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Patricia McCoy

Boston College Law School, patricia.mccoy@bc.edu

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A BEHAVIORAL ANALYSIS OF PREDATORY LENDING

Patricia A. McCoy*

To the dispassionate observer, predatory lending presents a conundrum.¹ Its victims are homeowners who are wedded to staying in their homes. Many of them, particularly the elderly, have minuscule mortgages or own their homes free and clear. Nevertheless, these homeowners sign seemingly irrational loan contracts that are structured to result in financial ruin in the form of impaired credit, bankruptcy, or foreclosure.²

Understanding why this happens has key public policy implications for the debate over predatory lending. Are affected borrowers rational economic actors who maximize expected utility when signing loan contracts that later are disputed? Or rather, do predatory lenders induce sub-optimal decisions by homeowners by exploiting anomalies in consumer behavior through marketing? Insights from behavioral economics indicate the latter.

This essay considers experimental evidence from behavioral economics can shed light on injured borrowers' decisionmaking processes and the choice of legal redress. Specifically, I posit that predatory lenders exploit the behavioral principle of framing effects to

* Professor of Law, University of Connecticut. My thanks to Peter Diamond, Kathleen Engel, Botond Köszegi, Jim Rebitzer, and Elizabeth Renuart for their insights. This work first appeared in an expanded version as *Predatory Lending Practices: Definition and Behavioral Implications*, in WHY THE POOR PAY MORE: HOW TO STOP PREDATORY LENDING 81 (Gregory D. Squires ed., 2004).

1. In the home mortgage market, predatory lending is a syndrome of exploitative loan terms or practices that involves one or more of the following six problems: (1) loans structured to result in seriously disproportionate net harm to borrowers; (2) rent seeking that is harmful to borrowers; (3) loans involving fraud or deceptive practices; (4) other instances of lack of transparency in loans that are not actionable as fraud; (5) loans that require borrowers to waive meaningful legal redress; and/or (6) servicing abuses. Predatory lending is generally found in the subprime market, which caters to borrowers with blemished credit. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1259-70 (2002). See also Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 756-61 (2004).

2. Engel & McCoy, *supra* note 1, at 1260.

manipulate homeowners' otherwise strong aversion to losing their homes to foreclosure. Through clever marketing, distraction, and an often legal lack of transparency concerning the true risks involved, predatory lenders are able to divert the focus of homeowners from the fear of losing their homes to other fears, many of which are often conducive to less destructive solutions.

In debates over predatory lending, those who oppose government intervention argue that aggrieved subprime borrowers should live by the bargains they strike. Such critics maintain that those borrowers are rational actors who knowingly and freely consent to the terms in their contracts.

Evidence from the new and evolving field of behavioral economics, however, suggests that this portrait of subprime borrowers misses the mark. In fact, borrowers often bring cognitive biases to the table that lenders exploit through clever marketing to manipulate them into signing abusive loan agreements, in violation of strong personal preferences to remain in their homes. The remainder of this essay examines evidence for that proposition and considers the public policy implications.

I. BACKGROUND: EXPECTED UTILITY THEORY AND ITS CRITIQUE

The rational actor assumption is grounded in expected utility theory, which has been the classic paradigm for decision-making under uncertainty for a half-decade or more. Neo-classical economics assumes that reasonable people seek to follow expected utility theory and that most of them actually do so.³

Despite its prominence, expected utility theory does not derive from empirical fact. Rather, expected utility theory reduces the complexities of human decision-making to the following mathematical formula for determining the overall utility (U) of a prospect:

$$U(x_1, p_1; \dots; x_n, p_n) = \sum p_i u(x_i) = p_1 u(x_1) + \dots + p_n u(x_n)$$

where $(x_1, p_1; \dots; x_n, p_n)$ is a risky prospect having possible outcomes x_i , $\{i = 1, 2, 3, \dots, n\}$, each with probability p_i , $p_1 + \dots + p_n = 1$, and $u(\cdot)$ is the utility the consumer would derive from outcome x_i .⁴ Expected utility theory posits that consumers prefer the prospect with the highest

3. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263, 263 (1979).

4. *Id.* at 263-64.

expected utility.⁵ Under that theory, consumers are said to be concerned with their final state of wealth, not with gains or losses.⁶

II. THE CRITIQUE OF EXPECTED UTILITY THEORY AND LOSS AVERSION

Skeptics have long complained that expected utility theory is normative in nature, not necessarily descriptive, and eventually set out to prove it. Starting in the 1970s, psychologists and economists began to document anomalies in consumer behavior that violated expected utility theory. Experiments by psychologists Daniel Kahneman and Amos Tversky, for instance, demonstrate that when certain loss is a possible outcome, people are concerned with avoiding the certain loss instead of their final state of wealth.

For example, when people were asked to choose between an 80 percent chance of losing \$4,000 or a certain loss of \$3,000, the majority of the subjects preferred the 80 percent gamble on losing \$4,000 to losing \$3,000 for sure.⁷ The desire to avoid a loss led the subjects to overweight the certain outcome – losing \$3,000 – and to opt for the risky choice, despite a bigger expected loss ($0.8 \times -\$4,000 = -\$3,200$).⁸ Conversely, when subjects were asked to choose between an 80 percent chance of winning \$4,000 or a certain win of \$3,000, the majority of subjects preferred the sure gain of \$3,000 to an expected but risky gain of \$3,200.⁹

Based on these and similar experiments, Kahneman and Tversky hypothesize that people overweight the probability of some events and underweight others, depending on whether they are confronting possible gains or losses.¹⁰ In addition, these results suggest that people are so loss-averse that they will take substantial risks to avoid losses, even if their total expected wealth is less as a result.¹¹ This theory, known as prospect theory, is an attempt to explain these phenomena.¹²

5. *Id.* at 264.

6. *Id.* See also Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCI.* 453, 453 (1981).

7. Kahneman & Tversky, *supra* note 3, at 266.

8. *Id.*

9. *Id.* at 264, 268-69, 274.

10. *Id.* at 274.

11. *Id.* at 275.

12. Kahneman and Tversky express prospect theory in mathematical terms by altering the formula for expected utility to add a value function $v(\cdot)$ on gains and losses, plus decision weights $\Pi(\cdot)$ on stated probabilities. The value function $v(\cdot)$ expresses the idea that people put greater value on avoiding losses than on making gains. The decision weights $\Pi(\cdot)$ capture the idea that people overweight outcomes with low probabilities and underweight outcomes with moderate and high

Prospect theory has several important principles with implications for predatory lending. The first principle is *loss aversion*. Loss aversion drives consumer behavior in a number of ways. As the experiments just discussed suggest, loss aversion is why people take substantial risks to avoid certain losses.¹³ Similarly, loss aversion causes people to focus on minimizing out-of-pocket expenses, rather than on opportunity costs.¹⁴ The reason for this is that “[f]oregone gains are less painful than perceived losses.”¹⁵ Finally, when people face potential outcomes that entail both gains and losses, loss aversion causes them to prefer combining smaller losses with larger gains.¹⁶ This outcome is attractive because the outcome is perceived as a net gain.¹⁷

In the home mortgage context, loss aversion is apparent in the strong aversion that homeowners normally have to losing their homes. Thus, Kahneman and Tversky note: “an individual’s aversion to losses may increase sharply near the loss that would compel him to sell his house”¹⁸ This intense aversion to losing one’s home is suggested by data showing that homeowners are seven times less likely to file for bankruptcy than people who do not own homes.¹⁹ Similarly, among people who do file for bankruptcy, homeownership makes them more likely to file for protection under the workout provisions of Chapter 13, instead of under the liquidation provisions of Chapter 7, specifically in order to save their homes.²⁰

The bankruptcy data provide valuable insights into the preference ordering of the average homeowner. Homeowners prefer to make other financial sacrifices to taking the risk of bankruptcy and of losing their homes. If debts do force homeowners into bankruptcy, they prefer to

probabilities. This results in the following equation expressing the decision-making process that loss-averse people are said to employ:

$$V = \Pi(p)v(x) + \Pi(q)v(y)$$

where p and q are probabilities and x and y are competing choices. Kahneman & Tversky, *supra* note 3, at 275-76. See also Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S257 (1986); Tversky & Kahneman, *supra* note 6, at 454.

13. Kahneman & Tversky, *supra* note 3, at 264, 268-69, 274.

14. Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193, 203 (1991).

15. *Id.*

16. Richard H. Thaler, *Mental Accounting and Consumer Choice*, 4 MARKETING SCI. 199, 202 (1985).

17. *Id.* See also Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183, 187 (1999).

18. Kahneman & Tversky, *supra* note 3, at 278-79.

19. Ian Domowitz & Robert L. Sartin, *Determinants of the Consumer Bankruptcy Decision*, 54 J. FIN. 403, 413 (1999).

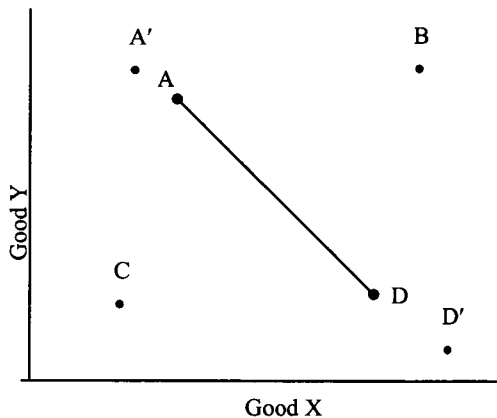
20. *Id.* at 410.

remain homeowners and reschedule their debts under Chapter 13, to losing their homes but obtaining total debt forgiveness under Chapter 7.

Given the strong loss aversion associated with homeownership, one would expect homeowners to make financial sacrifices or delay paying other bills in order to save their homes instead of sacrificing their homes to pay off other debts. Loss-averse homeowners should be highly reluctant to enter into loan transactions that threaten their future homeownership. Yet numerous subprime borrowers do precisely that. The answer to this paradox lies in how predatory lenders frame their sales pitches in order to manipulate the preference ordering of homeowners, as I now discuss.

III. REFERENCE DEPENDENCE AND FRAMING EFFECTS

Consumers do not evaluate gains and losses in the abstract. Instead, consumers evaluate their options in relation to some reference point, a phenomenon known as *reference dependence*.²¹ Imagine that someone has a choice between *A*, where she has less of good *X* and more of good *Y*, and *D*, where she has more of good *X* and less of good *Y*.²² If her reference point is *B*, she will regard the choice as a choice between two losses, while if her reference point is *C*, she will regard it as a choice between two gains.²³ From either reference point *A'* or *D'*, she will view it as a choice between mixtures of different proportions of two desirable goods.²⁴



21. Thaler, *Mental Accounting Matters*, *supra* note 17, at 185. See also Tversky & Kahneman, *supra* note 12, at S258.

22. See Kahneman et al., *supra* note 14, at 199-200.

23. See *id.* at 200.

24. *Id.*

In many cases, the reference point is not fixed, but can be manipulated depending on how the choice is framed. Marketers shift reference points by relabeling and thus framing possible outcomes, which can then shape consumers' responses. Predatory lenders exploit this ability to frame borrowers' reference points. This is why reference dependence and framing effects are such important concepts in thinking about predatory lending.

As the following experiment illustrates, people make different choices about identical outcomes, depending on whether the outcomes are framed as gains or losses. In the experiment, people were divided into two groups and were given different scenarios that involved choosing between two options. All of the choices would make the subjects \$400 richer, but for one group the choices were framed as gains and for the other as losses:

Scenario A Assume yourself richer by \$300 than you are today. You have to choose between: a sure gain of \$100 *or* a 50% chance to gain \$200 and a 50% chance to gain nothing

Scenario B Assume yourself richer by \$500 than you are today. You have to choose between: a sure loss of \$100 *or* a 50% chance to lose nothing and a 50% chance to lose \$200

In Scenario A, of 126 people surveyed, 72 percent chose a sure gain of \$100 and 28 percent chose the 50/50 wager.²⁵ In Scenario B, of 128 people surveyed, only 36 percent chose the sure loss of \$100, while 64 percent chose the 50/50 wager.²⁶

As this experiment shows, whether people were risk-loving or risk-averse depended on whether the outcomes were framed as gains or losses.²⁷ When the choice was framed as a gain, a majority became averse to uncertainty and chose the sure gain. But when the choice was framed as a loss, a majority sought to avoid the certain loss and chose uncertainty. A majority behaved inconsistently, even though they would become \$400 richer no matter what choice they made. Framing dictated whether the majority was risk-loving or risk-averse, again contradicting expected utility theory.²⁸

Framing creates an illusion that can induce inconsistent and

25. Tversky & Kahneman, *supra* note 12, at S258.

26. *Id.*

27. *Id.* at S259.

28. *Id.*

sometimes irrational consumer decisions. This illusion arises when two different statements of a choice are logically equivalent but not transparently equivalent.²⁹ Normally, consumers are not conscious of alternate ways of framing decisions or of the psychological effects of different frames.³⁰ Thus, how a decision is framed can manipulate and momentarily shift the order of a homeowner's preferences.³¹

Framing is the alchemy that permits predatory lenders to manipulate the order of homeowners' preferences and overcome their otherwise strong aversion to losing their homes. In reality, predatory loans are highly likely to result in losses, in the form of staggering debt, lost home equity, and possible foreclosure. Yet lenders never frame predatory mortgages in terms of major expected losses. One never sees ads saying: "Take \$20,000 today in exchange for a 50 percent chance that, in two years' time, you will lose your \$50,000 home." Such a marketing strategy would unleash loss aversion of profound proportions.

Instead, predatory lenders go to extreme lengths to frame their loans as gains and to obscure potential losses. Gains are portrayed not only as fast cash, but also as fast cash in the tens of thousands of dollars. Losses, on the other hand, are obscured by depicting them as initial monthly payments that are manageable in size. Lenders manipulate loan terms through legal means to give the appearance of reasonable monthly payments. They do this through initial teaser rates, extended loan maturities, balloon clauses, and adjustable rate mortgages.³² Left unsaid, or buried in fine print, is the fact that predatory loans are high-stakes ventures, with potential catastrophe looming down the road. The effect is to create the impression of huge, immediate gains offsetting small, eventual losses.

This key principle of framing—offsetting small perceived losses with the illusion of substantial gains³³—is particularly seductive to

29. Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LIT. 11, 36 (1998).

30. See Stephen E.G. Lea et al., *THE INDIVIDUAL IN THE ECONOMY: A TEXTBOOK OF ECONOMIC PSYCHOLOGY* 347 (1987). See also Tversky & Kahneman, *supra* note 6, at 453, 457-58; Tversky & Kahneman, *supra* note 12, at S260.

31. See Rabin, *supra* note 29, at 37. The related literature on preference reversals explores situations where different methods of elicitation lead to systematically different orderings of preferences. See *id.*; Paul Slovic & Sarah Lichtenstein, *Preference Reversals: A Broader Perspective*, 73 AM. ECON. REV. 596, 599-603 (1983); Amos Tversky et al., *The Causes of Preference Reversal*, 80 AM. ECON. REV. 204, 214-15 (1990); Amos Tversky & Richard H. Thaler, *Anomalies: Preference Reversals*, 4 J. ECON. PERSP. 201, 202 (1990).

32. Customers are less resistant to price increases when those increases are couched as cancellation of temporary discounts such as teaser rates. Tversky & Kahneman, *supra* note 12, at S261.

33. See Kahneman & Tversky, *supra* note 3, at 287; Tversky & Kahneman, *supra* note 6, at

homeowners who are in financial straits but have significant home equity. To homeowners desperate for lifesaving medical care, a car that works, roof repairs, or relief from bill collectors, lenders can easily shift their reference point from continued enjoyment of their homes to the creditors at the door. Despite pressing financial problems, most such homeowners – if asked – would prefer a solution that would allow them to stay in their homes. At a minimum, if the choice were put to them openly, most homeowners would delay paying other debts to losing their homes.

Nevertheless, subprime marketing can manipulate a temporary preference shift in debt-ridden homeowners by focusing a spotlight on their immediate financial problems while obscuring the eventual threat to their ownership of their homes. That is why predatory lenders pinpoint homeowners in crisis and promise to erase their debts with offers of instant cash. There are numerous ways to identify distressed homeowners. Predatory lenders monitor people's credit reports for debt problems, buy lists of delinquent debtors from debt collectors, and drive through neighborhoods looking for decrepit roofs and porches. At city halls, registries, and courthouses, they check filings daily for building code violations, tax liens, collection cases, divorce summonses, and mortgage payoffs. Lenders flush out likely victims with door-to-door sales and aggressive telemarketing campaigns. They use Home Mortgage Disclosure Act data to target low-income minority neighborhoods where Hispanics and African-Americans historically have been redlined and have lost hope of qualifying for home loans.³⁴ Then they target homeowners who appear in the crosshairs with a sales pitch. With a knock on the door or a phone call, the lenders miraculously appear and offer to wipe away the homeowners' financial difficulties with the illusion of large gains from a new loan.

IV. LACK OF TRANSPARENCY

Framing effects can occur when choices that are logically equivalent are not transparent.³⁵ In an experiment, Kahneman and Tversky examined decision-making anomalies that can result from lack of transparency. They asked 150 people:

Imagine that you face the following pair of concurrent decisions.

456.

34. See Departments of the Treasury & Housing and Urban Development, *Curbing Predatory Home Mortgage Lending* 39 (June 20, 2002); Engel & McCoy, *supra* note 1, at 1281-84.

35. Rabin, *supra* note 29, at 36.

First examine both decisions, then indicate the options you prefer.

Decision (1) Choose between:

- A. a sure gain of \$240
- B. a 25% chance to win \$1,000 and a 75% chance to gain nothing.

Decision (2) Choose between:

- C. a sure loss of \$750
- D. a 75% chance to lose \$1,000 and a 25% chance to lose nothing.

In Decision (1), 84 percent chose A and 16 percent chose B, while in Decision (2), 13 percent chose C and 87 percent chose D.³⁶ In effect, an overwhelming majority preferred A & D to B & C.³⁷ However, the combined expected value of B & C exceeds that of A & D, making B & C the rational choice:

B & C: The expected value equals $(0.25 \times \$1,000) - 750 = -\500

A & D: The expected value equals $\$240 + (-0.75 \times \$1,000) = -\$510$

When the options were presented transparently, people invariably chose B & C.³⁸ But when the options were presented in the obscure format of the problem posed above, 73 percent of the people chose combination A & D and only 3 percent of them chose the rational combination B & C.³⁹

This suggests that when the information people receive is confusing or difficult to evaluate, they cannot recognize the choice with the highest expected utility.⁴⁰ Thus, consumer choice depends not only on loss aversion, but also on transparency.⁴¹

Predatory lenders have multiple tools to defeat transparency. One technique involves search. A key objective of predatory lenders is to prevent homeowners, once solicited for loans, from engaging in comparison-shopping. This is one reason why predatory lenders generally focus on the refinance market, not the purchase-money market.⁴² In the purchase money market, individuals are actively

36. Tversky & Kahneman, *supra* note 12, at S255-56.

37. *Id.* at S256.

38. *Id.*

39. Tversky & Kahneman, *supra* note 12, at S265-66.

40. *See id.* at S265.

41. *Id.*

42. *See* Departments of the Treasury & Housing and Urban Development, *supra* note 34, at 30-31.

shopping for credit. In the refinance market, numerous homeowners who could refinance are not seeking to do so⁴³ and those are the people whom predatory lenders target. Once vulnerable prospects are identified, lenders aim to immediately lock them in psychologically. Rapid loan approval is key. So are high-pressure closings. By accelerating the loan process, lenders reduce the chance that borrowers will comparison-shop, making it easier for lenders to insert exploitative terms into loans. Finally, lenders carefully study homeowners' debt profiles to devise how to manufacture a sudden urge for a loan in homeowners who before had none.

In the rare cases when homeowners shop for subprime loans, their search is unlikely to be informative. Unlike the prime mortgage market, subprime quotes by different lenders are almost never posted side-by-side and when they are, the quotes do not permit meaningful comparison. It is well known that subprime interest rates go up as FICO scores go down.⁴⁴ Subprime loans are not advertised that way, however, and it is impossible for loan applicants to compare subprime loans based on FICO scores.⁴⁵ Similarly, subprime mortgage loans do not have standardized cost terms that permit easy comparison. One may have a prepayment penalty for three years, another for five.⁴⁶ One may offer single-premium credit life insurance, another may limit credit life policies to monthly premiums.⁴⁷ Under TILA, numerous cost elements can be excluded from the APR, hampering comparison-shopping.⁴⁸ Even when APRs are comparable, some lenders intentionally tell borrowers that only the nominal interest rate matters, not the APR.⁴⁹ Finally, lenders generally have no obligation to inform borrowers of alternative sources of credit or to advise them to get credit counseling or

43. See Glenn Canner et al., *Mortgage Refinancing in 2001 and Early 2002*, 88 FED. RES. BULL. 469, 470 (2002).

44. See, e.g., Departments of the Treasury & Housing and Urban Development, *supra* note 34, at 28, 33-34; Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUSING POL'Y DEBATE 503, 506 (2004).

45. See White, *supra* note 44, at 509. Cf. Thaler, *Mental Accounting and Consumer Choice*, *supra* note 16, at 209-11.

46. White, *supra* note 44, at 514-15.

47. See Patrick McGeehan, *Another Lender to Stop Sales Of Single-Premium Coverage*, N.Y. TIMES, July 12, 2001, at C9.

48. See, e.g., 15 U.S.C. §§ 1646, 1665a (2005) (including TILA provisions regarding disclosure of annual percentage rates).

49. See, e.g., *In re First Alliance Mortgage Company*, 298 B.R. 652, 657 (Bankr. C.D. Cal. 2003) (noting that loan officers, following a company script, told unsuspecting homeowners that the "interest rate is what consumers care about, APR is what the federal government cares about and yield is what the banks care about in evaluating a loan").

legal advice before proceeding to closing.

V. LACK OF EXPERIENCE

Predatory lenders purposefully target inexperienced borrowers who have not had prior opportunities for meaningful feedback regarding subprime refinance loans. Approximately 51 percent of homeowners have never refinanced their mortgages.⁵⁰ Subprime borrowers, many of whom historically have been credit-constrained, are even less likely than prime borrowers to have refinanced. In addition, because subprime borrowers are less well educated on average than prime borrowers, they are more apt to be confused by subprime loan terms and the intricacies of the subprime mortgage process.⁵¹

Predatory lenders capitalize on this lack of education and experience to lock borrowers into products that they do not understand and cannot afford.⁵² Once locked in, borrowers who cannot keep up with the monthly payments find few, if any, avenues of relief. Struggling borrowers would like to refinance on better terms, but their worsening financial conditions make them unpalatable to other lenders. With each late payment, their credit scores sink. Many become victims of repeated loan flipping, and with each loan “flip,” their loans mature later and have other, new abusive terms. Eventually, large prepayment penalties, interest arrears, and late fees strip their equity and, when combined with the outstanding principal, their indebtedness may exceed the value of their homes. The borrowers become locked into desperate situations and cannot get out.⁵³

VI. CHOICE HEURISTICS AND ERRORS IN ESTIMATING PROBABILITIES

All consumers, including subprime customers, use heuristic principles of one sort or another to simplify their financial decisions.⁵⁴ When these principles are sound, they provide a useful shortcut to financial decision-making.⁵⁵ Other choice heuristics, however, can lead

50. Canner et al., *supra* note 43, at 470.

51. See Departments of the Treasury & Housing and Urban Development, *supra* note 34, at 37. See also Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 234-35 (2002).

52. See Engel & McCoy, *supra* note 1, at 1281-83.

53. *Id.* at 1263, 1281.

54. Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1124 (1974).

55. *Id.*

to grave and systematic errors in weighing risks and benefits.⁵⁶

At least three choice heuristics lead homeowners to make bad choices when considering subprime mortgages. The first is the relative insensitivity of subprime customers to interest rate levels in general and annual percentage rates. These individuals tend to focus on whether the monthly payments offered are affordable, rather than on lower interest rates.⁵⁷ Pessimistic about whether other lenders would be willing to lend to them and fearful that the loan at hand will vanish, these borrowers jump at the first option offered as long as the payments seem feasible. Predatory lenders exploit that tendency by using long maturities, teaser rates, balloon clauses, and sometimes fraud to advertise low monthly payments on high-cost loans.

Two additional choice heuristics cause homeowners to make mistaken probability assessments. First, repeated studies have shown that people tend to overestimate the probability of compound events.⁵⁸ In order for a mortgage to be paid off successfully, a borrower must make on-time payments every month for up to thirty years. One missed payment can be enough to throw the loan into default. Under basic principles of probability, the longer the loan term and the greater the number of scheduled monthly payments, the more likely it is that the loan will go into default. Nevertheless, people tend to equate the likelihood of making the first mortgage payment — which is higher — with the likelihood of successfully paying off the entire loan. The less likely default seems, the more likely homeowners are to disregard the potential loss of their homes.⁵⁹

The last choice heuristic sheds light on the heightened propensity of subprime customers to buy credit life insurance and other, related insurance products at inflated prices. Experimental evidence reveals that people are willing to pay more to insure against vivid, catastrophic risks having low probability than more general risks.⁶⁰ In one survey, for example, subjects were willing to pay more for life insurance for death on an airplane flight due to terrorism than for death on a flight for *any* reason.⁶¹ Thus, while predatory lending victims underestimate the risk

56. *Id.*

57. George S. Day & William K. Brandt, *Consumer Research and the Evaluation of Information Disclosure Requirements: The Case of Truth in Lending*, 1 J. CONSUMER RES. 21, 22-23 (1974).

58. Tversky & Kahneman, *supra* note 54, at 1129.

59. Kahneman & Tversky, *supra* note 3, at 275.

60. See, e.g., Eric J. Johnson et al., *Framing, Probability Distortions, and Insurance Decisions*, 7 J. RISK & UNCERTAINTY 35, 39 (1993).

61. *Id.*

of default in general, they may overestimate the risk of default due to isolated risks such as death or disability and accordingly overpay for insurance for those risks.

VII. POLICY IMPLICATIONS

Predatory lending has a certain perverse genius. That genius lies in targeting cognitive anomalies in financial decision-making by individuals and masterminding marketing techniques to exploit those anomalies, all leading to disastrous effects for borrowers. Predatory lenders make attractive terms salient and obscure terms that might pose concern. They hunt down homeowners in financial straits and capitalize on the desperation that fuels risk-taking to snare their assent. They give a hard sell on credit life insurance, knowing that people will overpay for it. They do everything in their power to impede comparison-shopping by homeowners. And, all too often, they perpetrate fraud on victims.

These marketing techniques of predatory lenders have distinct public policy implications. Improved disclosure, for example, is often touted as the optimal remedy. However, it is hard to imagine Congress mandating a disclosure scheme so starkly plain that victims would turn down abusive, irrational loans. To do that, Congress would essentially have to mandate upfront marketing pitches of the form, "If you sign this loan, you will have w % chance of damage to your credit record, x % chance of going into default, y % chance of bankruptcy, and z % chance of losing your home to foreclosure." All subprime advertising would have to be heavily regulated for content, to prevent undermining that core message. All other marketing, including oral pitches, would have to be strictly limited.

Under the Securities Act of 1933, advertising is heavily regulated in just that manner for the sale of public securities offerings.⁶² Given the current political climate and the lobbying prowess of the mortgage industry, however, it is impossible to imagine Congress enacting similar advertising restrictions for the subprime mortgage industry today.

There is a further problem with disclosure, which is that disclosure fails to address the separate and thorny issue of intentionally targeting susceptible victims. To people already in dire straits, if lenders frame the only choice as a predatory loan or no loan at all – to the exclusion of other, more appropriate options such as government-subsidized home repair loans, home equity lines of credit or unsecured loans from

62. See, e.g., 15 U.S.C. § 77j (2005) (regulating what information has to be disclosed in the prospectus of a registered security).

reputable lenders – disclosures of the form outlined above are unlikely to deter potential victims from bad decisions. In recognition of this problem in the boiler-room securities sales context, securities regulators have mandated not only disclosures, but also more stringent measures, including a duty of suitability.⁶³

Another remedy often touted is homeowner education and/or counseling. In the long run, it is doubtful that sufficient financial resources would ever be devoted to effective nationwide counseling. More to the point, at a minimum, as Kahneman and Tversky pointed out, “[e]ffective learning . . . requires accurate and immediate feedback about the relation between the situational conditions and the appropriate response.”⁶⁴ For the reasons discussed earlier, mortgage lending, particularly predatory mortgage lending, does not lend itself to accurate and immediate feedback or to opportunities for corrective action.⁶⁵ Homeowner education in advance of marketing pitches by lenders is too early. Neutral homeowner counseling before an application is signed has the virtue of immediacy, but there are no good faith estimates of closing costs (GFEs) or concrete loan documents available yet for review. Without that information, it is difficult to counteract impulsive decisions by people in financial exigency, especially when the lenders are touting the virtues of the loans. While it is true that lenders are supposed to give applicants a GFE within three days after signing their loan applications, GFEs lack interest rates and finance charges and many lenders never deliver GFEs anyway. Homeowner counseling right at closing (or during the three-day TILA rescission period afterward) would have the potential benefit of access to HUD-1s and loan documents, but would face an uphill struggle to educate homeowners who are thirsting for their loan proceeds and who have already paid non-refundable application fees.

Homeowner education and counseling further assumes that cognitive anomalies can be eradicated. However, there is increasing evidence that experience and learning do not succeed in eliminating cognitive biases or improve people’s ability to apply the principles they learn to specific situations.⁶⁶

Finally, disclosure, education and counseling ignore the crucial fact that predatory lending is the product of relentless and fiendishly clever marketing that manipulates cognitive imperfections. Predatory lenders

63. See Engel & McCoy, *supra* note 1, at 1325-26.

64. Tversky & Kahneman, *supra* note 12, at S274.

65. See *supra* Section V.

66. See Rabin, *supra* note 29, at 31.

will always be better at reaching potential victims than legitimate lenders, community groups, churches, and the government. In large part that is because vulnerable customers often are not actively in the market for loans to begin with. As a result, the best way to pinpoint them is labor-intensive and costly: by mimicking predatory lenders and going door-to-door. Due to the high costs involved, reaching the potential victims of predatory lending thus presents an enormous hurdle for any educational campaign.⁶⁷

In the analogous context of insurance, Eric Johnson and his colleagues conclude that the “recognition that consumer perceptions and decision processes are imperfect and manipulable . . . support[s] insurance regulation and prohibition of certain types of insurance.”⁶⁸ Likewise, Kahneman and Tversky argue that framing places ethical duties on the marketer: “When framing influences the experience of consequences, the adoption of a decision frame is an ethically significant act.”⁶⁹ Particularly here, since predatory lenders and brokers can obviate the harm more cheaply than the victims, the onus should fall on the purveyors of predatory loans.

In the securities context, identical considerations caused the Securities and Exchange Commission long ago to impose a duty of suitability on securities brokers. Under that duty, securities brokers must refrain from recommending securities that are unsuitable, given an individual customer’s financial status, needs and goals.⁷⁰

The time has come for a comparable duty of suitability in subprime lending, one that is tailored to the realities of the subprime market. Such a duty would put the burden of preventing predatory lending on those who can afford it most cheaply (*i.e.*, predatory lenders and brokers) by empowering the federal government and individual victims to sue for loan reformation, disgorgement, and damages.⁷¹

67. See Engel & McCoy, *supra* note 1, at 1309.

68. Johnson et al., *supra* note 60, at 36.

69. Tversky & Kahneman, *supra* note 6, at 458.

70. See Engel & McCoy, *supra* note 1, at 1318.

71. *Id.* at 1339-56.