *supra* note 6, at 12-14. The OCC changes various assumptions in the Zorn study (*i.e.*, attributing forty basis points, rather than twenty-five, to servicing costs and starting with a lower price differential of 196, rather than 215, basis points) and concludes that only forty-five basis points in the difference between prime and high grade subprime loans are not attributable to risk. *Id.* In response to the OCC analysis, the Center for Responsible Lending (CRL) argues that the

factors contribute significantly to subprime mortgage pricing has been confirmed in a contemporaneous study.¹¹⁸ As documented by Professors Engel and McCoy¹¹⁹ and discussed below,¹²⁰ numerous information asymmetries and barriers to entry in the subprime market—and its predatory subset—allow lenders to persistently charge rates unrelated to credit risk.¹²¹ To illustrate one example here, the subprime lending market is heavily segmented. Because many subprime lenders specialize exclusively or predominantly in subprime loans,¹²² even if a borrower interested in a loan from that subprime lender could qualify for a prime loan, that subprime lender would have no incentive to lose that borrower or refer her to another mortgage provider; in fact, the subprime lender would have an incentive to keep that borrower in the dark and profit from her lack of connection to traditional lending sources.

A second reason the pricing of subprime loans is not efficient is the proven price discrimination against vulnerable groups. As described in detail below, race is a highly significant predictor of who gets a higher-priced subprime loan.¹²³ Other significant populations disproportionately affected by subprime lending are the elderly¹²⁴ and the financially unsophisticated.¹²⁵ Third, if pricing were accurately tied to risk, one would

OCC has changed assumptions without legitimate justifications (and that the basis point spread may be even larger than Zorn assumed) and otherwise has significant methodological flaws, including ignoring the role that excessive fees have in driving subprime market inefficiency. *See* CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 10-16. The CRL further accuses the OCC of being biased in its analysis regarding the failures of the subprime market and the effectiveness of state legislative reforms in order to justify the OCC's separate decision, described below, to preempt much state predatory lending legislation. *Id.* at 3-7.

118. Marsha J. Courchane et al., *Subprime Borrowers: Mortgage Transitions and Outcomes*, 29 J. REAL EST. FIN. & ECON. 365, 370-72 (2004). This study also demonstrates that subprime borrowers are generally less satisfied than prime borrowers with their respective mortgage lenders, which the authors suggest is another indication of market inefficiency. *Id.* at 376-81; *see also* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets Revisited*, 82 TEX. L. REV. 439, 443 (2003) (noting the “marked discontinuity” between prime rates and the best subprime rates and arguing that “[i]n a true risk-based pricing system, prices would either be graduated or display far smaller discontinuities between prime and subprime loans”).

119. *See* Engel & McCoy, *supra* note 9, at 1280-83.

120. *See infra* Part III.A.2.

121. *See also* JACK GUTTENTAG, UNIV. OF PA., ANOTHER VIEW OF PREDATORY LENDING 6 (2000) (“[L]oan prices are substantially higher than those the borrowers could have obtained on identical transactions had the borrowers been knowledgeable, and able to shop alternative sources effectively.”), available at <http://fic.wharton.upenn.edu/fic/papers/01/0123.pdf>.

122. GAO REPORT, *supra* note 8, at 22.

123. *See infra* Part III.A.3.

124. Lax et al., *supra* note 32, at 545, 546 fig. 9 (demonstrating marked increase in subprime lending to persons over age fifty-five). This corresponds to legions of studies and anecdotes regarding the prevalence of predatory lending among the elderly.

125. *See* Courchane et al., *supra* note 118, at 368, 371 (demonstrating that a host of nonrisk

expect to see more uniform underwriting standards and efficiently calibrated pricing rather than the apparently ad hoc and discretionary pricing that often currently occurs. As compared to prime lenders, the subprime industry employs underwriting standards that are far from uniform, either across the industry or for each individual lender.¹²⁶ According to Weicher's review of industry guidelines, "the only general agreement" in the industry is "that standards vary across firms," allowing individual lenders to weigh underwriting criteria differently.¹²⁷ Correspondingly, the range of interest rates offered by subprime lenders varies enormously over time. In Professor Mansfield's study, the range of interest rates offered by a cross-section of subprime lenders was between 5.0% and 17.99% in 1995; by 1999, the already substantial range increased to between 3.0% to 19.99%.¹²⁸ By contrast, the spread of rates on conventional mortgages was consistently below two percent.¹²⁹ The pricing spread in the subprime market, driven in part by inconsistent underwriting, can have a tendency to push a borrower into a loan with costs that are higher than necessary to secure a particular loan.¹³⁰ Indeed, a prominent concern in the predatory market is the practice of some lenders to extend credit without regard to a critical underwriting criterion—a borrower's ability to repay the loan.

Fourth, the subprime market dynamic creates perverse incentives that can hurt borrowers. For example, mortgage brokers, who originate half of subprime loans, often have strong incentives—in the form of yield spread

factors, including financial sophistication, explains subprime pricing, and suggesting that some borrowers may be inappropriately "channeled" into higher cost loans).

126. WEICHER, *supra* note 22, at 34 ("In sharp contrast to conditions in the prime mortgage market, there are no generally accepted credit standards for subprime home equity lenders.").

127. WEICHER, *supra* note 22, at 35. For example, a history of two thirty-day delinquencies may cause one lender to rate the borrower A- while another rates the same borrower B—a variation that would correspond to substantial additional cost to a borrower. *Id.* Even individual firms have shifted underwriting standards that either change over time or allow the lender significant discretion in grading a prospective borrower's credit risk. *Id.* (noting that lenders' subprime underwriting "matrices are themselves only general guidelines").

128. Mansfield, *supra* note 29, at 536. The median interest rate of subprime loans over that period was between 2.2 and 4.06 percentage points higher than conventional mortgages. *Id.* at 537.

129. *Id.* at 536.

130. *Id.* at 545 (noting, "[a]t the very least, pricing does not appear to be based on a legitimate assessment of risk and provision for an acceptable profit for the lender," and even worse, "it is not clear that pricing in the modern subprime home equity market has any basis at all"). Mansfield also noted, "[l]enders will not carefully correlate price to risk when they can just as easily charge whatever rate they choose." *Id.* at 544. *But see* GREGORY ELLIEHAUSEN & MICHAEL STATEN, REGULATION OF SUBPRIME MORTGAGE PRODUCTS: AN ANALYSIS OF NORTH CAROLINA'S PREDATORY LENDING LAW 14-15 (Credit Research Ctr., Georgetown Univ., Working Paper No. 66, 2002) (suggesting that data in North Carolina reveals that allegedly predatory loans are priced to reflect risk), available at <http://www.msb.edu/prog/crc/pdf/RevisedWP66.pdf>.

premiums—to steer borrowers to loans with higher costs than even the lenders’ underwriting standards would justify and, therefore, which are made without regard to borrower creditworthiness.¹³¹ These yield spread premiums loans do not, despite mortgage broker assertions, result in offering loans to subprime borrowers that have no or low fees;¹³² indeed, studies have indicated they are a tempting and frequently employed rent-seeking device.¹³³ In addition, securitization in the financing of the subprime lending industry creates strong incentives for subprime lenders to package and sell higher-cost loans for a secondary market that is eager for high rates of return.¹³⁴ This is particularly significant when coupled with the fact that the securitization process actually dilutes the risk to noteholders for abusive or unfair practices of brokers or lenders.¹³⁵ Finally, lenders often build other nonrate-related structures into a subprime loan to protect them from the risk of default¹³⁶ and foreclosure.¹³⁷ One economist

131. See *supra* text accompanying notes 72-74 (explaining that yield spread premiums are fees that lenders give to borrowers in exchange for placing borrowers in a higher-cost loan); GAO REPORT, *supra* note 8, at 22 (suggesting that yield spread premiums create potential for broker abuse).

132. See JACKSON & BERRY, *supra* note 74, at 6; STEIN, *supra* note 105, at 11 n.35 (noting that the HUD-1A forms for subprime loans, in which yield spread premiums were labeled, also uniformly contained high fees).

133. JACKSON & BERRY, *supra* note 74, at 9 (stating that variation in pricing between loans with YSPs and loans with other forms of compensation “strongly suggests that yield spread premiums are not simply another form of mortgage broker compensation, but rather that the payments constitute a deceptive device that the mortgage broker industry employs to extract unnecessary and excessive payments from unsuspecting borrowers”).

134. See LITAN, *supra* note 11, at 1 (citing industry executive who explained that subprime lenders rely on financing from the secondary mortgage market which is “accustomed to demanding higher interest rates on securities backed by loans that carry greater risks”); *supra* note 98. Indeed, profits from subprime lending industry are high enough that, at least for some lenders, the credit risk-profit correlation does not seem a tight fit.

135. See *supra* Part II.B.2.b.

136. Defaults rarely end in foreclosure; most are corrected by borrowers within three months. Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 124 (2002). Defaults do, however, cost lenders lost interest for that month as well as administrative time and the expense to collect. *Id.* To compensate for that loss, lenders routinely charge five percent of the payment due as a late fee, assessed on top of the monthly payment. *Id.*; ELIZABETH RENUART, NAT’L CONSUMER LAW CTR., STOP PREDATORY LENDING: A GUIDE FOR LEGAL ADVOCATES 26 (2002) [hereinafter STOP PREDATORY LENDING].

137. Because foreclosure sales typically recoup less than the market value of the home, subprime lenders insist on lower loan-to-value ratios—approximately sixty to seventy-five percent—than are demanded for prime loans—about eighty percent. STOP PREDATORY LENDING, *supra* note 136, at 26; see also WEICHER, *supra* note 22, at 60 (noting that the median loan-to-value ratio for subprime loans is seventy percent). Even in cases where subprime lenders do not recover the full value of the loan, NCLC contends that losses are typically no more than one percent of loan balances per year and, accordingly, insufficient to justify interest rates that are two to four percent higher than conventional. STOP PREDATORY LENDING, *supra* note 136, at 26-27.

has estimated that charging rates unrelated to credit risk has cost American borrowers \$2.9 billion annually.¹³⁸

2. Financing Excessive Points and Fees

Lenders and brokers in the subprime market also charge points and fees that often exceed any reasonable market justification. Conservative industry estimates suggest that subprime lenders charge on average 1.5% to 3% more in points and fees than prime lenders.¹³⁹ One prominent consumer advocacy group claims that subprime lenders “routinely” charge up to eight percent of the loan in points and fees.¹⁴⁰ Another estimate suggests that 750,000 mortgages per year are financed with points and fees above five percent of loan value.¹⁴¹ Substantial anecdotal evidence from reported cases, news reports, and witness testimony suggest that the assessment of points and fees in the subprime industry is very often not correlated to actual costs and is otherwise an enormous source of borrower exploitation.¹⁴²

In the conventional loan market, points and fees averaged 1.1% of the loan in 1999¹⁴³ and appear accurately correlated to origination costs¹⁴⁴ or, importantly, are part of a negotiated trade-off allowing the borrower to finance the loan amount at a lower interest rate.¹⁴⁵ While such a trade-off also can occur in the subprime market, the presence of high points and fees frequently makes a subprime loan predatory when those charges are

138. STEIN, *supra* note 105, at 9-11.

139. The Courchane study concluded that, of subprime borrowers who pay points, sixty percent pay between two and four points. *See* Courchane et al., *supra* note 118, at 376.

140. SEPARATE AND UNEQUAL, *supra* note 5, at 47 (finding an estimate based on the assumption that many subprime lenders service loans charge just below the eight percentage points and fees threshold that would trigger the regulatory protections for a borrower mandated by the federal Home Ownership Equity Protection Act); *see also* Courchane et al., *supra* note 118, at 376 (finding that five percent of subprime borrowers pay over six points, compared to virtually none in the prime market).

141. STEIN, *supra* note 105, at 7.

142. *See, e.g., Predatory Mortgage Lending Hearing*, *supra* note 51, at 12-20 (statements of Carol Mackey, Paul Satriano, Leroy Williams, and Mary Podelco, private citizens); SEPARATE AND UNEQUAL, *supra* note 5, at 47-48 (collecting witness testimonials); Mansfield, *supra* note 29, at 546-47 & nn.447-52 (summarizing findings in litigation that subprime lenders routinely charge more than eight percent in points and fees and that the larger subprime lenders such as United Companies Lending and Delta Funding systematically charged points and fees above ten percent and sometimes as high as twenty percent).

143. CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 15 (citing Peter Mahoney, The Role of Automated Underwriting in Expanding Minority Home Ownership, Address at the Fannie Mae Conference (June 8, 2000)). Indeed, in that efficient market, total points and fees paid to prime lenders have decreased from 1.6% in 1993 to 1.1% in 1999. *Id.*

144. Mansfield, *supra* note 29, at 546.

145. WEICHER, *supra* note 22, at 67-68.

simply stacked on top of already high interest rates.¹⁴⁶ Predatory lenders rely on a lack of price competition, information asymmetries, and a variety of hard sell or confidence tactics to discourage borrowers from shopping around for better rates,¹⁴⁷ avoid explaining the reason for assessing additional costs, or outright mislead borrowers about the terms of the loan.¹⁴⁸ Thus, points and fees of predatory lenders do not correlate reasonably to servicing or origination costs, nor do they derive from a legitimate arms-length transaction with a borrower possessed of access to adequate information in the mortgage marketplace. Rather, the imposition of high points and fees is often a source of pure exploitation and a classic form of rent-seeking.¹⁴⁹

Points and fees either are paid directly in cash by the borrower to the broker or lender from the proceeds of the loan amount, or they are folded into the total amount financed by the borrower. Refinancing high points and fees is particularly harmful to borrowers because, by adding to the loan amount while the house value remains the same, the borrower depletes equity in the home.¹⁵⁰ One study suggests that loans with points

146. See Engel & McCoy, *supra* note 9, at 1269-70 (“Predatory lenders . . . subvert th[e] conventional tradeoff [between upfront fees and lower interest rates] by layering points or prepayment penalties on top of high interest rates on a take-it-or-leave-it basis.”); see also *Equity Predators Hearing*, *supra* note 20, at 32-33 (statement of “Jim Dough,” anonymous former employee of a predatory lender) (“The practice is to charge the maximum number of points legally permissible for each loan and each flip . . . and [finance companies are] required to rebate any point income on [flipped] loans . . .”).

147. Engel & McCoy, *supra* note 9, at 1283 (describing predatory lenders’ ability to exploit their disproportionate market power and rely on chicanery or misinformation).

148. *Id.*

149. To corroborate this theory of rent-seeking behavior, Professor Mansfield discussed an incriminating document produced by a major subprime lender in *Newton v. United Companies Financial Corp.*, 24 F. Supp. 2d 444 (E.D. Pa. 1998). It read:

Mortgage brokers make their money on points that customers pay when their loan is closed. Legislation designed to protect the consumer is continuing to put pressure on the brokerage business. Disclosure of front-end and back-end fees is forcing brokers to justify these fees. In the future this may lead to brokers charging fees in accordance with the amount of service they provide the customer.

Mansfield, *supra* note 29, at 547 & n.456. In addition, artificially high points and fees are frequently the cause of the higher servicing costs associated with subprime borrowers’ higher rates of default and delinquency rather than the effect of those purportedly higher rates. See NAT’L CONSUMER LAW CTR. & CONSUMER FED’N OF AM., HOW TO AVOID PURCHASING OR INVESTING IN PREDATORY MORTGAGE LOANS (2001), at http://www.consumerlaw.org/initiatives/test_and_comm/fdic.shtml.

150. See STEIN, *supra* note 105, at 4. Stein stated:

The problem of excessive fees for the subprime refinancing borrower is two-fold: the fees seem painless at closing and they are forever. They are *deceptively*

and fees above a threshold of five percent of the loan costs borrowers \$1.8 billion a year.¹⁵¹

3. Disproportionate Impact on Racial Minorities

Studies have demonstrated a strong inverse correlation between income and mortgage costs in the subprime market.¹⁵² At first glance, it seems intuitive that subprime lending is heavily concentrated among low- and moderate-income borrowers: such persons may tend to have higher debt-to-asset ratios or perhaps shorter credit histories that would make them a legitimately higher credit risk. However, a most disturbing aspect of the explosion of subprime lending is its vastly disproportional presence in, and impact upon, minority communities. HUD analysis reveals that in 1998, over half of all mortgage lending in predominantly African American neighborhoods was subprime, compared to only nine percent in predominantly Caucasian neighborhoods; in other words, African American borrowers are five times more likely to obtain subprime loans than Caucasian borrowers.¹⁵³

costless to many borrowers because when the borrower “pays” them at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity value remaining in his or her home is reduced by the amount of fees owed. And *fees are forever* because, even if another lender refinances a family who financed exorbitant fees or who are subject to a prepayment penalty into a better loan just one week later, the borrowers’ wealth is still permanently stripped away.

Id. (first emphasis omitted).

151. *Id.* at 7. While the study advocates for a cap on financing of points and fees at three percent, the study uses a five percent threshold because it is the rate above which Fannie Mae, the North Carolina General Assembly, and Washington Mutual bank have determined a loan is abusive. *Id.*

152. According to HUD estimates in 1998, twenty-six percent of refinance mortgages in low- and moderate-income neighborhoods were subprime, as compared to the national average of eleven percent and an average of seven percent in upper-income neighborhoods. UNEQUAL BURDEN, *supra* note 47. In the poorest communities, forty-four percent of refinances were subprime. *Id.* A Fannie Mae study concludes that lower-income borrowers are twice as likely to get subprime, rather than prime, financing. Lax et al., *supra* note 32, at 545, 546 fig. 8. Despite preliminary expectations, however, this correlation may not be perfectly efficient. Income is not strongly correlated with FICO scores, *see id.*, and low-income borrowers may be stuck with more costly credit than is justified by their actual risk because of their financial unsophistication, *see infra* text accompanying notes 171-83, or because of other inefficiencies in the provision of subprime credit, *see supra* text accompanying notes 120-45.

153. A study by the Association of Community Organizations for Reform Now (ACORN) of sixty-one metropolitan areas demonstrated that 27.6% of all refinance loans to African Americans were subprime, compared to 6.7% subprime refinancing for Caucasians—a fourfold difference. SEPARATE AND UNEQUAL, *supra* note 5, at 16. Latinos received 17.1% of refinance loans from subprime lenders. *Id.* at 16. The study found, in addition, that neighborhood tracts with greater

Even where the variable of income is controlled, African Americans are disproportionately burdened by higher-cost loans. According to HUD, thirty-nine percent of upper-income African Americans refinance with subprime loans, compared to only six percent of upper-income Caucasian borrowers.¹⁵⁴ Indeed, *upper-income African Americans are more than two times as likely as low-income Caucasians* to turn to subprime refinancing.¹⁵⁵ In New York City, low-income African American borrowers are four times as likely as low-income Caucasian borrowers to obtain a subprime home-purchase or refinance loan, and *upper-income African American borrowers in New York are more than twice as likely as low-income Caucasians* to have a subprime loan.¹⁵⁶ A study of the Chicago metropolitan area housing market similarly concluded that race is the strongest noncredit risk factor—a factor stronger than income, debt, education, or home value in determining whether a borrower will obtain a subprime or prime loan.¹⁵⁷ Studies of mortgage markets in other jurisdictions have confirmed these conclusions.¹⁵⁸

concentrations of African Americans saw markedly increased incidence of subprime lending. *Id.* at 27.

154. UNEQUAL BURDEN, *supra* note 47. According to ACORN's study, African Americans are approximately four times as likely as Caucasians to receive subprime refinance loans, across four income categories, while Latinos are between two and two-and-a-half times as likely to get subprime refinancing than Caucasians across those income categories. SEPARATE AND UNEQUAL, *supra* note 8, at 22.

155. UNEQUAL BURDEN, *supra* note 47. ACORN's recent study confirms this result, finding that 19.6% of refinance loans to upper income African Americans and 13.4% of refinance loans to upper income Latinos are subprime, while 11.2% of refinance loans to low income Caucasians are subprime. SEPARATE AND UNEQUAL, *supra* note 8, at 22.

156. CHARLES E. SCHUMER, CAPITAL ACCESS 2002: LENDING PATTERNS IN BLACK AND WHITE NEIGHBORHOODS TELL A TALE OF TWO CITIES 1-2 (2002), available at http://www.schumer.senate.gov/SchumerWebsite/pressroom/special_reports/cap%20access%202002.pdf (demonstrating disproportionate prevalence of subprime lending in all economic sectors of African American communities in New York and concluding that "many who would qualify for prime loans are instead accepting subprime loans—in other words, a significant proportion of black residents in New York City are being unnecessarily channeled into more expensive financing") (emphasis omitted).

157. IMMERGLUCK & WILES, *supra* note 5, at 26-27. The study demonstrated that fifty-eight percent of refinance loans obtained in predominantly African American neighborhoods were subprime compared to only about ten percent in predominantly Caucasian neighborhoods, *id.* at 19, and that a significantly disproportional number of subprime loans went to African Americans even when the study compared neighborhoods with comparable incomes, *id.* at 25. This study also concluded that subprime lenders solicited borrowers in African American neighborhoods at rates grossly disproportional to marketing in predominantly Caucasian neighborhoods. *Id.* at 25 tbl. 6, 26 (demonstrating that seventy-four percent of refinance applications in African American neighborhoods are from subprime lenders compared to just twenty-one percent in predominantly Caucasian neighborhoods).

158. *See, e.g.*, CALVIN BRADFORD, CTR. FOR CMTY. CHANGE, RISK OR RACE? RACIAL DISPARITIES AND THE SUBPRIME REFINANCE MARKET (2002) (cataloguing data demonstrating racial

Economic literature appears in near consensus that African Americans generally obtain credit on disadvantageous terms.¹⁵⁹ Economists do not necessarily agree that the persistence of the racially disparate availability of good credit is the result of intentional discrimination. Several conclude that there are structural impediments minorities face in accessing good credit.¹⁶⁰ Others suggest that many lenders perpetuate existing disparities by relying on empirical data that African Americans, as a class, are a greater credit risk; or, in other words, many lenders use race as a proxy for credit risk.¹⁶¹ The studies and data regarding disparate impact are, in addition, corroborated by direct evidence of targeting vulnerable members of African American communities and of discrimination by subprime lenders against African American borrowers.¹⁶²

disparities in access to subprime credit in numerous geographic markets); ZIMMERMAN ET AL., *supra* note 5, at 7 (concluding that, after controlling for several important variables, including borrower income, African American borrowers in the Northern New Jersey area are 2.5 times as likely to obtain subprime refinancing than Caucasian borrowers and are three times as likely to obtain a subprime home improvement loan than similarly situated Caucasian borrowers); Tom Shean, *Study Points out Alarming Rise in Use of Subprime Mortgages by Minorities*, VIRGINIAN-PILOT, Mar. 25, 2004, at D1 (describing disproportionate use of subprime lending by African Americans in Virginia); Jeff Crump, *Subprime Lending in the Twin Cities: An Empirical Analysis* slide 18 (2001) (multimedia presentation) (with permission of author) (presenting findings that, in the Twin Cities of Minnesota, African Americans are three-and-a-half times more likely to have a subprime loan than Caucasians, even while holding income constant), *available at* <http://www.cura.umn.edu/programs/Housing-Forum/2004/Crump-presentation.pdf>.

159. See RANDALL M. SCHEESSELE, BLACK AND WHITE DISPARITIES IN SUBPRIME MORTGAGE REFINANCE LENDING 2-3 (U.S. Dep't of Hous. & Urban Dev., Working Paper No. HF-014, 2002), *available at* <http://www.huduser.org/publications/hsgfin/workpapr14.html>; Gary A. Dymski, *Is Discrimination Disappearing? Residential Credit Market Evidence, 1992-98*, 28 INT'L J. SOC. ECON. 1025, 1025-26 (2001); Gary A. Dymski, *Why Does Race Matter in Housing and Credit Markets? Current Research and Future Directions*, in RACE, MARKETS, AND SOCIAL OUTCOMES 157-60 (Patrick L. Mason & Rhonda Williams eds., 1997); Domenico Scalera & Alberto Zazzaro, *Group Reputation and Persistent (or Permanent) Discrimination in Credit Markets*, 11 J. MULTINATIONAL FIN. MGMT. 483, 484 (2001).

160. RACE, MARKETS, AND SOCIAL OUTCOMES, *supra* note 159, at 157-85; Ronald E. Wienk, *Discrimination in Urban Credit Markets: What We Don't Know and Why We Don't Know It*, 3 HOUSING POL'Y DEBATE 217, 218-22 (1992).

161. Paul Huck, *Home Mortgage Lending by Applicant Race: Do HMDA Figures Provide a Distorted Picture?*, 12 HOUSING POL'Y DEBATE 719, 719-20 (2001); Scalera & Zazzaro, *supra* note 159, at 484.

162. A study by the Urban Institute prepared for HUD employed "paired testing" to compare the quality of mortgage-related services to African American and Caucasian borrowers and concluded that similarly situated minorities were quoted higher rates and received less information about loan products and time from loan officers. URBAN INSTITUTE, WHAT WE KNOW ABOUT MORTGAGE LENDING DISCRIMINATION IN AMERICA (1999), *available at* <http://www.hud.gov/library/bookshelf18/pressrel/newsconf/menu.html> (last visited Feb. 21, 2005). Testers, both Caucasian and minority, with substantially similar credit status, attempted to obtain loans from the same lender. In most cases (four out of five of the cities where testing occurred), the Caucasian testers received more favorable terms than the minority testers, despite the similarity in their credit

At best, this evidence demonstrates that subprime financing is frequently not correlated with credit worthiness; in other words, borrowers with similar credit profiles are receiving different loan products. More troubling, however, is the likelihood that subprime lenders—and predatory lenders—are deliberately targeting African Americans to exploit their vulnerability and historic disconnection from financial markets.¹⁶³ While the presence of prime or traditional lenders in these communities has steadily fallen,¹⁶⁴ subprime lender concentration in African American neighborhoods has exploded.¹⁶⁵ As the joint HUD-Treasury study concluded, “[m]any of those served by the sub-prime market are creditworthy borrowers who are simply stuck with sub-prime loans or sub-prime lenders because they live in neighborhoods that have too few credit or banking opportunities.”¹⁶⁶

The disproportionate presence of subprime lending in African American communities amounts to a discriminatory denial of quality

status. *Id.* In *Associates Home Equity Services, Inc. v. Troup*, 778 A.2d 529, 538 (N.J. Super. Ct. App. Div. 2001), the appellate court ruled that allegations were sufficient to support the claim that the lender “participated in the targeting of inner-city borrowers who lack access to traditional lending institutions, charged them a discriminatory interest rate, and imposed unreasonable terms.” In a civil lawsuit brought by the federal government against alleged predatory lender Delta Funding Corporation, the government alleged that Delta instructed its brokers to deliberately charge African American women higher rates than Caucasian borrowers with similar credit histories. GAO REPORT, *supra* note 8, at 39 & n.19 (citing *United States v. Delta Funding Corp.*, No. CV00-1872 (E.D.N.Y. 2000)).

163. Bunce et al., *supra* note 35, at 258.

It does not seem likely that these high market shares by subprime lenders in low-income and African-American neighborhoods can be justified by a heavier concentration of households with poor credit in these neighborhoods. Rather it appears that subprime lenders may have attained such high market shares by serving areas where prime lenders do not have a significant presence.

Id.

164. According to a study by the Department of the Treasury, the number of banking offices in low- and moderate-income areas decreased twenty-one percent between 1975 and 1995, while the total number of those offices in the country increased twenty-nine percent. LITAN ET AL., U.S. DEP’T OF THE TREASURY, *THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT* 87 (2000). The study further demonstrated the importance of the physical presence of a bank in low- and moderate-income neighborhoods for those residents to obtain mortgage funding. *Id.*; see also Michael S. Barr, *Banking the Poor*, 21 *YALE J. ON REG.* 121, 130-41 (2004) (describing lack of conventional banking resources available in poor and minority neighborhoods and its detrimental effect on their access to good credit).

165. SEPARATE AND UNEQUAL, *supra* note 5, at 6, 16-22. In Chicago, for example, subprime loan activity grew by almost thirty times in black neighborhoods as compared to two-and-a-half times in Caucasian neighborhoods in the period between 1993 and 1998. IMMERGLUCK & WILES, *supra* note 5, at 28.

166. HUD-TREASURY JOINT REPORT, *supra* note 8, at 48.

credit or, as one civil rights activist has called it, a form of “reverse redlining.”¹⁶⁷ The cumulative effect has been to increase both the number of foreclosures on African American residences and the speed at which they have occurred.¹⁶⁸ As a result, once thriving African American neighborhoods have been destroyed.¹⁶⁹ To the extent that home ownership is a step in accessing the metaphorical American dream and its more tangible component parts of financial stability, social prestige, and community membership, the explosion of subprime lending and its concomitant contribution to residential foreclosures in minority communities can also properly be framed as an important, modern civil rights issue.¹⁷⁰

B. *Unfair and Abusive Lending Practices*

Predatory lenders have been successful not because they offer a valuable product for which there is a large, genuine market demand; indeed, there is little real price competition in the predatory market.¹⁷¹ Rather, their success comes from deliberately preying on communities that are the least connected to the economic mainstream—the elderly, the poor, the uneducated, and minorities—and the most vulnerable to abuse.¹⁷² In

167. *Predatory Mortgage Lending Hearing*, *supra* note 51, at 346 (prepared statement of David Berenbaum, Senior Vice President, Program and Director of Civil Rights of the National Community Reinvestment Coalition). African Americans invest far greater proportion of their wealth into home ownership—in 2000, sixty-two percent of African American homeowners’ net worth resided in their homes as compared to thirty-one percent for Caucasian homeowners. SEPARATE AND UNEQUAL, *supra* note 8, at 9. As a result, foreclosures and equity stripping practices associated with predatory lending have a significantly magnified effect on African American households and their aspirations for economic advancement.

168. See *infra* text accompanying notes 233-41.

169. See *infra* text accompanying notes 242-43. See generally *Predatory Lending Practices Hearing*, *supra* note 42, app. at 128-34 (prepared statement of Senator Charles E. Schumer); Bunce et al., *supra* note 35, at 262-67; IMMERGLUCK & WILES, *supra* note 5, at 10 (describing effect of foreclosures on African American neighborhoods in the Chicago area); ZIMMERMAN ET AL., *supra* note 5, at 7-8 (documenting effect of foreclosures on African American communities in northern New Jersey); Diana B. Henriques & Lowell Bergman, *Mortgaged Lives: A Special Report: Profiting from Fine Print with Wall Street’s Help*, N.Y. TIMES, Mar. 15, 2000, at A1.

170. This perspective becomes clearer when one remembers that subprime lending has done little to actually increase home ownership. As described, over eighty percent of subprime loans are refinancings and are thus made to borrowers who already own a home. See *supra* text accompanying notes 46-49; see also *Predatory Mortgage Lending Hearing*, *supra* note 51, at 349 (prepared testimony of David Berenbaum, Senior Vice President, Program and Director of Civil Rights of the National Community Reinvestment Coalition) (“[S]tatistics show the biggest gains [in home ownership] for minorities occurred in the first part of the [1990s] when [Community Reinvestment Act]-related lending surged—as opposed to the second part of the decade when subprime lending soared.”).

171. See Engel & McCoy, *supra* note 9, at 1280-84.

172. *Id.* at 1280-81. Engel and McCoy describe typical victims of predatory lending as

this subsection, I describe some of the ways in which predatory lenders target vulnerable communities and some of the lending practices lenders use to extort economic rents. In the following subsection, I will describe a series of terms that are frequently associated with predatory loans—and not with conventional loans—which put borrowers at an unreasonable risk of default or foreclosure. This sequencing is slightly artificial because the concepts—deceptive intent and harmful impact—are obviously interconnected in the operation of the real world market.

1. Aggressive and Misleading Marketing and Sales Techniques

Predatory lenders have developed specialized techniques to identify their targets. Some rely on census data to determine heavy minority presence and HMDA data to assess whether there is insubstantial prime market activity in an area;¹⁷³ some search deed registries to see who has paid off or nearly paid off a mortgage and, therefore, has substantial equity;¹⁷⁴ some also search tax records¹⁷⁵ to see who may be delinquent and in need of money;¹⁷⁶ and some obtain databases of persons sorted by age, gender, and race.¹⁷⁷ Once they identify targets, predatory lenders engage in highly aggressive direct marketing techniques, almost always advertising a way to consolidate outstanding debt, refinance a home, afford home repairs, or obtain needed cash.¹⁷⁸

historically excluded from the home-mortgage market because of credit rationing and discrimination. They may need credit but not be aware that they are eligible for loans. Many do not know that there are less expensive sources of credit. And when lenders and brokers give these borrowers estimates and loan documents, the borrowers may not be able to comprehend the information.

Id.

173. *Id.* at 1281.

174. *Id.* at 1282.

175. A study of subprime activity in Los Angeles County in 1999 demonstrated that property tax delinquency is a more dominant factor than income in determining which households have subprime loans. BILL PITKIN & NEAL RICHMAN, UCLA ADVANCED POLICY INST., SUBPRIME LENDING AND NEIGHBORHOOD CONDITIONS IN THE CITY OF LOS ANGELES 18 (2001) (on file with author).

176. Engel & McCoy, *supra* note 9, at 1282; *Equity Predators Hearing*, *supra* note 20, at 32 (statement of “Jim Dough,” anonymous former employee of a predatory lender) (describing a frequent finance company tactic of approaching current clients who are delinquent as a way of inducing them to refinance to avoid foreclosure, but extracting points and fees in the process).

177. Eggert, *supra* note 1, at 516.

178. Predatory lenders may employ workers to “blitz” a neighborhood with misleading phone calls and solicitations. *Id.* Other lenders send individuals “live checks” which, if deposited, offer victims a few thousand dollars in cash but force them into a high-cost loan with harsh terms. SEPARATE AND UNEQUAL, *supra* note 5, at 56; *see also Equity Predators Hearing*, *supra* note 20,

Victims of predatory lending frequently have little connection to or experience with financial markets, which makes them perfect targets of unscrupulous lenders.¹⁷⁹ Many victims also are elderly, infirm, or reluctant to either venture far from their home or to use the phone to access better credit offers; others have no relationships with a bank, or have few connections to family or friends with the sophistication to advise them on mortgage products.¹⁸⁰ Thus, they are obviously vulnerable to manipulative sales tactics¹⁸¹ or outright fraud engaged in by predatory lenders.¹⁸² Often, lenders rush customers into consummating a deal and even changing the previously agreed upon terms of the deal, before the competition can appear, by establishing a strong personal obligation on the borrower's part

at 31 (statement of "Jim Dough," anonymous former employee of a predatory lender).

[F]inance companies . . . use three primary methods to obtain new customers. First, they often send guaranteed loan vouchers to potential customers. . . .

Second, finance companies often run different types of promotions using the mail to seek business from new customers. . . .

Third, finance companies obtain many of their customers by participating in retail sales installment loans.

Id.

179. See Courchane et al., *supra* note 118, at 371-72 (describing data that demonstrates that subprime borrowers are less familiar with mortgage products and financial terms than are prime borrowers); see also *Equity Predators Hearing*, *supra* note 20, at 31 (statement of "Jim Dough," anonymous former employee of a predatory lender) ("[M]y perfect customer would be an uneducated widow who is on a fixed income, hopefully from her deceased husband's pension and Social Security, who has her house paid off, is living off of credit cards, but having a difficult time keeping up with her payments . . .").

180. See SEPARATE AND UNEQUAL, *supra* note 5, at 45-46; Barr, *supra* note 164, at 123-41 (describing poor and minority communities' lack of access to traditional financial services); Courchane et al., *supra* note 118, at 372 (demonstrating that subprime borrowers generally search less than prime borrowers for mortgage products and feel far less than prime borrowers that they have choices in mortgages products).

181. As Professors Engel and McCoy explain:

Predatory lenders . . . endear themselves with charm and solicitude that mask their guile. They consciously exude an aura of expertise and success, intimidating customers from questioning the advisability of the loans they are offering. Predatory lenders specifically cultivate the appearance of friendship, causing customers to believe that sales representatives have their best interests at heart. The seeming show of friendship makes it even harder for customers to ask hard questions.

Engel & McCoy, *supra* note 9, at 1283.

182. Lenders frequently obscure or hide critical terms in loan documents, pressure victims to sign documents without first reading them, or even forge signatures on documents. Eggert, *supra* note 1, at 516.

to close on the loan or by suggesting that the purportedly favorable terms are available for a limited time only.¹⁸³

2. Predatory Lending Practices

Two central practices of predatory lenders—loan flipping and lending without regard to ability to repay—represent central and highly profitable rent-seeking tactics by predatory lenders. They have no legitimate economic or underwriting justification and drain equity from homeowners.

a. Loan Flipping

Loan flipping refers to the repeated refinancing of a borrower's loan (typically within the first five years of the loan) through another fee-loaded loan and without any reasonable benefit to the borrower.¹⁸⁴ Cash-strapped borrowers are typically urged to undertake such loans when faced with large consumer debt that the lenders suggest should be consolidated into a home-secured debt.¹⁸⁵ Borrowers are typically offered lower monthly payments, in the form of longer maturities, but lenders typically finance additional points and fees into the refinanced loan.¹⁸⁶ As a result,

183. *Id.*; see also STOCK, *supra* note 5, at 23, 28 (presenting data that forty-five percent of study respondents whose subprime loans went into foreclosure reported that new fees and other charges which had not previously been discussed were announced at closing and that sixty-eight percent of those respondents accepted those new charges).

184. HUD-TREASURY JOINT REPORT, *supra* note 8, at 73. Loan flipping is distinct from another less prevalent practice of “property flipping,” in which lenders falsely appraise a property to sell it to an unsuspecting buyer. GAO REPORT, *supra* note 8, at 41 n.24. Frequently, property flippers target first-time home buyers who have been denied a loan because of poor credit or low income. *Id.* The property flippers will arrange loans well in excess of the real value of the property. *Id.* In order to fool the lender about the viability of such a big loan and about the inflated value of the property, property flippers will use fabricated credit documents and false appraisals. *Id.*

185. HUD-TREASURY JOINT REPORT, *supra* note 8, at 73. Or, lenders who issue loans without regard to a borrower's ability to repay can anticipate that borrowers will not be able to meet monthly payments and can simply target those borrowers again for repeated refinancing by falsely promising that each new loan will alleviate their burdens. *Id.* at 74.

186. See *Equity Predators Hearing*, *supra* note 20, at 31-32 (statement of “Jim Dough,” anonymous former employee of a predatory lender). “Jim Dough” stated that

we were trained to sell the monthly “savings”—that is, how much less per month the customer would be paying off if we flipped the loan. In reality, the “savings” that we were trained to sell to the customers were just an illusion. . . . What the customer would not figure out, and what we would not tell him, is that he would be paying for a longer period of time and, in the end, would pay a whole lot more.

Id. The practice depends on the cultivation of a relationship by the broker and lender of the borrower, with hard sell tactics and false reassurance of the value of the offer to refinance. *Id.* at 32. As “Jim Dough” explained:

borrowers will owe more in principal and interest to the lender and have correspondingly lower value in the home.¹⁸⁷ As equity decreases and loan balance increases, the borrower becomes less able to refinance with a legitimate lender.¹⁸⁸ Indeed, the ultimate goal of certain predatory lenders is to secure a borrower as a permanent customer: a borrower with an initially high-priced loan with difficult monthly payments is ready to be repeatedly “flipped” by the same, or another, predatory lender for more points and fees. As “Jim Dough,” a former employee of a subprime finance company, testified to Congress:

In my experience in the industry, flipping was a common practice. We were instructed and expected to flip as many loans as possible. One of my supervisors imposed a daily requirement that each branch employee obtain at least two applications from present borrowers to refinance their loans. In other words, each branch employee was supposed to try to flip at least two loans per day.¹⁸⁹

For our home equity customers, we stressed that the interest on the loan was tax-deductible. Because the terms of those loans did not usually exceed 15 years, we told customers that they could retire earlier, because their house would be paid off sooner. For our debt consolidation customers, we stressed that they could take the money that they were saving in their monthly payments and invest it in a mutual fund.

Id.

187. For example, as alleged by the debtor in *Carabellese v. Cammarano*, a woman obtained a \$28,000 home equity loan from Associates Financial Services Corporation. Defendant/Third Party Plaintiff's Answer, Cross-Claim and Third Party Complaint at 5, *Carabellese v. Cammarano*, No. F-13509-79 (N.J. Super. Ct. Ch. Div. filed Oct. 17, 1997). After Ms. Cammarano had difficulty making her payments, Associates Financial Services Corporation initiated contact with her and refinanced the loan three times in less than two years, increasing her total indebtedness to over \$56,000, which was primarily comprised of points and fees. *Id.* at 5-8. Similarly, testifying before the Senate Committee on Banking, Housing, and Urban Affairs, Ms. Podelco explained that she was flipped a total of seven times in the course of two years by different subprime lenders. *Predatory Mortgage Lending Hearing*, *supra* note 51, at 18-19 (testimony of Mary Podelco, private citizen). Her loan was flipped three times by Beneficial Finance, the originator of the loan, once by United Companies, twice by Equity One, and once by Cityscape, purporting to be Equity One's broker. *Id.* Her initial home improvement loan was for approximately \$12,000, which increased after the repeated flips and fees to over \$64,000. *Id.* at 19. In the course of two years, the home that she once owned free and clear was foreclosed upon. *Id.* at 18-19; *see also* Stevenson, *supra* note 4 (describing cases of elderly homeowners who sought small loans for minor home repairs being flipped serially into increasingly high-fee, high-interest loans until their mortgages overwhelmed their ability to pay).

188. Courchane et al., *supra* note 118, at 375-76.

189. *Equity Predators Hearing*, *supra* note 20, at 32 (statement of “Jim Dough,” anonymous former employee of a predatory lender); *see also* CAL. REINVESTMENT COMM., *supra* note 5, at 37

In a related practice, some lenders and brokers encourage a would-be borrower to default on their mortgage in order to refinance with them.¹⁹⁰ The practice not only hurts a borrower's credit risk, but also makes her vulnerable to that creditor's unreasonable loan products offered as part of the refinancing.

b. Lending Without Regard to a Borrower's Ability to Repay

Some subprime lenders make loans based on the amount of the homeowner's equity, even if it may appear that the borrower has insufficient income to make monthly payments.¹⁹¹ Also called "asset-based" or "equity-based" lending, the practice has caused a substantial number of residential foreclosures.¹⁹² Beyond its troubling ethical dimension,¹⁹³ the practice may, because of the high transaction costs typically associated with foreclosure, appear to contradict rational economic behavior. Nevertheless, unscrupulous lenders do find ways to make asset-based loans profitable by collecting high points and fees at closing¹⁹⁴ and even to make foreclosure profitable where there is significant equity in the home.¹⁹⁵

(finding that sixty-four percent of subprime borrowers in the study had refinanced their home from two to six times, that thirty-one percent have refinanced three or more times, and that approximately thirty-six percent of refinances took place within two years of a prior loan).

190. Azmy & Reiss, *supra* note 10, at 692-93.

191. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 61; OCC ADVISORY LETTER 2003-3, *supra* note 7, at 2 (describing central predatory lending behavior as underwriting a loan "predominantly on the basis of the liquidation value of the collateral, without regard to the borrower's ability to service and repay the loan according to its terms, absent resorting to that collateral"). Indeed, studies of the subprime market have shown that there is little incidence of subprime loans extended to borrowers with high loan-to-value ratios, even though such a ratio is a strong indicator of risk. See, e.g., Courchane et al., *supra* note 118, at 369. This suggests the prevalence of subprime and predatory lending that is based on the basis of a borrowers' equity. See *id.* A related, but analytically distinct, problem is issuing loans that exceed the value of the home. Unscrupulous lenders may accomplish this by obtaining a fraudulently high appraisal. The borrower is then locked into higher debt payments and fees and cannot refinance thereafter for a lower rate. SEPARATE AND UNEQUAL, *supra* note 5, at 40.

192. HUD-TREASURY JOINT REPORT, *supra* note 8, at 76-77; PREYING ON NEIGHBORHOODS, *supra* note 5, at 23 (contending that foreclosure rates in Chicago area are rising because "loans are being pushed upon borrowers who are not able to repay them").

193. According to testimony heard by the HUD-Treasury Task Force, many of these loans are "made to older borrowers living on fixed incomes, replacing low-cost, low-principal loans these borrowers had previously held." HUD-TREASURY JOINT REPORT, *supra* note 8, at 76.

194. OCC ADVISORY LETTER 2003-3, *supra* note 7, at 2-3 (explaining that a lender extending credit without regard to a borrower's ability to repay can expect to recover high fees or satisfy the outstanding obligation through foreclosure). Because brokers and lenders can generate substantial fees from the refinancing of loans, they have an incentive to exaggerate a borrower's income to consummate the loan and collect fees before the lender can detect any problem with the underwriting risk. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 76.

195. *Id.*; see also Engel & McCoy, *supra* note 9, at 1262 n.11. Engel and McCoy explain:

c. Home Improvement Contractor Abuse

Unscrupulous home improvement contractors are a prime source for predatory loans. Such contractors may troll a low-income neighborhood looking for a home in need of repair and aggressively encourage unnecessary or overpriced repairs.¹⁹⁶ The contractor will then arrange financing with a prearranged lender that is complicit in the scheme, issuing a loan with abusive terms.¹⁹⁷ These lenders may pay contractors directly, leaving the borrower with no control over the quality of work. Indeed, work is often incomplete or shoddily performed once the loan is closed and the lender has paid off the contractor's fees.¹⁹⁸ In this case, the borrower is left with a heavy loan, unfinished repairs, and no remedy.

C. Unfair Loan Structures

Typically, in connection with the practices just described, subprime loans include loan provisions that are nonexistent in the conventional loan market, extract unreasonable rents, undermine the fluidity and efficiency of the subprime market, and generally threaten borrowers with an unreasonable risk of default or foreclosure.

1. Prepayment Penalties

Prepayment penalties are charges that a borrower must pay to a lender if the borrower wishes to refinance the loan, either through the same lender or through a different one.¹⁹⁹ In theory, lenders do not want their loans paid off early because that would force them to reinvest the full amount of the loan in a market bearing the lower rate of return, which is presumably what motivates a borrower to refinance in the first place. Prepayment penalties are typically triggered if a borrower prepays within a period of

If borrowers have sufficient equity in their homes when they default, lenders can repeatedly refinance the borrowers' loans upon default, each time tacking huge fees onto the principal. When the borrowers have leveraged all their equity and default, the lenders receive their proceeds at the foreclosure sale; typically these proceeds greatly exceed the amount of cash the lenders initially provided to the borrowers.

Id.

196. HUD-TREASURY JOINT REPORT, *supra* note 8, at 79.

197. *See id.* at 80.

198. *See id.* at 39; SEPARATE AND UNEQUAL, *supra* note 5, at 52. These loans are particularly problematic because they may lead a homeowner with no mortgage or a low-interest loan into a high-interest subprime loan, simply because the borrower sought to make an inexpensive home repair. Mansfield, *supra* note 29, at 557-58.

199. *See* HUD-TREASURY JOINT REPORT, *supra* note 8, at 93.

years from the closing of the loan (usually no greater than five years).²⁰⁰ In the conventional mortgage market, however, market competition has made prepayment penalties virtually nonexistent: only one to two percent of prime loans contain prepayment penalties.²⁰¹ In sharp contrast, in very recent years, up to eighty percent of subprime loans contained prepayment penalties,²⁰² which regularly represent approximately five percent of the loan balance.²⁰³ The disparity between the prevalence of prepayment penalties in conventional and subprime markets undercuts any suggestion that borrowers genuinely choose prepayment penalties, perhaps in exchange for another favorable loan term.²⁰⁴ Indeed, borrowers are frequently either misled or at least not fully informed about the future consequences of a prepayment term in their loan document and may find out only after they have been flipped into a refinance loan.²⁰⁵

Subprime loans can be a device to permit those who are facing a temporary credit crunch and are willing take a chance on a high-cost loan until they are in a position to refinance to do so with a lower-cost loan. Prepayment penalties, however, create serious problems for subprime borrowers so inclined. First, prepayment penalties strip significant equity from borrowers. Lehman Brothers has estimated that over half of borrowers (the overwhelming majority of whom are subprime) prepay loans with prepayment penalties within the standard five year “lock-out period” and that prepayment penalties typically cost borrowers the value of six months interest, or for many borrowers, about four to five percent of the value of the loan.²⁰⁶ When a borrower refinances a loan with a

200. *Id.*

201. *Id.*

202. See GOLDSTEIN & SON, *supra* note 65, at 2 n.4.

203. *Id.* at 3. This proportion of subprime loans that contain prepayment penalties appears directly attributable to changes in governmental regulation in the mid-1990s. In 1996, the Office of Thrift Supervision (OTS) interpreted the Alternative Mortgage Transaction Parity Act of 1982 (AMTPA), 12 U.S.C. §§ 3801-05 (2000), to preempt states from enforcing prepayment penalty restrictions against finance companies. See Alternative Mortgage Transaction Parity Act, 67 Fed. Reg. 60,542, 60,548 & n.36 (Sept. 26, 2002) (to be codified at 12 C.F.R. pts. 560, 590, & 591). Because finance companies make up the vast majority of subprime loans, the OTS action caused the prevalence of prepayment penalties to increase from ten percent in 1995 to eighty percent in 2001. GOLDSTEIN & SON, *supra* note 65, at 2 n.4. In 2002, the OTS revised its interpretation and concluded that state regulation of prepayment penalties were no longer preempted by AMTPA. 67 Fed. Reg. 20,468 (Apr. 25, 2002) (to be codified at 12 C.F.R. pts. 560, 590, & 591). As a result, approximately thirty-five state laws limiting prepayment penalties will be given full effect. GOLDSTEIN & SON, *supra* note 65, at 6 n.23.

204. GOLDSTEIN & SON, *supra* note 65, at 6 (“Rational subprime borrowers with market power should prefer [prepayment penalties] no more often, and probably less often, than conventional borrowers so that they can refinance into a conventional loan at a significantly lower rate as soon as credit improves.”).

205. *Id.* at 7.

206. Goldstein & Son, *supra* note 65, at 3 (citing A. Chu & K. Kwan, Lehman Brothers, *Asset-*

prepayment penalty, the amount of penalty frequently gets financed again, driving up the overall cost of the loan to the borrower and stripping more equity as a percentage of the now greater total of the loan.²⁰⁷ The Stein study estimates that prepayment penalties drain \$2.3 billion annually from borrowers' home equity.²⁰⁸

In addition, and in part as a result of the resultant loss of equity, prepayment penalties significantly inhibit a subprime borrowers' ability to graduate into conventional financing or to otherwise take advantage of falling interest rates.²⁰⁹ The securitization process largely drives the prevalence of prepayment penalties in the subprime market²¹⁰ because the secondary market makes a substantial amount of money from securitizing such payment streams.²¹¹

2. Balloon Payments, Default Interest Rates, Call Provisions, and Advance Payments

A balloon payment is a lump-sum payment that occurs at a designated point in the repayment period where monthly payments have not fully amortized the loan principal.²¹² A borrower in theory may be willing to

Backed Securities, MBS AND ABS WEEKLY OUTLOOK, July 17, 2000, at 2, 8). In addition, to the extent that lenders need prepayment penalties as a hedge against losses from borrower refinancing, lenders frequently impose penalties for a period of time from the origination date of the loan longer than necessary to cover losses. *Id.* at 4.

207. Assuming a subprime borrower with a prepayment penalty wishes to refinance her \$150,000 mortgage with a 10% interest rate, she would face a prepayment penalty of 5% or \$7,500. STEIN, *supra* note 105, at 8. According to one estimate, this amount represents more than the total lifetime net worth for the median African American family. *Id.* This comparison is powerful because, as noted previously, African Americans are almost five times more likely to obtain a subprime refinance loan. *Id.*; see *supra* text accompanying note 153.

208. STEIN, *supra* note 105, at 9 (estimating 850,000 families per year pay such penalties).

209. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 94 (noting that prepayment penalties "can be especially problematic in cases where a good payment history may allow the borrower to 'graduate' to a lower-cost loan"); John Hechinger, *Home Bound: Nasty Surprise Haunts Some Folks' Mortgage: A Prepayment Penalty*, WALL ST. J., Aug. 1, 2001, at A1 (recounting case of one couple who could not refinance their eleven percent mortgage with a six percent mortgage because they could not afford the three thousand dollar prepayment penalty and of another couple who could not avoid foreclosure by selling their house because sale price would not cover prepayment penalty).

210. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 95 (concluding that "secondary market models have been built around the existence of these penalties" and proposing that prepayment penalties in high-cost loans be prohibited in order to dampen the incentive to securitize high-cost loans with abusive terms); STEIN, *supra* note 105, at 9 (describing class of securities specifically tied to cash flow from prepayment penalties).

211. According to a Lehman Brothers report, prepayment "penalty cash flows themselves are substantial." STEIN, *supra* note 105, at 9 n.26 (quoting Chu & Kwan, *supra* note 206, at 2).

212. KIDER & HALPERN, *supra* note 78, § 2.02[2][f]. Because balloon payments almost universally require refinancing, they are, in a sense, the opposite of prepayment penalties. Notwithstanding this, however, both can exist in the same subprime loan.

include a balloon payment in exchange for a lower interest rate and take a chance that she will be able to refinance at a favorable rate or sell her house sometime before the balloon payment becomes due; however, like prepayment penalties, many balloon payments are not a product of a meaningful choice by a borrower.²¹³ Many subprime borrowers are unaware that their loans have a balloon payment.²¹⁴ Predatory lenders frequently use the existence of a balloon payment, sometimes due in three to five years, as an opportunity to flip a subprime borrower and extract additional points and fees.²¹⁵

Default interest rate provisions cause borrowers to pay a substantially higher interest rate—sometimes up to forty percent—should they default on the loan.²¹⁶ The provisions are profoundly unjust because, at best, they make it enormously difficult for a borrower to cure default; at worst, they force a borrower into foreclosure or a refinancing with outrageous terms.²¹⁷ Discretionary call provisions entitle a lender to simply demand payment of the full loan amount at the lender's sole discretion, thereby ensuring lenders enormous leverage over subprime borrowers.²¹⁸ Advance payments require a borrower to prepay certain percentage of interest payments up front, at closing, rather than during the expected amortization of the loan.²¹⁹ Like balloon payments, these three provisions are frequently included without the borrower's knowledge or understanding.²²⁰ They also provide lenders with an excuse to initiate contact with borrowers and flip them into new high-fee loans, ostensibly to avoid application of these abusive terms.²²¹

3. Negative Amortization

Negative amortization is a loan structure where monthly loan payments are not large enough to cover the outstanding interest, causing the loan

213. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 97. About ten percent of subprime loans originated in 1999 included balloon terms. *Id.* at 96. In a study of 866 subprime loans in foreclosure in Dayton, Ohio, fourteen percent had balloon payment terms. STOCK, *supra* note 5, at 10. The incidence of balloon terms increased at higher interest rates, however: only two percent of loans with interest rates below nine percent had balloon payments, while twenty-three percent of loans with interest rates above twelve percent had balloon payments. *Id.* at 11.

214. SEPARATE AND UNEQUAL, *supra* note 5, at 54.

215. *Id.*

216. ELIZABETH RENUART & KATHLEEN E. KEEST, NAT'L CONSUMER LAW CTR., TRUTH IN LENDING § 10.4.3 & n.179 (4th ed. 1999).

217. *See id.*

218. Azmy & Reiss, *supra* note 10, at 661-62.

219. STOP PREDATORY LENDING, *supra* note 136, § 3.2.2, at 46 (noting that this practice “disguise[s] the real amount of credit extended and . . . increase[s] the consumer's obligation to pay interest”).

220. Azmy & Reiss, *supra* note 10, at 661.

221. *Id.* at 661-62.

principal to actually increase over time.²²² It is almost never in a borrower's interest to structure a loan this way because she will lose more equity in her home each month. Unscrupulous lenders typically sell such loans by misleadingly emphasizing these low interest payments. Not surprisingly, however, most borrowers do not understand that their loan is negatively amortized until they notice that their balance goes up.²²³

4. Financing Unnecessary Single Premium Credit Insurance (SPCI)

Predatory lenders frequently “pack” the cost of unnecessary and overpriced insurance policies into subprime loans without the borrowers' knowledge or informed consent.²²⁴ The insurance comes in several forms, all of which are linked to the specific debt or loan; the forms of insurance will pay off the remaining debt in the event of illness (credit health insurance), death (credit life insurance), or job loss (credit unemployment insurance).²²⁵ Credit insurance is rarely promoted in the prime market, but it is aggressively marketed in the subprime market in a “single-premium” form. Unlike traditional insurance, where the insured makes periodic (usually monthly) premium payments to sustain coverage, single-premium policies collapse the full premium charge into one up-front payment.²²⁶ The policies typically provide coverage for only five years, but because the premium is directly added to the loan amount, the premium is financed over the life of the loan.²²⁷

An industry study demonstrated that forty percent of borrowers receiving such credit insurance did not realize it was financed into their loan or otherwise believed that such insurance was either required or strongly recommended.²²⁸ Packing such loans can be very profitable for lenders because the financed insurance generates larger points and fees.²²⁹ However, the insurance is empirically of almost no benefit to borrowers.²³⁰ Estimates suggest that financing of single premium credit insurance costs

222. HUD-TREASURY JOINT REPORT, *supra* note 8, at 91.

223. *Id.* at 91-92.

224. *Id.* at 88.

225. *Id.* at 89.

226. *Id.* at 90.

227. *Id.* at 89-90.

228. STEIN, *supra* note 105, at 6-7.

229. *Predatory Lending Practices in the Home-Equity Lending Market: Before the Bd. of Governors of the Fed. Reserve Sys.* pt.A.1. (Sept. 7, 2000) (prepared statement of the Federal Trade Commission) (transcript available at <http://www.ftc.gov/os/2000/09/predatorylending.htm>). As a result, lenders also have no incentive to shop around for a lower-priced policy for the borrower. Moreover, lenders receive a commission of thirty percent from an insurance company on the sale of the single premium product. STEIN, *supra* note 105, at 7.

230. CONSUMERS UNION & CTR. FOR ECON. JUSTICE, CREDIT INSURANCE: THE \$2 BILLION A YEAR RIP-OFF 13-14 (1999).

up to five times as much as does unfinanced credit insurance paid periodically by the borrower.²³¹ The Consumer Federation of America calls financed single-premium credit insurance a rip-off; the practice costs American borrowers \$2.1 billion a year.²³²

D. *Predatory Impacts: Explosion of Residential Foreclosures*

The explosion of subprime and predatory lending has had real, measurable impacts on the communities in which such lending is concentrated. Several studies of residential foreclosure patterns in municipal regions document a staggering rise in residential foreclosures and demonstrate the causal role that subprime and predatory lending has played in that rise. These studies also suggest that overpriced loans are what cause high foreclosure rates in these communities and not, as many suggest, that high foreclosure rates in these communities drive up loan costs.

First, in many communities, the increase in the number of residential foreclosures in periods corresponding to the growth of subprime lending has been staggering. For example, in the Chicago metropolitan area, the number of residential foreclosures on borrowers with subprime loans grew from a total of only 30 in 1993 to 1417 in 1998.²³³ This represented a 4600% increase at a time when mortgage foreclosures on conventional loans increased by only 25%.²³⁴ In Atlanta and Boston, subprime foreclosures increased dramatically over comparable periods at the same time that conventional mortgage foreclosures actually decreased.²³⁵

231. Azmy & Reiss, *supra* note 10, at 659. Because the insurance is collateralized against the home, each time a borrower refinances, all of the terminated insurance premiums are stripped from the homeowner's equity. STEIN, *supra* note 105, at 5-6.

232. CONSUMER FED'N OF AM. & CTR. FOR ECON. JUSTICE, CREDIT INSURANCE OVERCHARGES HIT \$2.5 BILLION ANNUALLY (2001), available at <http://www.consumerfed.org/credins.pdf>; CONSUMERS UNION & CTR. FOR ECON. JUSTICE, *supra* note 230, at 1. Fannie Mae and Freddie Mac now refuse to purchase loans with financed single-premium insurance, and a number of reputable lenders have agreed to cease packing such insurance into loans. STEIN, *supra* note 105, at 6.

233. PREYING ON NEIGHBORHOODS, *supra* note 5, at 17.

234. *See id.* at 17-18 & tbl. 4. During this time, the proportion of total foreclosures in the area attributable to subprime lenders increased from 1.4% to 35.7%. *Id.* at 17 tbl.4.

235. Bunce et al., *supra* note 35, at 265 tbl. 2. In Atlanta, between the years 1996 and 1999, subprime foreclosures increased by 232% at the same time that conventional mortgage foreclosures decreased by 15%. *Id.* In Boston, between 1995 and 1999, subprime foreclosures increased by 158% while conventional mortgage foreclosures decreased by 50%. *Id.* In Akron, Ohio, between 1994 and 2000, foreclosures increased four-fold—an increase which city officials attribute to the rise of unscrupulous lending practices. Gloria Irwin, *Akron, Ohio, Neighborhoods Lead Area in Foreclosures*, AKRON BEACON J., Mar. 27, 2003, LEXIS, Business News, Knight Ridder/Tribune Business News File; *see also* Gargi Chakrabarty Gargi, *Hoosiers Face Bite of Predatory Lending: Foreclosures in State Soar*, INDIANAPOLIS STAR, Mar. 17, 2003, at 1C (describing a large increase in subprime foreclosures in the state, and quoting a community activist as saying, “[w]e estimate 70 percent of all foreclosures in this area are a result of predatory lending”); Teresa Dixon Murray,

One might expect the number of subprime foreclosures to increase as the overall number of subprime loan originations increase. Significantly, however, the growth of subprime foreclosures has substantially outstripped the growth of subprime originations and the speed at which subprime loans have gone into foreclosures has also increased dramatically. These data suggest, at best, great inefficiency in the subprime mortgage underwriting process; but, more troubling, they also suggest that predatory terms and practices produce these rates of foreclosure. In Chicago, for example, the proportion of subprime mortgage originations increased from 3% to 24% between 1991 and 1997; during roughly the same period, however, the subprime share of foreclosures increased from 1.3% to 35.7%.²³⁶ Similarly, in Baltimore, the subprime share of foreclosure petitions was 45%, more than double the 21% subprime share of mortgage originations.²³⁷

Moreover, the speed at which subprime loan originations wind up in foreclosure is remarkable, suggesting that many subprime mortgages were never realistically affordable in the first place. In Chicago, foreclosures on mortgages less than four years old tripled between 1993 and 1998, while foreclosures on mortgages more than eight years old decreased substantially over the same period.²³⁸ In Atlanta and Baltimore during comparable periods, the average age of subprime loans in foreclosure was under two years and occurred roughly twice as fast as foreclosures for conventional and FHA loans.²³⁹ In the northern New Jersey region, which includes Newark, the average age of foreclosures on subprime loans

Ohio Home Foreclosures Soar Economy, Predatory Lenders Blamed for Rising Rate, PLAIN DEALER (Cleveland), Jan. 10, 2003, at A1 (reporting dramatic rise of foreclosures in Ohio communities due in part to predatory practices and subprime loans made to persons unable to afford them); Chris Poynter, *Study Links Predatory Loans and Home Loss: Practice Found in Many Local Foreclosures*, Courier-Journal (Louisville, KY), Nov. 30, 2003, at 1B (describing study of foreclosures in Louisville metropolitan area and finding up to one-third had predatory characteristics); Orla O'Sullivan, *New Foreclosure Phenomenon*, ABA BANKING J., Nov. 2003, at 77, 77-78 (attributing rise of foreclosures during period of low interest rates in large part to growth of subprime and predatory lending).

236. HUD-TREASURY JOINT REPORT, *supra* note 8, at 49; *see also* DAN IMMERGLUCK & GEOFF SMITH, *RISKY BUSINESS: AN ECONOMETRIC ANALYSIS OF THE RELATIONSHIP BETWEEN SUBPRIME LENDING AND NEIGHBORHOOD FORECLOSURES 7-10 (2004)* [hereinafter *RISKY BUSINESS*] (concluding that foreclosures in Chicago metropolitan area between 1997 and 2002 were twenty times more likely for subprime than for prime loans, even after controlling for neighborhood demographics and economic conditions).

237. Bunce et al., *supra* note 35, at 266.

238. PREYING ON NEIGHBORHOODS, *supra* note 5, at 23.

239. Bunce et al., *supra* note 35, at 264-65. In Baltimore, subprime loans foreclosed after an average of 1.8 years while conventional mortgages foreclosed on an average of 3.2 years. *Id.* at 264. In Atlanta, the median age of foreclosed subprime loans was two years, compared to four years for conventional mortgages. *Id.* at 265. In Boston, the median ages of foreclosures of subprime loans and conventional mortgages was three years and seven years, respectively. *Id.*

decreased dramatically from 6.7 years in 1995 to 4.0 years in 2000.²⁴⁰ Moreover, the dramatically faster rates of foreclosure occurred at higher interest rates.²⁴¹ These data suggest that, contrary to the standard description of subprime pricing behavior, excessive interest rates tend to drive unnecessarily higher risk of foreclosure, not the other way around.

Rashes of foreclosures have transformed once vibrant neighborhoods into tracts of abandoned property.²⁴² The resulting externalities are broad and serious: the value of surrounding homes decreases, costing neighbors equity in their homes, and gangs, drugs, and general crime increases, driving up a need for increased government services and making future reinvestment or rehabilitation more difficult.²⁴³ Predatory lending, therefore, is not only hurting tens of thousands of American families annually, it is also slowly and steadily draining a major source of wealth from poor, minority, and elderly communities in the form of home equity—the very source of wealth that should offer the security and prosperity so centrally connected to the narrative of the American Dream.

IV. THE INSUFFICIENCY OF PRE-EXISTING REMEDIES

Prior to the recent proliferation of state anti-predatory lending legislation,²⁴⁴ only an ineffective patchwork of remedies, primarily federal, existed to combat predatory lending practices. Not surprisingly, predatory lenders aggressively exploited these regulatory gaps to great profit, in the ways previously described. In opposing further legislative reform, however, the subprime lending industry repeatedly argues that laws currently on the books could, if adequately enforced, do away with

240. ZIMMERMAN ET AL., *supra* note 5, at 8.

241. In Chicago, the fastest growth in foreclosures was for loans with rates four percent or more above the Treasury rate, representing more than an 840% increase between the years 1993 and 1998. PREYING ON NEIGHBORHOODS, *supra* note 5, at 18, 20 fig.6. In Atlanta, loans with interest rate spreads greater than four percent represented almost half of those subprime loans entering foreclosure. HUD-TREASURY JOINT REPORT, *supra* note 8, at 50.

242. See ZIMMERMAN ET AL., *supra* note 5, at 23 fig.5 (showing distribution of foreclosures heavily concentrated in minority neighborhoods of Essex County, New Jersey).

243. *Equity Predators Hearing*, *supra* note 20, at 88 (statement of William J. Brennan, Jr., Director, Home Defense Program of the Atlanta Legal Aid Society); RISKY BUSINESS, *supra* note 236, at 4-5 (“Cities, counties and school districts lose tax revenue from abandoned homes. . . . Foreclosures in struggling, low- or moderate-income and minority neighborhoods may have greater negative impacts than those in middle- and upper-income areas. In the latter case, the foreclosures are less likely to lead to abandoned buildings, blight and crime.”); STEIN, *supra* note 105, at 12-13 (“These additional costs from resulting social externalities may well dwarf other estimates made in this report.”); Eggert, *supra* note 1, at 582 (“Foreclosed homes often stay vacant longer than other homes, with less maintenance, becoming wrecked hulks that are breeding grounds for crime, depressing property values and economic development.”).

244. See *infra* Part V.A. & Appendix 1.

virtually all predatory lending behavior.²⁴⁵ In this section, I will explain what experience has already demonstrated—that neither the market nor currently constructed federal consumer protection laws can effectively combat predatory lending.

A. Market Responses

The subprime market within which predatory lenders operate is largely distinct from the prime market. As a result of the historic underservicing of low-income and, particularly, minority neighborhoods, the steady increases in minority-owned property values, and the boom in available financing created by the securitization of subprime loans, significant market opportunities for subprime lenders have emerged.²⁴⁶ In addition, in recent years, prodded by Fannie Mae's and Freddie Mac's increasing commitment to purchase loans originated in low- and moderate-income neighborhoods conforming to GSE underwriting criteria, some traditional lenders have begun to enter the subprime market.²⁴⁷ On the whole,

245. See LITAN, *supra* note 7, at 2 (highlighting that predatory lending abuses “already are prohibited under existing federal law”); Letter from Carl V. Howard, General Counsel, Citigroup, Inc., to Office of Thrift Supervision 2 (July 25, 2000) (“Adequate legislative and regulatory tools already exist to eliminate predatory lending.”), available at <http://www.ots.treas.gov/docs/4/48265.pdf>. In addition to aggressively enforcing existing laws, certain parts of the industry also have suggested that compliance with certain “best practices” would be sufficient to eliminate supposedly isolated instances of predatory lending, and they include, among other things: compliance with all state and federal laws; company-wide training in fair lending and training of correspondents and vendors; maintenance of a work environment that encourages compliance with best practices; and a commitment to treat customers fairly regardless of race, gender, and similar characteristics. MORTGAGE BANKERS ASS'N OF AM., “BEST PRACTICES” FOR SUBPRIME LENDING (2000). The National Association of Mortgage Brokers advocates increased enforcement of existing laws in combination with industry self-regulation and increased consumer education. *Predatory Mortgage Lending Hearing*, *supra* note 51, at 257 (statement of Neill A. Fendly, CMC, Immediate Past President of National Association of Mortgage Brokers).

246. See *supra* text accompanying notes 163-67 (discussing the underservicing of minority communities by traditional banks); *supra* text accompanying notes 78-98 (discussing the role of securitization in the growth of subprime lending).

247. Freddie Mac and Fannie Mae began purchasing subprime loans in 1997 and 1999, respectively, limiting their purchases to the most creditworthy subset of borrowers. GAO REPORT, *supra* note 8, at 74. According to a HUD study, which admits to some imprecision, Freddie Mac and Fannie Mae purchased about fourteen percent of subprime loans originated in 2002. *Id.* at 74-75. HUD has set goals for these entities to increase their purchases of loans for low-income and underserved communities, which should increase their share of subprime loan purchases. *See id.* at 75 & n.3. HUD hopes that the increased participation of Freddie Mac and Fannie Mae will help standardize subprime loans and thereby decrease interest rates on this set of loans. *Id.* at 75. And, although Freddie Mac and Fannie Mae have established guidelines to limit their purchases of loans containing abusive terms, those guidelines are still quite general and have not yet been endorsed by nine of the Federal Home Loan Banks that also have committed to purchasing subprime loans. HUD-TREASURY JOINT REPORT, *supra* note 8, at 108. In addition, although the Community

however, the brisk competition and regimented underwriting criteria in the prime market, which prevent lenders from imposing disadvantageous terms and which both moderate interest rates and keep them accurately calibrated to a borrower's credit risk, have not emerged in the subprime market. Despite the considerable profits to be captured in servicing subprime borrowers, legitimate lenders do not seem to be entering the subprime market in sufficient volume to eliminate abusive practices. In short, the market has not and cannot eliminate the abuses of the subprime lending industry on its own.

First, banks and thrifts perceive obstacles to substantial investment in subprime lending. Because subprime loans generally carry a greater risk of default, banks and thrifts are wary of damaging their cultivated reputations as community-friendly institutions if they start lending to, and foreclosing upon, lower-income and minority families.²⁴⁸ At the same time, the subprime lending industry (and predatory lenders in particular) focus on minority communities in part because traditional lenders have largely abandoned them on the premise that race correlates with creditworthiness.²⁴⁹ Moreover, the underwriting of subprime loans is traditionally more difficult because of greater uncertainty about a borrower's creditworthiness and the barriers to entering this market.²⁵⁰ Most banks and thrifts offer a wide variety of services and do not specialize in the way that subprime lenders do in evaluating and servicing riskier borrowers; as a result, many prime lenders perceive that costs associated with establishing underwriting criteria and implementing them do not justify the potential benefits of infiltrating the subprime market.²⁵¹

Reinvestment Act created incentives for banks and thrifts to originate loans in low- and moderate-income neighborhoods in order to increase their government merger approval ratings, *id.* at 105, it does nothing to prevent lenders from accumulating their CRA credits through the purchase of predatory loans, Engel & McCoy, *supra* note 9, at 1277 n.95. As a result, the remedial effects of increased participation by Fannie Mae, Freddie Mac and of the CRA are still highly speculative.

248. Engel & McCoy, *supra* note 9, at 1289-90.

249. See Harold A. Black, *Is There Discrimination in Mortgage Lending? What Does the Research Tell Us?*, 27 REV. BLACK POL. ECON., Summer 1999, at 23, 23 (1999); Fred Galves, *The Discriminatory Impact of Traditional Lending Criteria: An Economic and Moral Critique*, 29 SETON HALL L. REV. 1467, 1474 (1999); Ronald K. Schuster, *Lending Discrimination: Is the Secondary Market Helping to Make the "American Dream" a Reality?*, 36 GONZ. L. REV. 153, 162-73 (2000-2001); Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787, 792-802 (1995).

250. Barr, *supra* note 164, at 125 ("[B]anking the poor is unlikely to be seen as sufficiently profitable for many banks to incur the up-front costs of entering this market, particularly because most banks are not institutionally organized to focus on this market segment."); see *supra* text accompanying notes 27-28.

251. Engel & McCoy, *supra* note 9, at 1292; see also Barr, *supra* note 164, at 183 ("Financial institutions may be reluctant to expend the resources for research, product development, training, marketing, and education, which are necessary to expand financial services to lower-income clientele."). In addition, because banks and thrifts are heavily regulated, in a way that the majority

Moreover, most of the banks and thrifts that have subsidiaries or affiliates engaging in subprime lending have no processes in place to allow borrowers to move “up-stream” to the parent bank’s prime lending product.²⁵²

Second, the combination of specialized marketing techniques employed by predatory lenders and the persistence of information asymmetries between subprime lenders and borrowers gives predatory lenders a strong incentive to exclude legitimate lenders—prime and subprime—from the portions of the subprime market that they exploit. As described, predatory lenders rely on direct marketing techniques, usually full of misleading enticements, to prey upon persons who are financially unsophisticated and disconnected from the economic mainstream, even if those persons are not serious credit risks.²⁵³ Indeed, predatory lenders employ aggressive and deceptive measures to ensure that a deal is closed quickly and before a vulnerable borrower has an opportunity to compare loan packages with a competitor.²⁵⁴ Moreover, once victims are signed onto a loan, predatory lenders ensure that they cannot graduate to a conventional loan, thus making the borrowers vulnerable to being flipped into another predatory loan.²⁵⁵ Legitimate subprime lenders typically refrain from such unscrupulous marketing methods and, by contrast, attract borrowers who are sophisticated enough to shop around among the competition.²⁵⁶ The barriers to entry experienced by legitimate subprime lenders, combined with the slow emergence of bank and thrift participation in the subprime lending market, are significant. This suggests that elimination of predatory lenders might slowly encourage the lenders to service those who otherwise would be trapped with predatory loans.

Finally, the transformation of the mortgage market in the past decade has made it difficult for market participants to police each other or exert sufficient pressure to prevent fraud and abuse in the market. As described, the securitization process provides mortgage brokers with incentives to

of subprime lenders are not, they must document and justify their underwriting decisions in detail to bank regulators. *See* GAO REPORT, *supra* note 8, at 42-45. Indeed, banks and thrifts have decreased their presence in low-income and minority neighborhoods at the same time studies have indicated the importance of such a physical presence to enable low-income and minority borrowers to access credit. SEPARATE AND UNEQUAL, *supra* note 5, at 45-46. Re-establishing such a presence would present an additional cost to traditional prime lenders.

252. *Cf.* HUD-TREASURY JOINT REPORT, *supra* note 8, at 105 (urging prime banks to develop loan products that will allow more subprime borrowers to “graduate” to prime mortgage loans).

253. *See supra* Part III.B.1.

254. *See supra* Part III.B.1.

255. *See supra* Part III.B.2.a.

256. Engel & McCoy, *supra* note 9, at 1297; *cf. Predatory Mortgage Lending Hearing, supra* note 51, at 57 (prepared statement of Thomas J. Miller, Attorney General, State of Iowa) (“The notion of consumers shopping for a refinance loan or a home improvement loan, comparing prices and terms, is out of place in a sizeable portion of this [predatory lending] market. Frequently, these are loans in search of a borrower, not the other way around . . .”).

extort fees, steer borrowers into higher-cost loans, and extend loans without regard to a borrower's ability to repay; and, similarly, it allows lenders to pass off many of the risks associated with this behavior to the secondary market noteholders.²⁵⁷ Moreover, loan underwriters perceive that their primary obligation—and financial incentive—is to sell mortgage-backed securities on behalf of the issuer, rather than ferreting out abusive loan terms or practices.²⁵⁸

At the same time, secondary market noteholders also fail to seriously police predatory lending activity. Information asymmetries between loan originators—who are most familiar with the borrower but may not actually care about the high credit risk of a loan that will be securitized—and secondary market purchasers of loans—who know far less about the borrower but are concerned about risk associated with their investment—generally make it hard for some secondary market purchasers to identify abusive loans.²⁵⁹ While secondary market participants may be concerned about the costs associated with foreclosure, the holder-in-due-course doctrine gives them little reason to worry that underlying fraud or disclosure violations by loan originators would impede their ability to foreclose and recoup costs.²⁶⁰ In any event, whatever nominal financial incentives may exist for secondary market participants to deter predatory lending, they have yet to counteract the even stronger incentives to finance the extremely profitable securitization of high-cost loans, or to come close to matching the risks to borrowers caused by predatory lending. Any aggressive antipredatory lending efforts should as a result account for the financing of unscrupulous lenders and brokers by the secondary market.²⁶¹

257. See *supra* text accompanying notes 131-37.

258. See Tanoue, *supra* note 103 (“Securities must be attractive and marketable to investors, and the underwriter’s compensation is based on a percentage of the sales proceeds. Accordingly, the underwriter’s motivation appears to be to receive the highest price and best execution possible on behalf of the issuer . . .”).

259. See Anthony Pennington-Cross, *Subprime Lending in the Primary and Secondary Markets*, 13 J. HOUSING RES. 31, 35 (2002) (arguing that information asymmetries in the subprime market “are driven by the lack of . . . sophisticated evaluation models being used by originators, making it more likely that information is lost as the mortgage moves from originator to the private conduit in the secondary market”).

260. See *infra* Part IV.G.

261. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 108. The report indicated:

While the secondary market could be viewed as part of the problem of abusive practices in the subprime mortgage market, it may also represent a large part of the solution to that problem. If the secondary market refuses to purchase loans that carry abusive terms, or loans originated by lenders engaging in abusive practices, the primary market might react to the resulting loss of liquidity by ceasing to make these loans.

Id.; see also Eggert, *supra* note 1, at 617 (“If such disreputable lenders lose their access to the

B. Disclosure Regimes: TILA and RESPA

The Truth in Lending Act (TILA)²⁶² requires mortgage lenders to disclose to borrowers certain information deemed necessary to understand the true cost of a loan and “shop around” for the best financing deal.²⁶³ Before the consummation of the loan, lenders must disclose to the borrower the loan’s annual percentage rate (APR) (a standardized valuation of credit cost), finance charges, the total amount financed (including points and fees), the number of payments, and the payment schedule.²⁶⁴ Penalties available in civil suits for disclosure violations include statutory damages of twice the amount financed, actual damages, and attorneys’ fees.²⁶⁵ The Real Estate Settlement Procedures Act of 1974 (RESPA)²⁶⁶ also requires lenders to disclose details of the cost of settling a loan in a uniform settlement statement (HUD-1) and prohibits certain charges and kickbacks to third parties.²⁶⁷

secondary market and are forced to keep their loans themselves and attempt to collect from their own, often angry, borrowers who retain their defenses to the loan, these unscrupulous originators would, for the most part, be driven out of business.”); Tanoue, *supra* note 103 (“To effectively combat predatory lending, we must sever the money chain that replenishes the capital of predatory lenders and allows them to remain in business.”).

262. Truth in Lending Act (TILA), 15 U.S.C. §§ 1601-67 (2000).

263. *Id.* § 1601(a) (announcing congressional purpose to “assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit”).

264. *Id.* § 1639. The lender also must include the cost of credit life insurance as a finance charge, unless the lender notifies the borrower that coverage is optional, Regulation Z, 12 C.F.R. § 22.6.4(d) (2004), and disclose the borrower’s right to cancel the loan within three days of closing. 15 U.S.C. § 1635(a); 12 C.F.R. § 226.23(a)-(b).

265. 15 U.S.C. § 1640(a) (authorizing statutory damages of double the finance charge or up to one thousand dollars per violation). For damage actions, TILA contains a short statute of limitations period of only one year. *Id.* § 1640(e). TILA does provide an extended, three-year right to rescind a loan transaction for material violations, a right that extends to actions against an assignee. *Id.* § 1641(c); 12 C.F.R. 226.23(a)(3). Criminal penalties of a maximum five thousand dollar fine and one year in jail are also available for knowing or willful violations of TILA. 15 U.S.C. § 1611.

266. Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 1831b, 2601-2617 (2000).

267. *See id.* § 2601. After some initial uncertainty, courts have made it more difficult to demonstrate that a yield spread premium constitutes an illegal kickback under RESPA. *See, e.g.,* Hirsch v. Bankamerica Corp., 328 F.3d 1306, 1307-09 (11th Cir. 2003) (per curiam) (affirming summary judgment for defendant lender because plaintiff failed to show that the broker, in receiving the yield spread premium, did not provide “goods or services of the kind typically associated with a mortgage transaction” and because there was no evidence that the compensation was unreasonable) (quoting Heimmermann v. First Union Mortgage Corp., 305 F.3d 1257, 1263 (11th Cir. 2002); Levine v. N. Am. Mortgage, 188 F.R.D. 320, 328-29 (D. Minn. 1999) (denying summary judgment to plaintiff borrower because plaintiff failed to meet his “heavy burden” of

Disclosure regimes, such as TILA and RESPA are heavily favored by the classical liberal economic theory that has driven modern federal consumer regulation.²⁶⁸ In theory, by increasing consumer information about comparable loan terms, disclosure decreases the consumer's opportunity cost associated with the transaction, enhancing overall market efficiency.²⁶⁹ Classical liberal theory also suggests that disclosure enhances the social welfare of all market participants by ratifying consumers' freedom to choose products that consumers deems to be in their best interests.²⁷⁰ This normative preference for disclosure may be well-justified for products such as groceries, personal electronics, and even larger purchases like automobiles, because consumers can compare products within those categories relatively quickly and with few or no transaction costs. In the context of the subprime mortgage market, however, the theoretical premises of disclosure regulation seem quaint and utterly insufficient.²⁷¹

The overwhelming market power that the predatory sector of the subprime market has over its customers makes it nearly impossible for them to compare price terms. In the first place, there is little price competition in the predatory lending market that might provide a customer the opportunity to compare the cost of a particular loan against one offered by another lender.²⁷² Predatory loans often are deliberately made so complex²⁷³ and contain so much information that comparing loan products is altogether confusing.²⁷⁴ Further, TILA disclosures often are presented

demonstrating that HMD's interpretation of RESPA, setting forth a difficult two-prong test for determining the legality of yield spread premiums, is "irrational, arbitrary, or manifestly contrary to the language of the statute").

268. Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 883 (2003).

269. *Id.* at 881-83.

270. *Id.* at 883.

271. According to one idealized description, the Truth in Lending Act serves to promote "the traditional Yankee faith in the shrewdness of the consumer, and his ability to police the marketplace and choose the best buy." Ndiva Kofele-Kale, *The Impact of Truth-in-Lending Disclosures on Consumer Market Behavior: A Critique of the Critics of Truth-in-Lending Law*, 9 OKLA. CITY U. L. REV. 117, 120 (1984) (quoting Johnathan M. Landers, *Some Reflections on Truth in Lending*, 1977 ILL. L.J. 669, 669-70).

272. See *supra* text accompanying notes 257-65.

273. See Peterson, *supra* note 268, at 891 & n.635 ("[I]n the high-cost credit market, many creditors inject complexity into their contracts and the negotiation process preceding them simply for the strategic value of the complexity itself.").

274. *Id.* at 894 (describing significant costs often involved in investigating high-cost loan products, including paying for credit reports, application fees, and even deposits, which prevent comparison shopping). In addition, many lenders take advantage of ambiguities in TILA regarding what costs must be included in the "amount financed" so that true loan costs are not, in fact, fully disclosed; lenders frequently "unbundle" certain fees such as underwriting fees, document preparation fees, sellers' attorneys' fees, administrative fees, traditional title-related fees, and credit

to the borrower on the day of the loan closing, when a borrower has psychologically committed herself to the loan, and among stacks of other documents totaling hundreds of pages, all of which belies the idealized image of an informed consumer acting on rational economic preferences among comparable loan products.²⁷⁵

Indeed, although it initially protested what it claimed would be the prohibitive costs of compliance, the lending industry now recognizes legal and political advantages to disclosure regimes. For subprime lenders, compliance with simplified TILA disclosure requirements may be a way to mask underlying loan complexity and also to defend against otherwise legitimate allegations of oral misrepresentations.²⁷⁶ The disclosure paradigm also provides political cover against charges that high-cost loans are too expensive or abusive and a shield against calls for more regulation of substantive loan terms.²⁷⁷

C. Direct Limitations on High-Cost Loans: HOEPA

In 1994, recognizing that borrowers of high-cost loans are particularly vulnerable to certain exploitative lenders unaffected by TILA disclosure regulations, Congress passed the Home Ownership and Equity Protection Act (HOEPA).²⁷⁸ HOEPA designates a special class of nonpurchase, closed-end “high-cost” loans and prohibits lenders originating them from

insurance from the calculation of “points” that are the hallmark of loan transparency. KATHLEEN E. KEEST & GARY KLEIN, NAT’L CONSUMER LAW CTR., TRUTH IN LENDING § 3.2.2, at 77 (3d ed. 1995).

275. See Guttentag, *supra* note 121, at 19-20. The huge amount of complex documents is a problem of its own. *Id.* at 19. Guttentag states:

So many documents are required [at closing] that specialized firms have arisen that do nothing but provide documents. The flood of documents overloads the attention spans of many borrowers, allowing unscrupulous loan providers to take advantage

. . . .

Anyone who has gone through the process will understand. The TIL is one of a flood of documents that the borrower receives, “Prepayment” is one of many items on the TIL sheet, and the penalty warning is anything but clear.

Id. at 19-20.

276. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & DEP’T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT 1 (1998).

277. Peterson, *supra* note 268, at 881 (noting that “high-cost creditors have advocated disclosure rules to deflect legislative pressure for more substantive rules”).

278. HOEPA was passed as an amendment to TILA. Home Ownership and Equity Protection Act of 1994, 15 U.S.C. §§ 1639, 1648 (2000). The Federal Reserve Board is authorized under TILA to promulgate regulations, collectively referred to as Regulation Z. 12 C.F.R. §§ 226.31, 226.32 (2004).

employing specific loan terms or practices.²⁷⁹ Specifically, HOEPA protections apply if a loan meets one of two high-cost loan triggers: (i) the APR exceeds by eight percent the yield on Treasury securities of comparable maturity for first-lien loans, or above ten percent for subordinate lien loans (the “rate trigger” or “APR trigger”); or (ii) the total of all the loan’s points and fees exceeds eight percent of the loan total or \$400 (adjusted for inflation), whichever is greater (the “points and fees trigger”).²⁸⁰ Regulation Z, which implements HOEPA, specifies which charges count as points and fees to be included in the fee trigger²⁸¹ and includes compensation to a mortgage broker in the form of a yield spread premium²⁸² and, after recent amendments to Regulation Z, optional credit insurance.²⁸³

In addition to imposing supplemental disclosure requirements,²⁸⁴ HOEPA prohibits the inclusion of certain loan terms that tend to be

279. 15 U.S.C. §§ 1602, 1639.

280. *Id.* § 1602(aa)(1), (3); 12 C.F.R. § 226.32(a)(1)(i), (ii). The fee trigger was lowered by the Federal Reserve Board in 2001 from ten percent above comparable Treasury securities (for either first- or second-lien loans). Truth in Lending, 66 Fed. Reg. 65,606, 65,608-10 (Dec. 20, 2001) (codified at 12 C.F.R. pt. 226).

281. Those charges include:

- (1) Interest, time price differential, and any amount payable under a point, discount, or other system of additional charges.
- (2) Service or carrying charge.
- (3) Loan fee, finder’s fee, or similar charge.
- (4) Fee for an investigation or credit report.
- (5) Premium or other charge for any guarantee or insurance protecting the creditor against the obligor’s default or other credit loss.
- (6) Borrower-paid mortgage broker fees, including fees paid directly to the broker or the lender (for delivery to the broker) whether such fees are paid in cash or financed.

15 U.S.C. § 1605(a)(1)-(6).

282. *Id.* § 1602(aa)(4)(B); 12 C.F.R. § 226.32(b)(1)(ii) (requiring that “[a]ll compensation paid to mortgage brokers” be included in the points and fees calculation).

283. 12 C.F.R. § 226.32(b)(1)(iv). Real estate charges, such as title insurance and filing and recording fees, must also be included unless the charges are reasonable, offer no direct or indirect compensation to the creditor, and are paid to a third party unaffiliated with the creditor. *Id.* § 226.32(b)(iii).

284. A lender who originates a high-cost loan must provide to the borrower, at least three days before closing, notice that the borrower is entitled to cancel the loan despite having started the application process and that the borrower may lose the home and all equity in it as a result of nonpayment. 15 U.S.C. § 1639(a), (b); 12 C.F.R. § 226.31(c)(1); Official Staff Interpretations, 12 C.F.R. pt. 226 Supp. 1, sect. 226.31 (2004). When combined with TILA’s three-day postclosing right to rescind, this provision gives borrowers a total of six days to reflect on the appropriateness of the particular loan. This notice also must specifically disclose any balloon payment, the cost of credit insurance, plus notice that it is optional, and, for variable rate loans, the maximum possible monthly payment. 12 C.F.R. § 226.32(c).

predatory when made part of an already very expensive high-cost loan. For loans that fall into its high-cost loan triggers, HOEPA prohibits: (i) negative amortization in all cases;²⁸⁵ (ii) balloon payments on loans that balloon within five or fewer years of loan origination;²⁸⁶ (iii) default interest rate loan terms;²⁸⁷ and, in certain cases, (iv) prepayment penalties for financially vulnerable borrowers.²⁸⁸ Creditors are prohibited from engaging in asset-based lending—lending without regard to a borrower’s ability to pay²⁸⁹—but only if there is proof of a “pattern or practice” of such activity.²⁹⁰ Recent amendments to Regulation Z also place limits on loan flipping: creditors or their affiliates are forbidden from refinancing a HOEPA-covered loan within one year unless the refinancing is “in the borrower’s interest.”²⁹¹ Damages for violations of HOEPA include all those available under TILA plus enhanced statutory damages in the amount of the sum of all finance charges and fees paid by the consumer.²⁹² Importantly, HOEPA includes a provision for limited assignee liability.²⁹³ According to this provision, purchasers of HOEPA loans are liable for all claims and defenses a debtor could have raised against the loan originator unless the assignee can demonstrate that “a reasonable person exercising ordinary due diligence” could not have determined that the loan was covered by HOEPA.²⁹⁴ HOEPA, like TILA, has a one-year statute of

285. 15 U.S.C. § 1639(f); 12 C.F.R. § 226.32(d)(2).

286. 15 U.S.C. § 1639(e); 12 C.F.R. § 226.32(d)(1)(i); Official Staff Interpretations, 12 C.F.R. pt. 226, Supp. 1, sect. 226.32 (2004). For loan terms that exceed five years, balloon payments are permissible but must be disclosed. 12 C.F.R. § 226.32(c)(3).

287. 15 U.S.C. § 1639(d); 12 C.F.R. § 226.32(d)(4). Such terms, which sometimes increase interest rates by forty percent, are unfair because they make it very difficult, and sometimes impossible, for a borrower to cure a default. RENUART & KEEST, *supra* note 217, at 615 & n.179.

288. Prepayment penalties are permitted only if: (i) the loan will not cause the borrowers to pay more than fifty percent of their income to the monthly payments; (ii) income and expenses are verified by a financial statement signed by the consumer and supported by a credit report; (iii) the creditor is not refinancing one of its own or an affiliate’s loans; (iv) it occurs within the first five years of the loan; and (v) the penalty is legal under state law. 15 U.S.C. § 1639(c).

289. HOEPA defines this conduct as extending credit “based on the consumers’ collateral without regard to the consumers’ repayment ability, including the consumers’ current and expected income, current obligations, and employment.” *Id.* § 1639(h).

290. *Id.* Traditionally, the pattern or practice element of the prohibition has been a hard one for plaintiffs to satisfy, requiring proof of several instances of prohibited conduct in a short period of time. *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998). The recent amendments have loosened the requirement somewhat, creating a presumptive violation where the lender has failed to document and verify the borrower’s ability to pay. 12 C.F.R. § 226.34(a)(4).

291. 12 C.F.R. § 226.34(a)(3). In considering whether a refinancing is “in the borrower’s interest,” Regulation Z instructs lenders to consider the totality of the borrower’s circumstances at the time the credit was extended. *Id.* § 226.34 (a)(4).

292. 15 U.S.C. § 1640(a).

293. *Id.* § 1641.

294. *Id.* § 1641(d)(1). Due diligence requires that the purchaser examine all loan documentation required by TILA plus the itemization of amount financed and any other

limitations for affirmative suits but can be raised any time—including against assignees—as a defense to foreclosure.²⁹⁵

HOEPA's additional prohibitions on certain abusive loan terms improve, in important ways, upon the rigid disclosure paradigm governing TILA. Specifically, HOEPA recognizes that certain practices are inherently dangerous when connected with very high-cost loans and usually affect those least able to appreciate their dangers.²⁹⁶ In 2000, critics made many of the same (incorrect) predictions about ultimately enacted amendments that lowered HOEPA high-cost triggers as they now do in reaction to state anti-predatory lending legislation.²⁹⁷ Those predictions were, of course, wrong, as subprime lending has since continued to expand.²⁹⁸ Unfortunately, at the same time, HOEPA has had little success in eliminating those abusive practices it identifies. As consumer advocates have been arguing for years, HOEPA's points and fees triggers are simply too high.²⁹⁹ As a result, very few subprime loans—less than one percent in 1999—fall within HOEPA's points and fees trigger and are subject to regulation.³⁰⁰ Predatory lenders have successfully managed to conduct the

disclosures. RENUART & KEEST, *supra* note 217, § 10.7.2. This is an objective test; however, the purchaser will be responsible for any subjective knowledge it obtains from outside the written disclosures. In most cases, whether or not a loan is covered should be apparent on the face of loan disclosures, particularly because all HOEPA loans that are to be sold must include a special notice alerting the purchaser that the loan is high-cost and subjects the purchaser to assignee liability. 15 U.S.C. § 1641 (d)(4). As a result, most HOEPA loans will carry assignee liability.

295. 15 U.S.C. § 1640(e).

296. See HUD-TREASURY JOINT REPORT, *supra* note 8, at 53.

297. See *Predatory Lending Practices Hearing*, *supra* note 42, app. at 710 (prepared statement of Neill Fendly, President-Elect, National Association of Mortgage Brokers) (arguing that proposed HOEPA amendments, including “overly expansive restrictions on certain types of loan terms and burdensome disclosure and other affirmative obligations, can have unintended consequences. These include reducing competition in the marketplace by driving participants and investors away and elimination of consumer access to mortgage financing”); Letter from Howard Glaser, Senior Staff Vice President, Government Affairs/General Counsel, Mortgage Bankers Association, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System (Sept. 15, 2000) (“[T]he Board must take into consideration that the constriction of credit will be a real consequence of any downward adjustments of the triggers [I]f triggers are dropped, a significant portion of lenders would altogether refrain from extending credit to that segment of newly covered loans.”), available at www.mbaa.org/resident/lib2000/c_65fr42889.html; Mike Sorohan, *Fed Explores HOEPA's Effect on Predatory Lending*, REAL ESTATE FIN. TODAY ELECTRONIC EDITION, Aug. 21, 2000, 2000 WL 8249464 (reporting testimony of President of National Home Equity Mortgage Association before the Federal Reserve Board that “[l]owering HOEPA's triggers would significantly decrease access to credit for most lenders Changing the covered points and fees would have the same effect on exclusion.”).

298. See *supra* Part II.A.2 (documenting enormous growth of subprime lending from 1994 to the present).

299. See, e.g., RENUART & KEEST, *supra* note 217, § 10.1.1.

300. HUD-TREASURY JOINT REPORT, *supra* note 8, at 85 (demonstrating that 0.70% of subprime loans in 1999 offered rates greater than 16%, the rate at which HOEPA's 10% APR

bulk of their abusive activities using rates just below the HOEPA triggers but still high enough to provide enormous room for exploitation and profitability.³⁰¹ An additional problem is that HOEPA's coverage does not apply to purchase-money mortgages or open-end loans.³⁰² Thus, the twenty percent of subprime loans issued for home purchases³⁰³ are automatically exempt from HOEPA. In addition, lenders offering refinance loans can evade HOEPA's coverage by constructing, as they frequently do, their loan as a line of credit secured by the home. Evidence suggests that many lenders do this specifically to avoid HOEPA's prohibitions.³⁰⁴

In the end, if a loan falls below the HOEPA high-cost home loan triggers, HOEPA provides no protection at all.

D. Consumer Education

Representatives of the subprime lending industry suggest that consumer education can do much to resolve predatory lending without the costs they believe are associated with aggressive legislative initiatives.³⁰⁵ As described, many targets of predatory and subprime lenders are disconnected from the economic mainstream and lack basic financial

trigger came into play). The Federal Reserve estimates that the recent lowering of the APR trigger from 10% to 8% will increase HOEPA's coverage from 1% to 5% of subprime loans. Truth in Lending, 66 Fed. Reg. 65,604, 65,606, 65,608 (Dec. 20, 2001) (codified at 12 C.F.R. pt. 226).

301. See *Reform of the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA): Joint Hearing Before the Subcomm. on Fin. Insts. And Consumer Credit and the Subcomm. on Hous. and Cmty. Opportunity of the House Comm. on Banking and Fin. Servs.*, 105th Cong. app. at 440 (1998) (prepared statement of Margot Saunders, Managing Attorney, National Consumer Law Center); HUD-TREASURY JOINT REPORT, *supra* note 8, at 85; Eggert, *supra* note 1, at 587 & n.416 (describing the testimony of a subprime lender who admitted that ninety percent of his loans would fall into HOEPA coverage if credit insurance had to be included in calculating the fee trigger).

302. RENUART & KEEST, *supra* note 217, § 10.1.1.

303. See *supra* text accompanying note 46.

304. RENUART & KEEST, *supra* note 217, §10.1.1. Lenders may still be liable for HOEPA violations if they "spuriously" classify a closed-end loan as an open-end loan. Like a credit card or line of credit, which traditionally require fewer disclosures, an open-end loan must contemplate repeat transactions from the extension of credit and replenish the available credit as the borrower pays down the debt. *Id.* § 5.2.1.5. Thus, a loan extended only to refinance a home or pay for home improvements, but that does not allow a borrower to access additional credit as she pays down her debt, may be, in reality, a closed-end loan subject to HOEPA provisions.

305. LITAN, *supra* note 11, at 9 ("[S]ubprime borrowers—who tend to be less sophisticated in financial matters—may be able to benefit from more education and counseling about mortgage borrowing so that they can make proper use of what information is made available."); James C. Ballentine, *Progress on Predatory Lending*, AM. BANKER, Apr. 11, 2003, at 7 (arguing that a "balanced" approach of enforcing existing state laws and increasing consumer education is the best approach to solving predatory lending problem); Rick Grant, *Firms See Education and Competition as Antidotes to Predatory Lending*, NAT'L MORTGAGE NEWS, Apr. 20, 1998, at 28.

literacy.³⁰⁶ Financial illiteracy in this context leads to bad credit products and further debt, which in turn makes unsophisticated consumers susceptible to predatory lenders marketing superficially attractive debt consolidation packages. Studies regarding the effectiveness of financial literacy programs have, however, been mixed. General educational programs designed to increase overall familiarity with financial terminology and operations tend not to have a significant positive impact on at-risk borrowers.³⁰⁷ Targeted homebuyer counseling programs, in contrast, offer some encouraging results.³⁰⁸ Direct counseling of high-cost loan customers is a desirable, and even necessary, component of decreasing predatory lending; better educated borrowers may learn, at a minimum, to ask important questions and realize that alternative loan options may be available. However, education should be offered in addition to, not in place of, substantive legislative reform. The market power of predatory lenders is too great to have confidence that borrowers would be able to sufficiently comprehend the complex loan packages and manipulative and deceptive sales tactics they employ.

E. *Fraud and Antidiscrimination*

The Fair Housing Act (FHA)³⁰⁹ prohibits intentional discrimination against protected classes in connection with renting or selling residential real estate,³¹⁰ and the Equal Credit Opportunity Act (ECOA)³¹¹ prohibits discrimination against protected classes in credit transactions, including mortgages.³¹² Unfortunately, antidiscrimination causes of action are

306. See *supra* text accompanying notes 179-83. A study of subprime borrowers revealed that twelve percent were unfamiliar with terms such as “loan principal” and “interest rate” and that a full one-third of subprime borrowers were unfamiliar with the variety of mortgage products and terms available. HUD-TREASURY JOINT REPORT, *supra* note 8, at 58-59.

307. Sandra Braunstein & Carolyn Welch, *Financial Literacy: An Overview of Practice, Research, and Policy*, 88 FED. RES. BULL. 445, 452 (2002).

308. One study of the benefits of prepurchase home ownership counseling demonstrated that borrowers who had received individual counseling had a thirty-four percent lower ninety-day delinquency rate than those who received no counseling. *Id.* at 450. Those who received classroom and home study training had lower delinquency rates of twenty-six percent and twenty-one percent respectively. *Id.* Another study, examining almost 40,000 loans in a five-year period, estimated that prepurchase counseling reduces rates of ninety-day delinquency among borrowers below the median income by an average of nineteen percent, and that results were better for groups receiving individual counseling as opposed to classroom, take-home study, or telephone counseling. ABDIGHANI HIRAD & PETER M. ZORN, A LITTLE KNOWLEDGE IS A GOOD THING: EMPIRICAL EVIDENCE OF THE EFFECTIVENESS OF PRE-PURCHASE HOMEOWNERSHIP COUNSELING 3, 18 (2001), available at http://www.freddiemac.com/corporate/reports/pdf/homebuyers_study.pdf.

309. 42 U.S.C. §§ 3601-19 (2000).

310. *Id.* § 3605 (prohibiting discrimination on the basis of race, color, national origin, religion, sex, handicap, or familial status).

311. 15 U.S.C. §§ 1691-91(f).

312. *Id.* § 1691(a) (prohibiting discrimination on the basis of race, color, national origin,

notoriously hard to prove in lending cases: it is enormously difficult, particularly for the financially unsophisticated, to suspect, let alone, later isolate, the reason for their denial of credit; it is correspondingly easy for lenders to point to neutral criteria that may have contributed to it.³¹³

F. Federal Regulatory Activity

Federal regulatory agencies have limited jurisdiction over subprime market players. HUD has authority to enforce the FHA and RESPA, but it has taken only a “small number of actions” enforcing those laws against subprime or predatory lenders.³¹⁴ The Federal Trade Commission (FTC) has initiated—and settled—a number of actions against subprime lenders alleging unfair and deceptive practices in violation of the FTC Act³¹⁵ since 1998.³¹⁶ The Office of the Comptroller of Currency (OCC) regulates national banks and their operating holding companies and subsidiaries; the Office of Thrift Supervision (OTS) regulates national thrift institutions as well as their operating subsidiaries; and the National Credit Union Association (NCUA) regulates national credit unions.³¹⁷ The OCC has issued guidance letters to the national banks it regulates, alerting them to abusive lending practices they should avoid directly engaging in or

religion, sex, marital status, age, or receipt of public assistance).

313. See Stephen M. Dane, *Eliminating the Labyrinth: A Proposal to Simplify Federal Mortgage Lending Discrimination Laws*, 26 U. MICH. J.L. REFORM, 527, 532, 562 (1993). *But see* *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 537, 540 (N.J. Super. Ct. App. Div. 2001) (denying lender summary judgment on claim by African Americans of disparate treatment or “reverse redlining”). Victims of predatory lending also may be able to assert state law causes of action such as common law fraud, misrepresentation under a state’s Unfair and Deceptive Practices Act (UDPA), or unconscionability. Because of the difficulty of proving each of these types of claims, their limited damages remedies, and their inability to reach secondary market noteholders, case-by-case adjudication of such claims are unlikely to impose a meaningful deterrent to the thousands of predatory loans originated each year.

314. GAO REPORT, *supra* note 8, at 36.

315. Federal Trade Commission Act, 15 U.S.C. §§ 41-58. The Act specifically prohibits unfair methods of competition and unfair or deceptive acts or parties in or affecting commerce. *Id.* § 45.

316. See GAO REPORT, *supra* note 8, app. 1; *id.* at 37-38. For example, in 2002, the FTC settled a complaint against one of the largest subprime lenders, Associates First Capital Corporation and Associates Corporation of North America and its successor, Citigroup, alleging that the corporation deceived borrowers into refinancing debts into high interest rate loans and purchasing high-cost credit insurance. *Id.* at 37. That year, the FTC also settled an action against another major subprime lender, First Alliance Mortgage Company, that alleged that the company misled customers about loan origination fees, interest rate increases, and monthly payments on adjustable rate mortgages. *Id.* In 2000, the FTC recommended to Congress that it be given the additional authority to enforce violations of HOEPA which it currently does not have. See *Predatory Lending Practices Hearing*, *supra* note 42, at app. 334-35 (prepared statement of the Federal Trade Commission); see also Josh Davin Morton, *Predatory Lending*, in *Developments in Banking Law: 2002*, 22 ANN. REV. BANKING L. 158, 160-61, 164-65 (2003) (describing several enforcement actions brought by HUD and the FTC).

317. GAO REPORT, *supra* note 8, at 50 n.1.

indirectly subsidizing through purchasing in the secondary market,³¹⁸ and has recently issued a prohibition on making loans based on the equity value of a loan and without regard to the borrower's ability to repay.³¹⁹ The OTS, Federal Reserve Board, FDIC, OCC, and NCUA have issued interagency and independent advisories to institutions they regulate about avoiding certain abusive or predatory lending practices.³²⁰

Overall, however, these regulatory agencies have had a very limited role in controlling the abuses in the subprime market. First, only approximately ten percent of lending institutions that primarily engage in subprime lending are federally regulated depository institutions, such as banks or thrifts.³²¹ Federal regulators report that there is little evidence of predatory lending activity in those institutions³²² and, as a result, have not initiated any formal enforcement actions against them related to predatory lending behavior.³²³ In addition, there are significant jurisdictional limitations to the regulatory oversight by the OCC and OTS.³²⁴ These agencies do not regularly conduct supervisory investigations of operating subsidiaries (frequently state-chartered) of national banks and thrifts, or of independent mortgage lenders.³²⁵ The agencies have taken the position that

318. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2003-2, GUIDELINES FOR NATIONAL BANKS TO GUARD AGAINST PREDATORY AND ABUSIVE LENDING PRACTICES 1-2 (2003) [hereinafter OCC ADVISORY LETTER 2003-2], available at <http://www.occ.treas.gov/ftp/advisory/2003-2.pdf>; OCC ADVISORY LETTER 2003-3, *supra* note 7, at 1. The OCC concluded in part that some forms of "flipping" and "equity stripping" are unfair practices that violate the FTC Act. OCC ADVISORY LETTER 2003-2, *supra*, at 5-6.

319. Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1,904 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34).

320. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., INTERAGENCY GUIDANCE ON SUBPRIME LENDING 2 (Mar. 1, 1999); Letter No. 99-CU-05 from the National Credit Union Administration, to Federally Insured Credit Unions 1 (June 1999), available at <http://www.ncua.gov/letters/1999/99-cu-05.pdf>; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-7, ABUSIVE LENDING PRACTICES 1 (2000); Memorandum 131 from Richard M. Riccobono, Office of Thrift Supervision, to Chief Executive Officers 1 (Nov. 27, 2000), available at <http://www.ots.treas.gov/docs/2/25132.pdf>; Memorandum 132 from Richard M. Riccobono, Office of Thrift Supervision, Department of the Treasury, to Chief Executive Officers 1 (Nov. 27, 2000), available at <http://www.ots.treas.gov/docs/2/25131.pdf>; Letter No. 01-FCU-03 from the National Credit Union Administration, to Federal Credit Union Officials 1 (April 2001), available at <http://www.ncua.gov/letters/2001/01-FCU-03.pdf>.

321. See *supra* note 65 and accompanying text.

322. Press Release, Office of the Comptroller of the Currency, OCC Issues Final Rules on Preemption on Predatory Lending: Includes Strong Standard to Keep Predatory Lending out of National Banks (Jan. 7, 2004) (quoting Comptroller of the Currency John D. Hawke, Jr.) ("Predatory lending is a very significant problem in many American communities, but there is scant evidence that regulated banks are engaged in abusive or predatory practices"), available at <http://www.mortgagebankers.org/industry/news/04/0107.html>.

323. GAO REPORT, *supra* note 8, at 36.

324. See *id.* at 50.

325. *Id.* at 49.

direct operating subsidiaries do not engage in predatory lending³²⁶—a claim disputed by numerous state authorities and consumer advocates³²⁷—and, partly as a result, have ruled that state predatory lending laws that would apply to the activity of both national banks *and* their state-chartered direct operating subsidiaries are preempted by OCC and OTS regulations.³²⁸

These agencies also do little to regulate the activities of nonbank subsidiaries of national bank holding companies.³²⁹ According to some estimates, nonbank subsidiaries originated nearly a quarter of the total subprime loans made by the top twenty-five subprime lenders in 2003.³³⁰ Nevertheless, federal banking regulators do not conduct supervisory examinations of these entities to check for compliance with consumer protection laws.³³¹ They also have no authority over the remainder of subprime lenders—independent mortgage and finance companies³³²—that represent approximately sixty percent of the subprime market.³³³ In sum, federal enforcement actions have been insufficient deterrents over predatory behavior, and OTC and OCC regulatory oversight only touches a small fraction of the overall subprime lending market from which predatory behavior emerges.

G. Role of Securitization and the Holder-in-Due-Course Rule

Ultimately, all state law fraud and contract claims (and some federal disclosure claims)³³⁴ are of limited use, either as an affirmative claim for relief or as a defense to foreclosure—because the majority of subprime loans are securitized and sold onto the secondary market. Purchasers of those loans can invoke the holder-in-due-course rule, codified in the Uniform Commercial Code (U.C.C.), which immunizes them from defenses to underlying fraud or unconscionability claims and entitles them to proceed with foreclosure no matter how abusive the loan terms, if the holder of the note can demonstrate it purchased the note for value and was not aware of the debtors' defenses at the time of purchase.³³⁵ Suits against

326. *Id.* at 50-51.

327. *See, e.g.*, CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 7-10.

328. *See infra* Parts V.C.1.a. (OTS preemption), V.C.1.b. (OCC preemption).

329. GAO REPORT, *supra* note 8, at 51. Federal- and state-chartered banks and thrifts, as well as their subsidiaries, are frequently incorporated as part of a larger bank holding company. *Id.* That holding company also may own finance or mortgage companies, making them affiliates, but not subsidiaries, of the federally regulated bank or thrift. *See id.* at 50 fig.2, 51.

330. *Id.* at 52. And, according to HUD, twenty percent of the 178 lenders primarily engaged in subprime lending were nonbank subsidiaries of holding companies. *Id.*

331. *See* GAO REPORT, *supra* note 8, at 51-52.

332. *Id.* at 50 fig.2.

333. *See supra* note 65 and accompanying text.

334. *See supra* Parts II.B-E.

335. U.C.C. § 3-302 (2002). The rule applies to purchasers of mortgages if they are: (i) a

originating brokers and lenders are often futile: predatory brokers and lenders, often fly-by-night operations, are generally undercapitalized, in or on the precipice of bankruptcy, or otherwise judgment proof.³³⁶

Certain “real defenses” such as duress, lack of legal capacity, and fraud in the factum (e.g., where a signature was forged by the lender) survive, but they are extremely difficult to prove.³³⁷ The FTC has fully abrogated the holder-in-due-course doctrine’s application to the sale of consumer goods, thereby making the doctrine inapplicable to assignees of loans for manufactured homes or loans for home improvements.³³⁸ Plaintiffs may also be able to pierce the holder-in-due-course rule and assign liability to the noteholder in certain circumstances, such as where the holder knew of or participated in an underlying fraud.³³⁹ Nevertheless, in the vast majority of cases, victims of predatory lending whose loans have been sold to the secondary market will have no affirmative claims against the noteholder and, more troubling, will have no defense to the foreclosure brought by the noteholder. The problematic result is that, as Professor Eggert explained, “the holder in due course doctrine places the risk of loss for most fraud firmly on the back of the homeowner who signed the note.”³⁴⁰

V. STATE LEGISLATIVE RESPONSES AND THE MOVE TO PREEMPT THEM

Since 1999, when North Carolina passed the first comprehensive state law targeting predatory lending,³⁴¹ there has been an explosion of legislation at the state and local level passed in an attempt to fill the many regulatory gaps. Twenty-six states (including the District of Columbia) have enacted regulations targeting unfair lending practices.³⁴² Partially in response to studies documenting the ravages of predatory lending in municipal regions such as Chicago,³⁴³ Atlanta,³⁴⁴ New York,³⁴⁵ Northern

holder; (ii) of a negotiable note; (iii) who took the note for value; (iv) in good faith; and (v) without notice of the defenses to the note. See JAMES J. WHITE & ROBERT A. SUMMERS, UNIFORM COMMERCIAL CODE § 14-2 (5th ed. 2000).

336. See Eggert, *supra* note 1, at 522.

337. WHITE & SUMMERS, *supra* note 335, § 14-10.

338. 16 C.F.R. § 433.2 (2004).

339. WHITE & SUMMERS, *supra* note 335, § 14-10.

340. Eggert, *supra* note 1, at 613.

341. N.C. GEN. STAT. ANN. §§ 24-1.1E, 24-10.2 (West 2004).

342. See *infra* Part V.A.

343. See PREYING ON NEIGHBORHOODS, *supra* note 5, at 3-4.

344. See U.S. DEP’T OF HOUS. & URBAN DEV., UNEQUAL BURDEN IN ATLANTA: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING 1 (2000), available at <http://www.hud.gov/library/bookshelf18/pressrel/subpratl.html>.

345. See U.S. DEP’T OF HOUS. & URBAN DEV., UNEQUAL BURDEN IN NEW YORK: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING 1-2 (2000), available at <http://www.huduser.org/Publications/pdf/newyork.pdf>.

New Jersey³⁴⁶ and Los Angeles,³⁴⁷ states in which those municipalities are located have all pursued comprehensive, “aggressive” legislative responses to predatory lending, following a model established by the North Carolina law.³⁴⁸ Other states have adopted minor reforms, while about half have chosen not to respond legislatively at all.³⁴⁹ The variety of experimentation occurring at the state level tends to proceed on two axes: (1) following the basic “trigger” model developed by HOEPA to focus regulations on vulnerable, “high-cost” home loan borrowers; and (2) prohibiting loan terms and practices similar to those in the North Carolina law. The percolation of state and local regulations is thus generating a sophisticated invaluable regulatory dialogue between the federal and state governments—a real value to our federal system—and also demonstrates why efforts to silence it through complete federal preemption should be resisted.

A. Rapid and Experimental State Responses

In 1999, North Carolina enacted the first comprehensive state predatory lending legislation, which was modeled upon HOEPA’s high-cost loan framework, but significantly supplemented HOEPA’s prohibitions.³⁵⁰ The North Carolina law adopts the same APR trigger as HOEPA (eight percent), but sets the points and fees trigger a full three points lower at five percent.³⁵¹ In enacting the law, legislators and consumer advocates in

346. See ZIMMERMAN ET AL., *supra* note 5 (examining national and state level data to assess the dimensions of predatory lending practices in New Jersey and setting forth recommendations to combat the problem).

347. See CAL. REINVESTMENT COMM., *supra* note 5 (studying subprime lending in four California cities and finding that over one-third of borrowers included in the study may have been victimized by predatory lending practices); PITKIN & RICHMAN, *supra* note 175, at 2-3.

348. See *infra* Part V.A.1.a. In addition, several municipalities either have adopted “debarment”-style predatory lending ordinances, which specifically define predatory lending practices and bar lenders who engage in them from obtaining city contracts, or have prohibited use of certain predatory practices and terms. See, e.g., DEKALB COUNTY, GA., CODE § 2-130 (Supp. 2004); ATLANTA, GA., CODE §§ 58-100 to 58-102 (Supp. 2004); CHI., ILL., MUN. CODE § 2-32-440 (Supp. 2004); DAYTON, OHIO, CODE OF ORDINANCES §§ 112.40-.44 (Supp. 2004); L.A., CAL., MUN. CODE §§ 181.00-.12 (Supp. 2004); OAKLAND, CAL., MUN. CODE §§ 5.33.010-.33.120 (Supp. 2004); PHILA., PA., CODE §§ 9-2401 to 9-2407 (Supp. 2004); TOLEDO, OHIO, MUN. CODE § 795.20-.25 (Supp. 2004); CLEVELAND, OHIO, ADMIN. CODE §§ 178.181, 659.01-.06, 659.99 (Supp. 2004); N.Y. CITY, N.Y., ADMIN. CODE § 6-128 (Supp. 2004). Some of these, however, have since been expressly preempted by state predatory lending statutes. GA. CODE ANN. § 7-6A-11 (2004); 815 ILL. COMP. STAT. ANN. 137/150 (West 2004).

349. See *infra* text accompanying notes 420-23.

350. N.C. GEN. STAT. ANN. §§ 24-1.1E, 24-10.2 (West 2004). The law adds provisions to existing usury statutes and applies to all lenders who do business in the state, including national banks, thrifts, credit unions, their subsidiaries, and all licensed or unlicensed mortgage brokers, mortgage bankers, and finance companies. *Id.*

351. *Id.* § 24-1.1E(a)(6)b.

North Carolina believed that their priority should be to attack financed points and fees, which undermine loan transparency and hide costs that strip equity from home owners.³⁵² For loans that are deemed high-cost by the North Carolina triggers, the law also prohibits, among many other things, the financing of any points or fees, balloon payments, negative amortizations, default interest rate provisions, call provisions allowing the lender to accelerate the indebtedness at its discretion, advance payments, modification or payment deferral fees, lending without home ownership counseling, points and fees when refinancing an existing high-cost loan held by the same lender as the noteholder, direct payments from the lender to a home improvement contractor, and lending without regard to the borrower's ability to repay.³⁵³ Considering the practices unjustified in any circumstances, regardless of a borrower's risk profile, the North Carolina law also prohibits refinancing a loan where there is no "reasonable, tangible net benefit" to the borrower (loan flipping), encouraging a borrower to default, financing credit and disability life insurance products, and charging prepayment penalties.³⁵⁴ Remedies for violations of these provisions are stringent; significantly, however, the law does not abrogate the application of the holder-in-due-course doctrine by including an assignee liability provision.³⁵⁵

1. The Aggressive States: Variations on a North Carolina Theme

North Carolina has acted, as states have in other contexts, as a leader among states moving toward reform.³⁵⁶ Since 2000, approximately thirteen

352. *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Joint Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit and the Subcomm. on Hous. and Cmty. Opportunity of the House Comm. on Fin. Servs.*, 108th Cong. 2 (2003) (prepared testimony of George Brown, Senior Vice President, Self-Help, Spokesperson, Coalition for Responsible Lending) (discussing the choice, embodied in the North Carolina law, to limit points and fees, not interest rates).

353. N.C. GEN. STAT. § 24-1.1E(b)-(d). There is a presumption that the borrower is able to repay the loan when, at the time of loan consummation, the borrower's total monthly debts (including amounts owed under the loan) are less than fifty percent of their monthly gross income as verified by the lender by statutorily approved sources, such as a credit report or a financial statement. *Id.* § 24-1.1E(c)(2).

354. The prohibitions on loan flipping and lending without regard to ability to repay actually apply to a category of covered loans broader than the high cost loan category. *Id.* § 24-10.2(a), (c).

355. Violations of any of the provisions are considered usurious and therefore subject violators to either forfeiture of all interest and return of twice the interest paid, or treble actual damages and attorney's fees. *Id.* §§ 24-1.1E(d), 24-2, 75-1.1(a), 75-16, 75-16.1 (indicating plaintiffs may recover under either section 24-2 or sections 75-16 and 75-16.1). These damages can be sought by the Attorney General of North Carolina, the North Carolina Commissioner of Banks, or a private party. *Id.* § 24-1.1E(d).

356. This model corresponds to, for example, a number of reforms in the environmental context, where certain states took the lead ahead of other states and of the federal government to pass laws restricting auto emissions and hazardous waste disposal. *See* Richard L. Revesz,

“aggressive” jurisdictions have followed North Carolina’s initiative by lowering triggers and banning a variety of abusive lending practices, while others have more modestly supplemented HOEPA. A taxonomy of the variety of state experimentation follows.

a. Broader Coverage than HOEPA

Three jurisdictions have set high-cost home loan APR trigger lower than HOEPA. The District of Columbia set its APR trigger at six percent above the rate for a Treasury security of comparable maturity, two points lower than HOEPA’s first-lien loan trigger; Illinois and New Mexico set their APR triggers at six percent and seven percent, respectively, above rates on comparable Treasury securities.³⁵⁷ The other states that expand HOEPA’s loan coverage—Arkansas, California, Colorado, Georgia, Massachusetts, New Jersey, New Mexico, New York, North Carolina, and South Carolina—do so by employing lower points and fees triggers, although with variations among them. California and Colorado employ a flat 6 percentage points and fees trigger, while Illinois sets its trigger at the greater of five percent of the principle amount or \$800;³⁵⁸ other states employ a sliding scale trigger system, so that a lender can collect more points and fees for the smaller loans that carry proportionately greater origination and servicing costs.³⁵⁹ In most cases, these states also expand high-cost home loan coverage by requiring that more costs be included into the points and fees determination than does HOEPA, such as any direct or indirect compensation paid to mortgage brokers (e.g., the yield

Federalism and Environmental Regulation: A Public Choice Analysis, 115 HARV. L. REV. 553, 583-608 (2001).

357. D.C. CODE ANN. § 26-1151.01(7) (2004); 815 ILL. COMP. STAT. 137/10 (2004); N.M. STAT. § 58-21A-3 (2004). Maryland also has adopted an APR trigger of seven percent, MD. CODE ANN., COM. LAW § 12-124.1(a)(2) (2004), but it prohibits so few practices in connection with the high-cost loans (no financing single-premium credit insurance or lending without regard to ability to repay, *id.* §§ 12-124.1, 12-127, 12-311), that its regulation of high-cost loans should not be classified as an aggressive predatory lending regulation.

358. *Cf.* CAL. FIN. CODE § 4970 (Deering 2004); COLO. REV. STAT. ANN. § 5-3.5-101(2) (West 2004); 815 ILL. COMP. STAT. ANN. 137/10 (West 2004).

359. For example, North Carolina, Georgia, New Mexico, and South Carolina set the points and fees trigger at eight percent for loans less than \$20,000 and at five percent for loan amounts greater than \$20,000. GA. CODE ANN. § 7-6A-2(17) (2004); N.M. STAT. ANN. § 58-21A-3(N) (Michie 2004); N.C. GEN. STAT. § 24-1.1E(a)(6)(b); S.C. CODE ANN. § 37-23-20(15) (Law. Co-op. 2003); *see also* ARK. CODE ANN. § 23-53-103(7)(A)(ii) (Michie 2004) (setting points and fees trigger at five percent for loan amounts greater than \$75,000, six percent for loan amounts less than \$75,000, and eight percent for loan amounts less than \$20,000); N.J. STAT. ANN. § 46:10B-24 (West 2004) (setting points and fees trigger at 4.5% for loan amounts greater than \$40,000, 6% for loan amounts less than \$40,000, and the lesser of 6% or \$1000 for loan amounts less than \$20,000); N.Y. BANKING LAW § 6-1(1)(g)(ii) (Consol. 2004) (setting points and fees trigger is five percent for loan amounts greater than \$50,000 and the greater of six percent or \$1500 for loan amounts less than \$50,000).

spread premium),³⁶⁰ the cost of single-premium credit insurance (if not totally prohibited by the statute),³⁶¹ and the maximum prepayment penalties that can be charged.³⁶²

Notably, several states exclude up to two “bona fide [loan] discount points”—points that are charged in purposeful exchange for a slightly lower interest rate—from the calculation of relevant points and fees.³⁶³ This exclusion reflects a sensible impulse to model the interest rate discounting behavior that occurs when points and fees are assessed in the prime market but which is generally absent in the rent-seeking predatory subset of the subprime market. It also suggests, however, that states could lower the point and fees trigger even further when including a bona fide discount point exclusion; because so many subprime loans include points, the exclusion effectively raises the points and fees trigger by two percent.

In addition, and of great significance, unlike HOEPA, all of these state laws cover home-purchase mortgages and a few cover open-end lines of credit.³⁶⁴ Thus, the more aggressive states responding to the predatory lending phenomenon have supplemented HOEPA by including a greater proportion of loans to be subject to regulation.

b. Core Lending Prohibitions: Moving Toward a Definition of Predatory Lending

What emerges from the approximately dozen states that have attempted to aggressively regulate predatory lending within their borders is a legislatively constructed consensus, albeit preliminary, on core practices that make residential mortgages predatory or otherwise unacceptable. Some consensus prohibitions are categorical and identical; others aim for

360. *E.g.*, ARK. CODE ANN. § 23-53-103(6)(A); GA. CODE ANN. § 7-6A-2(12)(B); 815 ILL. COMP. STAT. ANN. 137/10; N.Y. BANKING LAW § 6-1(1)(f)(iii).

361. *E.g.*, GA. CODE ANN. § 7-6A-2(12)(C); 815 ILL. COMP. STAT. ANN. 137/10; N.J. STAT. ANN. § 46:10B-24.

362. ARK. CODE ANN. § 23-53-103(7)(B); GA. CODE ANN. § 7-6A-2(12)(D)-(E); N.J. STAT. ANN. § 46:10B-24.

363. *See, e.g.*, ARK. CODE ANN. § 23-53-103(3); D.C. CODE ANN. § 26-1151.01(3) (2004); N.J. STAT. ANN. § 46:10B-24; N.M. STAT. ANN. § 58-21A-3(B); N.C. GEN. STAT. § 24-1.1E(a)(3) (2004) (defining bona fide discount points as “loan discount points knowingly paid by the borrower for the purpose of reducing, and which in fact result in a bona fide reduction of, the interest rate . . . provided the . . . interest rate reduction . . . is reasonably consistent with established industry norms and practices for secondary mortgage market transactions”); *see also* N.Y. BANKING LAW § 6-1(1)(c) (“[A] point is [presumed to be] a bona fide loan discount point if it reduces the interest rate by a minimum of twenty-five basis points provided all other terms of the loan remain the same.”); MASS. REGS. CODE tit. 209, § 32.32(2)(c) (2004) (stating the presumption that “a point is a bona fide loan discount point if it reduces the interest rate by a minimum of 35 basis points or 3/8 of a point provided all other terms of the loan remain the same”).

364. ARK. CODE ANN. § 23-53-103(5)(A); CONN. GEN. STAT. ANN. § 36a-746a(4) (West 2003); D.C. CODE ANN. § 26-1151.01(7)(A); GA. CODE ANN. § 7-6A-2(8); N.J. STAT. ANN. § 46:10B-24; N.M. STAT. ANN. § 58-21A-3(I); N.Y. BANKING LAW § 6-1(1)(e).

the same general regulatory ends but employ interesting, observable variations. The states that share many of the same prohibitions are in effect imposing basic underwriting standards on a subset of subprime loans that otherwise do not abide by strict underwriting criteria.³⁶⁵ In other words, they impose upon high-cost lenders, through legislation, what GSEs and the force of competition have imposed on loans in the conventional market.

i. Categorical Prohibitions

All of the “aggressive” states that have expanded high-cost loan coverage, as well as several states that retain the HOEPA trigger in their predatory lending statutes—such as Pennsylvania, Connecticut, and Kentucky—ban certain practices outright and with little or no variation.³⁶⁶ Appendix 1 provides a state-by-state catalogue of prohibited practices in connection with high-cost loans. Those prohibitions can be generalized as follows:

No Negative Amortizations—With exceptions for reverse mortgages, loans must fully amortize interest due, so that the loan balance decreases over the life of the loan;³⁶⁷

No Balloon Payments—Loans may not schedule a single payment that is more than twice the monthly average payment either at any time during the life of the loan or for a set period of years;³⁶⁸

No Call Provisions—Loans may not include provisions that permit lenders to accelerate indebtedness at their sole discretion;³⁶⁹

365. See *supra* text accompanying notes 126-28.

366. See *infra* notes 367-73, 420 and accompanying text.

367. See, e.g., N.C. GEN. STAT. § 24-1.1E(b)(3); GA. CODE ANN. § 7-6A-5(3); D.C. CODE ANN. § 26-1152.15.

368. Compare N.C. GEN. STAT. § 24-1.1E(b)(2), GA. CODE ANN. § 7-6A-5(2), and S.C. CODE ANN. § 37-23-30(2) (Law. Co-op. 2003) (prohibiting scheduling payments twice the average monthly amount for life of loan), with COLO. REV. STAT. ANN. § 5-3.5-102(1)(a) (West 2004) (no scheduling payments twice the average monthly amount for a period of ten years after closing), and N.Y. BANKING LAW § 6-l(2)(b) (prohibiting scheduling payments twice the average monthly amount for a period of fifteen years after closing).

369. See, e.g., N.J. STAT. ANN. § 46:10B-25(e); N.Y. BANKING LAW § 6-l(2)(a); S.C. CODE ANN. § 37-23-30(1). The “no call provisions” do not, however, apply to provisions that allow acceleration upon borrower default, which is also common in the prime market. See, e.g., N.C. GEN. STAT. § 24-1.1E(b)(1).

No Advance Payments—Loans may not include provisions under which two or more periodic payments are consolidated and paid in advance from the loan proceeds;³⁷⁰

No Default Interest Rate—Loans may not contain provisions that increase the interest rate upon a borrower's default;³⁷¹

No Direct Payments to Home Improvement Contractors—Lenders are prohibited from making direct payments from loan proceeds to home improvement contractors unless payment is made jointly to the borrower and the contractor, to a third party escrow, or with an affidavit that the contracting work has been satisfactorily completed;³⁷²

Mandatory, Additional Disclosures—Lenders must separately include a disclosure to borrowers several days prior to loan consummation that informs borrowers, among other things that: (a) by agreeing to the loan, the lender will have a mortgage on the home; (b) default may lead to loss of the home; (c) the borrower may be able to obtain a loan that is less costly and should 'shop around' for that possibility; (d) the borrower should (or must) seek loan counseling to assess appropriateness of loan; and (e) the borrower is not obligated to go through with the loan at this point.³⁷³

ii. Variations on Core Prohibitions

In addition to the categorical prohibitions just described, "aggressive" states have addressed, in slightly varied ways, other core predatory lending practices such as lending without regard to repayment ability, assessing prepayment penalties, packing insurance fees, and flipping. These variations reflect the belief that the legitimacy of these practices, unlike the above categorical prohibitions, are more subjective and may ultimately depend upon the context in which they are engaged. Whatever variations are employed among them, all these states use the following regulations to prevent a common predatory strategy (if only for a small category of loans) of locking vulnerable borrowers into exploitative loans and pursuing practices that, in combination, repeatedly strip substantial equity from borrowers until they face an unreasonable risk of foreclosure.

370. See, e.g., 815 ILL. COMP. STAT. ANN. 137/85 (West 2004); ME. REV. STAT. ANN. tit. 9-A, § 8-206-A(11) (West 2003); N.C. GEN. STAT. § 24-1.1E(b)(5).

371. See, e.g., CONN. GEN. STAT. ANN. § 36a-746b (West 2003); KY. REV. STAT. ANN. § 360.100(2)(e) (Michie 2004).

372. See, e.g., ARK. CODE ANN. § 23-53-104(n) (Michie 2003); CAL. FIN. CODE § 4973(g) (Deering 2004); N.J. STAT. ANN. § 46:10B-26(h).

373. See, e.g., N.J. STAT. ANN. § 46:10B-26(f); N.M. STAT. ANN. § 58-21A-5(P) (Michie 2004); N.Y. BANKING LAW § 6-l(2)(l)(ii).

Lending without Regard to Ability to Repay (asset-based or equity-based lending)—Lenders are generally prohibited from extending high-cost loans unless they “reasonably” believe that the borrower, based on circumstances such as current and expected income, employment status, additional debt obligations, and financial resources other than equity in the home, is able to meet her monthly financial obligations.³⁷⁴ Most states create a presumption of ability to repay where the borrower’s total monthly debt obligations, including obligations for the home loan, do not exceed fifty percent of the borrower’s monthly gross income.³⁷⁵ Others do not establish any presumption, leaving the question up to a subjective determination by the courts.³⁷⁶ Most require that lenders specifically verify and keep records of a borrower’s income and obligations through authoritative methods such as credit reports, tax records, and payroll receipts;³⁷⁷

Prepayment Penalties—Two states ban all prepayment penalties for any residential mortgage loan—not just a high-cost loan—that has a value of less than \$150,000.³⁷⁸ Most states prohibit prepayment penalties on high-cost loans after a period of two or three years. Of those, some states set sliding scale limits on the percentage amount of a prepayment penalty, a scale which attempts to reasonably compensate

374. See, e.g., CAL. FIN. CODE ANN. § 4973(f)(1); N.Y. BANKING LAW § 6-1(2)(k); S.C. CODE ANN. § 37-23-40(2) (Law. Co-op. 2003).

375. See, e.g., N.Y. BANKING LAW § 6-1(2)(k); S.C. CODE ANN. § 37-23-40(2); see also CAL. FIN. CODE ANN. § 4973(f)(1) (stating presumption of repayment ability if monthly debt-to-income ratio does not exceed fifty-five percent); MD. CODE ANN., COM. LAW § 12-127(b) (2003) (stating presumption of repayment ability if monthly debt-to-income ratio does not exceed forty-five percent and the monthly gross income of the borrower is less than 120% of the median family income for the metropolitan statistical area); OKLA. STAT. tit. 14A, § 3-410(2)(c) (West 2004).

376. See, e.g., ARK. CODE ANN. § 23-53-104(1) (stating that creditors cannot lend unless they reasonably believe that the borrower “will be able to make the scheduled payments to repay the obligation based upon a consideration of their current and expected income, current obligations, employment status, and other financial resources other than the borrower’s equity in the dwelling that secures repayment of the loan). Some states that adopt HOEPA’s high-cost loan triggers prohibit the practice and adopt a fifty percent debt-to-income presumption of repayment ability, see KY. REV. STAT. ANN. § 360.100(2)(i), while others also adopt HOEPA’s prohibition on engaging in a “pattern or practice” of lending without regard to repayment ability. See COLO. REV. STAT. ANN. § 5-3.5-103(1)(b) (West 2004); ME. REV. STAT. ANN. tit. 9-A, § 8-206-A(12) (West 2003); PA. STAT. ANN. tit. 63, § 456.512(b) (West 2004).

377. See, e.g., GA. CODE ANN. § 7-6A-5(8) (2004); S.C. CODE ANN. § 37-23-40(2); see also COLO. REV. STAT. ANN. § 5-3.5-103(1)(b) (establishing a presumption of lending without ability to repay if the lender engages in a pattern or practice of making loans without verifying and documenting a borrower’s income and obligations).

378. N.C. GEN. STAT. § 24-2.4 (2004); TEX. FIN. CODE ANN. § 343.205 (2004).

lenders for the legitimately higher cost of an earlier prepaid loan.³⁷⁹ Other states set no maximum rate but prohibit a lender from collecting any prepayment penalty for refinancing a loan the lender already holds—a fee that otherwise encourages the same lender to refinance and strip equity from a borrower;³⁸⁰

Financing Single-Premium Credit Insurance—Of the substantial number of states that ban financing of single-premium credit insurance, a significant majority consider it so unreasonable that they forbid it in all residential mortgages.³⁸¹ A minority of states limits the prohibition to high-cost loans;³⁸²

Flipping—The greatest variation among the “aggressive” states is in their approaches to prohibiting loan flipping. A

379. GA. CODE ANN. § 7-6A-5(1) (requiring no prepayment penalty twenty-four months after loan consummation; two percent maximum penalty for loans prepaid in under twelve months; and one percent maximum prepayment penalty for loans prepaid in under twenty-four months); 815 ILL. COMP. STAT. 137/30 (West 2004) (requiring no prepayment penalty thirty-six months after loan consummation; three percent maximum prepayment penalty for loans prepaid in under twelve months; two percent maximum for loans prepaid in under twenty-four months; and one percent maximum for loans prepaid in under thirty-six months); *see also* KY. REV. STAT. ANN. § 360.100(2)(a) (employing HOEPA’s high-cost loan trigger but maintaining limits on prepayment penalties that are identical to Illinois’s limits).

380. *See* CAL. FIN. CODE ANN. § 4973(a); COLO. REV. STAT. ANN. § 5-3.5-102(g); MASS. REGS. CODE tit. 209, § 32.32(4)(f)-(g) (2004). All of these statutes also require that the lender disclose the prepayment penalty and offer an alternative loan product without such penalty. *See* CAL. FIN. CODE ANN. § 4973(a)(2); COLO. REV. STAT. ANN. § 5-3.5-102(g); MASS. REGS. CODE tit. 209, § 32.32(4)(f)-(g) (2004). Arkansas bans prepayment penalties at any time where the same lender is refinancing a loan. ARK. CODE ANN. § 23-53-104(m). Other states such as New York and New Jersey have no express limitations on prepayment penalties, perhaps because they have strong prohibitions on loan flipping that in other ways limit the possibility of unfairly refinancing with prepayment penalties. N.J. STAT. ANN. § 46:108-25(j) (West 2004); N.Y. BANKING LAW § 6-1(2)(i); *infra* Appendix 1. In contrast, California prohibits prepayment penalties in the circumstances described above, but it has no express prohibition on flipping. *See* CAL. FIN. CODE ANN. § 4973(a); *infra* Appendix 1.

381. *See, e.g.*, GA. CODE ANN. § 7-6A-3(1); N.C. GEN. STAT. § 24-10.2(b); N.J. STAT. ANN. § 46:10B-25(a) (West 2004). California anticipates lenders’ attempts to circumvent the prohibition by banning the financing of SPCI either at the loan closing or within thirty days later. CAL. FIN. CODE ANN. § 4979.7. Other states allow insurance premiums to be paid on a monthly basis. *See, e.g.*, 815 ILL. COMP. STAT. 137/40; N.Y. BANKING LAW § 6-1(2)(h) (Consol. 2004).

382. *See, e.g.*, UTAH CODE ANN. § 61-2d-107 (2004). Some states that adopt HOEPA’s high-cost triggers, such as Maine and Connecticut, merely require the lender to expressly disclose the cost of SPCI and offer the borrower a choice of insurance on a monthly-premium basis. CONN. GEN. STAT. ANN. § 36a-746f (West 2004); ME. REV. STAT. ANN. tit. 9-A, § 8-206-A(13-C) (2003). Such disclosure requirements will not deter the many predatory lenders who already are accustomed to packing such fees by misleading the borrower into believing it is necessary in order to consummate the loan.

minority of these states limit only the same lender from flipping a high-cost loan that the lender already holds with another high-cost loan.³⁸³ The others prohibit refinancings by any lender within certain time periods—one year, two years, three and a half years, or five years—and under certain conditions; lenders in these states are prohibited from refinancing a loan within a given time period unless the new loan provides a “reasonable, tangible net benefit to the borrower” (RTNB)—a term borrowed from North Carolina’s law.³⁸⁴ While several states leave open the question of what precisely constitutes a RTNB,³⁸⁵ other states attempt to set presumptions for a loan that would provide one. Those include: (i) a monthly debt-to-income ratio of not more than fifty percent; (ii) a beneficial change to the borrower in the duration of the loan; (iii) the borrower receives a reasonable amount of cash in excess of the costs and fees associated with the refinancing; (iv) the rate of interest is reduced by at least two percent; (v) a change from an adjustable to a fixed-rate loan;³⁸⁶

Counseling—Aggressive responses to predatory lending typically and correctly include some attempt to respond to demand-side problems that victims bring—namely a lack of sophistication with mortgage products.³⁸⁷ Most of the “aggressive” states include some kind of loan counseling provision in their predatory lending legislation. Some states make loan counseling mandatory: before a high-cost loan can be consummated, the lender must receive written verification

383. See COLO. REV. STAT. ANN. § 5-3.5-103(1)(c) (barring a lender that holds a loan from refinancing a loan within one year unless refinancing is in the borrower’s interest); N.Y. BANKING LAW § 6-1(2)(i) (barring a lender that holds a loan from refinancing such loan unless the refinancing provides a reasonable, tangible net benefit to borrower); N.C. GEN. STAT. § 24-1.1E(c)(3) (barring a lender that holds a loan from ever charging any points and fees to refinance such loan).

384. See ARK. CODE ANN. § 23-53-104(b) (barring refinancing by any lender at any time unless the new loan provides RTNB). North Carolina believes that the practice of flipping without a RTNB can never be justified and, accordingly, it bans the practice in connection with any residential mortgage loan. See N.C. GEN. STAT. § 24-10.2(c); GA. CODE ANN. § 7-6A-4(a) (barring refinancing of any loan within sixty months by any lender unless the new loan provides a RTNB); 815 ILL. COMP. STAT. 137/45 (barring refinancing by any lender within twelve months of loan consummation unless the new loan provides RTNB); S.C. CODE ANN. §§ 37-23-20(8), 37-23-70(A) (Law. Co-op. 2003) (barring refinancing of any residential loan by any lender within forty-two months of loan consummation without RTNB and charging points and fees on a refinancing by the same lender at any time); MASS. REGS. CODE tit. 209, § 32.34(1)(c) (2004) (barring charging points and fees in connection with a refinancing by any lender within twenty-four months of loan consummation, except allowing points and fees on any additional proceeds from the refinancing).

385. See, e.g., N.M. STAT. ANN. § 58-21A-4(B) (Michie 2004) (in determining RTNB, a lender should consider “all of the circumstances, including the terms of both the new and refinanced loans, the cost of the new loan and the borrower’s circumstances”).

386. See, e.g., S.C. CODE ANN. § 37-23-20(8).

387. See *supra* notes 179-83 and accompanying text.

that the borrower has met with an independent, certified loan counselor and has been advised about the affordability of the proposed loan.³⁸⁸ Other states mandate that originators of high-cost loans provide written notice to borrowers of the advisability of seeking loan counseling before consummating the loan and also require that the lender provide the borrower with contact information of third-party credit counseling agencies should the borrower choose to seek such counseling.³⁸⁹

c. Additional, Innovative Proposals

In addition to the core prohibitions described above, some of the “aggressive” states have other prohibitions that should be observed for their potential effects on the availability of both good and predatory subprime credit. For example, in order to increase the transparency of usually opaque predatory loans, North Carolina prohibits altogether the financing of any points and fees in connection with a high-cost loan;³⁹⁰ other states have placed caps on the total amount of points and fees that can be financed.³⁹¹ Banning the financing of points and fees (and to a lesser extent, placing a cap on them) forces loan costs to be revealed either in the APR or, for any origination and servicing costs, as an up-front cash payment. While such a provision may make it hard for cash-poor home equity borrowers to obtain subprime loans, the provision would force lenders to be more honest about charges they will assess and prevent harmful equity stripping, which many borrowers cannot apprehend at the loan closing.

California and D.C. are unique in attempting to expressly prohibit “steering” of borrowers to high-cost loans that are costlier than their credit risk would justify for the same lender.³⁹² This is a practice endemic to

388. See ARK. CODE ANN. § 23-53-104(k); G.A. CODE ANN. § 7-6A-5(7); N.C. GEN. STAT. § 24-1.1E(c)(1). Illinois’s counseling program appears the most comprehensive. The Illinois High Risk Home Loan Act requires the Commissioner of the Illinois Office of Banks and Real Estate to set up a Mortgage Awareness Program that includes a comprehensive curriculum, taught by certified loan counselors, on all aspects of mortgage financing. 815 ILL. COMP. STAT. ANN. 137/110. Any prospective high-risk loan borrower must: (i) attend a course, unless they sign a written waiver; (ii) meet in person with the loan counselor; and (iii) after sufficient appropriations have been made to finance it, have their loan reviewed by a state official as to its affordability. *Id.*

389. See CAL. FIN. CODE ANN. § 4973(k)(1) (Deering 2004); N.Y. BANKING LAW § 6-1(2)(1) (Consol. 2004); MASS. REGS. CODE tit. 209, § 32.32(6)(m).

390. N.C. GEN. STAT. § 24-1.1E(c)(3).

391. See, e.g., CONN. GEN. STAT. ANN. § 36a-746e(3) (West 2003) (capping prepaid finance charges at the greater of five percent or \$2,000); N.J. STAT. ANN. § 46:10B-26(1) (West 2004) (capping financing of points and fees at two percent); N.Y. BANKING LAW § 6-1(2)(1) (capping fees in connection with high-cost loans at three percent); N.M. STAT. ANN. § 58-21A-5(A) (capping the finance of points and fees at two percent); 209 MASS. REGS. CODE tit. 209, § 32.32(1)(a)(2) (capping financing of points and fees for refinancing at five percent).

392. CAL. FIN. CODE § 4973(l)(1) (Deering 2004). California’s law requires that

[a] person who originates a [high cost] loan shall not steer, counsel, or direct any prospective consumer to accept a loan product with a risk grade less favorable

predatory lenders and brokers who seek higher commissions associated with costlier loans, but it is difficult to prove. Unlike the above-described prohibitions, steering is not apparent from the face of the loan; it depends on discovery and a complex consideration of a lender's underwriting criteria to determine if a more appropriate loan package should have been offered. Nevertheless, California and D.C. appropriately recognize that steering represents pure rent-seeking behavior at a substantial cost to vulnerable borrowers and should thus be deterred.

In addition, several states have experimented with data collection to attempt to track developments with the subprime industry.³⁹³ Others have adopted additional, novel prohibitions particular to the circumstances of their jurisdictions; such prohibitions include banning door-to-door mortgage solicitations,³⁹⁴ restricting the content of lender advertisements,³⁹⁵ and placing catch-all prohibitions on "bad faith" charges that would further raise the cost of the loan by charging the borrower more than the actual worth of services or for services not actually rendered.³⁹⁶

than the risk grade that the consumer would qualify for based on that person's then current underwriting guidelines . . . if it is an appropriate risk grade category for which the consumer qualifies with the person.

Id. The District of Columbia's law states that

[a] lender shall not steer, counsel, or direct any prospective borrower to accept a loan product with a risk grade less favorable than the risk grade that the borrower would qualify for based on that lender's then current underwriting guidelines, prudently applied, considering the information available to that lender, including the information provided by the borrower.

D.C. CODE ANN. § 26-1152.06(a) (2004).

393. 815 ILL. COMP. STAT. ANN. 137/115 (requiring residential mortgage lenders to track and report to the state banking department data on the number, pace, and size of foreclosures semi-annually and to specifically identify foreclosure statistics for loans with interest rates above ten percent). Other states also require that a borrower's credit history be reported periodically. *See* D.C. CODE ANN. § 26-1152.07; MASS. REGS. CODE tit. 209, § 32.34(2)(h) (requiring lenders to report a borrower's credit history at least once per year); 63 PA. STAT. ANN. tit. 63, § 456.513(a) (West 2004) (requiring lenders to report payment history at least quarterly); COLO. REV. STAT. ANN. § 5-3.5-104 (2004) (requiring lenders to report a borrower's credit history every quarter).

394. FLA. STAT. § 494.00791(12) (2004).

395. *See* CONN. GEN. STAT. ANN. § 36a-746e(6) (West 2003); N.H. REV. STAT. ANN. § 397-A:14-a (2004); MASS. REGS. CODE tit. 209, § 32.34(2)(d) (2004).

396. *See, e.g.*, CONN. GEN. STAT. ANN. § 36a-746e(10); MASS. REGS. CODE tit. 209, § 32.34(2)(f).

2. Remedies and Assignee Liability

a. Remedies Against Loan Originators

Aggressive states have provided for remedies at law and equity in varying strengths. At equity, virtually all states authorize courts to void illegal loan provisions, or any part thereof, and to reform the loan so that it is no longer high-cost.³⁹⁷ Several states also provide for a significant right to rescind a violating loan.³⁹⁸ All states provide for statutory damages of some sort—typically offering a choice of the greater of double the finance charges already paid or a minimum penalty.³⁹⁹ Several states recognize that statutory damages of even double the interest paid may not always amount to much, so they classify a violation of their predatory lending laws as a *per se* violation of the state's unfair and deceptive practices act, which provides for treble damages.⁴⁰⁰ Recognizing the reality of the subprime market, most states include additional provisions. First, because large subprime lenders originate thousands of loans and, therefore, may make innocent classification or even calculation mistakes in originating loans, virtually all statutes offer lenders a defense to assignees and lenders who act in good faith to abide by the law.⁴⁰¹ Second, because victims of predatory lending, particularly those facing foreclosure, scarcely have money to afford the legal fees necessary to contest their loans, most states authorize a successful plaintiff to receive reasonable attorneys fees and costs;⁴⁰² unscrupulous lenders cannot, therefore, assume that violations will go unenforced by the indigent.

397. *See, e.g.*, ARK. CODE ANN. § 23-53-106(c) (Michie 2003); D.C. CODE ANN. § 26-1153.01(c)(1); GA. CODE ANN. § 7-6A-7(b) (2004).

398. *See, e.g.*, OHIO REV. CODE ANN. § 1349.29 (West 2004); S.C. CODE ANN. § 37-23-50(B)(1)(a) (2003). New York provides for an unlimited right to rescind a loan that violates its law. N.Y. BANKING LAW § 6-1(11) (Consol. 2004).

399. *See, e.g.*, KY. REV. STAT. ANN. § 360.100(4)(c) (Michie 2004); ME. REV. STAT. ANN. tit. 9-A, § 8-206-A(16-A) (West 2004); NEV. REV. STAT. ANN. 598D.110(2) (Michie 2004).

400. *See* 815 ILL. COMP. STAT. ANN. 137/135(b) (2004); N.J. STAT. ANN. § 46:10B-29(a) (West 2004); N.C. GEN. STAT. § 24-1.1E(d) (2004).

401. *See, e.g.*, ARK. CODE ANN. § 23-53-106(e)(1) (Michie 2003); FLA. STAT. § 494.00796(2) (2004); N.J. STAT. ANN. § 46:10B-29(c); S.C. CODE ANN. § 37-23-60 (Law. Co-op. 2003). These statutes generally state that a good faith defense exists if: (i) the lender has reasonable due diligence procedures in place to prevent origination of high-cost loans with prohibited terms; (ii) despite those procedures, the lender makes a bona fide error in calculation (not including errors of legal judgment); and (iii) the lender makes restitution and reforms the loan within a certain period of time after receiving notice from the borrower of statutory violations).

402. ARK. CODE ANN. § 23-53-106(a)(2)(A)(iv); COLO. REV. STAT. ANN. § 5-3.5-108 (West 2004); FLA. STAT. § 494.00794(3); N.J. STAT. ANN. § 46:10B-27(a); N.M. STAT. ANN. § 58-21A-7 (Michie 2004).

b. Assignee Liability Provisions

As previously described, the market dynamic surrounding predatory lending depends in large part on the securitization process.⁴⁰³ This process not only funds a majority of the subprime originations, it also creates perverse incentives which insulate loan originators from risk of foreclosure and, by virtue of the holder-in-due-course rule, insulates secondary market noteholders from liability or victim defenses to foreclosure.⁴⁰⁴ As a result, victims frequently have no recourse against a noteholder pursuing a foreclosure. Appreciating this dynamic, a handful of aggressive states have included provisions that abrogate the holder-in-due-course rule for certain high-cost loans.⁴⁰⁵ That is, these states would subject good faith purchasers of mortgage notes to some liability, jointly and severally with loan originators. These efforts are important, on the one hand, to cut off funding lines for unscrupulous lenders; on the other hand, as the Georgia experience has demonstrated, if assignee liability provisions are perceived to be too broad and aggressive, they may drive out risk-averse financiers of legitimate subprime loans.⁴⁰⁶

Georgia's original predatory lending statute,⁴⁰⁷ passed in 2002, was at the time regarded as the strongest in the nation, particularly because of the strength of its assignee liability provision.⁴⁰⁸ Ambiguities in the statute, however, appeared to subject purchasers of "covered home loans"—a category of loans with a lower points and fees trigger than high-cost loans (and therefore containing more loans than that latter category)⁴⁰⁹—to uncapped and unpredictable liability. This caused bond-rating agencies, such as S&P's and Moody's, to conclude that they could not rate a vast proportion of home loans originated in Georgia.⁴¹⁰ As a result, many

403. *See supra* Part II.B.2.

404. *See supra* Part IV.G.

405. *See, e.g.*, ARK. CODE ANN. § 23-53-105(a)(2); D.C. CODE ANN. § 26-1153.05 (2004); N.J. STAT. ANN. § 46:10B-27(b) (West 2004); N.M. STAT. ANN. § 58-21A-11(A) (Michie 2004).

406. *See infra* notes 407-14.

407. Fair Lending Act, GA. CODE ANN. §§ 7-6A-1 to 7-6A-13 (2002).

408. *Id.* § 7-6A-1; *see also* Diana B. Henriques & Jonathan Fuerbringer, *Bankers Opposing New State Curbs on Unfair Loans*, N.Y. TIMES, Feb. 14, 2003, at C1; Ernest Holsendolph & Robert Luke, *Mortgage Lenders Push to Rewrite Fair Lending Act*, ATLANTA J.-CONST., Jan. 23, 2003, at 1A.

409. GA. CODE ANN. § 7-6A-2(6) (2002) (a "covered home loan" is a residential mortgage transaction with a four percent APR trigger for first-lien mortgages and a points and fees trigger of three percent).

410. Specifically, the Georgia law: (i) appeared to create assignee liability for a broad category of "covered home loans," a category which itself was not very precisely defined; (ii) subjected assignees to punitive damages and broad class action liability; and (iii) provided no defense to purchasers who, despite the exercise of reasonable due diligence, inadvertently purchased a regulated loan. *See* Press Release, Standard & Poor's, Standard & Poor's to Disallow Georgia Fair

lenders, fearful that they could not sell their loans to the secondary market without critical agency ratings, threatened to stop financing Georgia home loans entirely.⁴¹¹ Georgia quickly thereafter amended its statute to alleviate industry concerns by: (i) limiting assignee liability to holders of high-cost loans only;⁴¹² (ii) eliminating the possibility of class action or punitive damages liability;⁴¹³ and (iii) providing an affirmative defense to liability for noteholders who can show that they exercised “reasonable due diligence” in order to avoid the purchase of a high-cost home loan.⁴¹⁴ The amendments reassured the credit-rating agencies that risk could be limited and predicted, and those agencies agreed to rate Georgia home loans.⁴¹⁵

Several other states have modeled assignee liability provisions on the Georgia experience in order to cut off funding for predatory loans while making subprime credit plentiful under the high-cost loan triggers. States like New Jersey, D.C., Arkansas, Maine, and Illinois have assignee liability provisions that entitle the borrower to assert against a purchaser all claims and defenses available against the originator, thereby largely abrogating the holder-in-due-course rule of high-cost home loans while providing a safe harbor for investors exercising due diligence to avoid the purchase of high-cost loans.⁴¹⁶ States like Colorado and Florida incorporate explicitly HOEPA’s assignee liability provisions.⁴¹⁷ In addition, however, these states limit subprime lenders’ exposure to liability by prohibiting

Lending Act Loans (Jan. 16, 2003), *available at* <http://www.mbaa.org/industry/news/03/0116b.html>; Press Release, Mortgage Bankers Association, Fitch Ratings Declines to Rate Georgia Loans in RMBS Pools Considers Impact to Other Predatory Lending Legislation (Feb. 5, 2003), *available at* <http://www.mbaa.org/industry/news/03/0205b.html>; Press Release, Moody’s Investors Services, Moody’s Expands Consideration of Assignee Liability for Residential Mortgages in Securitizations (Jan. 30, 2003), *available at* <http://www.mortgagebankers.org/industry/news/03/0130a.pdf>.

411. See Georgia Fair Lending Act: The Unintended Consequences 2-3 (2003), *available at* <http://www.gabankers.com/issues/predatorylendingwhitepaper.pdf>.

412. In fact, the amended Georgia statute eliminated the category of “covered home loans” entirely. Compare GA. CODE ANN. § 7-6A-2(7) (West 2004), with GA. CODE ANN. § 7-6A-2(6) (West 2003).

413. Compare GA. CODE ANN. § 7-6A-6(c) (West 2004), with GA. CODE ANN. § 7-6A-7(a) (West 2003).

414. GA. CODE ANN. § 7-6A-6(b) (West 2004).

415. See Press Release, Mortgage Bankers Association, Fitch to Rate RMBS After Amendment to Georgia Predatory Lending Statute, GFLA (Mar. 14, 2003), *available at* <http://www.mortgagebankers.org/industry/news/03/0314a.html>; Press Release, Standard & Poor’s, Standard & Poor’s Will Admit Georgia Mortgage Loans into Rated Structured Finance Transactions (Mar. 11, 2003), *available at* <http://www.standardandpoors.com>.

416. ARK. CODE ANN. § 23-53-105(a) (Michie 2004); D.C. CODE ANN. § 26-1153.05 (2004); 815 ILL. COMP. STAT. ANN. 137/135(d) (West 2004); ME. REV. STAT. ANN. tit. 9-A, § 8-209 (West 2003); N.J. STAT. ANN. § 46:10B-27(b) (West 2004).

417. COLO. REV. STAT. § 5-3.5-201 (2004); FLA. STAT. § 494.00793 (2004) (incorporating same assignee liability as in 15 U.S.C. § 1641 (2000)).

class action suits, limiting damages,⁴¹⁸ and offering noteholders a “reasonable due diligence” defense similar to Georgia’s and HOEPA’s. Pursuant to this provision, a note purchaser can avoid liability if the purchaser can demonstrate that it exercised reasonable due diligence to avoid the purchase of any high-cost home loans or otherwise has in place policies and procedures to avoid the purchase of regulated loans.⁴¹⁹

As the Georgia experience demonstrates, legislators will have to at least consider the effect of their regulation on the secondary market to be careful that they do not undermine the assurances, processes, and risks necessary for residential mortgage lending overall. Nevertheless, the states that have adopted assignee liability provisions to abrogate the holder-in-due-course doctrine for regulated loans have recognized the importance of severing the connection between predatory lending and the securitization process. By subjecting secondary market actors to liability for knowingly purchasing high-cost loans, such laws provide an incentive to avoid buying loans from unscrupulous lenders; and, indeed, in order to take advantage of the reasonable due diligence defense contained in the statutes, these actors will likely stop purchasing any high-cost home loans. At the same time, mortgage originators who can no longer sell predatory loans to third-party purchasers previously insulated by the holder-in-due-course rule will be forced to internalize the risks of their abusive lending practices.

3. Supplemental and Hesitant State Approaches

Other states have acknowledged that lending abuses are occurring within their borders but have not adopted “aggressive” responses. Several “supplemental” states, such as Pennsylvania, Connecticut, and Kentucky, adopted high-cost loan triggers identical to HOEPA’s. Although their statutes do not cover any more home loans, they do outlaw certain additional practices, akin to those banned by aggressive states, which are out of HOEPA’s reach.⁴²⁰ Many others, however, have taken very

418. See, e.g., ARK. CODE ANN. § 23-53-105(a)(2)(B) (limiting the assignee’s liability to the remaining indebtedness of the borrower); D.C. CODE ANN. § 26-1153.05(c) (limiting the assignee’s liability to actual damages for violation of high-cost loan provisions and to the remaining indebtedness for all other causes of action); 815 ILL. COMP. STAT. 137/135(d) (2004) (limiting the assignee’s liability to the amount required to extinguish the borrower’s liability under the high-cost home loan and to recover costs, including attorney’s fees, but not allowing class action suits); ME. REV. STAT. ANN. tit.9-A, § 8-209(4) (same).

419. See ARK. CODE ANN. § 23-53-105(a)(2)(A)(ii); 815 ILL. COMP. STAT. ANN. 137/135(d)(1); N.J. STAT. ANN. § 46:10B-27(b).

420. See CONN. GEN. STAT. ANN. § 36a-746 to 36a-746g (West 2004) (prohibiting call provisions, balloon payments, negative amortizations, default interest rates, and direct payments to home improvement contractors, but not regulating the financing of credit insurance or

hesitant approaches. Some such as Maryland, Minnesota, Michigan, Nevada, and Virginia choose only one or two practices to regulate, such as financing of credit insurance or the assessment of prepayment penalties;⁴²¹ others such as Washington merely establish a licensing scheme for mortgage brokers or finance companies and impose reporting and regulatory requirements upon them;⁴²² still others merely authorize and finance the broad study of predatory lending.⁴²³

These hesitant states may perceive that predatory lending is not as significant a problem in their jurisdiction or, even if they do perceive it to be, simply prefer an incremental solution until results start to appear in neighboring, aggressive states. Nevertheless, these states—as well as those who have yet to enact any legislation—provide an essential point of comparison for evaluating the federalist response to predatory lending. Specifically, federal and state regulators should observe the effects—positive and negative—that aggressive state predatory lending statutes have on the legitimate subprime market before proposing a uniform solution. The federal system is particularly well-suited for resolving the amorphous problem of predatory lending, in large part

refinancing low-cost mortgages with high-cost mortgages); KY. REV. STAT. ANN. § 360.100 (Michie 2004) (prohibiting call provisions, balloon payments, negative amortizations, default interest rates, advance payments from loan proceeds, and lending without regard to ability to repay, but not regulating loan modification or payment deferral fees or counseling disclosures); PA. STAT. ANN. tit. 63, §§ 456.511-.512 (West 2004) (prohibiting balloon payments under five years, negative amortization, and financing credit insurance, but not regulating prepayment penalties or asset-based lending).

421. See MD. CODE ANN., COM. LAW §§ 12-124.1(b)(1), 12-127(b) (2004) (prohibiting financing of single-premium credit insurance and lending without regard to ability to repay); MINN. STAT. ANN. § 58.137(2) (West 2003) (prohibiting prepayment penalties during the first forty-two months of the loan in certain circumstances); MICH. COMP. LAWS ANN. §§ 445.1631-.1637 (West 2004) (prohibiting charging fees for services not rendered and balloon payments during the first five years of the loan but requiring the borrower be provided with a borrower's Bill of Rights and the availability of counseling); NEV. REV. STAT. ANN. 598D.100 (Michie 2004) (prohibiting mandatory property insurance, lending without regard to ability to repay, financing of prepayment penalties, and credit insurance); TEX. FIN. CODE ANN. §§ 343.101, 343.104, 343.202-.205 (2004) (barring refinancing a low-cost home loan with a higher-cost home loan, financing single-premium credit insurance unless notice is provided that monthly premiums are available, balloon payments during the first five years of the loan, negative amortization or prepayment penalties, and lending without regard to ability to repay); UTAH CODE ANN. § 61-2d-103, 61-2d-104, 61-2d-105, 61-2d-107, 61-2d-110 (2004) (prohibiting prepayment penalties after three years, prepayment penalties that exceed eighty percent of the total interest paid on the preceding six payments, negative amortization, financing points and fees greater than eight percent of the loan amount, single-premium credit insurance, and encouragement of default); VA. CODE ANN. §§ 6.1-422, 6.1-422.1 (Michie 2004) (prohibiting call provisions, recommending of default, and flipping by refinancing a mortgage loan within twelve months, unless the refinancing is in the borrower's best interest).

422. *E.g.*, WASH. REV. CODE ANN. §§ 31.04.035, 31.04.102 (West 2004).

423. IND. CODE ANN. § 4-6-12-1 (Michie 2004).

because successful or unsuccessful responses—like recognition of the problem itself—depends largely upon analysis of empirical data for which the various states taking aggressive or hesitant approaches provide the perfect laboratories.

B. *Assessing the Preliminary Results of State Experiments*

Critics of state predatory lending reforms have continued to argue that the reforms are too restrictive—that they will drive up the cost of credit so much that legitimate creditors will find much lending unprofitable and subprime borrowers will not have access to sufficient credit.⁴²⁴ Identical arguments were made by industry representatives in opposing the 2000 amendments to make HOEPA stronger.⁴²⁵ These arguments were proven incorrect by the subsequent expansion of subprime credit.⁴²⁶ As previously described, this belief is premised on the incorrect assumption that the subprime market is efficient.⁴²⁷ The real inefficiency in the market, however, suggests that many borrowers are priced higher than their risk criteria would merit.⁴²⁸ Thus, the elimination of much of high-cost home-loan lending should mean that there would still be sufficient subprime credit available, just at lower rates.

Subprime loans average nationally about two to four percent higher than prime loans, and average even higher for lower-grade subprime borrowers.⁴²⁹ Most high-cost home-loan APR triggers for aggressive states are set, like HOEPA's, at eight percent above the Treasury rate.⁴³⁰ Only Illinois, New Mexico, and D.C. are set lower.⁴³¹ At this date, the Treasury rate for a bond with a thirty-year maturity is 5.02%.⁴³² Thus, most aggressive state laws cover, via the APR triggers, a very small proportion of extremely expensive loans at APRs of 13.02% and higher. Also at this date, the conventional mortgage rate for a thirty-year fixed loan—the rate a prime borrower would, on average, receive—is 5.327%.⁴³³ Between the conventional rate and the APR trigger set by the aggressive states, a significant margin of profitability should certainly remain by which

424. *See supra* note 11 and accompanying text.

425. *See supra* note 297.

426. *See supra* Part II.A.2.

427. *See supra* Part III.A.1.

428. *See supra* Part III.A.1.

429. *See supra* notes 29-33.

430. *See supra* note 280 and accompanying text.

431. *See supra* note 357 and accompanying text.

432. *See* Thirty Year Treasury Securities' Yield Outlook, at <http://www.marketvector.com/interest-rate/30-yr-t-bond.htm> (Feb. 13, 2005).

433. Real Estate Journal, The Wall Street Journal Guide to Property, at http://www.realestatejournal.com/toolkit_com/moneyandrates.html (Jan. 12, 2005) (concerning a standard fixed, thirty-year conventional rate for Fannie Mae conforming loan, delivery within thirty days).

lenders can accommodate the vast majority of subprime borrowers; and, indeed, it would remain if the APR trigger were set even lower.

This APR spread between conventional loan rates and rates at which loans become regulated as “high cost” in aggressive states also suggests that the points and fees thresholds could be set far lower than those set by the aggressive states. By lowering the points and fees thresholds, lenders could simply shift the costs purportedly associated with higher-risk borrowers into the more transparent and comprehensible interest rate figure.⁴³⁴ Furthermore, contrary to industry suggestion, the predatory lending regulations employed by aggressive states will hardly require a radical restructuring of the residential mortgage market. Rather, the emerging consensus among aggressive states regarding core prohibitions effectively imposes underwriting standards in the very high-cost sector of the subprime market, where few existed, and pushes those lenders to adopt some of the risk prevention underwriting criteria deemed necessary and common in the conventional market.

Industry representatives have leveled particularly vigorous opposition to the assignee liability provisions contained in many of the aggressive state statutes.⁴³⁵ They argue that these provisions create unreasonable and unpredictable risks for assignees, so much so that credit-rating agencies will refuse to rate a broad swath of lending in regulated jurisdictions and eventually stifle the financing of the legitimate subprime lending pipeline.⁴³⁶ Following the experience of Georgia, however, states that include assignee liability provisions have structured them to limit the liability to noteholders of high-cost home loans only, and to provide a defense if the purchaser has procedures in place to avoid purchasing high-cost home loans.⁴³⁷ There is a developing consensus about the procedures that residential mortgage purchasers can take in order to avoid the purchase of high-cost or regulated loans, thereby easily satisfying the “reasonable due diligence” criteria to avoid liability under the majority of assignee liability provisions.⁴³⁸ As a result, credit-rating agencies have

434. See *supra* Parts III.A.2, III.B.2.a (describing how points and fees represent hidden costs to borrowers, particularly when they are financed as part of the loan principle).

435. See *supra* Part V.A.2.

436. Kelly K. Spors, *Subprime Bill Aims to Mute State Laws: Republican’s Proposal to Police Predatory Lending Would Set Weaker National Standards*, WALL ST. J., Feb. 14, 2003, at A4.

437. ARK. CODE ANN. § 23-53-106(b), (e) (Michie 2004); D.C. CODE ANN. § 26-1153.05 (2004); 815 ILL. COMP. STAT. ANN. 137/135(d) (West 2004); ME. REV. STAT. ANN. tit. 9-A, § 8-208 (West 2004); N.J. STAT. ANN. § 46:10B-27(b) (West 2004).

438. See OCC ADVISORY LETTER 2003-3, *supra* note 7, at 8 (advising national banks to undertake certain investigatory procedures in order to satisfy a reasonable standard of due diligence that they are not purchasing a predatory loan); GAO REPORT, *supra* note 8, at 78 (“Before or after the sale, purchasers may review electronic data containing information on the loans, such as the loan amount, interest rate, and borrower’s credit score. Purchasers also may physically review a

come to a workable position that should allow subprime lending below state high-cost home-loan triggers to proceed at a healthy pace.⁴³⁹ Assignee liability provisions will have the predictable, and not entirely undesirable, effect of decreasing secondary market financing for all high-cost home loans (not only ones with prohibited terms) and decreasing incentives for originators to create and sell predatory loans to third parties who bear no liability risk.

Finally, industry representatives have pointed to a recent study of the subprime market in North Carolina, which they believe demonstrates that regulation of residential mortgages are counterproductive and supports arguments for federal preemption of more stringent state regulations.⁴⁴⁰ This view is likely incorrect and certainly premature. This study, conducted by researchers at Georgetown University's School of Business (the Elliehausen Study), concluded that the North Carolina predatory lending law caused a fourteen percent decline in subprime originations in the state, a decline the study found fell disproportionately on the state's lowest-income borrowers.⁴⁴¹ The results of the Elliehausen Study are, however, far from determinative. A subsequent study conducted by researchers at the University of North Carolina (the Quercia Study) found that the law operated almost exactly as intended.⁴⁴² The Quercia Study concluded that loan originations with predatory features decreased substantially in North Carolina after the law's enactment⁴⁴³ but did not materially decrease either

sample of individual loans, including items such as the loan applications and settlement forms.”); Tanoue, *supra* note 103, at 2 (arguing that, if secondary market purchasers “were to ask about the extent to which measures are taken to ensure the underlying loans do not contain any predatory characteristics, and made their purchase contingent upon receiving satisfactory answers to those questions, the underwriters’ incentives could change” and suggesting a series of inquiries to be undertaken).

439. See *Crystal Ball Reveals Strength in the Subprime MBS Market*, INSIDE B&C LENDING, Jan. 12, 2004, at 4 (“Fitch [credit-rating agency] anticipates few problems from pending or existing predatory lending laws, as both sellers and issuers have stepped up their due diligence efforts.”).

440. ELLIEHAUSEN & STATEN, *supra* note 130, at 14-15 (suggesting that data in North Carolina reveals that allegedly predatory loans are priced to reflect risk).

441. *Id.*

442. ROBERTO G. QUERCIA ET AL., UNIV. OF N.C. AT CHAPEL HILL, THE IMPACT OF NORTH CAROLINA’S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT I (2003), available at http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf; see also KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, NORTH CAROLINA’S SUBPRIME HOME LOAN MARKET AFTER PREDATORY LENDING REFORM, at iii (2002), available at http://www.mortgagebankers.org/state_update/2002/nc/nc_study_0814.pdf.

443. See QUERCIA ET AL., *supra* note 442, at 18-20, 36-38 tbls.11-13 (documenting North Carolina’s comparative decrease in loans containing prepayment penalties, balloon payments, and exceedingly high loan-to-value ratios); see also ERNST ET AL., *supra* note 442, at 8-9 (documenting postenactment decrease of seven percent in flipped loans without reasonable, tangible net benefit to the borrower, decrease of twenty-five percent in “excess fees,” decrease of twenty percent in single-premium credit insurance, and decrease of thirty-five percent in incidence of loans with

the supply of subprime credit to low-income borrowers or the diversity of subprime mortgage products traditionally extended to them.⁴⁴⁴

The Quercia Study improves upon the methodology employed by the Elliehausen Study. For example, the Quercia Study relied on loan data covering an additional period of almost two years after the North Carolina Act's enactment.⁴⁴⁵ More importantly, in lamenting the general decrease in subprime lending in North Carolina, the Elliehausen Study failed to distinguish between a decrease in desirable and undesirable subprime loans. The North Carolina law prohibits the practice of flipping borrowers from one loan into a new high-cost loan where the new loan offers no reasonable net benefit to the borrower.⁴⁴⁶ Thus, part of the reduction of subprime mortgage originations in North Carolina documented by the Elliehausen Study may well be attributable to a decrease in unreasonable refinances that the law intentionally targeted.⁴⁴⁷ On balance, it appears that predatory subprime originations have declined in North Carolina at the same time that the overall subprime market remains healthy.⁴⁴⁸

prepayment penalties and estimating that the law saved North Carolina homeowners a total of \$100 million).

444. See QUERCIA ET AL., *supra* note 442, at 12-21 (concluding that the subprime lending market in North Carolina is still large and vibrant after the law's enactment, that a substantial portion of the limited decrease in subprime lending is attributable to the decrease in predatory loans, and that subprime purchase loans actually increased after the law's passage); see also ERNST ET AL., *supra* note 442, at 3-7 (concluding that the subprime market in North Carolina is still very strong after the Act's passage, that the proportion of subprime lending to lowest-income borrowers actually increased after the law's passage, and that there has been no increase in the pricing in subprime loans since the law's passage that might have been associated with a decrease in loan availability).

445. Compare QUERCIA ET AL., *supra* note 442, at 10 (analyzing loans originated from 1998 to 2002), with ELLIEHAUSEN & STATEN, *supra* note 130, at 9 (analyzing loans originated from the first quarter of 1997 to the second quarter of 2000). Since the publication of both studies, commentators have criticized a variety of aspects of the studies' methodologies and data sets. See ROBERT E. LITAN, AEI-BROOKINGS JOINT CTR. FOR REGULATORY STUDIES, NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: STILL A PROBLEM DESPITE NEW STUDY 2 (2003) (criticizing Quercia Study); NAT'L CONSUMER LAW CTR. ET AL., COMMENTS TO THE OFFICE OF COMPTROLLER OF CURRENCY: BANKING ACTIVITIES AND OPERATIONS; REAL ESTATE LENDING AND APPRAISALS 38-39 (2003) (criticizing OCC Working Paper), available at <http://www.naca.net/CommentsOCCNatBnkPreempt.pdf>; OCC WORKING PAPER, *supra* note 6, at 2 (criticizing Quercia Study). But see MICHAEL A. STEGMAN ET AL., AEI-BROOKINGS JOINT CTR. FOR REGULATORY STUDIES, NC'S ANTI-PREDATORY LENDING LAW: DOING WHAT IT'S SUPPOSED TO DO: A REPLY 1 (2003) (responding to criticism of the Quercia Study and reaffirming that North Carolina's antipredatory lending law is working as intended), available at <http://aei-brookings.org/admin/authorpdfs/page.php?id=299>.

446. See *supra* note 354 and accompanying text.

447. See Keith D. Harvey & Peter J. Nigro, *Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. 435, 452 (2002) (attributing the limited decline of subprime lending in North Carolina to the decrease in loan application rates, not to loan denial rates).

448. See *Lenders Will Try to Pin Down Effects of NC Mortgage Law*, INSIDE B&C LENDING,

C. *The Premature Move Toward Federal Preemption*

The United States purports to maintain a “dual banking” system, sharing and dividing regulatory authority over the complex banking system between the federal and state governments.⁴⁴⁹ Traditionally, the federal government, through Congress and regulatory agencies, has heavily regulated national and state depository institutions to insure their financial stability and integrity, while states have maintained their traditional police power authority over contract, tort, and consumer protection law.⁴⁵⁰ As lending institutions have increasingly become national in their scope, however, they have sought and obtained the federal government’s preemption of state laws affecting the lending activities of these entities in an attempt to circumvent the need to comply with a multiplicity of allegedly complex, conflicting, and confusing state laws.⁴⁵¹ Indeed, in the past year, state legislators and consumer advocacy groups, recently successful in overcoming opposition to predatory lending legislation, are now engaged in another serious battle against previous opponents from the banking industry and preemption minded federal regulators and legislators; the state legislatures and consumer advocacy groups are battling to preserve their successful efforts and, more generally, their power to implement state policymakers’ conception of the best consumer protection regime.

Federal regulators at the OTS and OCC have already, with some controversy, preempted state predatory lending laws as they apply to institutions that the federal agencies regulate and to the operating subsidiaries of those institutions.⁴⁵² Meanwhile, a leading proposal in

Mar. 5, 2001, at 3 (reporting that North Carolina lenders were offering a full range of mortgage products after the Act’s enactment and that there was “little or no variation” in pricing of those products as compared with other neighboring states).

449. John P.C. Duncan, *The Course of Federal Pre-emption of State Banking Law*, 18 ANN. REV. BANKING L. 221, 222 n.5 (1999).

450. *Id.* at 224-25.

451. *Id.* at 225 (stating that financial institutions “are creating great pressure for federal pre-emption of the innumerable, often conflicting, state financial services laws in order to achieve ‘national uniformity’”). There are generally three ways an agency or court can find that a state law is preempted by federal law or regulation. First, courts or regulatory agencies will ask if Congress “explicitly” preempted state law in the text of the federal enactment. *English v. Gen. Elec. Co.*, 496 U.S. 72, 78 (1990). Second, courts or agencies will see if the scheme of federal regulations is so pervasive that Congress can be said to have exclusively “occupied the entire field” of regulations related to a particular area. *See id.* at 72, 79. Third, they will ask if the state enactment “conflicts” with a particular federal law, either because there would be a physical impossibility of complying with both or because the state law “stands as an obstacle” to the achievement of federal objectives. *Id.* at 79 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

452. *See infra* Part V.C.1.

Congress would regulate the entire subprime lending market—not just national institutions—and preempt all remaining state predatory lending legislation.⁴⁵³ Much of the regulators’ decisions are correct as a matter of law, but much else is discretionary and far from compelled by Congress. Similarly, though some congressional legislation appears promising, enactment of any federal proposals would be premature. Both Congress and federal regulators should forebear on preempting the remarkable response of state legislators to this country-wide crisis.

1. Regulatory Preemption

OTS and OCC have recently issued opinions and orders preempting the application of state predatory lending laws to the institutions the agencies regulate, as well as those institutions’ operating subsidiaries.⁴⁵⁴ Their decisions will affect at least ten percent of the entities that primarily engage in subprime lending—federally-chartered banks and thrifts.⁴⁵⁵ As described below, this decision is largely a plainly correct interpretation of congressional intent; much else is far from obvious and, therefore, represents little more than a discretionary choice by agency regulators. In exercising that choice, the agencies appear to give excessive regard to industry claims, stressing the value of uniformity at the expense of the countervailing interest in protecting the thousands of individual victims of predatory lending.

a. OTS Preemption

The Home Owners’ Loan Act (HOLA)⁴⁵⁶ authorizes OTS to provide for the incorporation, organization, and regulation of federal savings associations—called thrifts.⁴⁵⁷ Based on this authority and a Supreme Court determination that HOLA grants OTS “cradle to . . . grave” rulemaking authority,⁴⁵⁸ OTS has concluded that it has “plenary and

453. *See infra* Part V.C.2.

454. Federally-chartered thrifts and banks can request an opinion from these agencies about whether a particular state law is preempted by federal law and can choose to rely on the opinion in conducting their business. Letter from U.S. General Accounting Office, to the Honorable James A. Leach, Chairman, House Committee on Banking, Finance, and Urban Affairs 2 (Feb. 7, 2000) (letter No. 13-284372). If the entity is charged pursuant to a state law that an agency has deemed preempted, the court adjudicating the merits of the entity’s preemption defense will give the agency’s preemption interpretation great deference. *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 496 (1996) (holding that courts should give deference to agencies regarding determinations over the scope of their preemptive authority).

455. *See supra* note 65 and accompanying text.

456. 12 U.S.C. §§ 1461-68c.

457. *Id.* § 1464(a)(1),(2) (2004).

458. *Fid. Fed. Sav. & Loan Ass’n v. de la Cuesta*, 458 U.S. 141, 145 (1982).

exclusive” authority and thereby “occupies the field” of regulation of federal savings and loan institutions.⁴⁵⁹ According to OTS, this preemption authority entitles federal savings institutions to engage in business “without regard to state laws purporting to regulate or otherwise affect their credit activities.”⁴⁶⁰

Pursuant to this broad authority, OTS has issued letters concluding that predatory lending laws in Georgia, New York, New Jersey, and New Mexico, which regulate any aspect of terms of credit, loan-related fees, disclosures, or the ability of a creditor to originate or finance a loan, are preempted as they apply to savings institutions.⁴⁶¹ In addition, the OTS ordered that operating subsidiaries of federal savings associations also enjoy the same benefits of preemption as their parent institutions.⁴⁶² The OTS regulations ultimately may have little impact. Because of heightened underwriting requirements imposed upon thrifts as a consequence of the 1990 savings and loan crisis, thrifts have done very little subprime lending.⁴⁶³

459. 12 C.F.R. § 545.2 (2004); *see also id.* § 560.2(a) (stating that OTS “occupies the entire field of lending regulation for federal savings associations” in order to “enhance safety and soundness and to enable federal savings associations to conduct their operations in accordance with best practices”).

460. *Id.* § 560.2(a). OTS regulations related to loan activity suggest, for example, that the following categories of state laws are preempted: (i) state licensing, registration, and reporting laws; (ii) state laws governing the specific terms of credit agreements and loan-regulated fees; and (iii) state laws requiring lenders to comply with disclosure and advertising rules. *Id.* § 560.2(b). OTS regulations related to deposit-taking suggest that state laws related to the following activities are preempted: (i) abandoned and dormant accounts; (ii) disclosure requirements; (iii) fund availability; (iv) service charges and fees; (v) state licensing and registration requirements; and (vi) checking accounts. *Id.* § 557.12. Certain categories of state laws, that only incidentally affect lending or deposit-related activities of federal savings institutions, are not preempted, including, for example, those related to contracts, real property law, tort law, and criminal law. *Id.* § 560.2(c).

461. CAROLYN J. BUCK, PREEMPTION OF NEW MEXICO HOME LOAN PROTECTION ACT 1-2 (Office of Thrift Supervision, U.S. Dep’t of the Treasury, Opinion of Chief Counsel No. P-2003-6, 2003) [hereinafter OTS Opinion of Chief Counsel No. P-2003-6]; CAROLYN J. BUCK, PREEMPTION OF NEW JERSEY PREDATORY LENDING ACT 1 (Office of Thrift Supervision, U.S. Dep’t of the Treasury, Opinion of Chief Counsel P-2003-5); CAROLYN J. BUCK, PREEMPTION OF NEW YORK PREDATORY LENDING LAW 1 (Office of Thrift Supervision, U.S. Dep’t of the Treasury, Opinion of Chief Counsel P-2003-2); CAROLYN J. BUCK, PREEMPTION OF GEORGIA FAIR LENDING ACT 1 (Office of Thrift Supervision, U.S. Dep’t of the Treasury, Opinion of Chief Counsel P-2003-1).

462. *See* OTS Opinion of Chief Counsel No. P-2003-6, *supra* note 461, at 2 n.4 (“OTS has consistently concluded that state laws purporting to regulate the activities of a federal savings association’s operating subsidiary are preempted by federal law to the same extent such laws are preempted for the federal savings association itself.”).

463. *See* WEICHER, *supra* note 22, at 43-44.

b. OCC Preemption

The National Bank Act (NBA)⁴⁶⁴ provides for the creation and operation of national banks, enumerates national bank powers regarding core banking functions such as lending and deposit taking, and further grants national banks “all such incidental powers as shall be necessary to carry on the business of banking.”⁴⁶⁵ In 2003, the OCC issued a broad ruling in which it determined that the Georgia Fair Lending Act—and by implication all other state predatory lending laws—was preempted as applied to national banks and, most controversially, to their state-chartered bank subsidiaries.⁴⁶⁶ Unlike the OTS, the OCC does not claim it occupies the entire field of regulation affecting national banks. Rather, it exercised its preemption authority because of a purportedly direct conflict between the state laws and federal regulations.⁴⁶⁷

In support of its broad preemption order, the OCC relied upon federal regulations, promulgated pursuant to the National Bank Act. Section 34.4(a) of OCC regulations expressly preempts state laws related to five areas of fixed-rate mortgage lending, two of which are relevant to the predatory lending context.⁴⁶⁸ Pursuant to the first of these two, which expressly preempts state laws concerning the “schedule for repayment of principle and interest,”⁴⁶⁹ the OCC reasonably concluded that state prohibitions related to the following areas were preempted: balloon payments, negative amortization, advance payments, late fees, and prepayment fees (on the theory that both categories of fees are considered interest under OCC regulations).⁴⁷⁰ Pursuant to the second regulation, which preempts state laws concerning the “term to maturity of a real estate loan,” the OCC determined that state law prohibitions related to the following areas were also prohibited: acceleration of payments at the lender’s discretion and, again, prepayment penalties (on the theory that both sets of regulations frustrate a national bank’s ability to structure incentives to control loan maturity dates and rates).⁴⁷¹

464. 12 U.S.C. § 24 (2000).

465. *Id.*

466. Preemption Determination and Order, 68 Fed. Reg. 46,264 (Aug. 5, 2003). Although this OCC Order was limited to national bank-lending activities in Georgia, the OCC issued a notice of proposed rulemaking on the same date that would preempt all state predatory lending laws as applied to national banks and their operating subsidiaries. Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1,904, 1,904 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34); *see also* Donald C. Lampe, *Federal Preemption and the Future of Mortgage Loan Regulation*, 59 BUS. LAW. 1207, 1212 (2004).

467. Preemption Determination and Order, 68 Fed. Reg. at 46,270.

468. 12 C.F.R. § 34.4(a)(1)-(5) (2004).

469. *Id.* § 34.4(a)(4).

470. 68 Fed. Reg. at 46,276.

471. *Id.*

After this uncontroversial analysis, the OCC's determination becomes far less convincing. First, the OCC relied upon an additional regulation, section 34.4(b),⁴⁷² which purportedly gives it broad authority to preempt additional state predatory lending law provisions pursuant to "recognized principles of [f]ederal preemption" as determined on a case-by-case basis.⁴⁷³ Pursuant to this authority, the OCC claimed that it would preempt state laws that affect "the manner and content of the business of banking authorized for national banks" and thereby concluded that state laws related to the following practices were also preempted: loan flipping; lending without regard to a borrower's ability to repay; financing credit insurance; mandatory arbitration clauses; encouraging borrower default; lending by home improvement contractors; giving adequate notice to borrowers; counseling for high-cost loans; and, extending liability to assignees and contractors.⁴⁷⁴ These preemption determinations are premised on the theory that these state rules would stand in the way of the fluid operation of national banks and impede national uniformity in the national banking system.⁴⁷⁵ It is a premise that elicited angry reactions among consumer advocates⁴⁷⁶ and that is otherwise problematic in a number of ways.

First, it is hard to understand how compliance with the state predatory lending prohibitions and requirements would impede the efficient functioning of national banks. They are, for the most part, limited regulations directed at stopping a set of plainly abusive lending practices that would affect only a small portion of the subprime market—those loans that meet narrow high-cost home-loan triggers. Indeed, the OCC itself insists that national banks do not engage in predatory lending.⁴⁷⁷ Second,

472. 12 C.F.R. § 34.4(b).

473. 68 Fed. Reg. at 46,277, 46,278.

474. *Id.* at 46,276-78.

475. *Id.* at 46,277.

476. *See, e.g.,* Greg Ip, *Spitzer Tangles Again with Federal Regulators: New York Official Says Bank Overseer Hampers Predatory-Lending Probes*, WALL ST. J., Feb. 26, 2003, at A6 (describing the New York Attorney General's charges that the OCC is inhibiting state response to predatory lending); Deborah Lagomarsino & Rebecca Christie, *OCC Preemption Move Blasted: Congress to Hold Hearings*, DOW JONES NEWSWIRE, Jan. 7, 2004 (quoting Neil Milner, president of the Conference of State Bank Supervisors, as saying, "[t]he arrogance and audacity of the comptroller's actions are astounding. . . . State bank regulators and law enforcement officials are the first line of defense against unscrupulous lending practices"); Barbara A. Rehm, *Critics Are Many, but Hawke Isn't Budging*, AM. BANKER, July 23, 2004, at 1, 1 (describing the barrage of criticism leveled against OCC Chairman by state officials and consumer advocates); *see also* Lagomarsino & Christie, *supra* (quoting Representative Sue Kelly, Chairperson of the House Financial Services Committee on Oversight and Investigations, as saying "I am concerned that exclusive federal regulatory oversight of these entities will result in lesser, not greater, protections for consumers," and promising hearings to evaluate the OCC decision).

477. It also has issued guidance to the institutions it regulates to refrain from engaging in

the OCC's claim that many of the state prohibitions will unreasonably increase compliance costs or dry up the overall availability of subprime credit is little more than over-certain speculation or hypothesis,⁴⁷⁸ and of a kind previously proven false with the passage of amendments to strengthen HOEPA in 2000.⁴⁷⁹ As described, because the subprime market is not efficient, regulations can be effective in eliminating predatory behavior without undermining the flow of legitimate subprime credit.⁴⁸⁰

The second unpersuasive component of the OCC preemption determination is its conclusion that state-chartered national bank subsidiaries would also be covered, on the theory that bank subsidiaries engage in the same conduct and are subject to the same terms and conditions governing their parent institutions.⁴⁸¹ Nothing in the OCC's short analysis supports this conclusion. The OCC appears to have transformed the limited grant of federal authority of banks—to own and operate state-chartered banks for the purpose of advancing the national banking system—into a complete exemption from state regulation of their chartered banks' activities.⁴⁸² Further, the OCC's conclusion unnecessarily

certain of the practices its preemption order claims would interfere with uniform functioning of national banks if prohibited by state law. OCC ADVISORY LETTER 2003-2, *supra* note 318, at 1 (regarding lending without ability to repay).

478. *See* 68 Fed. Reg. 46,264, 46,278; *see also id.* at 42,670-01 (claiming that state antipredatory lending laws materially increase compliance costs for national banks or materially limit their actual lending activities and that “bank lenders will conclude—and have concluded—that they simply are unable to effectively cover these increased costs and risks” and will “reduce their product offerings to avoid subprime mortgage lending”). In support of this proposition, the OCC does cite to the OCC Working Paper, a document the agency issued one month before its preemption determination. The OCC Working Paper, however, uncritically adopts the industry position in evaluating the effects of the North Carolina antipredatory lending law and concludes that that law has significantly dried up subprime credit in North Carolina. *See* OCC WORKING PAPER, *supra* note 6, at 20-22. As described earlier, that conclusion is far from certain and likely not true. *See supra* text accompanying notes 440-48. Some consumer advocates have called the OCC's evaluation of the evidence regarding the efficiency of the subprime market and the effects of the subprime law biased toward industry. *See, e.g.,* CRL COMMENTS ON OCC WORKING PAPER, *supra* note 30, at 16.

479. *Supra* note at 297.

480. *See supra* text accompanying notes 113-38.

481. 68 Fed. Reg. at 46,280. Significantly, the OCC order does not conclude that nonbank mortgage-lending institutions that are subsidiaries of national bank-holding companies (ones that are structured as affiliates, but not subsidiaries, of national banks), *see supra* note 329, benefit from its preemption decision. Accordingly, the approximately twenty percent proportion of total subprime lending that this market sector engages in is still subject to state predatory lending legislation.

482. *See* Letter from Martin D. Eakes and Mark Pearce, Center for Responsible Lending, to the Office of the Comptroller of the Currency 12 (Oct. 6, 2003), *available at* <http://www.responsiblelending.org/pdfs/CRLCommentonOCCProposedRulemaking03-16.pdf> (“Congress intended to prevent national banks from using their operating subsidiaries to avoid the conditions placed on national banks by its federal charter. This proposed rulemaking improperly

undermines state regulatory authority, the possibility of innovative policymaking power embodied in state consumer protection statutes, as well as the dual banking system as a whole.⁴⁸³ Subsequent to the OCC decision, several major banks, including J.P. Morgan Chase, the country's largest state-chartered institution, have successfully converted their state charters into federal ones, at least in part to take advantage of the OCC's preemption rule and to avoid the need for compliance with the state antipredatory lending laws that would have applied to the prior state-chartered institutions.⁴⁸⁴ Finally, as described below, the decision artificially elevates the value of "uniformity" to a rule of decision rather than one admittedly important factor in the balance of regulatory banking power between the federal and state government.

2. Congressional Preemption

In the past five years, several federal laws have been proposed to address the nationwide predatory lending problem.⁴⁸⁵ Two leading House proposals are currently under consideration. The bill proposed by Congressman Robert Ney from Ohio would preempt all state predatory

flips this intention to mean that Congress wanted to remove these state-chartered entities from state regulation.").

483. See, e.g., Duncan, *supra* note 449, at 225 (concluding that preemption of traditional state banking regulations "interferes with the exercise by the states of their traditional police powers to implement their policymakers' customer protection and other financial services agendas"); Lagomarsino & Christie, *supra* note 476 (quoting Eliot Spitzer, New York Attorney General, as stating that "the OCC's actions 'would prevent the states from . . . enforcing almost any law against national banks' and represent an 'unprecedented' expansion of OCC's powers."); Arthur E. Wilmarth Jr., Editorial, *Danger of OCC's Preemption Moves Is Not a Myth*, AM. BANKER, May 21, 2004, at 10 (arguing OCC's preemption rule will accelerate the drive of state-chartered banks to flip to national charters and that, therefore, "our banking industry will no longer enjoy the flexibility, innovation, and responsiveness that have been hallmarks of our dual regulatory system").

484. Rehm, *supra* note 476 (stating that J.P. Morgan obtained approval for a federal charter); see also Press Release, HSBC, HSBC USA Receives Approval for National Charter (June 24, 2004) (reporting that HSBC Bank USA successfully converted from a state to federal charter), available at http://www.us.hsbc.com/inside/news/pressreleases2004_jun_24.html; *Predatory Lending in 2003, Hits Runs and Errors* (Dec. 16, 2003) (story summarized from AM. BANKER) (noting that "[S]ome large mortgage companies [including Wachovia and J.P. Morgan] took advantage of the OCC's impending preemption by moving their mortgage activities into their nationally chartered banks" to avoid state lending restrictions), at <http://www.housingchoice.org/news%20stories/2004/12162003.htm>; Chris Sanders, *J.P. Morgan Plans New Bank That May Avoid Local Laws*, REUTERS NEWS, Sept. 12, 2003 (describing plans to create one national bank to avoid state banking laws).

485. See S. 2415, 106th Cong. (2000) (lowering HOEPA's APR trigger to six percent and its points and fees trigger to five percent, and banning a series of core predatory loan terms and practices akin to those banned in "aggressive" states without preempting them); S. 2405, 106th Cong. (2000) (lowering HOEPA's points and fees trigger on a sliding scale and prohibiting similar loan terms and practices); H.R. 3901, 106th Cong. (2000) (lowering HOEPA's APR trigger to five percent and prohibiting similar loan terms and practices).

lending laws with less stringent regulations,⁴⁸⁶ while the bill proposed by Congressmen Brad Miller and Melvin Watt builds upon North Carolina's predatory lending law without imposing a preemptive effect on any state laws.⁴⁸⁷

The Ney bill improves on HOEPA only marginally, by lowering the points and fees trigger two points for first-lien loans to six percent, by limiting slightly the amount of prepayment penalties that can be charged, and by prohibiting advance payment provisions and a lender's encouragement of borrower default.⁴⁸⁸ However, it fails to address many predatory lending practices that states regulate, including balloon payments, negative amortization loans, loan flipping, asset-based lending, and others.⁴⁸⁹ Most problematic, the bill would preempt all state predatory lending legislation, not just laws affecting OCC and OTS regulatory scope.⁴⁹⁰ Not surprisingly, the lending industry supports preemption efforts in general, and the Ney bill in particular, because it would impose a uniform national solution that undercuts many of the prohibitions the industry has been fighting against at the state level.⁴⁹¹

The more recently proposed Miller-Watt bill, by contrast, offers much more consumer protection without any express preemptive effect.⁴⁹² What is particularly interesting about the Miller-Watt proposal is that these North Carolina representatives base their federal proposal in large part on the vanguard North Carolina predatory lending law. The bill lowers the HOEPA points and fees loan trigger to five percent above the Treasury rate and includes important additional costs in the calculation of the trigger such as yield spread premiums, insurance costs, and prepayment penalties.⁴⁹³ It also contains many of the high-cost loan core prohibitions from the North Carolina and other aggressive state predatory lending laws, such as those relating to balloon payments, negative amortizations, financing of single-premium credit insurance, lending without regard to a borrower's ability to repay, and capping prepayment penalties at two percent.⁴⁹⁴ In particular, the bill adopts the philosophy of loan transparency

486. Responsible Lending Act, H.R. 833, 108th Cong. § 104 (2003).

487. Prohibit Predatory Lending Act, H.R. 3974, 108th Cong. (2004).

488. H.R. 833 §§ 101(a), 102(g), (n),(r).

489. In places, the bill actually weakens federal home-loan protections. For example, the bill would amend RESPA to eliminate the required disclosure of yield spread premiums. H.R. 833 § 101(b).

490. H.R. 833 § 104.

491. See MORTGAGE BANKERS ASS'N, MBA ISSUE PAPER: SUBPRIME LENDING, (2002), at http://www.mbaa.org/library/isp/2002_5/01_17.html (supporting preemptive effect of the Ney bill); *supra* note 483 (suggesting that industry prefers federal preemption to variety of state laws).

492. H.R. 3974.

493. *Id.* § 2(a), (c).

494. *Id.* § 3.

and many of the predatory loan regulations originated by, and in some cases still unique to, North Carolina such as a ban on the financing of any points and fees in connection with high-cost loans and the prohibition on flipping, which is defined according to North Carolina's definition: a refinancing at *any time* if there is no "reasonable, tangible net benefit" to the borrower.⁴⁹⁵

Unlike the Ney bill, the Miller-Watt bill takes advantage of the significant value that regulatory experimentation adds to our federal system. It represents an important but rare process of interaction, learning, and adaptation between federal and state units of government by incorporating the experience of state legislatures, which in turn had relied on an interactive process among themselves in their goal of building upon the now insufficient baseline set by the federal government. The Miller-Watt bill, and other aggressive federal responses, likely would not have been possible without North Carolina's initiative, ratification of its action by many other reform-minded states, and the encouraging empirical results following its implementation. There is still much more to learn from experiences of other states, including for example, the effects on predatory lending and the legitimate subprime market of assignee liability provisions in states like New Jersey and Illinois. Thus, as much as the bill benefits from state experimentation, its enactment would still be premature.

VI. THE VALUE OF STATE EXPERIMENTATION IN THE FEDERAL SYSTEM

In recent years, noted scholars have attempted to look beyond some of the more abstract expositions about the virtues of federalism produced by the Supreme Court's jurisprudence in the years since *United States v. Lopez*⁴⁹⁶ and *Seminole Tribe v. Florida*,⁴⁹⁷ in order to question the value of federalism in a real, practical sense. Professor Erwin Chemerinsky has complained that "discussions about federalism are the ones where the underlying values are least discussed and are the most disconnected from the legal doctrines."⁴⁹⁸ He urges that courts and commentators employ a "functional analysis" to explore why state autonomy matters and to answer the basic question of when and how to allocate power between the federal

495. *Id.* §§ 4(m), 8.

496. 514 U.S. 549 (1995).

497. 517 U.S. 44 (1996).

498. Erwin Chemerinsky, *The Values of Federalism*, 47 FLA. L. REV. 499, 501 (1995); see also *id.* at 501 ("The Court's decisions about federalism rarely do more than offer slogans about the importance of autonomous state governments."); Alan R. Greenspan, *The Constitutional Exercise of the Federal Police Power: A Functional Approach to Federalism*, 41 VAND. L. REV. 1019 (1988) (analyzing federalism in the context of commerce clause jurisprudence).

government and state governments.⁴⁹⁹ Professor Barry Friedman has also suggested that the doctrine of federalism “lacks a coherent vision of when national authority or state authority should be exercised, as well as a clear understanding of the true worth of federalism,” and argues that quantifiable values should be ascribed to the various traditionally identified advantages or disadvantages of federalism.⁵⁰⁰ Similarly, Professor Larry Kramer has focused on a realistic, descriptive theory of “how federalism really works.”⁵⁰¹

I attempt to meet this type of challenge by demonstrating that, because of the tangible benefits associated with decentralized political experimentation (states as laboratories), regulatory responses currently occurring at the state level should be left undisturbed and even encouraged. My argument proceeds on a mutually reinforcing descriptive and normative loop. I explicate the theoretical arguments in favor of allowing the states to act as laboratories of democracy; and, I attempt to demonstrate how those benefits are actually being realized in the context of predatory lending reform and how efforts by banking industry groups, federal regulators, and some in Congress to preempt state reforms are both premature and rely too reflexively on federalism’s polar value, uniformity. I am not concerned here with the vexing question of when the theory of federalism should prompt judicially enforced limits on federal action. Rather, I intend to demonstrate that federal and state policymakers should themselves choose not to preempt the percolation of state regulatory activity so that the best public policy may emerge—which, in the end, I believe is the primary value of federalism.

A. *A Happy Incident of Federalism: States as Laboratories of Experimentation*

There are a handful of values traditionally cited in support of ensuring that states have significant decisionmaking autonomy in the federal system, though they are typically presented in the context of whether and when the judiciary should pass on the constitutionality of federal action. First, autonomous state governments can impede the aggregation of power in the central government, minimizing the likelihood of tyranny.⁵⁰² A

499. Chemerinsky, *supra* note 498, at 534.

500. Barry Friedman, *Valuing Federalism*, 82 MINN. L. REV. 317, 324 (1997).

501. Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485, 1490 (1994).

502. D. Bruce La Pierre, *Political Accountability in the National Political Process—The Alternative to Judicial Review of Federalism Issues*, 80 NW. U. L. REV. 577 (1985) (suggesting that multiple levels of accountability limits and diffuses power); Merritt, *supra* note 16, at 5-7 (1988) (suggesting that states limit and balance federal authority through their ability to lobby and regulate in areas untouched by federal government); Rapaczynski, *supra* note 16, at 385-90 (suggesting that the result of oppression should the federal government be captured by an authoritarian movement would

second asserted value of federalism is that it promotes the democratic ideal because state governments are more closely in tune with their citizens and therefore more accountable and responsive to local constituent needs.⁵⁰³ A variation on this value, favored particularly in the law and economics literature, is that, unlike the federal government, states can compete with one another productively in order to attract desirable citizens and businesses to aid in economic growth.⁵⁰⁴

A third and often related value is that decentralized decisionmaking promoted by federalism allows for more and better opportunities for innovation and experimentation with social and economic policy than does one centralized bureaucracy.⁵⁰⁵ The argument for encouraging states to serve as laboratories of democracy and experimentation comes from, of course, Justice Brandeis's famous proclamation in a dissenting opinion in *New State Ice Co. v. Liebmann*:

To stay experimentation in things social and economic is
a grave responsibility. Denial of the right to experiment may
be fraught with serious consequences to the nation. It is one

be much worse than if the same happened in any state).

503. See *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991) (stating that federalism “increases opportunity for citizen involvement in democratic processes”); SHAPIRO, *supra* note 16, at 91-92 (“[O]ne of the stronger arguments for a decentralized political structure is that, to the extent the electorate is small, and elected representatives are thus more immediately accountable to individuals and their concerns, government is brought closer to the people, and democratic ideals are more fully realized.”); Merritt, *supra* note 16, at 7-8 (suggesting an important advantage of federalism is the ability of state governments to “draw[] citizens into the governmental process,” which, in turn, increases representative accountability and voter confidence); Rapaczynski, *supra* note 16, at 396 (noting a traditional justification for federalism is that it enhances citizen participation which creates a “means of strengthening the representativeness of governmental institutions and enhancing the perception of its legitimacy”).

504. See *Gregory*, 501 U.S. at 458 (stating that federalism “makes government more responsive by putting the States in competition for a mobile citizenry”); Ann Althouse, *Variations on a Theory of Normative Federalism: A Supreme Court Dialogue*, 42 DUKE L.J. 979, 1003-13 (1993); Richard A. Epstein, *Exit Rights Under Federalism*, 55 L. & CONTEMP. PROBS. 147, 152, 161 (1992); Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1498-99 (1987) (book review) (arguing that, because states will compete for additional taxpayers to reduce each citizen's share of the tax burden, “competition among governments for taxpayers will be far stronger at the state and local than at the federal level”).

505. See *Gregory*, 501 U.S. at 458 (federalism “allows for more innovation and experimentation in government”); *Fed. Energy Regulatory Comm'n v. Mississippi*, 456 U.S. 742, 787-88 (1982) (O'Connor, J., concurring in the judgment in part and dissenting in part) (“The Court's decision undermines the most valuable aspects of our federalism. Courts and commentators frequently have recognized that the 50 States serve as laboratories for the development of new social, economic, and political ideas.”); SHAPIRO, *supra* note 16, at 85-86 (suggesting it is more likely for decentralized actors to experiment); Chemerinsky, *supra* note 498, at 528-29 (noting that the “states as laboratories” argument is frequently cited in support of federalism); Merritt, *supra* note 16, at 9 (citing empirical examples in support of state experimentation value).

of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.⁵⁰⁶

To list these as advantages of federalism in the abstract, however, offers little guidance on when or how these arguments should be valued in a debate about whether to leave regulation to the state, rather than the federal, level. As Professor Chemerinsky noted about the state experimentation rationale in particular: “when is it worth experimenting and when is experimentation to be rejected because of a need to impose a national mandate?”⁵⁰⁷ In fact, there are several compelling reasons why the variety of predatory lending reforms occurring at the state level should remain undisturbed by federal preemption efforts or, in other words, why experimentation with predatory lending legislation demonstrates real, quantifiable value to federalism.

First, as described, predatory lending is an elusive and hard to define concept.⁵⁰⁸ The current trend is taxonomic: state legislatures continue to help identify lending practices and loan terms regarded as predatory, a trend that should continue before the federal government adopts, perhaps prematurely, a singular definition. The state democratic process is operating as a kind of encyclopedia to catalogue and describe an otherwise ambiguous phenomenon. Second, the many state responses, by definition, reflect the particular needs of their communities. Some states may respond to strong progressive reform traditions or community advocacy groups as in New York, New Jersey, or California; some may have large urban communities hurt by predatory lending, such as Illinois; some may be responding to harm done to their elderly, rural, and African American populations, such as Arkansas. Others still, out of a concern for banking interests or because they do not perceive the problem to be serious enough, have refrained from enacting legislative reform.

Finally, because of the many unique attributes of the predatory lending program, no uniform national solution should be imposed until more data is available to evaluate whether the state reforms have worked or will work. More specifically, evaluation factors should include: (i) whether the variety of state options have worked in their jurisdictions to ameliorate predatory lending or whether unscrupulous lenders have been successful, as they often are, in circumventing state restrictions⁵⁰⁹ and (ii)

506. 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

507. Chemerinsky, *supra* note 498, at 529.

508. *See supra* text accompanying notes 1-11.

509. *See* HUD-TREASURY JOINT REPORT, *supra* note 8, at 69-70 (noting that bad actors are constantly developing new abusive practices, sometimes to evade government regulation); *cf.*

whether state laws have been or would be counterproductive, as the banking industry has suggested, by increasing compliance costs and liability risks so greatly that legitimate subprime credit is driven out of the communities which the predatory lending laws were intended to help. The federal government may thereafter assess the results of the multiplicity of state regulatory activity and adopt what it believes is the single best version, pick and choose features among the many, or based on empirical evaluation regarding the remaining availability of subprime credit, push regulatory restrictions even further.

1. Innovation and Experimentation

Although the Brandeis notion of states as laboratories is firmly lodged in the federalism canon, the opinion was for Justice Brandeis a typical dissent from a *Lochner*-era invalidation, on substantive due process grounds, of a state licensing requirement.⁵¹⁰ The opinion obviously reflects the budding faith of the day in technological and scientific progress,⁵¹¹ but it is also rich enough to suggest three perspectives for the application of his theory to the federalism debate. First, states will often react to social and economic problems more immediately and responsively than the federal government.⁵¹² Second, in a country as broad, diverse, and constantly changing as the United States, courts, and to a lesser extent the federally elected officials, must not interfere with states' attempts to meet the various, particular needs of their communities.⁵¹³ Finally, as a "happy incident" of our federal system, states may serve as laboratories for an omniscient federal government, which can observe experimentation in state petri dishes and choose the version it likes best.⁵¹⁴ All three interpretations are implicated in the predatory lending preemption debate.

Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168 (2002) (arguing that much consumer protection legislation is rendered ineffective by the targets' ability to circumvent black letter prohibitions).

510. The Court held that "a regulation which has the effect of denying or unreasonably curtailing the common right to engage in a lawful private business, such as that under review, cannot be upheld consistent with the Fourteenth Amendment." *New State Ice Co.*, 285 U.S. at 278; *see id.* at 311 (Brandeis, J., dissenting).

511. *See id.* at 310 (Brandeis, J., dissenting) ("The discoveries in physical science, the triumphs in invention, attest the value of the process of trial and error.").

512. *See id.* at 311 (Brandeis, J., dissenting) ("I cannot believe that the framers of the Fourteenth Amendment, or the states which ratified it, intended to deprive us of the power to correct the evils of technological unemployment and excess productive capacity which have attended progress in the useful arts.").

513. *See id.* (Brandeis, J., dissenting) ("There must be power in the states and the nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs.").

514. *See id.* at 310-11.

a. Filling in Gaps and Staying Ahead

The incentive for states to innovate or experiment has two facets. In the first instance, will state governments respond more quickly than the federal government to a widespread problem? If, as scholars suggest, states are more intimate, responsive, and accountable to their constituents, then one would expect them to respond more quickly to a perceived problem in their jurisdictions. Moreover, to the extent that states enjoy a respected zone of autonomous decisionmaking free from federal preemption in which they can construct public policy,⁵¹⁵ it is inevitable that fifty-one decentralized units will frequently act more quickly than the federal government. In the predatory lending context, a number of states have moved with great speed to fill in regulatory gaps left open by the federal government: following North Carolina's lead, twenty-five jurisdictions have acted within a five-year period.⁵¹⁶

A second facet of the innovation hypothesis proposes that some number of state units are more likely to adopt creative, original, or innovative solutions to economic and social policy problems than would the federal government. Scholars have suggested that state politicians are more likely to be risk-averse to experimentation because experimentation will only alienate important special interest groups without offering them any short-term political gains.⁵¹⁷ This view is wrong as a matter of logic, intuition, and experience. One central risk factor absent from a state policymaker's calculus is the possibility that a mistake will affect the entire nation⁵¹⁸ or, on the other hand, that the greater regional, social, or political opposition extant at the congressional level would either defeat or at least substantially water down innovative initiatives.⁵¹⁹ Without facing these risks, states may remain flexible, creative, and competitive with one another in solving mutually shared problems.⁵²⁰ The federal government,

515. See Rapaczynski, *supra* note 16, at 399-405.

516. See *supra* Part V.A.

517. See Susan Rose-Ackerman, *Risk Taking and Reflection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593, 614-16 (1980); see also Rubin & Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903, 923-26 (1994) (arguing that real experimentation could happen at the federal level only by employing decentralized units deliberately to try a variety of solutions). For criticisms of Rose-Ackerman's conclusion, see Friedman, *supra* note 17, at 398, stating that the "spirit of state experimentation is one of creative response to immediate necessity, often addressed to solving a real problem staring [an] official in the face," and Merritt, *supra* note 16, at 9 n.47, arguing that Rose-Ackerman's model ignores "several important incentives for innovation in the federal system."

518. See Greenspan, *supra* note 498, at 1043.

519. See *id.* at 1041-42.

520. McConnell, *supra* note 504, at 1498. McConnell believes that

by contrast, as is evident in the predatory lending debate, faces no comparable competitive force, is slowed by core bureaucratic problems associated with centralization,⁵²¹ and is the preferred target for industries that want to preempt progressive state reforms.⁵²² If necessity is the mother of invention, it must follow that multiple jurisdictions fighting a similar problem will react more quickly and come up with original solutions more frequently than one central government.⁵²³

Indeed, states have pioneered innumerable social and economic experiments, many of which were ultimately adopted in some form by the federal government. State governments were responsible for major innovations in workman's compensation, minimum wage laws,⁵²⁴ unemployment compensation in Wisconsin,⁵²⁵ public education in California, Massachusetts, and New York, welfare reform in New Jersey, health care, and a variety of issues surrounding taxation, criminal justice, and penal reform.⁵²⁶ States have also surpassed the federal government in responding to many environmental concerns.⁵²⁷ The wave of state

[i]f innovation is desirable, it follows that decentralization is desirable. This statistical proposition is strengthened, moreover, by the political reality that a smaller unit of government is more likely to have a population with preferences that depart from the majority's. It is, therefore, more likely to try an approach that could not command a national majority.

Id.

521. ALICE M. RIVLIN, *REVIVING THE AMERICAN DREAM: THE ECONOMY, THE STATES & THE FEDERAL GOVERNMENT* (1992) (arguing that even if it makes sense to have one national policy, it may not be efficient to control some subjects, such as schools, hospitals, and roads, from a single, central source); Greenspan, *supra* note 498, at 1042 (noting regulators' claims that they have little incentive to consider alternative or innovative approaches to problems); Richard B. Stewart, *Madison's Nightmare*, 57 U. CHI. L. REV. 335, 343 (1990) (arguing that national regulations are "inevitably procrustean in their application").

522. See Gerald E. Frug, *Why Neutrality?*, 92 YALE L.J. 1591, 1600 (1983) (industry typically seeks preemption to thwart local rules); Richard J. Lazarus, *Debunking Environmental Feudalism: Promoting the Individual Through the Collective Pursuit of Environmental Quality*, 77 IOWA L. REV. 1739, 1772 (1992) (describing industry efforts to seek federal preemption of state environmental laws); Richard J. Lazarus, *The Tragedy of Distrust in the Implementation of Federal Environmental Law*, 54 L. & CONTEMP. PROBS. 311, 315-17 (1991) (arguing that those with influence in existing power structure will resist reforms at local level); see also *supra* Part V.C. (describing banking industry efforts to preempt state reforms).

523. See SHAPIRO, *supra* note 16, at 85-86 ("[I]t seems clear that . . . fifty state units . . . are more likely to engage in experiments than one national unit, especially in a country with as many regional and social differences as ours.").

524. See Fed. Energy Regulatory Comm'n v. Mississippi, 456 U.S. 742, 788-89 (1982) (O'Connor, J., concurring in the judgment in part and dissenting in part).

525. Louis B. Kaden, *Politics, Money, and State Sovereignty: The Judicial Role*, 79 COLUM. L. REV. 847, 853-57 (1979) (describing unemployment insurance experiments in Wisconsin).

526. See SHAPIRO, *supra* note 16, at 87-88.

527. Lazarus, *supra* note 522, at 1772; Richard Revesz, *Federalism and Environmental*

predatory lending legislation represents perhaps the most compelling example of the speed and creativity with which state units in our federal system can respond to a pressing public crisis.

b. Responding to Local Needs

Brandeis' dissent implicitly suggests that experimentation is valuable because it allows states to adopt policies particular to their jurisdictions' needs—a suggestion that scholars have since made explicit.⁵²⁸ As just described, the existence of varying local conditions in the states is a contributing cause of legislative action and experimentation. The variety of solutions born of particular jurisdictional needs is also the efficient result of experimentation because the variegated process can maximize divergent preferences.⁵²⁹ State governments also frequently possess superior substantive knowledge of how a problem is shaped by the particular economic, political, or social circumstances of their jurisdiction.⁵³⁰ The states that legislated most quickly against predatory lending appear to have responded to strong evidence and community advocacy efforts related to circumstances in their own jurisdictions,⁵³¹

Regulation: A Public Choice Analysis, 115 HARV. L. REV. 553, 583-630 (2001).

528. See *supra* note 503.

529. See McConnell, *supra* note 504, at 1493. McConnell believes:

The first, and most axiomatic, advantage of decentralized government is that local laws can be adapted to local conditions and local tastes, while a national government must take a uniform—and hence less desirable—approach. So long as preferences for government policies are unevenly distributed among the various localities, more people can be satisfied by decentralized decision making than by a single national authority.

Id.

530. See DANIEL J. ELAZAR, *AMERICAN FEDERALISM: A VIEW FROM THE STATES* 2-9 (3d ed. 1984) (arguing that best public policy emerges when states can tailor programs to meet local conditions).

531. In North Carolina, the legislature has benefitted from the research and advocacy of a leading proponent of predatory lending reform located in the state, The Center for Responsible Lending. For numerous studies on subprime and predatory lending in North Carolina undertaken by the Center for Responsible Lending staff, see http://www.responsiblelending.org/predlend_nc/index.cfm. In New Jersey, the legislature had before it a report entitled *Predatory Lending in New Jersey*, which documented particular harm of predatory lending in northern New Jersey. See generally ZIMMERMAN ET AL., *supra* note 5 (examining national and state level data to assess predatory lending practices in New Jersey). Similarly, in Illinois, the legislature had the benefit of the report, *Preying on Neighborhoods*, which documented the effects of predatory lending in the Chicago metropolitan area. See generally PREYING ON NEIGHBORHOODS, *supra* note 5 (seeking to estimate the size and impact of the subprime market in the Chicago area). In Georgia, Massachusetts, New York, and Arkansas, press coverage persistently documented human stories of victimization by predatory lenders. See, e.g., D.L. Bennett, *Losing a Home So Easy, It's Scary*:

other states preempted local ordinances because of the perceived deleterious effects legislators thought those ordinances would have on the state.⁵³²

c. Eventual Adoption at the Federal Level

Finally, Brandeis's opinion suggests that an additional advantage of the experimentation model is that it permits the federal government to wait until states have acted to respond, adopting a uniform solution based on the results of state activities. Under one metaphor, the federal government can act like an omniscient scientist, picking and choosing parts of the best state reforms out of the variety offered that are best for national policy.⁵³³ Another, more appropriate metaphor, is one of natural selection, where the states themselves build on previous efforts of other states and the federal government, tweaking solutions as they go along to suit their particular

Metro Foreclosure Reaching Record Highs, ATLANTA J.-CONST., July 28, 2001, at 1A (documenting explosion of foreclosures on high cost home loans in the Atlanta metropolitan area); Russell Grantham, *Senator Targeting Predatory Lenders*, ATLANTA J.-CONST., Nov. 30, 2001, at D8 (describing Georgia state senator's response to the community's outrage and devastation resulting from predatory lending); Thomas Grillo, *Predatory Lending on the Rise, Study Says Activists Say State's New Rules Not Enough*, BOSTON GLOBE, Nov. 18, 2001, at J1 (describing the efforts of community activists to force legislators to respond to increasing reports of predatory lending in the Boston area); Thomas Grillo, *Retirement Panel Urged to Attack Predatory Lending City Council Vote Targets Stock of Household's Parent*, BOSTON GLOBE, June 2, 2002, at H1 (describing the efforts of local community organizations to lobby the Boston City Council, and the City's resolution condemning the actions of large a predatory lender); Dolores Kong, *Borrowers' Backlash Costly Fees, High Interest Rates Spur Campaign Against Subprime Lenders*, BOSTON GLOBE, Apr. 14, 2002, at H1 (describing the efforts of a government agency to respond to and investigate citizen complaints regarding predatory lending in the Boston area); Jordan Rau, *Stalking the Predators: State Legislature Eyes More Restrictions on Lending*, Newsday, June 27, 2001, at A06 (describing the efforts of a coalition of consumer groups to push the New York legislature to adopt stricter home lending laws); Jill Vejnaska, *The Loan Trap: Lenders Prey on Unwary 2nd Mortgages Often Put Borrowers in Poor House*, ATLANTA J. & CONST., Oct. 11, 1992, at 1A.

532. See Mortgage Bankers and Brokers and Consumer Equity Protection Act, 63 PA. CONS. STAT. ANN. §§ 456.301-.314 (West 2004); Mark Scolforo, *Pa.'s Predatory Lending Law Lacks Teeth of New, Tougher Laws Elsewhere*, ASSOCIATED PRESS, July 8, 2004 ("Consumer advocates say Pennsylvania approved industry-friendly regulations that did little more than help insulate lenders from civil suits and pre-empt a Philadelphia city ordinance that offered far more substantial protections for borrowers.").

533. Cf. Rubin & Feeley, *supra* note 517, at 923-26 (arguing that the good experimentation can happen only in a decentralized system, not a federal one, where a central decision-maker manipulates and evaluates controlled experiments). *But see* Friedman, *supra* note 17, at 398 (criticizing Rubin and Feeley's decentralization controlled experimentation model as unrealistic in light of the federal system we have inherited because the "spirit of state experimentation is one of creative response to immediate necessity, often addressed to solving a real problem staring [an] official in the face").

circumstances or changed conditions⁵³⁴ so that, as Professor Shapiro explains, “[u]ltimately, the experiences of the range of states will reflect back on, and redefine, the policy itself.”⁵³⁵ As described, this has been the course of experimentation in the predatory lending context, as states build upon, but alter, the work of other jurisdictions.⁵³⁶ Patience with policy experimentation, like patience with natural selection, may produce for the federal government the solution best adapted to the times.⁵³⁷

2. Without Risk to the Rest of the Country

As Brandeis noted, states have the advantage of being able to undertake experiments without their policy choices posing a “risk to the rest of the country.”⁵³⁸ This advantage provides both an incentive for states to act quickly and make innovative choices and, in the predatory lending context, a reason for the federal government to avoid preemption in order to evaluate the results of the flurry of state regulatory activity.

Much of the debate about the value of state predatory lending legislation turns on empirical questions posed by competing sides of the debate. First, will these laws successfully stem the rash of foreclosures and related abusive lending practices in the neighborhoods most affected by predatory lending, or are current reforms too modest still to meaningfully solve the problem? Similarly, will unscrupulous actors find creative ways around state enactments in order to continue to prey on vulnerable borrowers? Or, will the more aggressive of the state regulations and the presence of assignee liability provisions significantly increase lender compliance costs and liability risks to the extent that they will dry up valuable and legitimate subprime credit, thereby hurting the very communities the laws were intended to help? Multiple studies have been conducted on the effects of the North Carolina law.⁵³⁹ Supporters contend that the law worked exactly as intended, by decreasing abusive lending practices while preserving a healthy subprime lending market.⁵⁴⁰ Detractors argue that the law has driven out large swaths of subprime

534. See Deborah J. Merritt, *Federalism as Empowerment*, 47 FLA. L. REV. 541, 551 (1995) (“Despite his pseudo-scientific language, it is doubtful that Justice Brandeis expected states to engage in controlled social experiments. Instead, experimentation in a federal system is akin to natural selection.”).

535. SHAPIRO, *supra* note 16, at 77.

536. See *supra* Part V.

537. Significantly, the federal government followed the lead of vanguard states in enacting a variety of environmental reforms. See Revesz, *supra* note 356, at 584-600 (describing the leadership of states like California in developing auto emissions standards and New Jersey in developing hazardous waste disposal regulations to push the federal government to create national policy).

538. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

539. See *supra* text accompanying notes 441-48.

540. See, e.g., ERNST ET AL., *supra* note 442, at 12.

credit.⁵⁴¹ Indeed, industry representatives appear to believe that the conclusions of the study are dramatic enough to inspire the federal government to act quickly to pass uniform, preemptive laws that are less restrictive.⁵⁴²

This strategy is certainly counterproductive. The best analysis currently suggests that the North Carolina law is having its desired positive effect, with little collateral harm. At worst, however, the competing studies are inconclusive, rendering conclusions about the effectiveness of the aggressive state actions premature. The federal government should take advantage of the mix of solutions currently occurring at the state level and wait for more conclusive, comparative results before it takes action that, if too accommodating of industry concerns, can pose a risk to the rest of the country.

B. *The Countervailing, but Insufficient, Value of Uniformity*

On the other side of the debate about the relative advantages of state experimentation are arguments about the virtues of uniformity. Uniformity is, like federalism, a fundamental constitutional and political value, pursued by the framers through various constitutional provisions, which they hoped would create political bonds across the union.⁵⁴³ The value of uniformity also emerged where there was a need for the imposition of national moral norms against racial discrimination or in favor of baseline constitutional criminal procedure protections. In the economic and social policy context in which the predatory lending debate is situated, however, these stated virtues of uniformity add no more to arguments about the value of preemption or experimentation than do recent Supreme Court paeans to state autonomy or dignity. In the more concrete public choice and economic context, a primary justification for adopting uniform federal solutions is to eliminate negative externalities associated with independent state action or to interrupt, via a federal baseline, a state “race to the bottom.”⁵⁴⁴ Neither of these has been cited or is implicated in the debate

541. *See supra* note 441.

542. Donald C. Lampe, *supra* note 21, at 151-52.

543. *See* THE FEDERALIST NO. 23 (Alexander Hamilton); THE FEDERALIST NO. 10 (James Madison).

544. *See* McConnell, *supra* note 504, at 1495 (“Externalities present the principal countervailing consideration in favor of centralized government.”); Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the “Race-to-the-Bottom” Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1234-42 (1992) (explaining and refuting the “race-to-the-bottom” rationale for federal regulation in the environmental context). Others have argued that it is unlikely, because of pressure on states to competitively attract wealthy citizens and businesses to bolster their tax base, that states will adopt serious redistributive measures that inevitably attract poorer constituencies. *See* SHAPIRO, *supra* note 16, at 81. Although the state

about which unit of government should assume regulatory authority over the predatory lending problem.

Instead, federal regulators appear to have adopted the industry mantra about uniformity, accepting without substantial evidence the argument that being subject to a variety of state laws would make national bank compliance overly costly and would cause a substantial decrease in the overall availability of subprime credit.⁵⁴⁵ That identical position was taken by industry in opposing the 2000 amendments to HOEPA,⁵⁴⁶ and disproven by the enormous subsequent growth of subprime lending.⁵⁴⁷ That position has also brought some suspicion that the OCC is beholden to industry.⁵⁴⁸ At the same time, Congress is being heavily pressed by

predatory lending reforms are not classically “redistributive,” the aggressive, state consumer protection regulations and resistance to industry threats to pull out of jurisdictions with heavy regulations discount both the redistribution and the race-to-the-bottom theories.

545. Compare *supra* note 478 (regarding OCC statements about uniformity), with, e.g., Sanders, *supra* note 484, at 489 (quoting a J.P. Morgan representative as saying, “[a] patchwork of local and state regulation does not best serve the interests of consumers or the industry and can only result in reducing the availability of credit and increasing its cost”). Not surprisingly, the OCC preemption decision also has pleased the national banking industry. See Todd Davenport, *Standard on Predatory Nearer After OCC’s Moves*, AM. BANKER, Feb. 24, 2003, at 1. Davenport generally describes the industry’s elation at the OCC ruling and quotes an industry lobbyist as saying:

The OCC has issued a very strong declaration that it is fully empowered to, and stands ready to supervise and regulate all aspects of national bank operations The OCC doesn’t require the uninvited assistance from the attorneys general and banking departments of the 50 states to carry out its mandate.

Id.; Michele Heller, *In Congress, It’s Been a Banner Year for Banks*, AM. BANKER, Dec. 10, 2003, at 1 (describing numerous legislative and regulatory victories obtained by the banking industry to preempt state laws and move toward a uniform “national standard”).

546. See *supra* note 297.

547. See *supra* Part II.A.2.

548. See *Federal Preemption Increasingly Occupies Center of Predatory Lending Debate; OTS, NCUA Carve out Exceptions for Savings Institutions and Credit Unions*, CRA/FAIR LENDING BULL., Jan. 2003 at 1, 2 (noting that the OCC “has aggressively asserted federal preemption in other areas”); Stacy Mitchell, *Rogue Agencies Gut State Banking Laws*, NEW RULES, Fall 2001, at 4 (describing the history of unjustified OCC preemption of state laws and quoting Ed Mierzwinski, Consumer Program Director for the U.S. Public Interest Research Group, calling the OCC more an “indentured servant of the industry than a regulator concerned with the will of Congress”). Some in Congress also suggested that the OCC may have acted with imperfect motives. See Michele Heller, *Senate Democrats Assault OCC’s Preemption Rules*, AM. BANKER, Apr. 8, 2004, at 3 (quoting Senator Sarbanes as saying that the OCC preemption decision is “at best, misguided and, at worst, a blatant attempt to increase the power of the OCC at the expense of homeowners, the sovereignty of the states, and the intent of Congress”); Greg Ip, *Fed Chief Says Deflation No Longer Remains a Risk; Treasury Bond Yields Surge*, WALL ST. J., Apr. 21, 2004, at A2 (noting Alan Greenspan’s expressed concern about “maintain[ing] the appropriate balance between state and federal [banking] regulators” and that the states’ role in the dual banking system not be

industry representatives with the same generalities regarding the benefits of uniformity that motivated federal regulators.⁵⁴⁹

The arguments on behalf of uniformity as a dispositive rule in this context are not persuasive. First, there is no limiting principle associated with the goal of national uniformity, permitting federal regulators to increasingly marginalize the role of states in the “dual banking system.” Indeed, arguments about the inefficiencies or increased compliance burdens associated with state regulation, taken to their logical conclusion, would simply justify the elimination of fifty-one separate jurisdictions and the inherent inefficiency produced by the federal system. Second, federal regulators and industry representatives have never attempted to quantify the increased compliance costs they face as a result of variegated state requirements. Nor have they demonstrated that such varying requirements are marginally or substantially more burdensome than a host of other regulatory requirements that banks must regularly comply with already. To the contrary, evidence indicates the subprime industry has been very healthy in recent years and is growing as strong as ever, in spite of the purportedly burdensome patchwork of state predatory lending regulations.⁵⁵⁰ As previously argued, many of the core prohibitions contained in state predatory lending laws apply to a narrow category of very high-cost loans and for that category merely impose certain uniform underwriting standards that should reduce lender profitability no more than the underwriting requirements imposed on lenders in the prime market by the strong forces of competition and GSE’s conforming loan criteria.

Most importantly, the principle of uniformity advanced by the banking industry and some congressional legislation and understood by the OCC leaves little room to assess the critical, countervailing value at stake—namely, the serious harms associated with predatory lending that state laws are attempting to remedy. Indeed, it seems safe to say that the lending industry would support the value of uniformity only so long as a proposed uniform, preemptive law impose substantially weaker requirements than those that are in place among the aggressive states. Uniformity in this context, thus serves no benefit to the federal system; instead, arguments on its behalf represent little more than the current

“undercut”).

549. See MORTGAGE BANKERS ASS’N, *supra* note 491 (endorsing the Ney bill in particular because it would preempt a variety of state predatory lending laws); *supra* text accompanying notes 484, 498 (demonstrating strong industry support for federal preemption in general and the Ney House bill in particular); see also Revesz, *supra* note 356, at 607 (describing industry attempts to pursue federal preemption of state environmental regulations).

550. See *Crystal Ball Reveals Strength in the Subprime MBS Market*, *supra* note 439, at 4 (“Fitch [credit-rating agency] anticipates few problems from ‘pending or existing’ predatory lending laws, as both sellers and issuers have significantly stepped up their due diligence efforts.”); *supra* Part II.A.2.

policy preference for less regulation over more.⁵⁵¹ And, in exchange for relieving lenders of the marginal—but not yet quantified—costs of compliance with state laws, the arguments for uniformity ignore real, significant costs: the continuation of predatory lending practices in a number of states that have caused and, left unregulated, will continue to cause emotional and financial devastation to borrowers trapped by them, and impose substantial externalities associated with foreclosures on the communities in which these disproportionately low-income and minority borrowers live.⁵⁵² The arguments, without data regarding the anticipated positive and potentially negative effects of the state responses, should not yet be considered.

Even from the perspective of reforming the predatory lending problem, my suggested approach does bear risks. The approach suggests a tolerance for a system in which nearly half the states have taken no or minimal formal action to respond to the predatory lending crisis and which therefore leaves thousands of borrowers in those states still vulnerable to abusive lending practices. The tolerance is justified. As an initial matter, the risk of state inaction is not as troublesome in a social or economic policy context as it would be when considering fundamental constitutional norms, such as ending racial discrimination, for which a uniform constitutional or moral consensus emerges that requires uniform legal rules to be imposed across the country, regardless of state preferences.⁵⁵³ The risk, moreover, is tempered by a faith in the state democratic process. Currently, a number of additional states are also considering predatory lending legislation in order to protect homeowners in their jurisdictions, some of which should become law in upcoming legislative sessions.⁵⁵⁴ However, my approach must include a willingness to accept legislative judgments in various jurisdictions that either reform is not urgently needed under the particular conditions of a state or that legislation would benefit from evaluating the experience of other state jurisdictions that have

551. Wilmarth, *supra* note 483 (arguing that because the OCC will not preempt state laws that “promote” the national banking business, “the OCC will recognize only state laws that it believes are helpful to national banks”).

552. *See supra* Part III.D.

553. *Cf. City of Cleburne v. Cleburne Living Ctr.*, 473 U.S. 432, 440-41 (1985) (explaining a principle of constitutional law that state legislatures are entitled to substantial deference when courts are considering economic or social policy legislation but are subject to heightened judicial scrutiny when fundamental rights are at issue).

554. For example, in the past year, legislatures in Hawaii, Indiana, Louisiana, Minnesota, Missouri, New Hampshire, Tennessee, Vermont, and Washington have introduced some form of predatory lending legislation. *See 2004 Detailed Status Summary Chart of State and Local Predatory Lending Legislation* (Oct. 1, 2004), at <http://www.butera-andrews.com/legislative-updates/directory/State/Legislature/Bills/sbc/State%20Bill%20Chart%202004.pdf> (cataloguing predatory lending developments in all fifty state legislatures) (last visited Feb. 21, 2005).

already taken the lead. In any event, the risk is worth taking if the alternative is a rush into uniform, national predatory lending reform that fails to learn and incorporate the wealth of available lessons from ongoing state experimentation.

