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A Tale of Three Markets: The Law and Economics of Predatory Lending

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Articles

A Tale of Three Markets: The Law and Economics of Predatory Lending

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I. “Predatory Lending” Defined	1259
A. Loans Structured to Result in Seriously Disproportionate Net Harm to Borrowers	1261
B. Harmful Rent-Seeking	1265
C. Fraud or Deceptive Practices	1267
D. Other Forms of Lack of Transparency That Are Not Actionable As Fraud.....	1268
E. Loans that Require Borrowers to Waive Meaningful Legal Redress	1270
II. Market Segmentation and Predatory Lending	1270
A. The Conventional Theory of the Market for Home Mortgages.....	1271
B. Changes in the Home-Mortgage Market	1273
1. <i>Securitization</i>	1273
2. <i>Expanded Mortgage Products</i>	1275

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3.	<i>Incentives to Lend to LMI Borrowers</i>	1276
4.	<i>The New Market Structure</i>	1277
C.	Market Failures and Predatory Lending	1280
1.	<i>Information Asymmetries: Opportunities for Predatory Lenders and Brokers</i>	1280
2.	<i>Taking Advantage of Information Asymmetries: Locating and Marketing Predatory Loans to Disconnected Borrowers</i>	1281
3.	<i>Efforts by Lenders and Secondary Market Participants to Protect Themselves Against the Risks of Predatory Lending Will Not Correct Market Inefficiencies</i>	1286
4.	<i>Deterrents to Banks and Thrifts Making Loans to Borrowers Who Are Disconnected From the Credit Market</i>	1289
5.	<i>Impediments to Legitimate Subprime Lenders Making Loans to Borrowers Who Are Disconnected From the Credit Market</i>	1296
6.	<i>Lack of Price Competition Among Predatory Lenders</i>	1297
III.	Remedies	1298
A.	Market Discipline	1299
B.	Remedies Under Contract Law and the Uniform Commercial Code	1299
C.	Antifraud Laws	1302
D.	Disclosure	1305
E.	Consumer Education and Counseling.....	1309
F.	Price Regulation.....	1311
G.	Antidiscrimination Remedies	1314
IV.	Suitability.....	1317
A.	A Brief Overview of Suitability in Securities and Insurance	1321
1.	<i>Suitability in the Securities Industry</i>	1321
2.	<i>Suitability in the Insurance Industry</i>	1329
B.	Theoretical Bases for Suitability in the Subprime Market.....	1334
C.	Adapting Suitability to Subprime Mortgage Lending	1337
1.	<i>Structure and Enforcement Channels</i>	1337
2.	<i>An SRO Requirement</i>	1338
3.	<i>A New Cause of Action for Breach of the Duty of Suitability</i>	1339
D.	Critiques of Suitability in Subprime Mortgage Lending and Responses	1357
1.	<i>Normative Objections</i>	1358
2.	<i>Market Arguments</i>	1359
3.	<i>Concerns About Frivolous Litigation</i>	1361
E.	Other Needed Areas of Regulatory Attention.....	1363
1.	<i>Regulation of Mortgage Brokers</i>	1363
2.	<i>Regulation of Appraisers</i>	1364

3.	<i>Due Diligence by the Secondary Market</i>	1364
4.	<i>CRA Credit for Predatory Loans</i>	1364
5.	<i>Federal Agencies Need to Exercise Preemption Responsibly</i> ...	1365
6.	<i>Marketing Abuses</i>	1366
7.	<i>SEC Material Litigation Disclosure</i>	1366
V.	Conclusion	1366

Predatory lending—exploitative high-cost loans to naïve borrowers—has dominated the headlines in recent years and has sent foreclosure rates soaring.¹ There is fierce debate over how best to respond to this surge in predatory lending.² Too often, the debate over predatory lending has been couched in moral terms. Opponents of predatory lending air exposés of

1. The Coalition for Responsible Lending recently estimated that predatory lending costs U.S. borrowers \$9.1 billion annually. ERIC STEIN ET AL., QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 2 (2001), available at <http://www.responsiblelending.org/CostofPredLend.pdf>; cf. Robert E. Litan, A Prudent Approach to Preventing “Predatory” Lending 3–6 (Feb. 1, 2001) (unpublished manuscript, on file with the Texas Law Review) (tracing the corresponding growth in the subprime market). One of the most noteworthy indicia of the rise in predatory lending has been an unprecedented rise in foreclosures across the country. Between 1990 and 1998, when interest rates were dropping, the home-foreclosure rate increased by 384%. See UNITED STATES CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES, BANKING, FINANCE AND INSURANCE tbl.823 (1999) (reporting rates of mortgage delinquency and foreclosure from 1980 to 1998). The bulk of these foreclosures involved borrowers who had subprime—including predatory—loans. See Cathy L. 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 (2000); see also NATIONAL TRAINING AND INFORMATION CENTER, PREYING ON NEIGHBORHOODS: SUBPRIME MORTGAGE LENDING AND CHICAGOLAND FORECLOSURES 11–21 (1999) [hereinafter PREYING ON NEIGHBORHOODS] (noting that in metropolitan Chicago alone, foreclosures nearly doubled from 1993 to 1998, and that subprime lenders and services accounted for 1.4% of the foreclosures in 1993 but for 35.7% of the 1998 foreclosures), available at <http://www.ntic-us.org/preying/preying.html>.

Predatory lending is highly visible, but gaps in reported data have hampered efforts to accurately assess the extent of the problem. In 2002, the Federal Reserve Board expanded the types of data that must be reported on home-mortgage loans under the Home Mortgage Disclosure Act (HMDA), and increased the number of nonbank entities required to file HMDA reports. Under the regulation, HMDA reporting entities would have to report on all home-mortgage refinancings, home-improvement loans, and home-equity lines of credit. In addition, lenders would have to report yield spreads for first-lien loans whose annual percentage rates exceed the yield for comparable Treasury securities by at least 3%. Lenders must also report whether an application or loan involves a manufactured home. See Federal Reserve System, Home Mortgage Disclosure, 67 Fed. Reg. 7222 (Feb. 15, 2002) (codified at 12 C.F.R. pt. 203) [hereinafter Federal Reserve, *Home Mortgage Disclosure*]. Concurrently, the Federal Reserve issued a proposed rule eliciting comment on three issues: (1) the appropriate price thresholds for triggering reporting of yield spreads, (2) whether the lien status of a loan should be reported, and (3) whether lenders should be required to ask telephone applicants their ethnicity, race, and sex. See Federal Reserve System, Home Mortgage Disclosure, 67 Fed. Reg. 7252 (proposed Feb. 15, 2002) (to be codified at 12 C.F.R. pt. 203).

2. See, e.g., *Lending Group Forces Delay of Predatory Ordinance*, NAT’L MORTGAGE NEWS, Aug. 24, 2001 (reporting a statement by a trade association representative that “his group is willing to challenge any local effort to regulate” subprime lending), available at <http://www.thebankingchannel.com/comm/story.jsp?story=TBCMJK3OYOC>.

unscrupulous lenders and their diabolical tactics. Industry supporters, on the other hand, question the extent of predatory lending, blame borrowers for their profligacy, and assert that existing remedies suffice.

Condemning predatory lenders as immoral does not tell us what needs to be done to address the problem. Similarly, criticizing borrowers for impulsive borrowing and spending does not take into account the market failures that enable predatory lenders to flourish and to exploit unsophisticated borrowers. Nor does it address the serious negative externalities that predatory lending inflicts on society at large in the form of bankruptcies, foreclosures, poverty, and deteriorating neighborhoods.

To advance the debate beyond the realm of moral accusations, we need to determine how incentive structures in the home-mortgage market have fueled predatory lending and how these incentives can best be countered. In this Article, we embark on these tasks, arguing that the market incentives that historically led lenders to engage in credit rationing have given way to a market where lenders can profit from exploiting new information asymmetries to the detriment of unsophisticated borrowers. Further, we argue that government intervention is needed to curb these lending abuses by putting the burden of harm on those best able to bear the loss. Toward this end, we propose imposing a duty of suitability on lenders that is narrowly tailored to address the harms they cause through predatory lending.

Following this introduction, the Article proceeds in four parts. In Part I, we identify five problems associated with abusive lending practices and define predatory lending as a syndrome involving one or more of these five problems.

We begin Part II by describing the information asymmetries that until recently led to Stiglitz-Weiss credit rationing. We then describe how changes in the financial-services market have caused classic credit rationing to disappear. In particular, we argue that an increase in the amount of capital available for mortgages due to securitization, increased incentives for lenders to specialize in lending to low- and moderate-income borrowers, and new information asymmetries have made it possible for predatory lenders to thrive. We argue that the convergence of these forces has produced three markets for home mortgages: a prime market, a legitimate subprime market, and a predatory market.

The prime market provides mortgages to low-risk borrowers with strong credit histories. Legitimate subprime lenders, who are usually nonbank lenders,³ cater to borrowers who have experience shopping for credit but who, for one reason or another, lack the sterling credentials needed to qualify for prime loans. Predatory lenders, on the other hand, target naïve people

3. Throughout this Article, the term "nonbank lenders" refers to lending entities that are not federally insured depository institutions.

who, because of historical credit rationing, discrimination, the exodus of banks from inner-city neighborhoods, and other social and economic forces, are disconnected from the credit market and hence are vulnerable to predatory lenders' hard-sell tactics.

We conclude Part II by describing why competition has not driven out predatory lenders. We contend that because of reputational and regulatory concerns, banks and thrifts shy away from lending to borrowers who typically become victims of predatory lenders. In addition, we argue that legitimate, nonbank subprime lenders, whom we would expect to compete with predatory lenders, have marketing strategies that do not reach the victims of predatory lending.

Based on this understanding of the home-mortgage market, in Part III we ask whether there are remedies that could force predatory lenders to internalize the harm that they cause. To that end, we evaluate extant remedies for redressing predatory lending, including contract remedies, antifraud statutes, disclosure laws, consumer education and counseling, price regulation, and antidiscrimination laws. We conclude that none of these remedies can effectively curb predatory lending. We also critique proposals to regulate loan prices, concluding that such controls would curtail the availability of credit. Instead, we contend that the best avenue for redressing predatory lending would be a direct approach that focuses on abusive loan terms and practices, without imposing usury limits.

In the final part of the Article, Part IV, we propose such a remedy: a duty of suitability in subprime mortgage lending. In fashioning a suitability remedy, we draw on the suitability requirement in securities and insurance to impose a similar obligation on subprime lenders and brokers, albeit one that is tailored to the subprime mortgage market. This new duty of suitability puts the onus of preventing predatory lending on those who can afford it most cheaply (*i.e.*, predatory lenders and brokers) by authorizing the federal government and aggrieved victims to sue for loan reformation, disgorgement, and damages. In addition, we propose formation of an industry self-regulatory organization under federal supervision to promote the development of best-practices rules. Our position is that suitability successfully balances the need to curb predatory lending and the need to encourage beneficial market activity.

I. "Predatory Lending" Defined

In 2000, Senator Phil Gramm, then the chairman of the Senate Banking Committee, famously asserted that predatory lending could not be addressed until it could be defined.⁴ With that remark, Senator Gramm shrewdly seized

4. See Michele Heller & Rob Garver, *Gramm Takes Stand Against Predator Bills*, AM. BANKER, Aug. 24, 2000, at 1, 2000 WL 25344935 ("As the regulators themselves admit, there is no

on the difficulties in defining predatory lending, while stoking the flames that have surrounded any attempt at definition. Opponents of reforms to redress predatory lending have maintained that in the absence of a definable problem, remedies are not needed.⁵ Conversely, some community activists have brushed definitional issues aside, reasoning that “you know predatory lending when you see it.”

Any serious attempt to address the problem of predatory lending, however, must be able to describe it. To date, predatory lending generally has been described as a catalogue of onerous lending practices, which are often targeted at vulnerable populations and result in devastating personal losses, including bankruptcy, poverty, and foreclosure.⁶

This catalogue provides a useful starting point for detecting and describing the pathologies that underlie predatory lending. When these lists are examined, five basic problems emerge. We can thus define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of the following five problems:⁷

- (1) loans structured to result in seriously disproportionate net harm to borrowers,
- (2) harmful rent seeking,
- (3) loans involving fraud or deceptive practices,
- (4) other forms of lack of transparency in loans that are not actionable as fraud, and
- (5) loans that require borrowers to waive meaningful legal redress.

definition of predatory lending. I don't know how we can hope to address the problem before we have decided what it is.”); *see also News Conference With Senator Phil Gramm*, FED. NEWS SERVICE, Jan. 22, 2001.

5. *See, e.g.*, Richard Boisky, Editorial, *In Reality, “Predatory Lending” Isn’t Easy to Define*, NEWS & OBSERVER (Raleigh, N.C.), Oct. 24, 2000, at A10, 2001 WL 3950594.

6. In one of the most exhaustive catalogues of predatory-lending practices, Patricia Sturdevant and William Brennan listed a broad array of exploitative terms and practices, including racial targeting in advertising and loan solicitations, loans in connection with home-improvement scams, kickbacks in the form of yield-spread premiums, the steering of borrowers to high-cost lenders, loan payments in excess of the borrowers’ ability to repay resulting in foreclosure (equity stripping), fraud on borrowers and on secondary-market buyers via falsified loan applications, forged signatures, inflated appraisals and the like, high annual interest rates, high points, balloon payments, negative amortization, padded or duplicative closing costs and fees, insurance packing and single-premium credit life insurance, excessive prepayment penalties, mandatory-arbitration clauses, loan flipping (repeated refinancings by the same lender), refinancings of low- or no-interest mortgages at higher rates, shifting unsecured debt into mortgages, making loans in excess of 100% of the loan-to-value ratio of the underlying collateral, abusive collection practices, and foreclosure abuses. *See Patricia Sturdevant & William J. Brennan, Jr., A Catalogue of Predatory Lending Practices*, 5 CONSUMER ADVOC. 4 (1999); *see also Mansfield, supra* note 1, at 532–61.

7. As we argue later in this Article, predatory lenders target vulnerable consumers for financial exploitation, often because of their race, gender, income, or class. *See infra* notes 112–122. However, predatory loans can occur in the absence of such targeting, so we do not include it as a defining feature.

Most, if not all, predatory loans combine two or more of these problems. Similarly, some abusive terms or practices fall into more than one category. Rather than serving as a proposed statutory definition, our definition of predatory loans is intended as a diagnostic tool for identifying problematic loan practices that require redress.

In the overwhelming percentage of cases, predatory loans are a subset of subprime loans, which are loans with higher interest rates that are designed for borrowers with impaired credit or who do not otherwise qualify for loans in the conventional prime market.⁸ Nevertheless, legitimate subprime loans and predatory loans are analytically distinct. Legitimate subprime loans do not display any of the five markers of predatory loans listed above. Conversely, predatory loans are not necessarily subprime. It is possible for prime-interest loans to display one or more of the problems that are common to predatory loans.

While the definition of predatory loans is not restricted to the subprime market,⁹ that is where predatory loans are most prevalent. Accordingly, predatory loans in the subprime market are the focus of our analysis. In addition, because of the serious personal and social consequences of default and foreclosure, we have identified loans secured by first or subordinate mortgages on borrowers' homes as the most pressing area of concern.

A. Loans Structured to Result in Seriously Disproportionate Net Harm to Borrowers

In the subprime market, the lending industry has relaxed numerous conventional underwriting standards in order to facilitate loans to less creditworthy customers. Many of the new standards redound to the mutual benefit of subprime lenders and borrowers.¹⁰ In some instances, however,

8. See *Predatory Mortgage Lending: Hearing Before the House Comm. on Banking and Financial Services*, 106th Cong. 308-19 (2000) (testimony of Donna Tanoue, former Chairman, FDIC). The Interagency Guidance on Subprime Lending defines subprime lending as credit extensions "to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ET AL., INTERAGENCY GUIDANCE ON SUBPRIME LENDING 1 (1999); see also BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, EXPANDED INTERAGENCY GUIDANCE FOR SUBPRIME LENDING PROGRAMS 2 (2001). Subprime loans have higher interest rates to compensate lenders for the higher risk of default. See, e.g., Departments of the Treasury and Housing and Urban Development, *Curbing Predatory Home Mortgage Lending*, at 28 (June 20, 2000) [hereinafter HUD-Treasury Report] (explaining that "borrowers that present less risk receive lower interest rates"), available at <http://www.huduser.org/publications/pdf/treasrpt.pdf>.

9. North Carolina attempted to grapple with this problem in its 1999 predatory-lending statute, which regulates certain predatory practices in all consumer loans under \$150,000, regardless whether those loans are prime, subprime, or predatory. See N.C. GEN. STAT. §§ 24-1.1A(c)-(c2), (g), 24-1.1E(a)-(b), 24-10.2(b)-(e) (1999). Similarly, predatory loans are not restricted to a single product line; they run the gamut of consumer-loan products, from car loans and credit-card abuses to closed-end home-mortgage loans.

10. Examples include loans to borrowers with histories of late payments or bankruptcies or higher debt-to-income ratios, and loans with higher loan-to-value ratios. See, e.g., JOHN C.

lenders have overridden conventional underwriting norms in order to structure loans that inflict seriously disproportionate net harm on borrowers, often in catastrophic proportions. When the harm outweighs the benefit of those loans to borrowers and society at large, such practices are predatory in nature.

The foremost example today involves violations of the norm that no mortgage shall be made to anyone who, on the face of the loan application, cannot afford the monthly payments (a practice known as “asset-based lending”).¹¹ These quintessential predatory loans often cause borrowers to suffer bankruptcy or lose their homes to foreclosure.¹²

Asset-based loans are fundamentally repugnant because they violate widely shared beliefs about the acceptable outer limits of mortgage lending. One such belief is that home mortgages should not be structured with the primary objective of foreclosure. That belief is rooted in a variety of rationales. One is based on distributive justice—that home ownership is a basic necessity of life and that homeowners should not be deprived of their homes through exploitation. Another related rationale, rooted in efficiency concerns, is that homelessness imposes unacceptably large negative externalities on society as well as on the homeless. Finally, loans that result in bankruptcy or foreclosure or both pose undue risks of loss to ultimate holders of those notes, raising concerns about economic efficiency and possibly systemic risk.¹³

WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT 30, 34, 60–61 & tbl.4.4 (1997) (describing the lending options available to subprime borrowers).

11. Mortgage Bankers Association of America, Best Practices/Legislative Guidelines: Subprime Lending, Legislative Guidelines ¶ 6 (advising against lending without regard to repayment ability), available at <http://www.mbaa.org/resident/lib2000/0525b.html>. Arguably, due to the high costs of foreclosure, lenders are not acting in their best interests when they make loans without regard to borrowers' ability to repay the loans. Evidence, however, suggests the contrary. 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. Alternatively, where lenders can convince secondary-market purchasers to purchase predatory loans, the lenders can foist future losses off on these unsuspecting purchasers. See *infra* text accompanying notes 142–44.

12. See, e.g., HUD-Treasury Report, *supra* note 8, at 21, 22, 24–25, 27 n.12; Sturdevant & Brennan, *supra* note 6, at 37; Plaintiffs' Statement of Points and Authorities in Opposition to Defendant's Motion for Judgment on the Pleadings or, in the Alternative, for Summary Judgment at 1, 19, Hargraves v. Capital City Mortgage Corp., 140 F. Supp. 2d 7 (D.D.C. 2000) (No. 98-1021); cf. Fannie Mae, Lender Letter No. 03-00: Eligibility of Mortgages to Borrowers with Blemished Credit Records (Apr. 11, 2000) (“[T]he borrower [must have] a reasonable ability to make the mortgage payments and [must be] likely to do so.”), available at http://www.efanniemae.com/singlefamily/forms_guidelines/lender_letters/db_lender_letters.jhtml#03-00; PREYING ON NEIGHBORHOODS, *supra* note 1, at 23–27 (suggesting that foreclosure rates in Chicago are rising because “loans are being pushed upon borrowers who are not able to repay them”).

13. This latter problem is endemic of the agency problems among brokers, lenders, and secondary-market purchasers that we discuss later in this Article. See *infra* section II(C)(3).

Asset-based lending often spawns another abusive practice known as "loan flipping," in which lenders persuade homeowners to refinance their mortgages repeatedly at extremely short intervals, up to three or four times a year.¹⁴ Since the victims are usually cash-poor, any prepayment penalties and "refinancing" charges are wrapped into the old principal and then financed. Predatory lenders manufacture these situations by making asset-based loans in the first place with payments that the borrowers cannot meet. When the borrowers default, as is sure to happen, the lenders offer them an opportunity to escape foreclosure by refinancing. Flipping offers borrowers temporary relief in the form of lower monthly payments by extending the loan maturities.¹⁵ Ultimately, however, the borrowers end up owing higher total principal and interest to the lenders. Thus, "loan flipping" results in "equity stripping," as owners' home equity declines with each refinancing. As equity vanishes and total loan balances rise, the borrowers' ability to refinance with legitimate lenders drops. Eventually the borrowers leverage all of their equity and then default, sometimes leaving secondary-market purchasers holding the bag.¹⁶

Likewise, from borrowers' perspectives, there is usually little economic rationale for mortgages with negative amortization. Under negative amortization, scheduled payments are not enough to cover the interest due, causing the outstanding principal to increase with time. As a result, borrowers who make regular payments actually lose equity in their homes as time goes on.¹⁷ Other examples of loans that result in seriously disproportionate net harm to borrowers include loans where lenders persuade borrowers to shift unsecured debt into mortgages in order to strip the equity out of their homes and loans where lenders insist on financing higher

14. In December 2001, the Federal Reserve Board prohibited creditors or assignees of high-cost loans under the Home Ownership and Equity Protection Act (HOEPA) from refinancing these loans within the first 12 months unless the refinancings are in the borrower's interest. See Federal Reserve System, Truth in Lending, 66 Fed. Reg. 65,604 (Dec. 20, 2001) (codified at 12 C.F.R. § 226.34(a)(3) (2002)) [hereinafter Federal Reserve, *Truth in Lending*].

15. See, e.g., HUD-Treasury Report, *supra* note 8, at 21, 73-74; Jeff Bailey, *A Man and His Loan: Why Bennie Roberts Refinanced 20 Times*, WALL ST. J., Apr. 23, 1997, at A1, 1997 WL 2418002; Sturdevant & Brennan, *supra* note 6, at 39.

16. For unsuspecting secondary-market purchasers who find themselves in this situation, the costs of foreclosure usually erase any profit from the predatory loan. See generally Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489 (1991) (reviewing the costs associated with foreclosure).

17. See, e.g., HUD-Treasury Report, *supra* note 8, at 91-92. Reverse mortgages under the Home Equity Conversion Mortgage (HECM) program administered by HUD are an exception. These reverse mortgages permit elderly homeowners to cash out their home equity in exchange for an income stream. Reverse mortgages are heavily regulated, however, and are subject to mandatory-counseling requirements. See *id.* at 92. Concerns about the injurious effects of negative amortization led the Federal Reserve Board, pursuant to its authority under HOEPA, to ban negative amortization in high-cost, closed-end home-mortgage refinance loans. See 12 C.F.R. § 226.32(d) (2001). Today, mortgages with negative-amortization provisions are not regulated unless they are subject to HOEPA or HECM.

principal amounts than customers request.¹⁸ Still another refinancing abuse involves lenders who induce homeowners to refinance no-interest or low-interest mortgages at higher interest rates without economic justification.¹⁹

Similarly, the harm seriously outweighs the benefit where lenders steer naïve borrowers who qualify for prime-rate loans (or other loans on better terms) to costlier loans that are better suited for customers with weaker credit ratings.²⁰ Such steering is frequently fueled by “yield-spread premiums,” which are side payments by lenders to mortgage brokers for persuading borrowers to agree to higher interest rates when the lenders in fact are willing to extend credit to the borrowers at lower rates.²¹ Lenders are under no obligation to disclose yield-spread premiums.²² When lenders do disclose

18. See, e.g., Nina Simon, *Predatory Lending from Around the Country: A Broad Range of Tools* 3 (Apr. 14, 2001) (unpublished manuscript, on file with the Texas Law Review) (describing equity stripping in more detail); Sturdevant & Brennan, *supra* note 6, at 40; Brief of the United States as Amicus Curiae in Support of Plaintiffs’ Opposition to Defendant’s Motion for Judgment on the Pleadings or, in the Alternative, for Summary Judgment at 3–4, *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7 (D.D.C. 2000) (No. 98-1021) (arguing that the defendant mortgage lender had led the plaintiff to believe that it would be difficult to get a smaller loan than that which the defendant had offered); Teresa Dixon Murray, *Borrower Beware Predatory Mortgage Brokers Don’t Give Terms Promised, Causing Some to Lose Their Homes*, PLAIN DEALER (Cleveland), Aug. 28, 2000, at 1C, 2000 WL 5162867.

19. See Sturdevant & Brennan, *supra* note 6, at 39–40. In the most egregious cases, lenders convince borrowers to refinance their original zero-percent Habitat for Humanity loans in the early years of those mortgages. See, e.g., Sandra Fleishman, *Fed Favors Tougher Loan Rules; Abuses in Subprime Lending Are Targeted*, WASH. POST, Dec. 14, 2000, at E1, 2000 WL 29921414; Joe McDermott, *Predatory Lending Termed “A Major Problem,”* MORNING CALL (Allentown), Dec. 10, 2000, at B1, 2000 WL 29200622; Richard A. Oppel, Jr. & Patrick McGechan, *Along With a Lender, Is Citigroup Buying Trouble?*, N.Y. TIMES, Oct. 22, 2000, § 3, at 1, LEXIS, News Library, NYT File. The Federal Reserve Board’s December 2000 proposed rule under HOEPA would prohibit creditors in the first five years of zero-interest rate or other low-cost loans from refinancing these loans with higher-rate loans, unless the refinancings were in the interest of the borrowers. In December of 2001, however, the Fed withdrew that proposed rule for reconsideration. Federal Reserve, *Truth in Lending*, *supra* note 14.

Of course, some refinancings at higher interest rates have a valid economic justification from the borrowers’ perspectives. For instance, homeowners who have substantial equity in their homes and who obtained their mortgages years ago at lower interest rates may wish to refinance, even though interest rates have risen, in order to finance their children’s college educations or home improvements. Absent other indicia of predatory lending, these loans can be legitimate where the homeowners can afford the monthly loan payments.

20. For instance, a Freddie Mac study reported that anywhere from between 10% to 35% of subprime borrowers qualified for prime-rate loans. See Freddie Mac, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America’s Families* ch. 5 & nn.5–6 (Sept. 1996), available at <http://www.freddiemac.com/corporate/reports/>; see also Sturdevant & Brennan, *supra* note 6, at 37; Stein, *supra* note 1, at 9–10; cf. Fannie Mae, *supra* note 12 (“Lenders that offer higher cost products that are designed for less creditworthy borrowers should not steer applicants to these products if they can qualify for a lower-cost standard mortgage product.”).

21. See, e.g., HUD-Treasury Report, *supra* note 8, at 40; Simon, *supra* note 18, at 22–23.

22. In computing finance charges under the Truth in Lending Act (TILA), lenders do not have to include yield-spread premiums. See, e.g., Kenneth M. Lapine, *Referral Fees and Other Compensation Issues Under the Real Estate Settlement Procedures Act of 1974*, in *BANKING LAW* (1998); RALPH J. ROHNER & FRED H. MILLER, *TRUTH IN LENDING* 121, 187–88 (2000). Courts are divided over whether yield-spread premiums are prohibited kickbacks or legitimate payments for

these premiums, borrowers often cannot detect them in the array of loan documents that lenders provide them. Even when borrowers know that they are paying yield-spread premiums, they do not understand the purpose or the fact that their interest rates are higher as a result.

B. Harmful Rent-Seeking

Although predatory loans can include prime-rate loans, predatory lending more commonly entails higher subprime interest rates and fees. High costs are not problematic per se. However, when subprime lenders use their market power to charge rates and fees that exceed the rates and fees they would obtain in a competitive market, they extract harmful rents from borrowers.²³ Such rent-seeking is another common feature of predatory lending.

From the viewpoint of distributive justice, interest per se and high interest in particular have been condemned as usurious since ancient times because they impose heavy costs on those who are least able to pay them. With experience, however, it has become apparent that subprime loans to riskier borrowers entail increased costs that lenders must be able to recoup. Subprime loans historically have had higher rates of delinquency, default, and foreclosure than loans in the prime market.²⁴ As a result, they carry

goods and services under the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §§ 2601(b)(2), 2607(a), (c) (2000). Compare *Culpepper v. Inland Mortgage Corp.*, 132 F.3d 692, 697 (11th Cir. 1998) (holding that yield-spread premiums are prohibited kickbacks); and *DuBose v. First Security Sav. Bank*, 974 F. Supp. 1426, 1432 (M.D. Ala. 1997) (denying a lenders' motion for summary judgment on grounds that yield-spread premiums may be illegal referral fees); and *Martinez v. Weyerhaeuser Mortgage Corp.*, 959 F. Supp. 1511, 1522 (S.D. Fla. 1996) (same); and *Mentecki v. Saxon Mortgage, Inc.*, 1997 U.S. Dist. LEXIS 1197, No. 96-1629-A, slip op. (E.D. Va. Jan. 10, 1997) (denying a lender's motion to dismiss on grounds that the borrowers stated a claim in arguing that a yield-spread premium violated the anti-kickback provisions of RESPA); and *Moses v. Citicorp Mortgage, Inc.*, 982 F. Supp. 897, 901-02 (E.D.N.Y. 1997) (same), with *Barbosa v. Target Mortgage Corp.*, 968 F. Supp. 1548, 1563 (S.D. Fla. 1997) (holding that a yield-spread premium was a lawful payment for services). See also Robert M. Jaworski, *Overages: To Pay or Not to Pay, That is the Question*, 113 BANKING L.J. 909 (1996) (questioning the legality of yield-spread premiums under RESPA); Leonard A. Bernstein, *RESPA Invades Home Equity, Home Improvement and Mobile Home Financing*, 48 CONSUMER FIN. L.Q. 194, 197 (1994) (same).

In 1999, the Department of Housing and Urban Development (HUD) issued a policy statement on the legality of yield-spread premiums paid by lenders. See 64 Fed. Reg. 10,079 (Mar. 1, 1999). HUD does not consider yield-spread premiums illegal per se. Rather, the legality of those payments is to be judged according to two questions. First, were goods, services, or facilities actually provided for the compensation paid? Second, were the payments reasonably related to the value of those goods, services, or facilities? See *id.* at 10,085-86. For a description of the finance charge for purposes of TILA, see *infra* text accompanying note 43.

23. See, e.g., 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 315-22 (Peter Newman ed., 1998) (commenting that "[r]ent seeking is unproductive; it destroys value by wasting valuable resources"). For a discussion of how subprime lenders can exert such market power, see *infra* subsection II(C)(2)(b).

24. See WEICHER, *supra* note 10, at 69, 74-88; HUD-Treasury Report, *supra* note 8, at 27; see also Sturdevant & Brennan, *supra* note 6, at 38 ("Predatory lenders may charge rates of 19 to 25

higher interest rates to compensate for the added risk.²⁵ In addition, higher interest rates, either alone or with prepayment penalties, compensate lenders for the fact that subprime loans “tend to be prepaid at a much faster rate than prime mortgages.”²⁶

Origination costs and servicing costs of subprime loans are higher as well. Subprime loans are more expensive than prime loans to originate because they require closer scrutiny of income and credit history and result in a lower percentage of approved applications.²⁷ Concomitantly, subprime mortgage loans on average are substantially smaller than prime mortgages. Their smaller average loan size makes the origination costs for subprime loans higher than for prime loans, not only in absolute dollars but also as a percentage of loan amounts.²⁸ Likewise, servicing costs are higher because subprime borrowers are more likely to default than their prime counterparts and loan administration requires more constant vigilance.²⁹

While subprime loans generally are more expensive than prime loans for legitimate reasons, the high cost of subprime loans may also evince rent-seeking. The practice of steering prime borrowers to high-cost lenders is an example of pricing that is designed to extract harmful rents. Rents can also inhere in added fees and closing costs, including fees for items such as credit reports and document preparation that exceed market rates.³⁰ Other forms of padding are even more blatant. Lenders may bill borrowers for duplicative charges, fees for services never rendered, or surcharges on government recording fees.³¹ In a similar manner, credit life insurance and similar types of insurance have been singled out for pricing abuses. The insurance abuses are rife and range from premium charges that are high relative to actual loss payouts, single-premium payments for insurance that extends beyond the life

percent, or 2 times rates being charged for conventional mortgages, which are usually obtainable at rates of 7 to 7.5 percent.”).

25. See generally Dwight M. Jaffee & Thomas Russell, *Imperfect Information, Uncertainty, and Credit Rationing*, 90 Q.J. ECON. 651 (1976).

26. HUD-Treasury Report, *supra* note 8, at 28; see also WEICHER, *supra* note 10, at 69.

27. See WEICHER, *supra* note 10, at 67; HUD-Treasury Report, *supra* note 8, at 28. This assumes, of course, that underwriting is actually performed, which is rarely the case in asset-based loans by predatory lenders.

28. See WEICHER, *supra* note 10, at 61–62, 67; HUD-Treasury Report, *supra* note 8, at 28.

29. See WEICHER, *supra* note 10, at 56–57 & tbl.4.1, 69–70, 74–88; HUD-Treasury Report, *supra* note 8, at 28.

30. See Sturdevant & Brennan, *supra* note 6, at 38–39. In a recent study of settlement fees, Mark Shroder found “huge deviations in total lending and title fees paid for transactions” of similar value to sellers. He also found that higher fees for particular line items correlated positively with higher fees for other line items, suggesting that “some people are candidates for high fees in both title [insurance] and lending.” MARK SHRODER, *THE VALUE OF THE SUNSHINE CURE: EFFICACY OF THE RESPA DISCLOSURE STRATEGY*, 14–15 fig.2, tbl.4 (HUD, Working Paper, Apr. 2000).

31. See Sturdevant & Brennan, *supra* note 6, at 38–39.

of the loans, policies issued to borrowers who do not qualify for insurance,³² and insurance policies written on total indebtedness, not on repayment of principal.³³

C. *Fraud or Deceptive Practices*

The most blatant forms of predatory lending involve the age-old problem of fraud. All of the deceptive practices in this category are violations of existing laws, such as state fraud statutes, state consumer-protection laws, state fiduciary duties, and federal disclosure statutes such as the Truth in Lending Act (TILA)³⁴ or the Real Estate Settlement Procedures Act (RESPA).³⁵

Lending fraud comes in endless varieties and is only limited by the ingenuity of the perpetrators. Nevertheless, recent incidents in the home-lending market can be divided into two basic types of fraud. The first type of fraud consists of deception aimed at borrowers.³⁶ The most notorious deceptions include fraudulent disclosures, failures to disclose information as required by law, bait-and-switch tactics, and loans made in collusion with home-repair scams. There are reports of lenders financing fees without borrowers' knowledge, secretly conveying title to borrowers' property, and deliberately concealing liens on borrowers' homes. Some lenders misrepresent to borrowers that they must purchase credit life insurance in order to proceed to closing. Others misrepresent that they are affiliated with a federal agency such as the Veterans Administration or the Federal Housing Administration. Brokers may dupe borrowers into believing that they are acting in the best interests of the borrowers when their real financial loyalties are to the lenders. Brokers and lenders alike may lure borrowers to closing

32. Older homeowners, for example, often do not qualify for credit life insurance due to their advanced age.

33. See HUD-Treasury Report, *supra* note 8, at 81, 88 & n.85, 89, 91; Sturdevant & Brennan, *supra* note 6, at 39; *Unscrupulous Lenders Exploit Poor, Elderly*, ATLANTA J. & CONST., Dec. 13, 1998, at R4, 1998 WL 3731367; cf. Freddie Mac, Industry Letter, Single-Premium Credit Insurance Products (Apr. 21, 2000) (prohibiting prepaid single-premium credit life insurance in mortgages sold to Freddie Mac), available at <http://www.freddiemac.com/sell/selbuln/421indltr.html>; Fannie Mae, *supra* note 12 (same for mortgages sold to Fannie Mae); see generally NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, A BACKGROUND STUDY OF THE REGULATION OF CREDIT LIFE AND DISABILITY INSURANCE (1970); NATIONAL CONSUMER LAW CENTER, COMPUTING RATES FOR CREDIT LIFE INSURANCE AND CREDIT ACCIDENT AND HEALTH INSURANCE (1976).

34. 15 U.S.C. §§ 1601–1693r (2000).

35. 12 U.S.C. §§ 2601–2617 (2000).

36. See generally HUD-Treasury Report, *supra* note 8, at 24, 79–90; EXPANDED INTERAGENCY GUIDANCE FOR SUBPRIME LENDING PROGRAMS, *supra* note 8, at 10; Brief of the United States as Amicus Curiae in Support of Plaintiffs' Opposition to Defendant's Motion for Judgment on the Pleadings or, in the Alternative, for Summary Judgment at 1–6, *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7 (D.D.C. 2000) (No. 98-1021); Lara Becker et al., *Some Subprime Lenders Are Causing Pain for Residents*, DEMOCRAT & CHRON., Feb. 27, 2000, at A1.

by promising to finance needed home repairs or to refinance loans at lower rates.

The other type of fraud consists of deception that is aimed at capital sources, such as secondary-market purchasers of loans,³⁷ federal loan guarantors, and sometimes even loan originators themselves. Such fraud typically takes the form of falsified loan applications or inflated real estate appraisals.³⁸ For instance, a lending officer may induce an unsuspecting, impoverished borrower to sign a blank loan application that the mortgage broker or lender then falsifies to paint a glowing financial picture of the borrower so that the loan can easily be resold on the secondary market. Similarly, unscrupulous lenders may commission inflated appraisals to support a federal loan guarantee; unscrupulous mortgage brokers may do the same to justify a higher amount of principal. In most cases, the borrowers are unaware of the fraud and generally are the secondary victims. As we will describe later, this second form of fraud is symptomatic of agency problems that characterize lenders, borrowers, mortgage brokers, federal loan guarantors, and the secondary market.

D. Other Forms of Lack of Transparency That Are Not Actionable As Fraud

Even in mortgages devoid of fraud, lack of transparency may still be a problem. In contrast to loans involving fraud, this group of loans involves misleading omissions that are currently countenanced by law. In most mortgages, federal law requires the disclosure of certain loan terms or costs, either under TILA³⁹ or RESPA.⁴⁰ Both statutes seek to supply consumers with standardized cost information about mortgage loans in order to facilitate comparison shopping. TILA does so by requiring lenders to disclose two key figures: the finance charge and the annual percentage rate (APR). The finance charge purports to measure the total cost of credit in dollars, including interest payments, points, origination fees, and private mortgage insurance. The APR provides a different measure of total credit costs by translating the lump-sum finance charge into an effective interest rate per year.⁴¹

37. All references to the secondary market in this Article denote the market for the sale of mortgage-backed securities to investors, either through private placements or public offerings. Institutional investors such as banks and thrifts and government-sponsored entities such as Fannie Mae and Freddie Mac purchase mortgage-backed securities in private placements. The public can invest in mortgage-backed securities through public offerings.

38. See, e.g., HUD-Treasury Report, *supra* note 8, at 21–22, 80; Sturdevant & Brennan, *supra* note 6, at 37; Patrick Barta, *Is Appraisal Process Skewing Home Values?*, WALL ST. J., Aug. 13, 2001, at A1, 2001 WL 2872444.

39. 15 U.S.C. §§ 1601–1693(c) (2000).

40. 12 U.S.C. §§ 2601–2617 (2000).

41. See generally Department of Housing and Urban Development & Federal Reserve Board, Joint Report to Congress, *Truth in Lending Act and the Real Estate Procedures Act*, Executive Summary at I (1998) [hereinafter HUD-Fed Joint Report], available at

RESPA seeks to provide consumers with adequate disclosures about closing costs for mortgages. Under RESPA, lenders must provide borrowers with two different disclosure statements. In the good-faith estimate of settlement costs (GFE) provided three days after application, lenders must provide borrowers with an itemized estimate of the closing costs. Later, at the closing, lenders must provide a HUD-1 settlement statement that reflects the actual closing costs that borrowers must pay.⁴²

Both RESPA and TILA have loopholes that hinder effective disclosure. Under TILA, significant costs are excluded from the finance charge and APR, meaning that the reported total cost of credit is too low. These exclusions include fees for credit reports, appraisals, inspections by lenders, flood certifications, document preparation, title searches, and title insurance, as well as notary fees, recording fees, and government taxes.⁴³ RESPA's disclosure system has flaws in timing and enforcement. GFEs do not have to be provided until three days after application, after an application fee has already been paid. Furthermore, since lenders face no liability for errors on the GFE, estimates sometimes bear little relationship to actual costs. Both flaws mean that GFEs are not useful tools for comparison shopping.⁴⁴ Similarly, while borrowers may request their HUD-1 settlement statements a day before closing, they do not need to be informed of that right. Furthermore, just as with the GFE, there is no requirement that HUD-1 statements be accurate.⁴⁵

Other pricing practices that are not regulated by TILA and RESPA hamper transparency as well. In the prime-mortgage industry, points generally are accompanied by a reduction in the interest rate.⁴⁶ The purpose of this tradeoff is to afford borrowers the option of defraying part of the cost of borrowing by paying a liquidated sum up-front in points in exchange for lower interest payments in the future. For similar reasons, conventional

<http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf>; ROHNER & MILLER, *supra* note 22, at 179.

42. See generally HUD-Fed Joint Report, *supra* note 41, Executive Summary at II.

43. See *id.* at X.

44. See *id.* at XI. In a recent survey of GFEs, economist Mark Shroder found that many of the GFEs were off by "a fair amount" and that a minority of borrowers received "large underestimates." SHRODER, *supra* note 30, at 12.

45. See HUD-Fed Joint Report, *supra* note 41, Executive Summary at XIX. HOEPA provides somewhat stronger protections for the scant 5% of subprime loans that fall within its coverage. Under HOEPA, the lender must make certain written disclosures three days before closing. See 12 C.F.R. § 226.31(c) (2001); see also *infra* notes 210-11 and accompanying text.

46. See, e.g., KATHLEEN E. KEEST & ELIZABETH RENUART, *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES* 163 (2d ed. 2000) ("[P]oints are usually treated as a discount withheld from the loan, thus reducing the amount that the borrower receives."); Sturdevant & Brennan, *supra* note 6, at 38; WEICHER, *supra* note 10, at 67 (explaining that in the legitimate subprime market, "[t]he higher the interest rate a borrower is willing to pay, the fewer points may be charged, and conversely").

lending norms state that prepayment penalty provisions go hand-in-hand with reductions in interest rates.⁴⁷

The rationale for these norms is to afford borrowers a choice in how they wish to defray the time-price differential of money. Legitimate lenders provide such a choice. Predatory lenders, in contrast, subvert this conventional tradeoff by layering points or prepayment penalties on top of high interest rates on a take-it-or-leave-it basis. In competitive loan markets, market forces and disclosures are generally sufficient to curb such abuses. In the market for predatory loans, however, disclosures are usually incomprehensible and market forces do not provide sufficient constraints against that conduct, for reasons that we will explain.

E. Loans that Require Borrowers to Waive Meaningful Legal Redress

Many home-mortgage loans, particularly subprime loans, contain non-negotiable, mandatory-arbitration clauses that bar the borrowers from seeking judicial redress.⁴⁸ Some clauses may prohibit borrowers from joining plaintiff class actions against lenders. Other clauses shift lenders' attorneys' fees on to the borrowers.⁴⁹

II. Market Segmentation and Predatory Lending

As we have suggested, the pathologies that epitomize predatory lending are the product of market failures in the subprime mortgage market. In this

47. See Boisky, *supra* note 5, at A10 ("Please keep in mind that having no prepayment penalty is a double-edged sword: it helps with eliminating prepayment penalties at the price of a much higher interest rate."); WEICHER, *supra* note 10, at 71-74.

Under HOEPA, the Federal Reserve Board limits prepayment penalties for high-cost, closed-end home-mortgage refinance loans. Prepayment penalties are only allowed if they are in effect for no more than five years following closing, if the refinancing is performed by someone other than the original lender or an affiliate, and if the consumer's total monthly debts at closing (including the HOEPA loan) do not exceed half of her verified monthly gross income. See 12 C.F.R. § 226.32(d) (2001). Loans that are outside of HOEPA's coverage are not subject to these restrictions on prepayment clauses.

48. See Shelly Smith, *Mandatory Arbitration Clauses In Consumer Contracts: Consumer Protection and the Circumvention of the Judicial System*, 50 DEPAUL L. REV. 1191, 1191-92 (2001) (discussing the problems with mandatory-arbitration clauses in consumer contracts).

49. See HUD-Treasury Report, *supra* note 8, at 99. In the recent case of *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79 (2000), which involved a TILA claim by a borrower against a mobile-home finance lender, the loan contained a mandatory-arbitration clause that was silent as to arbitration procedures, costs, and fees. The borrower sought to invalidate the arbitration clause, arguing that she did not have sufficient resources to pay if the arbitration eventually resulted in fees. In a 5-to-4 decision, the Supreme Court rejected her claim for lack of evidence of prohibitive fees: "[W]here, as here, a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs." *Id.* at 93. While the Court suggested that prohibitive filing fees or charges by the arbitrator would provide grounds for striking down an arbitration clause, it created a Catch-22 by requiring litigants to proceed to arbitration in order to adduce proof that they face excessive fees.

section of the paper, we describe how changes in the financial services market have altered the conventional home-mortgage market and given rise to predatory lending. In particular, we argue that today's home-mortgage market is replete with information asymmetries that predatory lenders have exploited to the detriment of borrowers who are disconnected from the credit market. We begin with a discussion of the conventional theory of the market for home mortgages and the impact of historical lending practices on low- and moderate-income (LMI) borrowers. Later, we examine the ways in which securitization, new mortgage products, and incentives for lenders to focus on LMI borrowers have altered the home-mortgage market. We then explain the emergence of predatory lenders and how they have been able to exploit information asymmetries to the detriment of many LMI borrowers. In the concluding section, we explain why the market will not correct these inefficiencies.

A. *The Conventional Theory of the Market for Home Mortgages*

In a market with full information about borrowers' characteristics, we would expect that the price⁵⁰ of a loan would reflect the risk presented by the borrower. All else being equal and with full information, for every borrower, lenders could determine a loan price that would be the risk-adjusted equilibrium price. The reality, however, is that lenders do not have full information about the risk that borrowers will default, the costs of foreclosure if they do default, and the net amount recoverable in the event of foreclosure. As a result, lenders cannot accurately identify borrowers who present the greatest risk and cannot price loans accurately based on risk.

Over twenty years ago, Stiglitz and Weiss recognized that this lack of information creates an adverse-selection problem that prevents the market for mortgages from clearing.⁵¹ The key to this adverse-selection problem is that high interest rates deter the borrowers who are risk-averse and who present a low risk of default. Conversely, high interest rates are less likely to deter borrowers who are willing to take on high levels of risk and who present a greater risk of default.⁵² Thus, according to Stiglitz and Weiss, if lenders

50. The price of loans includes the nominal interest rate, points, insurance, and all other fees associated with a loan.

51. See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981) [hereinafter Stiglitz & Weiss, *Credit Rationing*]; JOSEPH E. STIGLITZ & ANDREW WEISS, MACRO-ECONOMIC EQUILIBRIUM AND CREDIT RATIONING (Nat'l Bureau of Econ. Research, Working Paper No. 2164, 1987), available at <http://papers.nber.org/papers/w2164>. For an expanded discussion of the Stiglitz and Weiss model, see William C. Gruben et al., *Imperfect Information and the Community Reinvestment Act*, ECON. REV., Summer 1990, at 27, 30-31.

52. Borrowers who are less risk averse will be more likely to assume loan obligations that they cannot meet. This may be because they have an inflated sense of their ability to meet their loan obligations, because they are by nature risk-taking, because they do not understand the loan terms, or because they would face comparatively low personal costs upon default. For an analysis of the

raise interest rates, they will attract loan applicants who present elevated risks of default and will deter borrowers who present lower default risks.⁵³

Given that lenders cannot identify the less risky borrowers and that high interest rates deter the very borrowers whom they seek to attract, lenders, operating under Stiglitz-Weiss conditions, will set the price of loans below the market-clearing rate.⁵⁴ Lenders further reduce their risk by limiting the amount that borrowers can borrow.⁵⁵ This has the effect of creating an additional safeguard against default by risky borrowers and deters risky borrowers that want to borrow more money than lenders will permit.⁵⁶ The result under the Stiglitz and Weiss model is that: (1) the demand for loans will exceed the supply, (2) to the extent that lenders can identify applicants⁵⁷ who are high default risks,⁵⁸ the lenders will reject their applications for loans, and (3) among the remaining applicants in the queue, who are observationally indistinct, some will receive loans and others will not.⁵⁹

Until the late 1980s, the home-mortgage market behaved as Stiglitz and Weiss predicted. Federally insured banks and thrifts dominated the market for home-mortgage loans.⁶⁰ There was minimal risk-adjusted pricing,⁶¹ each

private costs of default, see Jan K. Brueckner, *Mortgage Default with Asymmetric Information*, 20 J. REAL EST. FIN. & ECON. 251, 252 (2000).

53. See Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1566-68 (1995) (observing that if lenders were to make loans to the highest bidders, the lenders would be lending to the riskiest and least risk-averse borrowers).

54. See Stiglitz & Weiss, *Credit Rationing*, *supra* note 51, at 394.

55. This could be done through loan-to-value ratios or through across-the-board limits on the maximum size of loans.

56. See Brueckner, *supra* note 52, at 252, 264.

57. Sometimes it is not possible to observe the risk presented by borrowers, for example, when borrowers do not participate in the credit economy and, therefore, have no credit history. Even where it may be possible to evaluate the risk that borrowers present, the cost of obtaining and evaluating the relevant information may exceed the benefit of extending credit to these borrowers. See Klausner, *supra* note 53, at 1568.

58. The determination that borrowers are risky can be based on an array of different factors. It could be that the borrowers have weak or no credit histories. In other cases, borrowers may not have financial information in a form that is easy for lenders to assess, or there may be a risk that the underlying collateral will not retain its value.

59. The reason that lenders will not lend to all observationally indistinct borrowers is that when lenders set the price of loans at a rate below the market-clearing level, the amount of funds that they can raise to lend is limited. The marginal cost of procuring additional funds that would meet the demand of the excluded, observationally indistinct borrowers would exceed the marginal benefit that would accrue from lending to them. For a model of this phenomenon, see Stiglitz & Weiss, *Credit Rationing*, *supra* note 51, at 397. The theory of credit rationing persists even if borrowers are able to provide collateral. For a discussion of the role of collateral in credit rationing, see generally Dwight M. Jaffee & Franco Modigliani, *A Theory and Test of Credit Rationing: Reply*, 66 AM. ECON. REV. 918 (1976).

60. As one author described the situation: "[T]he banking system had a monopoly on the liquid assets of the nation." Lowell Bryan, *The Risks, Potential and Promise of Securitization*, in A PRIMER ON SECURITIZATION 172 (Leon T. Kendall & Michael J. Fishman eds., 1996). Finance companies and other nonbank lenders wrote home loans, but they only represented a fraction of the home-mortgage market.

bank was limited in the amount of funds it could lend,⁶² and demand exceeded supply.⁶³ Most important, for the purposes of this Article, credit rationing significantly constrained the amount of mortgage capital available to low- and moderate-income borrowers. This is because LMI borrowers tend to present greater risks of default than their more affluent counterparts.⁶⁴

B. Changes in the Home-Mortgage Market

Beginning in the 1980s, several changes in the financial-services market led to an increase in the amount of capital available to lend and spurred the emergence of new types of lenders. The most important changes were the securitization of home mortgages, the availability of new mortgage products, and incentives for lenders to increase their lending activity in LMI neighborhoods.

1. Securitization.—Freddie Mac spearheaded the securitization movement in the 1970s in an effort to increase the amount of available mortgage capital. Widespread securitization by government-sponsored entities (GSEs)⁶⁵ and the private sector began in the 1980s, and by 1993, sixty percent of home-mortgage loans were securitized.⁶⁶ In the process, securitization single-handedly transformed the financial-services market. It

61. See John V. Duca & Stuart S. Rosenthal, *Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence on Rate Sorting and Credit Rationing*, 8 J. REAL EST. FIN. & ECON. 99, 107 (1994) (providing statistics that show lenders did not vary mortgage rates across neighborhoods with different credit risks).

62. See Susan M. Phillips, *The Place of Securitization in the Financial System: Implications for Banking and Monetary Policy*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 130–33 (discussing government regulations that impede the flow of loanable funds).

63. See Lewis S. Ranieri, *The Origins of Securitization, Sources of its Growth, and its Future Potential*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 32 (“The demographic forces were going to create a demand for funds greater than the ability of the thrifts to attract capital and grow their balance sheets.”).

64. See Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237, 258–59 (1996); Klausner, *supra* note 53, at 1568 (describing some of the risks associated with lending in low-income neighborhoods).

While there was some rate sorting (*i.e.*, offering borrowers different loan prices based on their observable levels of risk) in the past, the overwhelming evidence reveals that credit rationing had the effect of rationing most LMI borrowers out of the home-mortgage market. See Stiglitz & Weiss, *Credit Rationing*, *supra* note 51, at 406–07; Duca & Rosenthal, *supra* note 61, at 101–02 (analyzing how lenders have responded to credit rationing and concluding that “legal restrictions that limit rate sorting may increase the degree to which nonrate terms are used to impose binding debt ceilings on high risk loan applicants”).

65. The most well-known GSEs today are Fannie Mac and Freddie Mac. See Leland C. Brendsel, *Securitization's Role in Housing Finance: The Special Contributions of the Government-Sponsored Enterprises*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 17.

66. See *id.* at 17–19. During the same time period, investment-fund managers were looking for new investment vehicles, and mortgage-backed securities fit the bill. See Leon T. Kendall, *Securitization: A New Era in American Finance*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 2–3.

is now routine for lenders to originate loans and sell them to secondary-market institutions, which provide a steady stream of capital to lend.⁶⁷

Securitization is the process of converting packages of home loans into securities that are backed by collateral in the form of loans.⁶⁸ The first step in the securitization process is for a lender to make loans to borrowers.⁶⁹ The loans then are bundled and transferred to an entity, often known as a "special-purpose vehicle" (SPV) that passively holds the loans.⁷⁰ The SPV adds credit enhancements that have the effect of reducing the risks associated with defaults.⁷¹ The SPV then creates and issues the mortgage-backed securities and sells the securities to investors.⁷² In some cases, the SPV services the loans (*i.e.*, collects the loan payments) and distributes the proceeds to the investors.⁷³ In other cases, the seller of the loans retains the servicing rights.

Securitization, by making possible a constant flow of money to the home-mortgage market, has dramatically altered the business of mortgage lending. Banks and other lenders do not suffer from liquidity restraints and more funds are available to lend. Securitization also has created opportunities for nonbank lenders to enter the home-mortgage market.⁷⁴ Lenders no longer need to be large financial institutions with significant deposits and capitalization. Rather, thinly capitalized mortgage bankers and finance companies can originate loans for sale on the secondary market.⁷⁵

67. Securitization not only generates more mortgage capital but also adds value by reducing risks and costs through diversification. By pooling individual loans, the collective risk of a package of loans defaulting is less than the average risk of any one loan going into default. *See* Bryan, *supra* note 60, at 174-75 (discussing why securitization is cost-effective).

In addition, once loans are securitized, under the holder-in-due-course rule, borrowers typically cannot defend nonpayment on the grounds that the lenders engaged in unlawful activity related to the loans, such as committing certain types of fraud on borrowers. *See infra* notes 195-96 and accompanying text. This has the effect of increasing the value of the loans upon securitization.

68. *See* Tamar Frankel, *Securitization (Asset-Backed Securities and Structured Financing)*, in FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS 4-2 (Clifford E. Kirschl ed., 1999).

69. *Id.* at 4-4.

70. These entities may take a number of different organizational forms (*e.g.*, trusts, corporations, or partnerships). *See id.*

71. Examples of credit enhancements are insurance and third-party guarantees. *See id.* at 4-15; Kendall, *supra* note 66, at 4. In addition, secondary-market purchasers can require recourse provisions, which also reduce the risks associated with default.

72. When loans are securitized by government-sponsored entities, the GSEs purchase and package the loans, create the securities, and market the securities through brokers. *See* Brendsel, *supra* note 65, at 21.

73. As discussed *infra* at note 143 and accompanying text, when sellers retain servicing rights, they have a greater interest in the quality of the loans.

74. *See* Brendsel, *supra* note 65, at 24 (explaining that the "unbundling of the mortgage process" has generated increased competition in the "originating, servicing, credit risk taking and investing" functions of the mortgage process).

75. *Id.*

2. *Expanded Mortgage Products.*—Historically, lenders primarily offered cookie-cutter, fixed-rate loans. Coincident with the expansion of the home-mortgage market in the early 1980s, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)⁷⁶ and the Alternative Mortgage Transactions Parity Act of 1982 (AMTPA),⁷⁷ both of which paved the way for the proliferation of new mortgage products.⁷⁸

In DIDMCA, Congress extended the favorable variable-rate ceiling for national banks to all federally insured banks and thrift institutions⁷⁹ and preempted all state usury ceilings on “interest, discount points, finance charges, or other charges” for loans secured by first mortgages on debtors’ homes, including conventional homes and mobile homes.⁸⁰ As a result, lenders who wanted to charge higher rates had new incentives to refinance first mortgages, rather than offering junior mortgages, whether home-equity lines or otherwise, that were subject to state usury laws.⁸¹

In a similar vein, in AMTPA, Congress extended the liberal mortgage-lending regulations for federally chartered depository institutions to most lenders making senior and junior residential mortgages.⁸² These regulations preempted old restrictions that limited lenders to making fixed-rate, amortizing mortgages.⁸³ As a result, lenders received the green light to make adjustable-rate mortgages, mortgages with balloon payments, and non-amortizing mortgages where borrowers pay off the interest but not the principal.

76. Pub. L. No. 96-221, 94 Stat. 132 (1980).

77. Pub. L. No. 97-320, §§ 801–807, 96 Stat. 1469, 1545–48 (1982).

78. See generally Office of Thrift Supervision, Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17,811, 17,812–14 (Apr. 5, 2000); Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. PUB. INT. L.J. 1 (2000) (describing how the DIDMCA enabled savings and loans to compete with commercial lenders).

79. 12 U.S.C. §§ 1463(g), 1785(g), 1831d(a) (2000); see also *id.* § 85. That change permits insured depository institutions of all types to set interest rates as high as 1% over the discount rate on 90-day commercial paper in effect at the Federal Reserve District in which the institution is located.

80. 12 U.S.C. § 1735f-7a (2000).

81. Although Congress permitted the states to enact laws opting out of federal preemption, only sixteen did so, either in part or in whole. See KEEST & RENUART, *supra* note 46, at 64, 72–74; Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 398–400 (1994); Mansfield, *supra* note 1, at 509 (explaining the actions that a state must take to opt out of DIDMCA preemption).

82. 12 U.S.C. §§ 3801–3806 (2000).

83. See Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17,813–14. The Act authorizes lenders to make alternative mortgage loans as long as the transactions are “in accordance with” appropriate and applicable OTS regulations. OTS is considering whether to amend those regulations to deter predatory loans. See *id.* at 17,815–16. Congress gave states the ability to opt out of federal preemption, but only six states chose to exercise that option. See KEEST & RENUART, *supra* note 46, at 64, 72–74, 109–11; Forrester, *supra* note 81, at 400–01.

3. *Incentives to Lend to LMI Borrowers.*—Both market incentives and federal initiatives have made it appealing for some lenders to focus on LMI borrowers. In the past, credit rationing excluded many potential LMI borrowers from the home-mortgage market. As a result, there have been high levels of demand for loans and little competition from traditional lenders in LMI neighborhoods. In addition, many LMI homeowners experienced a rise in their wages and home values in the 1990s.⁸⁴ Lenders have tapped into borrowers' increased cash flow and have secured loans with borrowers' increased equity.

In terms of federal initiatives, one piece of legislation that has encouraged lenders to focus on LMI borrowers is the 1992 Federal Housing Enterprise Financial Safety and Soundness Act,⁸⁵ pursuant to which the Department of Housing and Urban Development (HUD) sets affordable-housing lending goals for Freddie Mac and Fannie Mae. The 1996–2000 goals issued pursuant to the Act required that forty-two percent of Freddie Mac's and Fannie Mae's loan purchases come from low- and moderate-income households. The goal for 2001 was fifty percent.⁸⁶ Additional HUD mandates required that Fannie Mae and Freddie Mac significantly increase their purchases of loans from high-minority or low-income census tracts.⁸⁷ The HUD goals expanded the market for lenders who originate loans in LMI neighborhoods with the intention of selling their loans to Fannie Mae or Freddie Mac. Similarly, the Community Reinvestment Act (CRA) created incentives for bank and thrift holding companies to originate or purchase loans in LMI neighborhoods in order to improve their CRA examination ratings and prospects for merger approval.⁸⁸

84. Glenn B. Canner et al., *Recent Developments in Home Equity Lending*, 84 FED. RES. BULL. 241, 249 (1998) (discussing the rise in home prices and the emergence of the subprime market); Arthur Kennickell et al., *Family Finance in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 1, 5 (1997) (noting the rise of median net worth for groups with annual incomes less than \$25,000).

LMI borrowers are the fastest growing group of borrowers in the mortgage market. Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197, 205 (2000).

85. 12 U.S.C. §§ 4501–4641 (2000).

86. Fannie Mae, *HUD's Proposed Affordable Housing Goals: Fannie Mae's Comment Letter*, at 110 (May 8, 2000).

87. *Id.*

88. See, e.g., HUD-Treasury Report, *supra* note 8, at 106; Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. (forthcoming 2002). There is some dispute whether CRA actually is responsible for increased home-mortgage lending to LMI borrowers. For a discussion of attempts to study the impact of CRA on low- and moderate-income lending, see SALLY R. MERRILL ET AL., III HOUSING FINANCE FOR LOW AND MODERATE INCOME HOUSEHOLDS: INNOVATIONS IN THE UNITED STATES AND AROUND THE WORLD 14–17 (2000); see also ROBERT E. LITAN ET AL., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT 69 (2000) (assessing the impact of CRA on LMI lending); Eric S. Belsky et al., *The Impact of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending* (Mar. 2001) (unpublished manuscript, on file with the

FHA insurance through HUD creates an additional incentive⁸⁹ for lending in LMI neighborhoods by reducing the cost to lenders of default. The majority of borrowers who are covered by FHA insurance are low- to moderate-income households.⁹⁰ If and when these FHA-insured borrowers default, the FHA reimburses the lenders for their foreclosure costs and expenses related to the sale of covered property.⁹¹ In addition, FHA insurance reimburses lenders for the outstanding interest that accrues between default and foreclosure, property taxes, and maintenance costs.⁹² Given that there is evidence that LMI borrowers have elevated risks of default, the increased availability of FHA insurance decreases the downside risk to lenders.⁹³

4. *The New Market Structure.*—The changes in home-mortgage markets have made it possible for borrowers of all risk levels to work with an array of different loan originators and select from a menu of loan products offered by both prime and subprime lenders. An irony of these market changes is that they have contributed to the emergence and success of predatory lenders. Conceivably, predatory lenders now can originate predatory loans in LMI neighborhoods and sell them to private secondary participants and, conceivably, the GSEs: Fannie Mae and Freddie Mac.⁹⁴ Likewise, they can find potential loan purchasers among banks that seek to fulfill their CRA obligations by purchasing loans made to LMI borrowers.⁹⁵

Texas Law Review) (finding that CRA has been effective in increasing home-purchase mortgages in LMI neighborhoods). *But see* Keith N. Hylton & Vincent D. Rougeau, *The Community Reinvestment Act: Questionable Premises and Perverse Incentives*, 18 ANN. REV. BANKING L. 163 (1999) (challenging the efficiency of CRA); Drew Dahl et al., *Does the Community Reinvestment Act Influence Lending? An Analysis of Changes in Bank Low-Income Mortgage Activity (May 2000)* (unpublished manuscript, on file with the Texas Law Review) (calling into question the impact of regulatory pressure on low- and moderate-income lending).

89. In January 2001, HUD announced an increase of 9% in the size of the mortgages that it insures. *HUD Raises Ceiling on FHA Mortgages*, PORTLAND OREGONIAN, Jan. 14, 2001, at H11, 2001 WL 3581529.

90. LMI borrowers accounted for 70% of FHA-insured loans in 1998. *See* MERRILL ET AL., *supra* note 88, at 5.

91. *See* Terrence M. Clauretie & Thomas Herzog, *The Effect of State Foreclosure Laws on Loan Losses: Evidence from the Mortgage Insurance Industry*, 22 J. MONEY, CREDIT & BANKING 225 (1990). This reduction in transaction costs also has the perverse effect of reducing the costs to predatory lenders of foreclosure. *See* HUD-Treasury Report, *supra* note 8, at 21.

92. Terrence M. Clauretie & Mel Jameson, *Interest Rates and the Foreclosure Process: An Agency Problem in FHA Mortgage Insurance*, 57 J. RISK & INS. 701, 701-02 (1990).

93. These savings are not inconsequential. The period between default and foreclosure sale can easily take as long as a year.

94. In response to this risk, Fannie Mae and Freddie Mac instituted controls to help them to identify predatory lenders and loans containing predatory terms. *See* David Andrukonis, *Address to the Neighborhood Reinvestment Corporation Training Conference (Feb. 23, 2000)*, at http://www.freddiemac.com/speeches/pred_spch.html; Fannie Mae, *supra* note 86, at 30, 167-69.

95. Nothing in CRA restricts banking entities from fulfilling their CRA obligations by purchasing or originating loans that contain predatory terms. Donna Tanoue, Former Chairman,

Similarly, predatory lenders can make predatory, FHA-insured loans and insulate themselves somewhat from the cost of defaults.⁹⁶ Lastly, as we discuss *infra*, AMTPA has enabled predatory lenders to peddle complex and predatory-loan products that are difficult for inexperienced and unsophisticated borrowers to understand.

We contend that as a result of the changes in the home-mortgage markets, the market has segmented into three mortgage markets: a prime market, a legitimate subprime market, and a predatory market.⁹⁷ The prime market looks much like its historical predecessor. It continues to cater to low-risk borrowers, who obtain loans from traditional banks and thrifts as well as from the new breeds of lenders. Although prime lenders still set interest rates below the market-clearing rate to attract borrowers who present low risks of default,⁹⁸ more of the observationally indistinct borrowers in the Stiglitz and Weiss queue are able to obtain credit. There are two reasons for this change. The first is that lenders now have longitudinal data and sophisticated credit-scoring and underwriting models that make it possible for them to engage in more accurate risk assessment of people who, in the past, were observationally indistinct.⁹⁹ The second factor is securitization

FDIC, Address at the Bank Administrative Institute Conference (June 19, 2000) ("The problem is that our examination procedures today concentrate on where a loan was made without regard for the characteristics of the loan."), available at <http://www.fdic.gov/news/speeches/chairman/sp19June00.html>; Adam Wasch, *CRA Assessment Methods Need Update, Seidman Says, Calling It Top Regulatory Issue*, BNA BANKING REP., Oct. 16, 2000, at 497; Adam Wasch, *Democrats Propose CRA Update Bill Supporters Say Gore Would Sign*, BNA BANKING REP., July 24, 2000, at 131; see generally PATRICIA A. MCCOY, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS § 8.03[1][b] (2d ed. 2000).

96. The FHA has become aware of this risk and is now taking steps to identify predatory lenders who work with FHA-eligible borrowers. HUD-Treasury Report, *supra* note 8, at 11–12; John B. O'Donnell, *FHA Begins Acting on Complaints of "Flipping"; U.S. Will Demand Redress for Exploited Homeowners*, BALT. SUN, May 20, 2000, at 4B, 2000 WL 4867388; see also Mortgage Review Board, Administrative Actions, 66 Fed. Reg. 38,302–10 (July 23, 2001) (listing dozens of administrative actions HUD took against mortgagees who engaged in predatory lending in violation of FHA requirements).

97. For a discussion of a parallel phenomenon in the consumer-credit industry, see Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking about the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000).

98. For reasons discussed *infra* in section III(C)(4), banks and thrifts tend to continue to focus their direct lending activities on prime borrowers.

99. Fannie Mae's Desktop Underwriter, for example, provides for more accurate risk assessment. See Fannie Mae, *supra* note 86, at 166–68. Arguably, lenders' enhanced ability to assess risk and the increased availability of mortgage capital should lead to risk-based pricing, under which the terms of any loan would reflect the unique risk that a borrower presents based on the lender's risk-assessment model. But for reasons discussed in section II(C)(4), *infra*, banks and thrifts may be reluctant to charge higher interest rates to riskier borrowers and thus may elect to limit their direct lending to prime borrowers. Just the same, some commentators contend that as automated underwriting becomes more commonplace in the subprime market, the prime and subprime markets will integrate and risk-based pricing will become the norm. See MAKING FAIR LENDING A REALITY IN THE NEW MILLENNIUM 23–27 (A. Bogdon & C. Bell eds., 2000) [hereinafter MAKING FAIR LENDING].

itself. Securitization has reduced the marginal cost of procuring additional capital to lend and consequently lenders are less constrained in terms of the amount of money that they can lend.¹⁰⁰

Borrowers who present elevated risk levels, including people with impaired credit, can now look to the subprime market for credit where they can take advantage of the influx of mortgage capital and flexible, subprime loan products.¹⁰¹ Subprime lenders charge these borrowers interest and fees that exceed the rate that traditional prime borrowers pay, commensurate with the higher risk that they present.¹⁰² Most subprime lenders are nonbank entities¹⁰³ that emerged as the result of securitization. We refer to the subprime lenders who do not engage in predatory practices as legitimate subprime lenders.

The third market is the predatory-loan market. The borrowers in this market are people who, because of historical credit rationing, discrimination, and other social and economic forces, are disconnected from the credit market.¹⁰⁴ They have a range of credit ratings and some actually would qualify for prime loans.¹⁰⁵ Others may have blemished credit histories and rightly are classified as subprime borrowers. Still others may be able to afford modest loan payments, but cannot afford large loans with high interest rates. The final group of borrowers in the predatory loan market cannot afford any credit regardless of the terms. In the predatory-loan market, brokers and originators exploit borrowers' disconnection to the credit market and make loans with predatory terms.

100. As Stiglitz and Weiss's model predicted, an increase in the ability to assess risk and a decrease in the marginal cost of obtaining capital to lend has led to reduced credit rationing in the prime market. Stiglitz & Weiss, *Credit Rationing*, *supra* note 51, at 397.

101. In recent years, the subprime market has grown tremendously. The percentage of home-purchase mortgages issued by prime lenders dropped from 95% to 86% between 1993 and 1998. During this same period of time, subprime lenders tripled the number of loans they issued. Glenn B. Canner & Wayne Passmore, *The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Borrowers*, 85 FED. RES. BULL. 709, 709-10 (1999). Subprime lenders issued fewer than 1% of mortgages in the early 1990s. By the end of 1997, one industry expert estimated that subprime lenders had captured in excess of 10% of the home-mortgage market. See WEICHER, *supra* note 10, at 37.

102. See Canner et al., *supra* note 84, at 249.

103. This is not to say that banks limit their lending to prime borrowers. Increasingly, evidence suggests that banks have a presence in the subprime market, including participating in predatory lending, through their subsidiaries and through the purchase of subprime loans and securities backed by subprime mortgages. See, e.g., Evan M. Gilreath, *The Entrance of Banks into Subprime Lending: First Union and the Money Store*, 3 N.C. BANKING INST. 149 (1999).

104. Cf. *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 536 (N.J. Super Ct. App. Div. 2001) (citing expert testimony that a "'dual housing finance market exists in New Jersey for the refinance and home repair loans'" market).

105. See Freddie Mac, *supra* note 20, ch. 5 & nn.5-6 (estimating that between 10% and 35% of subprime borrowers qualified for prime-rate loans); see also Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency* 16 (Dec. 21, 2000) (unpublished manuscript, on file with the Texas Law Review) (finding, as an empirical matter, that there are borrowers with subprime loans who do not present elevated levels of risk).

C. *Market Failures and Predatory Lending*

The fact that there are subprime and prime-eligible borrowers who enter into predatory loans suggests that the home-mortgage market is inefficient. In this section of the paper, we identify the inefficiencies that have impeded the evolution of a price-competitive home-mortgage market and enabled predatory lenders to thrive. We begin by discussing how predatory lenders exploit information asymmetries to the detriment of borrowers who are disconnected from the market. We then discuss why lenders and secondary-market participants, both of whom ostensibly have an interest in countering the information asymmetries in the market, will not take steps to correct them. In the concluding portion, we explain why competition among banks, thrifts, legitimate subprime lenders, and predatory lenders has not eliminated the market for predatory loans.

1. *Information Asymmetries: Opportunities for Predatory Lenders and Brokers.*—The emergence of new market intermediaries has led to a significant increase in information asymmetries among brokers, lenders, secondary-market participants, and borrowers. For example, lenders and secondary-market purchasers have different levels of knowledge about borrowers' risk and different levels of commitment to accurate risk assessment.¹⁰⁶ This enables lenders to gain an advantage by withholding information from secondary-market purchasers. Our main concern here is with the information asymmetries¹⁰⁷ that exist between inexperienced borrowers, who are disconnected from the credit market, and predatory lenders and brokers. An understanding of the nature of these information asymmetries and the ways that lenders can exploit them is critical to our analysis, as any proposals to redress predatory lending should be designed to counteract the market inefficiencies that make predatory lending possible.

Lenders and brokers have extensive knowledge about the credit market and mortgage products. In contrast, the typical victims of predatory lenders are unsophisticated about their options.¹⁰⁸ Many were 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

106. See Brendsel, *supra* note 65, at 26 (noting that when lenders originate and hold loans, they are more committed to maintaining quality).

107. Information asymmetries also exist between brokers and lenders and also between lenders and secondary-market participants. See *infra* section II(C)(3).

108. See Lax et al., *supra* note 105, at 2 (finding that risk is the key factor in determining whether borrowers' loans are prime or subprime, but also finding that "borrowers' demographic characteristics, knowledge, and financial sophistication . . . play a statistically and practically significant role in determining whether they end up with subprime mortgages"). For a fuller discussion of these issues, see *infra* section II(C)(2).

documents, the borrowers may not be able to comprehend the information. Predatory brokers and lenders take advantage of these information asymmetries and induce borrowers to commit to predatory loans. When the borrowers cannot repay, the predatory lenders reappear on their doorsteps, offering the borrowers an opportunity to escape foreclosure by refinancing (“flipping”) their loans.¹⁰⁹ Each time the borrowers refinance,¹¹⁰ the lenders tack huge “refinancing” fees and prepayment penalties on to the original principal. The fees and penalties mount with each refinancing and eventually many borrowers leverage all their equity. Upon default, the lenders collect their profits at foreclosure.¹¹¹

2. *Taking Advantage of Information Asymmetries: Locating and Marketing Predatory Loans to Disconnected Borrowers.—*

a. *Identifying Communities and People to Target.—*In order to exploit these information asymmetries, predatory lenders need to identify people who are disconnected from the credit economy and therefore unlikely or unable to engage in comparison shopping. The people most likely to meet these criteria are LMI people¹¹² of color¹¹³ who, because of credit rationing, discrimination, and other social forces, have not had experience with legitimate lenders.¹¹⁴ It is relatively easy for predatory lenders to identify these potential borrowers. They can use Home Mortgage Disclosure Act (HMDA) data to identify areas of cities in which there is minimal or no lending activity by prime lenders. They can also use census data to find neighborhoods with high percentages of people of color and LMI residents.

109. See HUD-Treasury Report, *supra* note 8, at 74–75 (discussing the practice of “flipping” and suggesting possible reforms).

110. When borrowers cannot meet their loan obligations, they have to choose between defaulting and refinancing. As they drain their equity and increase their payment obligations, their ability to obtain loans from prime lenders drops.

111. For loans with initially high loan-to-value ratios, of course, a strategy based on realizing the price through foreclosure is risky because the profits from the predatory loans may be offset by the costs of foreclosure and because there is a risk of deflating housing values. See generally Schill, *supra* note 16, at 493 (reviewing the costs associated with foreclosure).

112. Although it is possible that more-affluent borrowers could fall prey to predatory lenders, affluent borrowers typically have the financial means to hire attorneys to review loan documents and sufficient market experience and sophistication to protect themselves.

113. Predatory lenders particularly target LMI people of color. See, e.g., Lax et al., *supra* note 105, at 8 (finding that subprime borrowers tend to live in low-income neighborhoods with disproportionately high concentrations of people of color). For instance, in one lawsuit against a predatory lender, the evidence revealed that the lender’s predatory-loan activity was primarily in low-income neighborhoods of color and that the lender did “little or no business in predominantly white [low-income] neighborhoods.” HUD-Treasury Report, *supra* note 8, at 22.

114. Approximately 13% of American households did not have any relationship with a bank in 1992 and 1995; the bulk of these people had low to moderate incomes. Kennickell et al., *supra* note 84, at 7. Less than half of African American households maintained checking accounts in 1989. Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PA. L. REV. 1533, 1536 (1995).

Not all LMI borrowers are disconnected from the credit market and thus vulnerable to the wiles of predatory lenders. Just the same, there may be practical reasons why even LMI borrowers with past experience with lenders fall prey to predatory lenders. This may be because they have become infirm or feel that it is not safe to venture far from their homes.¹¹⁵ They may not have phones needed for comparison shopping and applications or, if they have them, they may find it difficult to understand people over the phone.¹¹⁶ Likewise, they may not have access to transportation that could bring them to the offices of legitimate lenders. These concerns are heightened for disabled people and senior citizens.¹¹⁷ More affluent borrowers facing these obstacles can enlist friends or family members who have the resources to help them understand and shop for loans.

Armed with these various incentives to lend in LMI neighborhoods, predatory lenders procure information that enables them to identify specific individuals¹¹⁸ with equity in their homes and pressing needs for money.¹¹⁹ They can search registries of deeds to identify homeowners who do not have mortgages or who are close to paying off their mortgages.¹²⁰ From the local tax office, they can learn of homeowners who have outstanding taxes¹²¹ and, therefore, may need money. From municipal offices, they can identify homeowners who have been cited for housing-code violations and thus may

115. See HUD-Treasury Report, *supra* note 8, at 39, 72 (noting that certain home-improvement contractors target the elderly or infirm and that elderly or impaired persons are particularly vulnerable to aggressive loan tactics).

116. LITAN ET AL., *supra* note 88, at 18.

117. An AARP survey found that over half of respondents over 50 did not comparison shop before taking out home-equity loans. AMERICAN ASSOCIATION OF RETIRED PERSONS, AARP CONSUMER HOME EQUITY/HOME IMPROVEMENT LENDING SURVEY 4 (2000).

118. Anecdotal evidence suggests that predatory lenders identify potential borrowers by searching through title records and then offering homeowners the opportunity to refinance or obtain second mortgages. This marketing strategy is less effective in capturing home purchasers, who are more difficult to identify and who may be more likely to comparison shop.

119. One way that lenders identify people who are unsophisticated and need money is through what are known as "live checks." Lenders send unsolicited checks to potential borrowers with a letter explaining that if the recipients cash the checks, they will be entering into loans with the lenders. The interest rates on these loans are as high as 29%. Lenders know that the recipients who cash the checks are willing to borrow money at high interest rates, presumably because they do not have access to legitimate lenders. The lenders then approach the borrowers and offer to refinance their homes, wrapping in the previously unsecured debt. Interview with Lisa Donner, Campaign Director, ACORN (Aug. 17, 2001) (interview notes available from authors).

120. See Timothy C. Lambert, *Fair Marketing: Challenging Pre-Application Lending Practices*, 87 GEO. L.J. 2181, 2191 (1999).

121. For an example, see Steve Jordon, *Lending Agency Convicted of Predatory Lending Practices*, OMAHA WORLD-HERALD, Jan. 23, 2001, 2001 WL 10114546. In Cleveland, a lender sent out notices the week that real-estate property taxes were due, saying that property owners' taxes might be overdue and offering loans to cover their overdue taxes and other expenses. See Teresa D. Murray, *Notices Alarming Property Owners*, PLAIN DEALER (Cleveland), July 21, 2001, at C1, 2001 WL 20540241; cf. Lambert, *supra* note 120, at 2186-89 (discussing different sources lenders can use to identify potential borrowers).

be in need of home-repair loans. They can drive through neighborhoods and identify homes with sagging porches, aged roofs, and peeling paint.¹²²

b. Predatory Lenders' Marketing Tools.—Predatory lenders approach the people whom they have identified as potential borrowers and 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.

Predatory lenders exercise market power by persuading borrowers to proceed to closing before their competitors knock on the door.¹²³ To accomplish this, predatory lenders have a host of marketing tools at their disposal. Some lenders resort to out-and-out fraud. Other, more sophisticated lenders make truthful disclosures as required by law, but use a variety of hard-sell tactics. Many of these hard-sell tactics capitalize on LMI borrowers' lack of experience with this new breed of lenders and their complex products.

Predatory lenders pressure naïve borrowers to commit to loans under the pretext that their opportunity to borrow will soon vanish. The coup de grâce lies in persuading customers to sign their loan applications; once they have signed the applications, customers have a strong psychological urge to justify their decisions, rather than second-guess them.¹²⁴ In the end, the borrowers commit to the loans, grateful for the lenders' personal service and willingness to loan them money.

c. Predatory Lenders' Products.—As we have already discussed, the information asymmetries affecting borrowers are greatest when the borrowers are disconnected from the credit market. These borrowers are least able to understand the terms of their loans¹²⁵ and associated risks. In addition, they often do not know how to seek help understanding loan documents and identifying important questions to ask lenders. Predatory lenders take advantage of the borrowers' lack of sophistication and lack of

122. See Forrester, *supra* note 81, at 389.

123. See, e.g., *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 535 (N.J. Super Ct. App. Div. 2001) (noting evidence that a home-improvement contractor “arranged a limousine to transport” homeowners to the lender’s “office to close the loan”).

124. Cf. Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 649–55 (1996) (describing similar sales tactics and behavioral responses in the securities industry).

125. See Lax et al., *supra* note 105, at 10.

access to financial advice and insert loan terms that are not transparent¹²⁶ and that would not be acceptable to more experienced borrowers.

In the prime market, borrowers with the best credit can obtain conventional-rate mortgages with payment terms that are relatively easy to analyze. The prime market features conventional fixed-rate mortgages with interest rates that do not fluctuate, thereby assuring borrowers that they will have the same payments for principal and interest every month for the life of the loan. Although the prime market does offer balloon payments and adjustable-rate mortgages, these mortgages are alternatives to the fixed-rate variety and are left to the discretion of borrowers. Prepayment penalties are likewise rare in the prime market. Thus, prime borrowers who are contemplating a fixed-rate loan can calculate with assurance the due date and amount of each payment due under their loans. Their ability to repay hinges solely on their future income and not on changes in the wider economy such as interest-rate movements.

In contrast to prime-mortgage lenders, predatory lenders rarely make plain-vanilla, fixed-rate loans with easily understood payment terms. Most predatory loans contain terms that require borrowers to make difficult probabilistic computations about the likelihood and magnitude of future market events¹²⁷ that are entirely outside their control. For example, predatory loans often feature adjustable-rate mortgages (ARMs) whose interest rates and, therefore, monthly payments fluctuate. In order for borrowers to predict their monthly mortgage payments in any rigorous way, they would have to calculate the probability of changes in interest rates for each period over the life of the loan, and determine how the projected changes in the interest rates would affect their monthly payments. Introductory teaser rates, which are also common in predatory loans, exacerbate matters by masking true interest rates and lulling loan applicants into a false sense of security about their ability to repay. Predicting interest-rate movements confounds even the brightest financial analysts. Thus, the prevalence of adjustable-rate mortgages in predatory loans makes it difficult for borrowers to predict their ability to meet their monthly payments with any confidence.

126. See HUD-Treasury Report, *supra* note 8, at 60, 89–99 (describing a variety of techniques that take advantage of consumer ignorance, including negative amortization, prepayment penalties, balloon payments, mandatory-arbitration clauses with limited borrower rights, financing points and fees, and packaging credit-insurance policies into the loan).

127. In this way, the technological advances that have helped lenders better assess credit risk and predict movements in the market with respect to more complex products have served to exacerbate, rather than ease, informational asymmetries suffered by borrowers. Cf. John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1196 (1997) (commenting that earlier technological advances in securities trading widened the information gap between professional traders and average investors).

To compound the market uncertainty associated with adjustable-rate mortgages, the ARMs that predatory lenders market often contain onerous provisions that increase the risk to borrowers' equity. For example, ninety-eight percent or more of subprime home loans contain substantial prepayment penalties that exceed the liquid resources of most LMI borrowers.¹²⁸ On their face, prepayment penalties only seem problematic if borrowers seek to refinance their loans on their own initiative. The reality, however, is that in the subprime market, prepayment penalties spring to life when borrowers default or are forced to refinance on less favorable terms in order to avoid default. Because borrowers with ARMs and prepayment penalties cannot predict with confidence their ability to meet their loan obligations, they cannot predict the likelihood that they will trigger the prepayment penalties.

A smaller subset of subprime loans involves balloon payments, which require probabilistic computations of a different nature. With balloon payments, the date and amount of the payments are certain.¹²⁹ What is unknown at the outset, however, is whether market conditions and borrowers' future financial situations will permit them to refinance on affordable terms when the balloon payments come due. While the availability and cost of future credit is a concern for all borrowers with balloon payments, it is a particular concern for borrowers with limited access to credit on affordable terms.¹³⁰ Finally, predatory loans often authorize special fees and higher interest rates if borrowers default. When loans are consummated, borrowers cannot know whether they will fall behind on their loan payments and incur these additional fees or higher interest rates.

Most borrowers, whether they are LMI borrowers or more affluent, are risk-averse and measure the benefits of entering into loans against the downsides—the increased debt burden and the risk of default and foreclosure. Almost everyone who engages in this calculation, however, “discount[s] risks whose likely occurrence is some time away.”¹³¹ Such discounting may seem rational because most mortgage borrowers, including LMI borrowers, have never lost their homes to foreclosure before. Just the same, LMI borrowers may be more likely to make unintentional errors in discounting because of their tight finances and the complex, probabilistic terms of their subprime loans. The consequences of such errors are more

128. See HUD-Treasury Report, *supra* note 8, at 93; see also *infra* app.

129. Balloon payments can be uncertain, however, when they contain hidden fees or unpaid interest due to missed payments or negative amortization.

130. See, e.g., *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 537 (N.J. Super Ct. App. Div. 2001) (relating the story of a homeowner who “was confused because of the number and complexity of the documents,” and reporting that “[w]hen she asked [the lender’s attorney] if the principal balance [would] be due in fifteen years, the attorney told her not to worry about it”); see also *infra* app.

131. See *Langevoort*, *supra* note 124, at 640.

devastating for LMI borrowers, who have fewer personal and familial resources to draw upon if they misjudge the risks that they can afford.

In short, the borrowers targeted by predatory lenders end up committing to complex mortgages with probabilistic terms, while prime borrowers, who are generally more sophisticated, can take advantage of straightforward, fixed-rate mortgages without any penalty provisions or contingent price terms.¹³² In the end, the victims of predatory lenders sign documents without having a clear sense of the terms of the contracts, how much they borrowed, what they purchased, the terms of repayment, or the risks they assumed.

3. *Efforts by Lenders and Secondary Market Participants to Protect Themselves Against the Risks of Predatory Lending Will Not Correct Market Inefficiencies.*—Borrowers are not the only market actors who can be harmed when predatory lenders and predatory brokers exploit information asymmetries. Predatory brokers deceive lenders about borrowers' true credit risks, and predatory lenders similarly deceive secondary-market purchasers. As a result, both lenders and secondary-market participants can assume more risk than they intend and may be faced with unexpectedly high numbers of loans in default.

In this section, we describe how brokers can deceive lenders, and how lenders can deceive secondary-market participants. In addition, we posit why lenders and secondary-market institutions will not correct the information asymmetries and curb predatory lending. Our basic argument is this: (1) some market participants do not have sufficient incentives to monitor other actors, (2) it is often difficult for lenders and secondary-market participants to identify predatory lenders and brokers, and (3) even when lenders and secondary-market actors have incentives and the ability to implement safeguards, any protections they implement do not trickle down to benefit consumer victims of predatory lending.

Lenders who sell loans on the secondary market often use brokers¹³³ to market their products.¹³⁴ These brokers have little incentive to ensure that borrowers are creditworthy because they do not bear the risk of loss in the

132. See Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2363–64 (1996) (making the point that unsophisticated investors in the securities markets can invest in safe money-market funds or government bonds in which return of capital is essentially guaranteed and does not require complex probabilistic calculations).

133. The mortgage-broker industry estimates that brokers originate over half of all home mortgages. See Patrick Barta, *Land Grab? Why Big Lenders Are So Frightened by Fannie and Freddie*, WALL ST. J., Apr. 5, 2001, at A1, 2001 WL 2859344.

134. See HUD-Treasury Report, *supra* note 8, at 37. By using brokers, lenders reduce their overhead substantially because they do not have to pay for office space, support staff, or employee benefits.

event of default.¹³⁵ Brokers do, however, have an incentive to deceive lenders regarding borrowers' ability to pay. This is because lenders typically compensate brokers only for loans that the lenders approve, based on the interest rate and the size of the loans.¹³⁶ For example, predatory brokers may write loans with very high interest rates that borrowers cannot afford and then falsify borrowers' credit histories to indicate to the lenders that the borrowers have the financial wherewithal to meet their loan obligations.¹³⁷ Brokers stand to benefit from such fraud in three ways: (1) loans are made that otherwise would have been denied, thereby generating commissions for the brokers, (2) these commissions are larger than normal because the face amount of the loans often is more than borrowers can afford, and (3) the brokers may earn yield-spread premiums.¹³⁸ Meanwhile, lenders have assumed the risk of loans that are very likely to default.

Lenders who sell loans on the secondary market may not care whether brokers deceive them about borrowers' default risks because the lenders do not bear the ultimate risk of loss.¹³⁹ In these situations, lenders have reduced incentives to police the brokers they use. Even when lenders retain predatory loans generated through brokers, if the lenders themselves are predatory, they can still make tidy profits by repeatedly refinancing the properties to strip borrowers of their equity, and then foreclosing.¹⁴⁰

Lenders who are not predatory may find it difficult to identify and exert control over predatory brokers. They can inadvertently finance predatory loans¹⁴¹ through brokers and not learn of the predatory nature of the loans for some time because borrowers generally do not default immediately. Additionally, if a broker originates predatory and nonpredatory loans, it may

135. See *id.* at 39–40 (explaining that mortgage brokers arrange financing with lenders and that the borrowers pay the brokers for this service).

136. See Mansfield, *supra* note 1, at 534 (noting that in these situations, the larger the loan, the higher the broker's fee); HUD-Treasury Report, *supra* note 8, at 40 (explaining that brokers receive payments not only from borrowers but also from lenders in the form of yield-spread premiums).

137. See HUD-Treasury Report, *supra* note 8, at 22; see also Barta, *supra* note 38, at A1 (writing that “[s]ince brokers at times collect fees based on loan size and have little or no stake in whether the mortgage defaults, they could be tempted to pressure appraisers to come up with bigger values”).

138. Stanley D. Longhofer, *Measuring Pricing Bias in Mortgages*, ECON. COMMENT., Aug. 1, 1998, at 1–2 (explaining that many lenders allow their brokers to negotiate with borrowers for a rate higher than the minimum price on the rate sheet and that they allow brokers to retain any points borrowers pay over the minimum they require); see also Stanley D. Longhofer & Paul S. Calem, *Mortgage Brokers and Fair Lending*, ECON. COMMENT., May 15, 1999, at 2 (noting that lenders provide the brokers with rate sheets that state the minimum price for loans). For further discussion, see *supra* text accompanying notes 21–22.

139. See Barta, *supra* note 38, at A1 (noting that since lenders can commonly sell loans on the secondary market, they should be less concerned about the accuracy of property appraisals).

140. Of course, this is not possible when brokers deceive lenders by inflating the amount of equity borrowers have in their property.

141. These typically are loans for which the brokers inflated the borrowers' income streams to suggest that they could afford the payments when, in fact, they could not.

be difficult for a lender to determine whether any particular default was bad luck or the result of a predatory loan. Even in the best-case scenario, where a lender identifies and terminates its relationship with a predatory broker, the broker can always find another predatory lender with which to work and predatory lending will continue.

Principal-agent problems also arise because lenders have first-hand access to information about borrowers' creditworthiness.¹⁴² This information is not normally available to secondary-market purchasers who must, instead, rely on lenders' assurances about credit quality. An additional factor compounds the effect of this informational asymmetry. Predatory lenders, who sell their loans on the secondary market, make their profits from high origination fees. Thus, their incentives to maintain credit quality are low relative to those of loan purchasers. As a result of the information asymmetry and the lenders' reduced commitment to creditworthiness, lenders can obscure from loan purchasers the true risk of borrowers' defaulting while generating substantial profits from up-front points and fees.

Secondary-market institutions can protect themselves¹⁴³ to some extent from deception by lenders. For example, secondary-market actors can insert recourse provisions, requiring that lenders take back loans in the event of borrower default. Recourse provisions will not necessarily deter predatory lending. If defaulting borrowers have sufficient equity in their property, the lenders can take back the loans pursuant to the recourse provisions, flip the loans a few times, each time tacking on huge fees, and eventually foreclose. Alternatively, if the lenders are undercapitalized and secondary-market institutions try to invoke recourse provisions following widespread defaults,

142. Wayne Passmore & Roger Sparks, *The Effect of Automated Underwriting on the Profitability of Mortgage Securitization 7* (May 1997) (unpublished manuscript, on file with the Texas Law Review) (explaining that mortgage originators try to hide information on borrowers' bad credit histories from purchasers).

143. The securities market is beginning to look at the risks created by information asymmetries. Some investors are demanding unbundling of loan packages so that they can have greater information on the risks associated with individual loans. See Mark L. Korell, *The Workings of Private Mortgage Bankers and Securitization Conduits*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 99. Others are requiring that lenders retain the loan-servicing rights, in which case the lenders would have some interest in creditworthiness because servicing costs rise with the risk of default. In addition, secondary-market participants can protect themselves from losses through insurance, diversifying their risk, recourse provisions, and bonding.

For a discussion of how the secondary market can insulate itself against the risks created by inadequate incentives to assure credit quality, see Neil D. Baron, *The Role of Rating Agencies in the Securitization Process*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 85-86 (suggesting, among other options, the possibility of obtaining a guarantee from a surety company); see also Karen B. Gelemt, *Comment: Avoiding Predator Risk in the Secondary Market*, AM. BANKER, July 7, 2000, at 9 (outlining the measures secondary-market participants should take when evaluating loan packages and originators). An unanswered question is the extent to which secondary-market actors could be liable for the predatory-lending activities of the lenders from whom they buy loans. See Robert Julavits, *Legal Risks Move Up Financial World's Food Chain*, AM. BANKER, Apr. 12, 2000, at 1, 7, 22 (discussing predatory-lending claims brought against trustees and underwriters).

the lenders can declare bankruptcy or dissolve. Of course, if lenders continuously misinform loan purchasers about risk, the lenders' ability to sell loans on the secondary market will decline.¹⁴⁴ But lenders, like brokers, can tuck predatory loans in with bundles of good loans having low default rates, making it difficult for secondary-market participants to detect the lenders' predatory-lending activities. Of the various measures that legitimate lenders and secondary-market participants can implement to protect themselves from predatory brokers and lenders, none adequately protects the victims of predatory lending.

4. *Deterrents to Banks and Thrifts Making Loans to Borrowers Who Are Disconnected From the Credit Market.*—If, in fact, there is unmet demand in LMI neighborhoods and borrowers are entering into loans with inflated fees that do not reflect their risk levels, banks, thrifts, and legitimate subprime lenders should be entering the market¹⁴⁵ and stimulating competition. This has not occurred. We posit that this disequilibrium has arisen because there are disincentives for banks and thrifts to enter the subprime market and because the business models that legitimate subprime lenders employ prevent them from identifying many of the potential borrowers who ultimately become victims of predatory lenders.

a. *Reputational Concerns.*—Banks and thrifts are community institutions with valuable reputations. They may perceive that even legitimate subprime lending could damage their reputations. Subprime loans entail a greater risk of default either because of risks associated with the particular borrowers or the risk that the assets securing the loans will depreciate because of unstable prices¹⁴⁶ in LMI neighborhoods. When applicants present higher risks, lenders will either charge higher, risk-adjusted prices or reject the applicants. Either response could evoke community protests that the lenders are being unfair.¹⁴⁷ Furthermore, in some cases, the only way to realize the price of a loan is through

144. See *Market for B & C Servicing on the Rise*, NAT'L MORTGAGE NEWS, Sept. 22, 1997 (describing the negative effect low ratings have on an actor's ability to sell future loans for securitization); Brendsel, *supra* note 65, at 26 (observing that lenders have a reduced incentive to maintain credit quality because they sell the loans rather than service them).

145. Less than 2% of FDIC-insured banks have significant subprime loan portfolios. Mark Maremont & William M. Bulkeley, *FDIC Seizes Chicago-Area Thrift Institution*, WALL ST. J., July 30, 2001, at C1, 2001 WL 2871049.

146. If neighborhood housing prices are dropping or there is a probability that they will drop in the future, the value of borrowers' collateral will decrease. See Robert B. Avery et al., *Information Dynamics and CRA Strategy*, ECON. COMMENT., Feb. 1, 1997, available at <http://www.clev.frb.org/research/com97/0201.htm>.

147. There is evidence that banks feel uncomfortable charging high interest rates because they are concerned that the public will perceive them as "unfair." See Hylton & Rougeau, *supra* note 64, at 258 (citing David D. Haddock & Fred S. McChesney, *Why Do Firms Contribute Shortages? The Economics of Intentional Mispricing*, 32 ECON. INQUIRY 562, 566–68 (1994)).

foreclosure.¹⁴⁸ Banks often find foreclosure socially repugnant as well as unprofitable, and worry that multiple foreclosures could hurt their reputations.¹⁴⁹

Banks and thrifts also are concerned that if their rejection rates¹⁵⁰ or risk-adjusted prices bear any correlation with race, they will be perceived as engaging in mortgage-lending discrimination.¹⁵¹ This perception could hurt their reputations and give rise to enforcement actions and costly lawsuits.¹⁵²

Predatory lenders are less concerned about their reputations because they are simply conduits, not community institutions.¹⁵³ And, to the extent predatory lenders do care when their reputations are tarnished, they can readily dissolve and re-emerge in the same communities under different names. Another feature of predatory lenders that distinguishes them from banks and thrifts is that high interest rates and foreclosure, which may be abhorrent to banks, are not repugnant to predatory lenders. To the contrary, high interest rates and foreclosure are defining features of their lending practices. Lastly, the threat of lawsuits alleging fair-housing violations may be inconsequential for predatory lenders because these lenders typically are undercapitalized and therefore judgment-proof.

b. Regulatory Concerns.—Banking regulations that mandate loan-loss reserves and require adequate capitalization may create further obstacles to banks that want to expand into subprime lending.¹⁵⁴ If banks and thrifts engage in subprime lending, bank examiners may view the loans as a risk to

148. Cf. Carrick Mollenkamp et al., *Banker Beware: As Economy Slows, "Subprime" Lending Looks Even Riskier*, WALL ST. J., Aug. 16, 2001, at A1, 2001 WL 2872861 (noting that banks' reputations may be damaged if they have to "crack[] down on financially shaky borrowers who [are] late on their mortgage payments").

149. Being perceived as a hawkish lender could have particularly serious repercussions for banks and thrifts that want to expand their financial services and are therefore subject to close CRA scrutiny in the community. See MCCOY, *supra* note 95, § 8.03[1][b][ii].

150. See George W. McCarthy & Roberto G. Quercia, *Bridging the Gap Between Supply and Demand: The Evolution of the Homeownership, Education and Counseling Industry* (2000), at <http://www.housingamerica.org/docs/RIHA00-01.pdf>.

151. See LITAN ET AL., *supra* note 88, at 76.

152. See Duca & Rosenthal, *supra* note 61, at 101 (discussing how the fear of liability under fair-lending laws may make lenders wary of using risk-adjusted prices if they are correlated with race).

153. Predatory lenders can typically sweep through communities until their tactics are disclosed and community pressure forces them to relocate or resurface under a new name. See, e.g., Opper & McGeehan, *supra* note 19, § 3, at 1 (explaining why consumer advocates fear that the predatory practices of Associates First Capital will continue unabated because they will be hidden by Citigroup's franchise and brand name).

154. See WEICHER, *supra* note 10, at 30. Of course, banks may be able to avoid some of these regulatory concerns by selling the higher-risk loans on the secondary market. See Baron, *supra* note 143, at 83. At worst, the regulatory concerns include the possibility of closure. In July 2001, FDIC regulators closed down Superior Bank FSB when the bank "ran aground lending money to people with bad credit." David Barboza & Jonathan D. Glater, *S. & L. Fails, Along With a Friendship*, N.Y. TIMES, July 31, 2001, at C1, LEXIS, News Library, NYT File.

the safety and soundness of the banks and require that the banks increase their loan-loss reserves. In addition, federal banking regulators have tightened capital requirements for subprime loans, and they are expected to tighten those requirements even further.¹⁵⁵ In contrast, nonbank lenders are not subject to federal loan-loss reserve or capitalization requirements.¹⁵⁶

155. In January 2001, federal banking regulators increased the capital requirements for all institutions with subprime lending programs that equaled or exceeded 25% of their tier one regulatory capital. See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ET AL., EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 2, 5-6 (2001) (stating that, in general, a lending institution should hold capital against a subprime portfolio in an amount one-and-a-half to three times greater than for non-subprime assets of a similar type); cf. Seth Lubove, *Bust and Boom in the Subprime Market: Wall Street Overhyped It a Few Years Ago and Underrates It Now: The Business of Lending to Iffy Consumers*, FORBES, Dec. 27, 1999, at 71 (citing a statement by then-FDIC Chairman Donna Tanoue that the banks she oversaw that were involved with subprime lending would be "getting extra attention from her examiners"); Susan M. Phillips, *The Place of Securitization in the Financial System: Implications for Banking and Monetary Policy*, in A PRIMER ON SECURITIZATION, *supra* note 60, at 129, 137 (stating that the Federal Reserve is concerned about "whether there is an appropriate level of protection for unsophisticated parties" and has questions about "banks' responsibilities in assessing whether a transaction is appropriate for a particular customer"); Jeffery W. Gunther, *Between a Rock and a Hard Place: The CRA-Safety and Soundness Pitch*, ECON. & FIN. REV., 2d Quarter 1999, at 32 (discussing safety and soundness concerns in the context of CRA lending).

Banks and thrifts also face heavier future reporting requirements for subprime loans than nonbank subprime lenders. In May 2000, federal banking regulators proposed amending call reports by banks to include information on subprime loans, securitizations, and asset-sale activities. See Federal Reserve System, Proposed Agency Information Collection Activities; Comment Request, 65 Fed. Reg. 34,801 (proposed May 31, 2000); see also Office of Thrift Supervision, Proposed Agency Information Collection Activities, 65 Fed. Reg. 48,049 (proposed Aug. 4, 2000); Kenneth Talley, *Proposal for More Data on Subprime Loans Could Burden Banks, Limit Credit*, CBA SAYS, 75 BNA BANKING REP., Aug. 28, 2000, at 272. While the proposed reporting of subprime loan data remains under study, the regulators adopted another of the proposed reporting requirements. See Federal Reserve System, Agency Information Collection Activities: Submission for OMB Review, 66 Fed. Reg. 13,368 (Mar. 5, 2001). In February 2002, the Federal Reserve Board addressed reporting disparities in part by expanding reporting responsibilities under HMDA for nonbank subprime lenders. See Federal Reserve, *Home Mortgage Disclosure*, *supra* note 1, at 7237-38 (codified at 12 C.F.R. § 203.4 (2002)).

Regulators are also concerned about the risks that arise when banks purchase securities backed by subprime mortgages that could be predatory. In response to this concern, in December 1999 the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision announced that, in light of securitization, they would review institutions that purchased mortgage-backed securities on the secondary market and might "require, in appropriate circumstances, that [these] institutions hold additional capital commensurate with their risk exposure." OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., INTERAGENCY GUIDANCE ON ASSET SECURITIZATION ACTIVITIES 11 (1999). Federal banking regulators also adopted joint interagency regulations that require insured banks and thrifts to hold higher capital against residual interests retained from asset securitizations. See Federal Reserve System, Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations, 66 Fed. Reg. 59,614 (Nov. 29, 2001) (codified at 12 C.F.R. pt. 225 (2001)).

156. See HUD-Treasury Report, *supra* note 8, at 18 (noting that the absence of federal oversight is a factor that helps to make the subprime lending market vulnerable to predatory practices). There are some regulations and laws that predatory lenders may be more sensitive to than legitimate lenders. For example, one subprime lender stated that it would "sly away from states like Illinois with . . . stringent licensing requirements." Scott Kersnar, *JB1 Funding Stresses*

c. *Difficulties Assessing Creditworthiness.*—Borrower creditworthiness and collateral are core concerns of regulated lenders¹⁵⁷ regardless whether they are engaged in prime, subprime, or predatory lending. This is because bank examiners require banks to document the ability of borrowers to repay their loans and the adequacy of the equity in the property securing the loans. These concerns, which unregulated lenders do not have, are made more burdensome by the fact that banks and thrifts are ill-equipped to evaluate the creditworthiness of many LMI borrowers or to assess property values in LMI neighborhoods.

LMI borrowers are less likely than more affluent borrowers to have credit histories that fit neatly into banks' underwriting standards.¹⁵⁸ For example, it is not uncommon for LMI borrowers to receive some or all of their income in cash. Because of problems verifying cash income, banks' underwriting standards may exclude income received in cash when calculating an applicant's income. Lenders who want to make loans to LMI borrowers need to develop special tools to assess LMI borrowers' creditworthiness. Banks and thrifts are poorly suited¹⁵⁹ to developing this expertise because their function is to provide diverse services, from deposit-taking to commercial and personal lending. The cost of developing new risk-assessment methods¹⁶⁰ might well exceed any potential gains they would generate from making loans in LMI communities.¹⁶¹

Service as It Starts High LTV Lending, NAT'L MORTGAGE NEWS, Sept. 22, 1997. Similarly, predatory lenders may avoid states where the costs of foreclosure are high and instead opt to focus their lending activity in states where they can strip equity and foreclose more economically. See Claurette & Herzog, *supra* note 91, at 221 (observing that foreclosure rates are higher in states where the laws facilitate the foreclosure process); Terrence M. Claurette, *State Foreclosure Laws, Risk Shifting, and the Private Mortgage Insurance Industry*, 56 J. RISK & INS. 544, 547 (1989) (citing a 1975 Federal Home Loan Bank Board study that concluded that "the magnitude of the financial impact of foreclosure is a function of state foreclosure law"); Austin J. Jaffe & Jeffrey M. Sharp, *Contract Theory and Mortgage Foreclosure Moratoria*, 12 J. REAL EST. FIN. & ECON. 77, 80–82, 88 (1996) (discussing the impact of foreclosure-moratoria legislation on loan prices).

157. This may be less true when banks can sell loans immediately on the second market; however, regulators would still review the loans and the banks would not be able to evade secondary-market controls, like recourse provisions, easily by dissolving or declaring bankruptcy in the event of multiple defaults.

158. See LITAN ET AL., *supra* note 88, at 87–88. For example, LMI borrowers are more likely to have weak or nonexistent credit histories. Similarly, some LMI borrowers—including those who are self-employed or who function solely in the cash economy—do not have documentation of their finances in a form that is easy for lenders to assess.

159. See Avery et al., *supra* note 146 (noting that it is expensive to gather information on loan applicants and neighborhoods).

160. See WEICHER, *supra* note 10, at 36 (explaining that "[e]ach mortgage application and each closed loan is an individual situation, and each must be evaluated individually" and that automated underwriting systems "cannot be applied accurately to subprime loans"); see also Hylton, *supra* note 84, at 211–14 (discussing the difficulties in assessing the credit risk of LMI borrowers).

The increased availability of historical data on subprime loans and more sophisticated underwriting models should lead to more cost-effective and accurate risk assessment throughout the home-mortgage market. Robert B. Avery et al., *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621, 627 (1996); see also Raphael W. Bostic & Brian J.

Similarly, the lack of available data on home values in LMI neighborhoods can impede banks' ability to accurately assess the value of property securing loans. In low- and moderate-income communities, where there are fewer home sales, there is little comparative data on home values.¹⁶² Without reliable comparative data, banks may not be able to provide the documentation on home values that examiners require. Given that traditional methods for validating home appraisals in the prime market are not available, lenders need to develop alternative tools for determining the value of homes. Again, this would require a level of specialization and an expenditure of funds that banks and thrifts may be unwilling to assume.

Relative to banks and thrifts, predatory lenders are much less concerned about borrower risk because they can engage in an array of possible deceptions and then unload their loans on the secondary market. Even if secondary-market institutions attempt to shift the loss back to lenders when borrowers default, lenders can avoid liability by dissolving or declaring bankruptcy. In addition, predatory lenders do not have regulators and examiners looking over their shoulders to ensure that borrowers are creditworthy and that their loans are adequately collateralized. Lastly, predatory lenders are willing to pursue foreclosure aggressively, which makes it more likely that they will recover their investments before property values decline. When predatory lenders do engage in some evaluation of borrowers' risk, they can do so more cost effectively than banks. This is because predatory lending is a niche market. Lenders serving this market focus on one class of borrowers and provide only one service—home loans. This enables them to concentrate on particular geographic areas, and, either directly or through brokers, gather information about the relevant economic

Surette, *Have the Doors Opened Wider? Trends in Home Ownership Rates by Race and Income* 9 (Apr. 1, 2000) (unpublished manuscript, on file with the Texas Law Review) (discussing the efficiency gains from credit scoring and automated underwriting in the subprime market).

161. See Klausner, *supra* note 53, at 1567–68 (noting that a model in which risk-assessment costs are high predicts lower rates of lending, and observing that community-development experts have suggested that these costs are partly responsible for low lending rates in LMI neighborhoods); see also Robert B. Avery et al., *Neighborhood Information and Home Mortgage Lending*, 45 J. URB. ECON. 287 (1999) (finding empirically that there are economies of scale to collecting information on neighborhood characteristics and that insufficient market demand may prevent banks from exploiting these economies). In addition to the costs associated with assessing risk, banks would incur additional costs servicing loans. This is because the servicing of high-risk loans entails special expertise and more personnel than prime loans require. Lax et al., *supra* note 105, at 18.

162. See William W. Lang & Leonard I. Nakamura, *A Model of Redlining*, 33 J. URB. ECON. 223 (1993) (modeling the effect of limited sales transactions on banks' willingness to lend in poor and minority areas); David C. Ling & Susan M. Wachter, *Information Externalities and Home Mortgage Underwriting*, 44 J. URB. ECON. 317 (1998) (establishing empirically the Lang and Nakamura hypothesis).

conditions and residents.¹⁶³ They then use this information to determine home values and borrowers' creditworthiness.

d. Discrimination.—Predatory lenders disproportionately target communities of color. To the extent that banks have an aversion to lending to people of color that outweighs any market incentives to expand into subprime or predatory lending, they will refuse to lend in these areas.¹⁶⁴ Similarly, lenders may use race as a proxy if they find that it is correlated with creditworthiness. If race is easy to determine and creditworthiness is not, then making loans based on race can be more efficient for lenders than investing significant resources into determining applicants' ability to pay.¹⁶⁵ Of course, either type of discrimination, whether based on animus or efficiency, is illegal. In contrast to banks, some of which may discriminate against people of color, predatory lenders target people of color precisely because discrimination, as well as credit rationing, has prevented these borrowers from having access to capital.

e. Geographic Constraints.—Banks and thrifts, for the most part, do not have a significant presence in LMI neighborhoods.¹⁶⁶ As a result, they

163. For a discussion of a bank that has successfully specialized in nonpredatory, LMI, neighborhood-based lending, see Klausner, *supra* note 53, at 1578–79.

164. The existence and scope of mortgage-lending discrimination is hotly debated. See Hylton & Rougeau, *supra* note 64, at 250–51, 268–75 (discussing the economic theory of discrimination and the various studies aimed at determining whether there is lending discrimination); Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 *FORDHAM URB. L.J.* 281, 283 (1993) (citing studies of mortgage-lending discrimination); James Berkovec et al., *Mortgage Discrimination and FHA Loan Performance*, 2 *CITISCAPE* 9 (1996) (analyzing FHA data and finding no evidence of mortgage lending discrimination); Robin Smith & Michelle DeLair, *New Evidence from Lender Testing: Discrimination at the Pre-Application Stage*, in *MORTGAGE LENDING DISCRIMINATION: A REVIEW OF THE EXISTING EVIDENCE* 23 (Margery Austin Turner & Felicity Skidmore eds., 1999) (finding evidence of race discrimination by some lenders).

Lawrence Lindsey, a former Federal Reserve Board Governor, posited that to the extent banks discriminate, it is against marginal borrowers. He contends that if a borrower presents a very good risk, a bank will enter into the loan without regard to the applicant's race. Similarly, if an applicant is an unequivocally bad risk, a bank will reject the applicant regardless of her race. Banks will engage in discrimination when faced with borrowers who fall between these two groups—the marginal applicants—because this is where lenders can exercise the greatest discretion. See Hylton & Rougeau, *supra* note 64, at 260.

165. See Charles W. Calomiris et al., *Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor*, 26 *J. MONEY, CREDIT & BANKING* 634, 650 (1994) (arguing that, because information-gathering is expensive, lenders are more likely to judge potential borrowers by race and economic stereotypes surrounding race).

166. Studies have found that banks and thrifts are less likely to have branches in LMI neighborhoods than in more affluent areas. See John P. Caskey, *Bank Representation in Low-Income and Minority Urban Communities*, 29 *URB. AFF. Q.* 617 (1994). There is some evidence that the reduction in the number of branch bank offices in LMI neighborhoods reflects declining customer bases in these neighborhoods. See Robert B. Avery et al., *Changes in the Distribution of Banking Offices*, 83 *FED. RES. BULL.* 707, 719–21 (1997).

have limited opportunities to develop relationships with LMI borrowers at retail sites¹⁶⁷ or to obtain valuable information on the social capital in LMI communities.¹⁶⁸ To compound this problem, LMI borrowers may be reluctant to approach banks and thrifts outside their own neighborhoods.¹⁶⁹ As a result, the most effective means for banks to target customers for subprime loans would be to establish branch banks in LMI neighborhoods, operate out of storefronts,¹⁷⁰ or to solicit borrowers door-to-door. Banks may perceive that the cost of establishing new offices would outweigh any profits¹⁷¹ they could realize from subprime or predatory lending. Less expensive options, like storefront operations and door-to-door solicitations, often run counter to bank culture.

f. The Role of Holding Company Subsidiaries and Affiliates of Banks and Thrifts.—Although there are compelling reasons why banks and thrifts may be reluctant to enter LMI communities and compete with predatory lenders, banks and thrifts can be involved in and benefit from

167. Cf. Michael S. Padhi et al., *Credit Scoring and Small Business Lending in Low and Moderate Income Communities*, in BUSINESS ACCESS TO CAPITAL AND CREDIT 587, 604–05 (Jackson L. Blanton et al. eds., 1999) (finding empirically that the presence of branch banks in LMI communities is “a significant factor” in the number of small-business loans that lenders originate).

168. See Hylton, *supra* note 84, at 217–19. A number of major cities have small, minority-owned banks that one might expect to fill some of the gap in lending that was created when larger banks left LMI neighborhoods. But anecdotal and statistical evidence suggests that these banks have not filled the gap and that their lending practices parallel those of their large, commercial counterparts. This may be because the smaller banks do not have sufficient capitalization. See Hylton & Rougeau, *supra* note 64, at 254–55.

169. See LITAN ET AL., *supra* note 88, at 18.

170. Banks decide where to locate their offices based on the demand for both consumer and business services. In contrast, finance companies and other lenders that focus on consumer lending can locate their offices where the demand for mortgages is greatest without having to consider other factors such as business demand. See Dwight R. Lee & James A. Verbrugge, *The Subprime Home Equity Lending Market: An Economic Perspective* 20 (July 1, 1998) (unpublished manuscript, on file with the Texas Law Review).

Some banks have established branches in supermarkets or partnered with check-cashing outlets. See, e.g., Laura Mandaro, *Union Bank, Check Casher Team Up*, AM. BANKER, Sept. 25, 2000, at 1 (describing how a partnership between Union Bank and a check-cashing chain is helping to deliver banking services to low-income neighborhoods). These lenders have the vantage point and customer base that could make it profitable for them to engage in LMI lending.

171. Even if banks opened new branches in LMI neighborhoods, borrowers who have experienced mortgage-lending discrimination by banks in the past or who for other reasons are wary of banks might not consider applying for bank loans. This could further reduce the potential profitability to banks of setting up branches in LMI neighborhoods. See Hylton & Rougeau, *supra* note 64, at 250 (discussing the demoralizing effects of discrimination); see also ANTHONY PENNINGTON-CROSS ET AL., CREDIT RISK AND MORTGAGE LENDING: WHO USES SUBPRIME AND WHY? 16 (Research Institute for Housing America, Working Paper No. 00-03, Sept. 2000) (discussing the role that fear of discrimination may play in the decision of whom people of color approach for loans); Barbara A. Good, *The “Unbanked” Population: Who Are They and Why Do They Shun Banks?*, COMMUNITY REINVESTMENT F. 2 (1998) (citing JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR (1994) for the proposition that unbanked consumers harbor a deep-seated distrust of financial institutions and prefer to handle their financial affairs through alternative financial service providers).

predatory lending in a veiled capacity. Some banks and thrifts, whose direct lending is legitimate, have subsidiaries and affiliates that employ predatory-lending practices.¹⁷² For example, in July 2001, employees of CitiFinancial Mortgage, a subprime mortgage lending unit of Citigroup, Inc., signed affidavits alleging that CitiFinancial “had a policy of not giving borrowers legally required disclosures in a timely manner, that employees there regularly forged borrowers’ signatures on legal documents, and that loan officers were instructed to avoid telling potential borrowers about points and fees on loans.”¹⁷³ These alleged practices fall within our definition of predatory lending.

Bank subsidiaries and affiliates can shield their relationships with their parent or sister banks by functioning under different names.¹⁷⁴ The lack of a transparent association allows the subsidiaries and affiliates to offer predatory loans without many of the regulatory and reputational concerns that the banks would have to take into account if they adopted predatory-lending tactics.¹⁷⁵ Banks and thrifts can also play a role in predatory lending by purchasing securities that are backed by mortgages obtained through predatory lending.

5. *Impediments to Legitimate Subprime Lenders Making Loans to Borrowers Who Are Disconnected From the Credit Market.*—Although banks and thrifts may be reluctant to lend directly in LMI neighborhoods, one would expect that legitimate subprime lenders, who are not subject to safety-and-soundness regulation and have the capacity to specialize in higher-risk lending, would market their lower-priced products to LMI borrowers. Arguably, they should be underbidding predatory lenders and spurring a competitive market. The reality, however, is that even though subprime lenders have increased their lending to LMI borrowers, they have neither driven down the price of loans nor driven out predatory lenders.

The most likely explanation for this market failure has to do with differences in the ways that legitimate subprime and predatory lenders

172. During a period of declining profits on prime loans, banks may have a strong incentive to increase their bottom-line profitability by having subsidiaries enter the subprime or predatory-lending market. For a general discussion of banks purchasing subprime lenders, some of which could engage in predatory lending, see Lubove, *supra* note 155, at 71. See also Gilreath, *supra* note 103, at 149 (“One of the most important changes is the increased participation of banks in the subprime market.”).

173. Rob Garver, *Citi Corroborates Two Allegations*, AM. BANKER, July 30, 2001, at 4.

174. See LITAN ET AL., *supra* note 88, at 76 (discussing how banks can use subsidiaries to engage in subprime lending without having to contend with the same reputational concerns that banks face).

175. Because subsidiaries’ losses have an impact on their parent banks’ profits, banks with subsidiaries that engage in predatory lending may be more concerned about risk than other predatory lenders and may be subject to regulatory intervention if their subsidiaries are not profitable.

market their products and generate applicants. Legitimate subprime lenders, like banks and thrifts, rely on widespread, impersonal marketing to attract customers. They advertise their products through mass mailings, in newspapers, and on-line. This business model is based on the premise that their potential customers are people who are looking for loans and are comfortable contacting an anonymous lender or using a computer to apply for a loan. Given that the people who fall prey to predatory lenders tend not to be actively looking for loans, are disconnected from the credit market, and do not know how to shop for loans, they are unlikely to respond to the marketing techniques of legitimate subprime lenders.¹⁷⁶ As a result of these differences in marketing strategies, legitimate subprime and predatory lenders serve separate and distinct groups of borrowers. The legitimate subprime lenders attract and cater to borrowers who have blemished credit histories, but are knowledgeable enough about credit markets to shop for loans among legitimate subprime lenders. In contrast, predatory lenders solicit and cater to borrowers who need credit (and may or may not be high risk) and are disconnected from the credit market. For legitimate subprime lenders to attract the borrowers that predatory lenders serve, they would have to transform their business models and engage in unsavory practices that they may find untenable.

6. *Lack of Price Competition Among Predatory Lenders.*—One also would expect that competition among predatory lenders would drive down the price of loans. Again, information asymmetries prevent this from occurring.¹⁷⁷ The typical borrowers who commit to predatory loans often believe that they are ineligible for any credit. Frequently, they are not actively looking for loans even though they have pressing financial needs. These borrowers have little or no experience with lenders and loan terms,¹⁷⁸ and do not know how to shop for credit. The arrival of a lender on their doorstep just when they are facing a daunting financial obligation is a “dream come true.” They leap at the chance to obtain the money and look no further, fearful that the opportunity to borrow is fleeting.¹⁷⁹ As a result, they do not

176. One representative of a subprime lender has stated that her company is “desperate” for LMI borrowers for prime and subprime loans. Page Wittkamp, Panelist at Consumer Bankers Association Community Reinvestment Act Conference (May 21, 2001).

177. Economists are beginning to find empirical evidence that supports our position that the market for high-cost loans is inefficient. See Lax et al., *supra* note 105, at 11.

178. It is noteworthy that Freddie Mac is trying to reach these same borrowers by putting personal computers that have access to information on homeownership and credit at selected McDonald’s restaurants. Amilda Dymi, *Financial Literacy on McDonalds’ Menu*, NAT’L MORTGAGE NEWS, Aug. 6, 2001, 2001 WL 9322303. Many vulnerable borrowers, however, are not computer literate.

179. See HUD-Treasury Report, *supra* note 8, at 17–18. This is particularly true for borrowers who are facing a serious personal crisis, such as a family member’s medical care or a housing-code violation.

look beyond the lenders who approach them first. Although the predatory lenders who reach borrowers first do run the risk that other lenders will be on their heels and will offer less expensive loans, the lenders minimize this risk by creating a false sense of urgency¹⁸⁰ so that borrowers will move quickly to commitment and closing. This combination of market power¹⁸¹ and savvy enables predatory lenders to write loans with onerous terms that borrowers cannot decipher.¹⁸²

III. Remedies

For the most part, neither the states nor the federal government have comprehensive laws designed to redress predatory lending. Instead, victims of predatory lending currently must rely on a loose assortment of statutes and common-law rules that were not designed to address the devastating harm inflicted by predatory lenders. These remedies are rooted in traditional liberal notions of informed consent and free will.¹⁸³ Consistent with that liberal ideology, under current remedies, predatory-lending contracts are generally enforceable except where fraud or nondisclosure has operated in some way that is inimical to free will. Barring this sort of culpable misrepresentation, however, the law normally does not question the substance of predatory-loan terms.

180. Predatory lenders often accelerate the loan process by telling borrowers that the time period in which they can secure the loan is limited. *Id.* at 79.

One set of predatory-lending victims in Chicago reported that on the day that they were scheduled to sign their loan papers, their broker sent a limousine to take them to the closing. When they arrived, they were presented with a loan on terms that differed from those to which they had previously agreed. "Fearing that they would not be driven home from the unfamiliar area, they signed for the mortgage." Anthony Burke Boylan, "*Predatory Practices: Chain Reaction: Neighborhoods Face Aftershocks of Foreclosure Wave*," *CRAIN'S CHI. BUS.*, May 21, 2001, at 13, 2001 WL 7067044.

181. As Richard Hynes and Eric A. Posner have noted:

Even if there are numerous lenders in a market, each lender may have market power because of the inability of consumers to costlessly compare prices and terms. Depending on the source of the information failure, this may result in either an abnormally high price or abnormally harsh [loan] terms. Some creditors will lend only to those customers who are unable to compare the (price or nonprice) terms of the loan offered with the terms available elsewhere in the market.

Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance* 7 (Feb. 20, 2001) (unpublished manuscript, on file with the Texas Law Review), available at <http://www.law.uchicago.edu/lawecon/index.html>.

182. As one set of economists has written: "[T]he economic burden of any pricing inefficiency will rest on the shoulders of borrowers with subprime loans." Lax et al., *supra* note 105, at 19.

183. See, e.g., E. ALLAN FARNSWORTH, *CONTRACTS* § 4.29 (2d ed. 1990) ("[L]egislatures have favored . . . disclosure of terms, rather than control of terms . . . as more consistent with a market economy.").

A. *Market Discipline*

From the standpoint of neoclassical economics, market solutions are the preferred answer to predatory lending. Theoretically, if predatory lending results in profits that equal or exceed the profits generated by legitimate prime and subprime lending, competitors should enter the predatory-loan market and restore equilibrium. Similarly, if predatory lenders are exploiting information asymmetries to the detriment of secondary-market purchasers, we would expect secondary-market purchasers to step in to protect themselves, thereby forcing predatory lenders out of business.

Despite these predictions, the market will not correct. As we have already discussed, regulatory and reputational concerns impede legitimate lenders from entering the subprime market.¹⁸⁴ In addition, the marketing strategies that they would have to employ to reach the typical victims of predatory lending run counter to their business plans and firm culture. Likewise, secondary-market purchasers will not drive out predatory lenders. This is because the protections that secondary-market purchasers implement to insulate themselves from the harms arising from predatory lending do not trickle down to benefit the consumer victims of predatory lending.¹⁸⁵

B. *Remedies Under Contract Law and the Uniform Commercial Code*

Predatory loans are grounded in the law of contract and the Uniform Commercial Code, which govern promissory notes and security agreements. Most contract defenses go to defects in formation of assent, rather than to disparities in bargaining power or fairness in contracts' substantive provisions.¹⁸⁶

Three doctrines in the law of contracts and the UCC permit challenges to the underlying substance of contract provisions: unconscionability, impracticability, and frustration. Of these, the latter two generally do not apply to predatory-lending cases.¹⁸⁷ The doctrine of unconscionability holds out some promise for victims of predatory lending, although its utility in practice has been limited.

The equitable principle of unconscionability is found in section 2-302 of the Uniform Commercial Code, which states:

184. *See supra* section II(C)(4).

185. *See supra* section II(C)(3).

186. Traditional contract defenses include fraud, mental incompetency, incapacity, infancy, duress, undue influence, and mistake. In general (apart from infancy and fraud), these defenses are construed narrowly so as to preclude relief in the vast majority of cases. *See generally* FARNSWORTH, *supra* note 183, chs. 4-5, 9.

187. Impracticability only applies when a party to a contract cannot perform for reasons outside that party's control, such as a change in the controlling law. Frustration is limited to situations in which the contract relies on the occurrence of an event that later fails to materialize. *See generally* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 3-10 (5th ed. 2000).

If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause so as to avoid any unconscionable result.¹⁸⁸

Although section 2-302 only applies by its terms to “transactions in goods” and not to credit, numerous courts have extended the unconscionability doctrine to contracts generally.¹⁸⁹

Unconscionability has been defined to include “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”¹⁹⁰ For a number of reasons, many courts have been reluctant to condemn excessive prices as unconscionable, “without more.”¹⁹¹ As E. Allan Farnsworth has explained, “the price term is somewhat peculiar, for rarely can a party claim surprise as to price.”¹⁹² Of equal importance, courts have legitimate reservations about their competence to judge fairness as to price. Accordingly, to the extent that borrowers have prevailed in asserting unconscionability, they have largely prevailed only with respect to nonprice terms in loan contracts.¹⁹³

188. U.C.C. § 2-302(1) (1998).

189. See FARNSWORTH, *supra* note 183, § 4.28. The doctrine of unconscionability can be used as a defense to enforcement of a contract. See *id.* Recent cases have also allowed borrowers to sue affirmatively for unconscionability in order to obtain damages, rescission, or injunctive relief. See, e.g., *Eva v. Midwest Nat'l Mortgage Banc, Inc.*, 143 F. Supp. 2d 862, 894–96 (N.D. Ohio 2001); *Williams v. First Gov't Mortgage & Investors Corp.*, 225 F.3d 738, 747–49 (D.C. Cir. 2000); *Dienes v. McKenzie Check Advance of Wis., LLC*, No. 99-C-50, 2000 U.S. Dist. LEXIS 20389, at *12–*16 (E.D. Wis. Dec. 11, 2000); *Mitchem v. Am. Loan Co.*, No. 99-C1863, 2000 U.S. Dist. LEXIS 5785, at *9–*11 (N.D. Ill. Mar. 13, 2000); *Sharp v. Chartwell Fin. Servs. Ltd.*, No. 99-C3828, 2000 U.S. Dist. LEXIS 3143, at *10–*12 (N.D. Ill. Feb. 28, 2000); *Cobb v. Monarch Fin. Corp.*, 913 F. Supp. 1164, 1179 (N.D. Ill. 1995); *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 543–44 (N.J. Super. Ct. App. Div. 2001).

190. *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965).

191. See FARNSWORTH, *supra* note 183, § 4.28. For the rare cases to the contrary, see WHITE & SUMMERS, *supra* note 187, § 4-5 (“[T]he reported litigation based on excessive price has dwindled to a trickle.”). See also *Carpenter v. Suffolk Franklin Sav. Bank*, 346 N.E.2d 892, 900 (Mass. 1976) (involving a suit to enforce a mortgage); Steven W. Bender, *Rate Regulation at the Crossroads of Usury and Unconscionability: The Case for Regulating Abusive Commercial and Consumer Interest Rates Under the Unconscionability Standard*, 31 HOUS. L. REV. 721, 762 (1994) (noting that “[p]rice litigation has slowed under section 2-302” and that unfair-pricing claims generally proceed under newer statutes with more detailed standards). The fact that the plaintiff signed a non-negotiable boilerplate loan agreement that was drafted by the lender is usually not enough, standing alone, to demonstrate unconscionability. FARNSWORTH, *supra* note 183, § 4.28.

192. FARNSWORTH, *supra* note 183, § 4.28; see also WHITE & SUMMERS, *supra* note 187, § 4-5.

193. See, e.g., *Williams*, 350 F.2d at 450 (striking down a security provision that gave the seller the right to repossess all consumer purchases by a borrower if she missed a payment on any of her retail installment accounts, when the seller had sold the borrower a \$514 stereo on credit knowing that she had seven children and only received \$218 a month in welfare).

The ability to raise unconscionability as a defense, like many other contract defenses, is subject to further restrictions when parties who purchased loans on the secondary market sue delinquent borrowers. In those cases, the borrowers' ability to raise defenses is severely limited by the holder-in-due-course doctrine. Under that doctrine, a secondary-market purchaser can defeat "personal" defenses if it meets the following requirements for a holder in due course: (1) the purchaser is the holder, (2) of a negotiable note, (3) who took the note for value, (4) in good faith, and (5) without notice of the defenses.¹⁹⁴ Once a purchaser qualifies as a holder in due course, it can cut off the defense of unconscionability, as well as all other personal defenses to the loan agreement.¹⁹⁵

Finally, unconscionability claims and defenses are extremely expensive to litigate, dampening incentives to bring those claims.¹⁹⁶ Proof that the price is dictated by commercial reality may be sufficient to defeat the claim or defense and such proof may be easy to come by, depending on the nature of the price term in question. In the case of a predatory loan, for example, a lender may be able to adduce proof that the high price of the loan is justified by risk-based pricing, where prices rise in response to the added risk presented by the borrower.

The sum effect of these limitations is to make it exceedingly difficult for borrowers to challenge predatory-loan agreements as void under traditional contract law or the Uniform Commercial Code. In addition, because

194. See generally WHITE & SUMMERS, *supra* note 187, §§ 14-1-14-7.

195. See *id.* § 14-10. Personal defenses include failure or lack of consideration, breach of warranty, unconscionability, and fraud in the inducement. Borrowers who are sued by secondary-market purchasers may still raise the "real" defenses of infancy, duress, lack of legal capacity, illegality of the transaction, fraud in the factum (*i.e.*, fraud in which the plaintiff signed the wrong document and was not at fault), and discharge of the debtor through insolvency. Furthermore, duress, lack of legal capacity, illegality, and fraud in the factum only constitute real defenses for void contracts, which are extremely rare. Where a contract is simply voidable, not void, the latter four defenses are personal defenses and cannot be raised against holders in due course.

The Federal Trade Commission has a rule abrogating the holder-in-due-course rule, but this rule only applies to HOEPA loans and the financing of sales of goods or services secured by home mortgages. See *id.* § 14-9(b) (discussing the holder-in-due-course regulations at 16 C.F.R. § 433.2 (2000)); Federal Reserve System, *Truth in Lending*, *supra* note 14; KEEST & RENUART, *supra* note 46, at 426; see also *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 540-43 (N.J. Super. Ct. App. Div. 2001) (holding that a fact issue existed as to whether lenders who granted a mortgage to finance home repairs could cut off claims under the holder-in-due-course rule).

196. See, e.g., Creola Johnson, *Welfare Reform and Asset Accumulation: First We Need a Bed and a Car*, 2000 WIS. L. REV. 1221, 1256 ("[D]isgruntled consumers are not likely to succeed in litigation on the grounds of unconscionability . . ."); WALTER K. OLSON, *THE LITIGATION EXPLOSION* 218 (1991) ("By invoking the new doctrines [including unconscionability], either side . . . can threaten a messy and expensive look into all the circumstances surrounding the course of dealings between the parties."); Arthur Allen Leff, *Unconscionability and the Crowd—Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349, 354-57 (1969) (criticizing case-by-case litigation of unconscionability claims as inefficient in consumer transactions); SINAI DEUTCH, *UNFAIR CONTRACTS* 243 (1977) (noting that unconscionability challenges are rare due to the cost and risk of litigation).

secondary-market purchasers can evade responsibility for most misconduct by loan originators, they have little incentive to police originators.

C. *Antifraud Laws*

Fraud laws are some of the oldest measures designed to redress information asymmetries in the formation of contracts. Common-law fraud requires proof of affirmative misrepresentation and does not encompass misleading omissions or manipulation. In addition, common-law fraud requires proof of detrimental reliance by the borrower.¹⁹⁷ Perpetrators can be subject to criminal sanctions and compensatory damages in civil actions brought by victims.

The limited scope of common-law fraud, coupled with pragmatic concerns, has constrained the number of criminal fraud prosecutions against predatory lenders and brokers. Effective criminal fraud prosecution depends on the willingness of district attorneys to prosecute predatory-lending fraud. With isolated exceptions such as the model program in the County of Los Angeles,¹⁹⁸ criminal-law systems have been slow to mount fraud prosecutions against predatory lenders. This is due, in part, to the technical nature of predatory-lending cases and the lack of systematic reporting systems to bring predatory abuses to prosecutors' attention. Even absent these impediments, the fact that state criminal enforcement is highly dispersed at the local level means that individual local prosecutors make the decision whether to make predatory lending a priority. All too often, limited local expertise, constrained resources, and other pressing prosecutorial demands—such as violent crime and drug trafficking—combine to militate against prosecuting predatory lenders.

Criminal fraud actions generally afford little or no relief to the victims of predatory lending. An alternative route—private causes of action for common-law fraud—could be a vehicle for such redress. But as mentioned earlier, "fraud" is narrowly defined at common law. Civil fraud claims are deficient in other respects, as well. For example, common-law fraud actions may not afford victims full relief in the form of loan forgiveness. Similarly, the private bar lacks adequate incentives to file suits for loan fraud. Under the "American Rule," in which each party bears its own attorneys' fees and costs, suits for injunctive relief such as rescission or loan forgiveness generally do not generate sufficient funds to compensate plaintiffs' counsel. The need to prove individual reliance, moreover, in fraud cases often makes it difficult to bring class actions. Compounding matters, mandatory-

197. See, e.g., RESTATEMENT (SECOND) OF TORTS §§ 525, 537–45 (1977).

198. See Joan Potter, *Fighting Home Equity Fraud and Predatory Lending: One Community's Solution*, COMMUNITY REINVESTMENT REPORT (Federal Reserve Bank of Cleveland ed., Summer 2000); see also Mike Tobin & Bob Paynter, *Feds Raid Real Estate, Mortgage Operations*, PLAIN DEALER (Cleveland), Aug. 22, 2001, at A1, 2001 WL 20548585.

arbitration clauses in many predatory-loan agreements preclude resort to court altogether.

In response to the limitations inherent in common-law fraud, Congress, all of the states, and the District of Columbia passed unfair-and-deceptive-acts-and-practices (UDAP) statutes in the twentieth century.¹⁹⁹ The federal statute, which the states have tracked in their own statutes, prohibits unfair or deceptive acts or practices in or affecting trade or commerce.²⁰⁰ The federal act grants enforcement to the Federal Trade Commission (FTC), but does not

199. See generally NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 1.1 (4th ed. 1997 & Supp. 2000) [hereinafter UNFAIR AND DECEPTIVE ACTS AND PRACTICES].

The Racketeer Influenced and Corrupt Organization Act (RICO), 18 U.S.C. §§ 1961–1968 (1994), may afford another source of civil redress and one that offers treble damages. Cf. *Emery v. Am. Gen. Fin.*, 71 F.3d 1343, 1348 (7th Cir. 1996) (ruling that a complaint stated a RICO claim for predatory lending if more than one violation has been alleged). Under RICO, “any person injured in his business or property by reason of a violation of section 1962” may sue for civil redress. 18 U.S.C. § 1964 (1994). Section 1962 forbids “any person” from (a) using income received from a pattern of racketeering activity or from the collection of an unlawful debt to acquire an interest in an enterprise affecting interstate commerce, (b) acquiring or maintaining through a pattern of racketeering activity or through collection of an unlawful debt an interest in an enterprise affecting interstate commerce, (c) conducting or participating in the conduct of the affairs of an enterprise affecting interstate commerce through a pattern of racketeering activity or through collection of an unlawful debt, and (d) conspiring to participate in any of these activities. *Id.* § 1962; Richard L. Bourgeois, Jr. et al., *Racketeer Influenced and Corrupt Organizations*, 37 AM. CRIM. L. REV. 879, 903–08 (2000). A “pattern of racketeering activity” requires proof of commission of two or more predicate acts, among which are mail fraud and wire fraud. 18 U.S.C. § 1961(1) (1994); *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 232 (1989); *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 481–82 (1985). For a comprehensive description of the elements of RICO, see Bourgeois et al., *supra*, at 883, which reports that the elements of a RICO claim include “(A) two or more predicate acts of racketeering activity; (B) pattern; (C) enterprise; (D) effect on interstate commerce; (E) prohibited acts; and (F) scope of outsider liability.”

RICO claims are not a panacea, however. Because the typical RICO claim in the predatory-lending context would rest on predicate acts of fraud, RICO claims for predatory lending have some of the same drawbacks as fraud claims generally. See, e.g., *Vandenbroeck v. Commonpoint Mortgage Co.*, 210 F.3d 696, 701–02 (6th Cir. 2000) (holding that plaintiffs failed to allege mail fraud or wire fraud with specificity). Furthermore, satisfying the complex elements of a RICO claim can be difficult. For RICO violations under section 1962(c), a racketeering enterprise must be proven. See *United States v. Turkette*, 452 U.S. 576, 583 (1981). Proof of such an enterprise can be difficult in predatory-lending cases. See *Vandenbroeck*, 210 F.3d at 699–701 (holding that the plaintiffs failed to allege that a subprime lender and the secondary purchasers to whom it sold loans “functioned as a continuous unit” rising to the level of an enterprise). In addition, the circuits disagree on what level and duration of activity rises to a pattern of racketeering. See Bourgeois, *supra*, at 885–92, 900. Indeed, under analogous provisions in HOEPA providing a cause of action for a pattern and practice of asset-based lending, 15 U.S.C. § 1639(h) (2000), plaintiffs have had difficulty proving that lenders engaged in a pattern and practice of making subprime mortgages without regard to repayment ability. See *Newton v. United Co. Fin. Corp.*, 24 F. Supp. 2d 444, 456 (E.D. Pa. 1998); see generally Harkness, *supra* note 78, at 14–15, 24–26. Proving a pattern of racketeering is also costly, involving extensive discovery and expert witnesses. Finally, some predatory-lending victims have had difficulty satisfying the statute of limitations under RICO. See *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7, 17 (D.D.C. 2000) (granting summary judgment for the lenders on certain RICO claims due to a limitations bar).

200. See section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. § 45(a)(2) (2000).

provide a private right of action (either express or implied).²⁰¹ In contrast, state UDAP statutes usually allow for private damages actions as well as state enforcement.²⁰²

The FTC has filed a number of recent enforcement actions challenging actions by predatory lenders as unfair and deceptive under Section 5 of the Federal Trade Commission Act. Some of those actions have resulted in monetary relief to borrowers.²⁰³ Nevertheless, the absence of a private cause of action, shifting political winds, and constraints on the FTC's enforcement resources make private relief under the Federal Trade Commission Act highly unlikely for the vast majority of victimized borrowers.

Although state UDAP statutes allow private rights of action, they are sometimes restricted in their scope. Some state statutes exclude credit and insurance transactions, often because financial institutions are exempted or because credit and insurance are deemed not to be "goods and services."²⁰⁴ In states where state UDAP statutes do cover credit, enforcement heavily depends on the priorities of individual state attorneys general and available resources. Only a few attorneys general, such as those in North Carolina and New York, have actively pursued enforcement of state UDAP statutes

201. See UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 199, § 9.1 & n.2 (citing cases).

202. See *id.* § 8.1.

203. See *FTC v. Fleet Fin., Inc.*, No. C3899 (FTC Oct. 5, 1999) (approving a \$1.3 million settlement for consumer redress and injunctive relief, based on charges that Fleet's failure to provide accurate, timely disclosure of the costs and terms of home-equity loans to consumers and cancellation rights violated section 5 of the Federal Trade Commission Act); Consent Judgment and Order, *FTC v. Barry Cooper Properties*, No. 99-07782 WDK (Ex) (C.D. Cal. July 30, 1999) (holding that asset-based lending violated section 5); Complaint, *FTC v. Capital City Mortgage Corp.*, No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998) (alleging that asset-based lending violated the Federal Trade Commission Act); Prepared Statement of the Federal Trade Commission before the California State Assembly Committee on Banking and Finance on Predatory Lending Practices in the Home-Equity Lending Market 5-7 (Feb. 21, 2001), available at <http://www.ftc.gov/os/2001/02/predlendstate.htm>; Press Release, Federal Trade Comm., Sub-prime Lender Agreed to Pay \$350,000 Civil Penalty to Settle Charges of Violating Federal Lending Laws (Aug. 24, 2000) (reporting that lender violated section 5 by misrepresenting that consumers were purchasing only credit life insurance when, in fact, they were also purchasing accident and health insurance), available at <http://www.ftc.gov/opa/2000/08/actionloan.htm>; Press Release, Federal Trade Comm., Sub-prime Lender Agrees to Settle FTC Charges of Violating Federal Lending and Consumer Protection Laws (July 18, 2000) (reporting that a lender violated section 5 by failing to disclose material credit information and information concerning the right to rescind), available at <http://www.ftc.gov/opa/2000/07/nuwest.htm>; see also Paul Beckett, *FTC Charges Citigroup Unit In Lending Case*, WALL ST. J., Mar. 7, 2001, at B15, 2001 WL 2856289; Richard A. Oppel, Jr., *U.S. Suit Cites Citigroup Unit on Loan Deceit*, N.Y. TIMES, Mar. 7, 2001, at A1, LEXIS, Nexis Library, NYT File. The FTC has predicated other enforcement actions and counts involving allegations of predatory lending on violations of HOEPA, TILA, RESPA, the Equal Credit Opportunity Act (ECOA), and the Fair Debt Collection Practices Act. See Prepared Statement of the Federal Trade Commission, *supra*, at 5-7.

204. See UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 199, §§ 2.2.1-4, 2.3.1.

against predatory lenders.²⁰⁵ Similarly, weak attorneys' fee provisions in some state UDAP statutes discourage the private bar from bringing state UDAP claims.²⁰⁶

D. Disclosure

Disclosure is yet another paradigm for reinedying abusive lending practices. In consumer lending, several federal statutes mandate the disclosure of standardized price information on loans. For example, TILA requires lenders to disclose finance charges and annual percentage rates to applicants for home mortgages.²⁰⁷ Similarly, RESPA entitles home-mortgage borrowers to good-faith estimates of settlement costs (GFES) and statements of their actual closing costs in HUD-1 settlement statements.²⁰⁸

For high-cost, closed-end home mortgages (other than purchase-money mortgages), the Home Ownership and Equity Protection Act (HOEPA) requires additional disclosures three days before closing.²⁰⁹ Under HOEPA advance-disclosure provisions, the lender must inform the borrower of the APR, the dollar amount of the periodic payments, the size of any balloon payments, the amount borrowed, and any charges for optional credit insurance or debt-cancellation coverage. HOEPA lenders must also advise borrowers in writing that they could lose their homes and are not obligated to proceed to closing simply because they signed a loan application or received disclosures. Finally, for adjustable-rate mortgages that fall within HOEPA, lenders must disclose that the interest rate and monthly payment could increase, plus the amount of the single maximum monthly payment.²¹⁰

Violations of all three statutes are subject to agency enforcement.²¹¹ Violators of TILA and HOEPA are also subject to criminal penalties.²¹² In

205. See, e.g., Oppel & McGeehan, *supra* note 19, § 3, at 1; Rob Christensen, *Easley*, NEWS & OBSERVER (Raleigh, N.C.), Oct. 6, 2000, at A1; Press Release, Office of New York State Attorney General Eliot Spitzer, Court Freezes Assets of Mortgage Bank (Feb. 22, 2001) (freezing the assets of Anvil Mortgage Bank, Ltd.); Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer Announces Landmark, \$6 Million Settlement With Long Island Mortgage Company (June 23, 1999) (announcing settlement with Delta Funding).

206. See UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 199, §§ 8.8.2.1–6.2.

207. See *supra* notes 39–41 and accompanying text.

208. See *supra* notes 40–42 and accompanying text.

209. 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b) (2000). HOEPA is a subsection of TILA. See *supra* note 34 and accompanying text.

210. 12 C.F.R. § 226.32(c) (2001); see generally NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING ch. 10 (4th ed. 1999) [hereinafter TRUTH IN LENDING]. In December 2001, the Federal Reserve Board amended HOEPA's regulations to provide that HOEPA borrowers must be informed in advance of the loan closing that the total amount borrowed may be substantially higher than the amount requested due to the financing of insurance, points, and fees. See Federal Reserve, *Truth in Lending*, *supra* note 14, at 65,610–11.

211. See 15 U.S.C. § 1607 (2000). The Federal Reserve Board of Governors has exclusive authority for promulgating regulations implementing TILA and HOEPA. See *id.* § 1604(a). Responsibility for enforcing TILA and HOEPA, however, is divided among nine federal agencies.

addition, TILA, RESPA, and HOEPA authorize private rights of action, but differ significantly in the types of relief they afford borrowers. Under TILA, injured borrowers may seek actual damages, statutory damages, and attorneys' fees, either individually or in class actions.²¹³ In addition, homeowners can stave off foreclosure for up to three years after closing under TILA's provisions granting the right to rescind covered home mortgages, where specified disclosures were not correctly made at closing.²¹⁴ HOEPA's private remedies include all of the remedies that are available under TILA, plus special enhanced damages consisting of all finance charges and fees paid by the borrower²¹⁵ and expanded rights of rescission.²¹⁶

Under RESPA, private damages for erroneous disclosures generally cannot be awarded unless borrowers can prove that lenders: (1) failed to inform them that their loans could be transferred,²¹⁷ (2) received kickbacks,²¹⁸ or (3) steered them to title companies.²¹⁹ Specifically, lenders have no liability under RESPA for errors in GFEs or HUD-1 settlement statements, thereby weakening their incentives for accuracy.

TILA, RESPA, and HOEPA all have major weaknesses in the activities they prohibit and the relief that they provide.²²⁰ TILA has not lived up to its goal of standardizing disclosures on the total cost of credit because a long list of closing costs are currently excluded when computing finance charges and

Id. §§ 1607(a), (c). See ROHNER & MILLER, *supra* note 22, ¶¶ 6.09[5], 13.02[1]. State attorneys general are also empowered to enforce HOEPA. 15 U.S.C. § 1640(e) (2000). See TRUTH IN LENDING, *supra* note 210, § 10.6.3. Agency enforcement authority for RESPA is vested in HUD. 12 U.S.C. §§ 2602(6), 2617(a) (2000).

212. Lenders who willfully and knowingly violate any requirement of TILA or HOEPA, for example, face a maximum fine of \$5000 and imprisonment for up to one year. See 15 U.S.C. § 1611 (2000); see also *id.* § 1644 (punishing certain types of credit-card fraud).

213. See generally TRUTH IN LENDING, *supra* note 210, ch. 8.

214. See generally *id.* ch. 6. Julia Patterson Forrester has aptly pointed out, however, that borrowers often inadvertently waive this right in fast-moving foreclosure actions because naïve borrowers fail to assert affirmatively their TILA and HOEPA remedies. See Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 ORE. L. REV. 1095, 1111–26, 1129–31 (1996); see also *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 545 (N.J. Super. Ct. App. Div. 2001) (affirming dismissal of rescission claim under TILA because the lender's notice of the right to cancel within three days complied with TILA).

215. See 15 U.S.C. § 1640(a)(4) (2000); see generally TRUTH IN LENDING, *supra* note 210, § 10.6.

216. See 15 U.S.C. § 1635 (2000); 12 C.F.R. § 226.23(a)(3) (2000); see generally TRUTH IN LENDING, *supra* note 210, §§ 10.3.3, 10.6.2.

217. See 12 U.S.C. § 2605(f) (2000) (authorizing actual damages, statutory damages, costs, and attorneys' fees).

218. See *id.* § 2607 (authorizing treble damages and attorneys' fees).

219. See *id.* § 2608. The defendant is liable for up to three times the amount that was charged for the title insurance. *Id.* § 2608(b).

220. HUD and the Federal Reserve Board raised concerns about the efficacy of these statutes in a joint report to Congress. See HUD-Fed Joint Report, *supra* note 41, Executive Summary at II. For a good description of additional evidentiary and limitations problems impeding relief under TILA and HOEPA, see Harkness, *supra* note 199, at 11–24.

annual percentage rates.²²¹ These omissions are exacerbated when lenders pad closing fees and engage in insurance packing.

As previously discussed, in addition to deficient private enforcement, RESPA suffers from poorly thought-out timing provisions.²²² The result is lengthy and confusing GFEs and HUD-1 settlement statements that are too late and too unreliable to be meaningful to the consumers they are meant to serve.

This state of affairs puts unsophisticated loan applicants at risk of high-pressure tactics at closing, where borrowers may learn for the first time that they will be paying higher interest, points, or fees. Confronted by surprise disclosures, they need financial or legal advice at the exact moment that they have to commit. Without that advice, fearful that they will lose their loans and desperate for funds, most borrowers sign the closing documents. These and other related problems caused Congress to enact the advance-disclosure requirements in HOEPA.

Although HOEPA is an improvement over TILA and RESPA, HOEPA is easy to evade because of its narrow coverage. To begin with, HOEPA does not apply to purchase-money mortgages, reverse mortgages, or open-end credit lines of any kind.²²³ Furthermore, for home mortgages within its coverage, HOEPA only applies if at least one of the following triggers is satisfied:

- the annual percentage rate at consummation exceeds the yield on Treasury securities of comparable maturity plus eight percent for first-lien loans (or ten percent for subordinate-lien loans); or
- the total points and fees exceed eight percent of the total loan amount or \$400 (subject to annual indexing), whichever is greater.²²⁴

Accordingly, to evade HOEPA, a lender can either style a loan as an open-end extension of credit or keep the interest or total points and fees below the respective ten- and eight-percent triggers.²²⁵ HOEPA's triggers are

221. See HUD-Fed Joint Report, *supra* note 41, Executive Summary at VII–XI; see also *supra* note 43 and accompanying text.

222. See *supra* notes 44–45 and accompanying text.

223. See 15 U.S.C. §§ 1602(i), (w), (bb) (2000); 12 C.F.R. § 226.32(a)(2) (1997).

224. See 15 U.S.C. §§ 1602(aa)(1)–(4) (2000); 12 C.F.R. §§ 226.32(a)(1), (b)(1) (1997). In addition, there is a complex system of exclusions from “total points and fees.” The exclusions encompass certain application fees, late charges, closing costs, security-interest charges, and filing and recording fees. See TRUTH IN LENDING, *supra* note 210, § 3.9.

225. To avoid HOEPA's disclosure requirements, lenders can create lines of credit secured by borrowers' homes and advance the credit lines in their full amounts to the borrowers at closing. Effectively, these spurious “open-ended” mortgages are closed-end mortgages in all but name. See Sturdevant & Brennan, *supra* note 6, at 39. The Federal Reserve Board amended HOEPA's rules in December 2001 to prohibit creditors from including “payable on demand” or “call provisions” in HOEPA loans in order to classify home loans as open-ended. See Federal Reserve, *Truth in Lending*, *supra* note 14, at 65,611–12.

so high that most lenders, including predatory lenders, are able to price their loans below the triggers.²²⁶ Subprime lenders have compensated for the lower resulting interest rates by raising the charges for items excluded from total points and fees.²²⁷

A handful of states have responded to the problem of evading HOEPA by adopting measures, patterned after HOEPA to a large degree, that lower the coverage triggers for lenders in those states. The first such measure was North Carolina's predatory-lending statute, enacted in 1999. In the statute, North Carolina retained the federal trigger for APRs of ten percent. The trigger for total points and fees was lowered, however, to five percent for total loan amounts greater than or equal to \$20,000, or the lesser of \$1000 or eight percent of principal for smaller loans. North Carolina's statute is also broader than HOEPA in that it covers home mortgages with prepayment penalties that either exceed two percent of the amount prepaid or are payable more than thirty months after closing.²²⁸ The New York Banking Board followed suit in 2000 by amending part 41 of its regulations to lower the APR trigger from ten to eight percent and the trigger for total points and fees from eight to five percent.²²⁹

226. See, e.g., HUD-Treasury Report, *supra* note 8, at 85; TRUTH IN LENDING, *supra* note 210, § 10.1.1; *Hearing on Predatory Mortgage Lending Before the Illinois House of Representatives*, 1999 Leg., 90th Sess. (Ill. 1999) (testimony of Woodstock Institute, delivered by Daniel Immergluck, Senior Vice President), available at <http://www.woodstockinst.org/predlendtest.html>; Sturdevant & Brennan, *supra* note 6, at 36, 39.

John Weicher's data on the average interest rates on subprime loans confirm that lenders can easily make subprime loans that fall below HOEPA's triggers. According to Weicher, subprime rates closely track the interest rates on prime loans. On average, Weicher found that interest rates on B loans were 300 basis points higher than those on prime loans, 450 points higher on C loans, and 600 points higher on D loans (D loans being the lowest quality subprime loans). (One hundred basis points equal one percentage point.) See WEICHER, *supra* note 10, at 56-57 & tbl.4.1. Accordingly, even average rates for D loans fall below HOEPA's 10% trigger.

In December 2001, the Federal Reserve Board lowered the APR trigger from 10% to 8% for first-lien loans and expanded the trigger for points and fees to include premiums paid at closing for optional credit-protection products. The Board estimates that lowering the APR trigger by two percentage points would expand HOEPA's coverage from 1% to 5% of subprime mortgages. See Federal Reserve, *Truth in Lending*, *supra* note 14, at 65,606-10.

227. Cf. James R. Ostay, *Effects of Usury Ceilings in the Mortgage Market*, 31 J. FIN. 821, 829 (1976) (arguing that in response to price controls, "lenders will attempt to maximize profits by charging higher than normal loan closing fees").

228. N.C. GEN. STAT. §§ 24-1.1E(a)(4), (a)(6) (1999). North Carolina excludes bona fide discount points, some prepayment penalties, and certain other legitimate fees from the definition of total points and fees. Bona fide discount points are specifically defined 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 or time-price differential applicable to the loan, provided the amount of the interest-rate reduction purchased by the discount points is reasonably consistent with established industry norms and practices for secondary-mortgage market transactions." *Id.* § 24-1.1E(a)(3).

229. N.Y. COMP. CODES R. & REGS. tit. 3, § 41.1(d)-(e) (2000).

For their part, HUD and the Federal Reserve Board urged Congress in 1998 to enact amendments fine-tuning federal disclosure requirements.²³⁰ Those amendments are long overdue. Nevertheless, increased disclosure is not enough because lenders will always find ways to evade disclosure requirements. Furthermore, most victims of predatory lending already find current disclosures incomprehensible. For naïve borrowers, piling on more disclosures will not help. The high-pressure nature of closings only exacerbates that confusion, by discouraging borrowers from reading loan documents at closing or asking questions when they do. Because most borrowers are not represented at closing, moreover, questions are likely to result in self-serving answers by title company officials or lenders. More disclosure would simply compound the confusion that currently exists.

E. Consumer Education and Counseling

Consumer education and counseling are other possible responses to the problem of exploitative loan terms. Currently, however, government-sponsored credit counseling, whether mandatory or optional in nature, is virtually nonexistent, and consumer-education programs are only in their infancy.

Under federal law, credit counseling is mandatory only for reverse mortgages for older homeowners under the Home Equity Conversion Mortgage program administered by HUD.²³¹ Only two states have provisions on subprime credit counseling. New York requires high-cost lenders to advise applicants that credit counseling is available and to provide them with a list of counselors. But counseling is not mandatory.²³² North Carolina goes further and requires counseling by state-approved counselors for all high-cost loans.²³³ Otherwise, previous counseling proposals have been rejected, due to industry opposition and concerns about cost.

Consumer-credit education and counseling unquestionably should be available for those who seek it. Education, however, is not a cure-all for predatory lending. Reaching the potential victims of predatory lending is the biggest challenge for any educational campaign. Oftentimes, these individuals are not actively in the market for loans to begin with. The best way to reach likely victims is labor-intensive and costly—for example, by imitating predatory lenders and going door-to-door. Even then, there is no guarantee that the individuals will understand the information or be able to

230. See HUD-Fed Joint Report, *supra* note 41, Executive Summary at III (explaining that HUD and the Federal Reserve were not able to reach complete agreement and thus issued some recommendations jointly and others individually).

231. See HUD-Treasury Report, *supra* note 8, at 92. For a description of this program, see generally Harkness, *supra* note 199, at 39–41.

232. N.Y. COMP. CODES R. & REGS. tit. 3, § 41.3(a) (2000).

233. N.C. GEN. STAT. § 24-1.1E(c)(1) (1999).

apply it when predatory lenders come to call.²³⁴ Until this country comes to grips with low literacy rates, financial literacy efforts are not likely to succeed.

Consumer counseling has serious limitations. For those who lack the time, the funds, or the confidence to visit a credit counselor, optional counseling is nothing more than a fig leaf. In contrast, mandatory counseling would require consumers to go to a counselor as a condition of getting a loan. The efficacy of that counseling, however, is questionable.²³⁵ How much use is counseling before closing, when customers do not have loan agreements and final HUD-1 settlement statements in front of them? Who would pay for an edifice of certified, independent credit counselors nationwide, sufficiently trained in loan analysis and predatory practices to provide customers with adequate advice?²³⁶ How much specific guidance could counselors give customers about comparison shopping? Could counselors veto loan agreements as overreaching or could customers unconditionally reject their advice? And would one counseling session be enough to help people who are under severe financial strain to cope with inadequate finances?

Wholly apart from these issues, there is a more basic problem with relying on education and counseling. A solution founded on education or counseling puts the onus on potential victims to avoid predatory-loan terms,

234. Cf. Abdighani Hiram & Peter M. Zorn, *A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling* 1, 18 (May 22, 2001) (reporting that "telephone counseling had no demonstrable effectiveness in reducing delinquency rates" in Freddie Mac's Affordable Gold mortgage program), available at <http://www.freddiemac.com/corporate/reports>.

235. In an examination of mandatory prepurchase homeownership counseling under Freddie Mac's Affordable Gold program, Abdighani Hiram and Peter M. Zorn recently concluded that individual, classroom, and home-study counseling were effective in reducing 90-day delinquency rates. *Id.* at 2. These programs were different from credit counseling for potential victims of predatory loans, however, in two important respects. First, the Affordable Gold program provided counseling to individuals who were actively seeking financing for the initial purchase of a home (*i.e.*, purchase-money mortgages). Many predatory lenders, in contrast, seek to convince individuals who are *not* in the market for loans to refinance their mortgages. Accordingly, self selection may have influenced the outcome of the study. *See id.* at 2 ("[W]e are unable reliably to confirm that this reduction comes from the counseling itself rather than the assignment/selection of borrowers into these programs."). Second, the counseling programs that Hiram and Zorn examined covered a much broader set of topics than pure credit counseling and involved "explaining the home buying and financing process, encouraging financial planning and money management, and going over home maintenance and repair issues and concerns." *Id.* at 5.

236. Cf. Federal Reserve, *Truth in Lending*, *supra* note 14, at 64,604 ("Both consumer and creditor commenters acknowledged the benefits of pre-loan counseling as a means to counteract predatory lending. There was uniform concern, however, about requiring a referral to counseling for HOEPA loans because the actual availability of local counselors may be uncertain."); Harkness, *supra* note 199, at 43 (noting that "many housing counseling agencies . . . expressed concern about having enough funding to provide basic housing counseling services," such as counseling on landlord-tenant law, foreclosures, and fair-housing laws).

rather than on the perpetrators.²³⁷ Such reliance is nothing more than caveat emptor served up with an informational brochure or loan counseling. Likewise, education and counseling do little to redress the basic inequities in bargaining power that underlie many predatory loans.

F. Price Regulation

Price controls in the form of usury laws have been an ancient and venerable state response to problems of abuse in lending. For centuries, usury laws have been at the crux of debates over the need for personal responsibility and free choice versus protecting those without bargaining power from exploitation.

The recent history of usury limits for residential mortgages in the United States has been one of deregulation, accompanied by the re-imposition of limits on noninterest price terms in high-cost loans. Following high inflation in the 1960s and 1970s, usury limits for home mortgages were largely abolished in the United States. As already discussed, deregulation in residential mortgages resulted from two federal statutes, DIDMCA²³⁸ and AMTPA,²³⁹ that were enacted in the early 1980s. DIDMCA preempted state usury limits on first mortgages and AMTPA permitted lenders to make adjustable-rate mortgages, mortgages with balloon payments, and nonamortizing mortgages.²⁴⁰

In 1994, early concerns about predatory lending led Congress to amend TILA to add HOEPA, which imposed price controls on the noninterest terms of high-cost, closed-end home mortgages other than purchase money mortgages. HOEPA does not limit nominal interest rates per se. However, for the small group of subprime loans that activate its triggers,²⁴¹ HOEPA prohibits certain other price terms,²⁴² including balloon payments (maturing in less than five years) in loans other than bridge loans, negative amortization, advance payments,²⁴³ higher interest rates on default, and numerous prepayment penalties.²⁴⁴

237. In the context of cyberspace, Lawrence Lessig has criticized similar education programs for "confus[ing] responsibility and hence confus[ing] politics." See LAWRENCE LESSIG, CODE AND OTHER LAWS OF CYBERSPACE 96 (1999); see generally *id.* at 95-98.

238. See *supra* note 76.

239. See *supra* note 77.

240. See *supra* notes 76-83 and accompanying text.

241. See *supra* note 224 and accompanying text.

242. 15 U.S.C. § 1639(c)-(i) (2000); 12 C.F.R. § 226.32(d) (2002).

243. By "advance payments," we mean payment schedules that consolidate three or more periodic payments and pay them in advance from the proceeds.

244. Under HOEPA, however, prepayment penalties are permissible only if lenders are limited to imposing them in the first five years following consummation of the loan, if the source of the prepayment funds is not a refinancing by the creditor or an affiliate of the creditor, and if the consumer's total monthly debts at closing (including the HOEPA loan) do not exceed 50% of the consumer's monthly verified gross income. 12 C.F.R. § 226.32(d)(7) (2002).

HOEPA has been so easy to evade that its practical effect has been negligible.²⁴⁵ In recent years, dissatisfied with HOEPA's narrow coverage, a handful of states adopted further restrictions on noninterest price terms in home-mortgage loans. Texas took the lead with an amendment to the Texas Constitution, which took effect on January 1, 1998, prohibiting prepayment penalties and balloon payments on all home-equity loans and imposing a three-percent cap on points for those loans, regardless of the interest rate.²⁴⁶

In 1999, North Carolina enacted a sweeping predatory-lending law that covers a broader group of high-cost home loans than HOEPA.²⁴⁷ For high-cost mortgages within its coverage, the North Carolina law bans all of the pricing practices banned by HOEPA, plus balloon payments of any type (not just balloon payments due within five years of closing), and all fees to modify or defer payments on high-cost loans.²⁴⁸ Other provisions of the North Carolina law ban prepayment penalties for all consumer home loans under \$150,000 whether high-cost or not, except where preempted by federal law.²⁴⁹ Under North Carolina law, it is also unlawful to finance any single-premium credit life, disability, unemployment, life, or health insurance for "consumer home loans" of any size.²⁵⁰ Finally, for most home loans under \$300,000, points may only be paid to reduce the interest rate or time-price differential of money.²⁵¹

In 2000, the New York Banking Board took a similar tack by lowering HOEPA's coverage triggers for high-cost home loans.²⁵² For loans within those lower triggers, the Board prohibited balloon payments except where due and payable no earlier than seven years following origination, negative amortization, increased interest rates upon default, advance payment penalties, and modification and deferral fees.²⁵³

Continued abuses by predatory lenders have fueled calls to extend HOEPA's price controls and those of its state-law analogues to subprime loans generally. Some proponents go farther and argue for the re-imposition

245. See *supra* notes 225–26 and accompanying text.

246. TEX. CONST. art. 16, § 50(a). For an in depth review of the 1998 amendment, see Charles C. Boettcher, *Taking Texas Home Equity for a Walk, But Keeping It on a Short Leash*, 30 TEX. TECH L. REV. 197 (1999).

247. See *supra* text accompanying note 228 for a description of North Carolina's lower triggers. See generally Richard R. Daugherty, Note & Comment, *Will North Carolina's Predatory Home Lending Act Protect Borrowers from the Vulnerability Caused by the Inadequacy of Federal Law?*, 4 N.C. BANKING INST. 569 (2000).

248. N.C. GEN. STAT. § 24-1.1E(b) (1999).

249. *Id.* § 24-1.1A(b)(1).

250. *Id.* §§ 24-10.2(b), (e).

251. *Id.* § 24-1.1A(c)(1)(b). Home loans under \$10,000 by unapproved lenders may not assess points at all. *Id.* § 24-1.1A(a)(3).

252. See *supra* text accompanying note 230.

253. N.Y. COMP. CODES R. & REGS. tit. 3, § 41.2 (2000).

of usury limits on interest rates and points and fees.²⁵⁴ Studies on past interest-rate restrictions in the United States indicate, however, that price controls have a direct adverse effect on the availability of credit to LMI borrowers and exacerbate the natural incentives toward credit rationing.²⁵⁵ Most research to date has concluded, for example, that usury laws reduce the quantity of credit that flows to the residential mortgage market. Differences in usury rates have caused loan funds to flow out of states with stricter interest caps to more permissive states. Similarly, usury limits disproportionately hurt the poor. Studies on the distributive effect of usury laws on prime versus subprime borrowers, for example, have concluded that interest ceilings impede weaker loan applicants from obtaining credit because lenders cannot charge sufficient interest to recoup the higher costs of underwriting, collection, and possible default. Where usury limits become binding, lenders ration credit by requiring higher down payments, increasing loan fees, shortening loan maturities, and restricting the size of loans. The sum effect is to handicap LMI borrowers in competing for loans.²⁵⁶

These effects are not limited to interest ceilings, but also extend to price controls on points and fees. New York, for example, had a highly restrictive usury law from 1969 to 1976 that capped all loan fees, charges, and points for residential mortgage loans. The law, one of the strictest in the country, resulted in higher down-payment requirements and reductions in new mortgages. Moreover, the resulting decline in mortgage activity in New York was the most severe in census tracts with lower average income, lower average housing values, and higher ratios of rental housing.²⁵⁷ Other research examining usury limits for federally chartered credit unions found that imposition of a twelve-percent cap on all credit charges, including

254. See, e.g., KEEST & RENUART, *supra* note 46, at 60–64; Mansfield, *supra* note 1, at 573–75 (arguing that federal usury limits may offer some protections); PREYING ON NEIGHBORHOODS, *supra* note 1, at 36 (advocating limiting points and fees on all mortgages to 3% of principal when the interest rate on the loan exceeds 8%). For thoughtful treatments of this debate, compare Drysdale & Keest, *supra* note 97, with James J. White, *The Usury Trompe l'Oeil*, 51 S.C. L. REV. 445 (2000).

255. See *supra* notes 61–64 and accompanying text.

256. See, e.g., Norman N. Bowsher, *Usury Laws: Harmful When Effective*, 56 REV. FED. RES. BANK OF ST. LOUIS 16, 17–23 (1974); James McNulty, *A Reexamination of the Problem of State Usury Ceilings: The Impact in the Mortgage Market* 21–24 (Fed. Home Loan Bank Bd. 1979); Harold C. Nathan, *Economic Analysis of Usury Laws*, 10 J. BANK RES. 200, 202–10 (1980); Ostas, *supra* note 228, at 830–31 (concluding that legal restrictions on contract interest rates result in higher loan fees and larger down payments); Michael M. Tansey & Patricia H. Tansey, *An Analysis of the Impact of Usury Ceilings on Conventional Mortgage Loans*, 9 J. AM. REAL EST. & URB. ECON. ASS'N 265 (1981); Bruce Yandle & Jim Proctor, *Effect of State Usury Laws on Housing Starts: Comments*, 13 J. FIN. & QUANTITATIVE ANALYSIS 549, 554–55 (1978) (observing that under specified conditions, state usury laws may contribute to the flow of capital from states with strict usury laws to states with less constrained markets).

257. See Dwight Phaup & John Hinton, *The Distributional Effects of Usury Laws: Some Empirical Evidence*, 9 ATLANTIC ECON. J. 91, 92–95 (1981).

service charges and loan-origination fees, resulted in substantial declines in lending by federal credit unions after that ceiling became binding.²⁵⁸

Ultimately, price controls are counterproductive. They restrict the flow of credit, thereby hurting the very individuals they are designed to serve. That is true whether price controls take the form of interest-rate ceilings or restrictions on noninterest price terms. Furthermore, there is no reason to believe that legislators or regulators will have more success than the market at setting prices that deter predatory lending and do not unduly restrict the availability of capital to borrowers.²⁵⁹

In warning against the dangers of usury laws, we need to make a caveat. Certain price terms, such as points or certain fees, may warrant intervention for other reasons. Unregulated use of certain price terms may impede transparency. Other price terms may be problematic because they assess an excessive lump-sum charge for services such as insurance that are normally provided and charged on a monthly basis. Single-premium credit life insurance is one example that comes to mind. In the appendix, we discuss these issues in detail with respect to specific loan terms and practices.

G. Antidiscrimination Remedies

The evidence suggests that predatory lenders target members of protected groups and that their practices often have a disparate impact on protected groups. Thus, some victims of predatory lending may have disparate treatment,²⁶⁰ disparate impact,²⁶¹ or "pattern and practice"²⁶² claims under federal law.²⁶³ The Equal Credit Opportunity Act of 1974 (ECOA) prohibits lenders from discriminating in credit transactions, including mortgages, according to race, color, religion, national origin, sex, marital

258. See John D. Wolken & Frank J. Navratil, *The Economic Impact of the Federal Credit Union Usury Ceiling*, 36 J. FIN. 1157, 1165 (1981).

259. Nor are floating price controls the answer. In an unregulated market, price terms vary widely from lender to lender. Accordingly, market forces will usually cause some lenders to exceed floating ceilings, no matter how high the floating ceilings rise. See McNulty, *supra* note 256, at 23. Floating price ceilings thus lack sufficient flexibility to avoid restricting credit.

260. See Ronald K. Schuster, *Lending Discrimination: Is the Secondary Market Helping to Make the 'American Dream' a Reality?*, 36 GONZ. L. REV. 153, 163-66 (2000-2001); see also *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 537 (N.J. Super. Ct. App. Div. 2001) (permitting African American homeowners to proceed to discovery on a reverse-redlining claim under the theory of equitable recoupment as an affirmative defense to foreclosure).

261. See Schuster, *supra* note 260, at 166-68 (discussing the elements of a disparate-impact discrimination claim).

262. See Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEXAS L. REV. 787, 832 (1995) (proposing the use of testing to detect patterns of discrimination); see also *Assocs. Home Equity Servs., Inc.*, 778 A.2d at 536-40 (granting borrowers discovery on their claim of "a pattern of discriminatory lending practice in New Jersey's inner cities").

263. Cf. Lambert, *supra* note 120, at 2181 (discussing the possibility of bringing marketing-discrimination claims under federal laws).

status, age, or receipt of public assistance.²⁶⁴ ECOA only gives standing to actual loan applicants.²⁶⁵ Thus, customers who are the victims of credit discrimination prior to the application process fall outside of ECOA's protections. The relevant provisions of the Fair Housing Act (FHA) prohibit discrimination in the financing of residential real estate on the grounds of race, color, religion, national origin, sex, handicap, or familial status.²⁶⁶

Although both statutes authorize private damages actions,²⁶⁷ few victims of lending discrimination have brought claims under these statutes.²⁶⁸ There are several explanations for this paucity of claims. Many loan applicants cannot discern lending discrimination because they do not have inside information about the factors that went into the lenders' decisionmaking.²⁶⁹ Even when borrowers do have an inkling that they may have been victims of discrimination, they may not know that the lenders' actions were illegal under the FHA or ECOA. The few consumers who realize that lenders discriminated against them in violation of fair-lending laws encounter significant obstacles in proving their discrimination claims.²⁷⁰ In most cases, lenders can point to neutral underwriting criteria and reasons why applicants failed to meet their criteria.²⁷¹ In addition, loan information pertaining to

264. 15 U.S.C. § 1691(a) (2000).

265. *Id.* § 1691e.

266. 42 U.S.C. § 3605 (1994) (Title VIII of the Civil Rights Act of 1968); *see generally* Frank Lopez, Note, *Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. ON POVERTY L. & POL'Y 73 (1999).

267. 15 U.S.C. § 1691e (2000); 42 U.S.C. § 3613 (1994).

268. *See, e.g.*, Stephen M. Dane, *Eliminating the Labyrinth: A Proposal to Simplify Federal Mortgage Lending Discrimination Laws*, 26 U. MICH. J.L. REFORM 527, 549 (1993) (noting that there has not yet been much private or public litigation under ECOA); *cf.* Hylton & Rougeau, *supra* note 64, at 262 (arguing that "if discrimination in the allocation of credit is based on [disparate impact], it would be hard to attack through the application of a civil rights statute"); A. Brooke Overby, *The Community Reinvestment Act Reconsidered*, 143 U. PA. L. REV. 1431, 1505 (1995); Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349, 368-69 & n.62 (1993); Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463, 1473, 1478 (1994).

269. *See* Michele L. Johnson, *Your Loan is Denied, But What About Your Lending Discrimination Suit?* *Latimore v. Citibank Federal Savings Bank*, 151 F.3d 712 (7th Cir. 1998), 68 U. CIN. L. REV. 185, 214-15 (1999) (opining that most borrowers lack the sophistication needed to discern if they have been victims of discrimination).

270. For a general discussion of the impediments to victims of discrimination pursuing and prevailing in claims under the FHA, *see* Kathleen C. Engel, *Moving up the Residential Hierarchy: A New Remedy for an Old Injury Arising from Housing Discrimination*, 77 WASH. U. L.Q. 1153, 1188-91 (1999).

271. There is some debate whether the McDonnell-Douglas burden-shifting scheme used in employment-discrimination cases applies to lending-discrimination claims. In jurisdictions where the courts have rejected the McDonnell-Douglas approach in fair-lending cases, the hurdle for plaintiffs is even higher. *See* Johnson, *supra* note 269, at 185 (discussing the Seventh Circuit's rejection in *Latimore* of the McDonnell-Douglas approach in the lending-discrimination context); *see also* G. Carol Brani, *Civil Rights and Mortgage Lending Discrimination: Establishing a Prima Facie Case under the Disparate Treatment Theory*, 5 RACE & ETHNIC ANC. L.J. 42 (1999) (same).

other applicants, which would assist plaintiffs in establishing discriminatory treatment, is difficult and costly to obtain.²⁷²

Testers, who have proven valuable in establishing landlords' and sellers' discriminatory intent in garden variety housing-discrimination claims, are rarely used in the fair-lending context. This is because testers can be subject to state and federal prosecution for signing false loan applications. Absent use of testers or other proof of intentional discrimination, plaintiffs have to comb through lenders' individual loan files to locate evidence that the lenders' practices had a disparate impact on members of the plaintiffs' protected class, or to document statistical discrimination²⁷³ (*i.e.*, disparate treatment of similarly situated individuals). Data from individual loan files are not publicly available, however, and aggrieved applicants do not have access to lenders' loan files before they file complaints. Furthermore, even when the information is available, the cost of extensive discovery and expert statistical analysis can be prohibitively expensive.²⁷⁴

Low and uncertain damage awards further reduce the number of fair-lending cases that are filed. Plaintiffs often do not incur significant damages and have difficulty quantifying their damages,²⁷⁵ making them reluctant to file suit and often unable to find attorneys to represent them.²⁷⁶

Punitive-damages awards, which should provide incentives for victims of discrimination, fail to perform their intended function. This is, in part, because the FHA limits punitive awards to \$11,000.²⁷⁷ In addition, the reference points that courts use to determine the reasonableness of punitive awards serve to limit punitive damages in fair-lending cases. For example, one guidepost is that punitive awards should bear a reasonable relationship to civil penalties. Under ECOA and the FHA, however, civil penalties are capped, placing a further limitation on punitive-damages awards. The relationship between compensatory awards and punitive damages is another criterion that courts consider in determining the amount of punitive awards.

272. See Dane, *supra* note 268, at 544 (explaining that the Fair Housing Act does not require reporting or data collection).

273. In statistical-discrimination claims, the intent to discriminate is inferred from statistical evidence showing a pattern or practice of discriminatory treatment.

274. See, *e.g.*, Dane, *supra* note 268, at 543-44 (noting that the only way to identify discrimination is by comparing treatment of similarly qualified loan applicants, but such information is not available to the public). Professors Keith Hylton and Vincent Rougeau have furthermore pointed out that disparate treatment for reasons that are economically rational creates an evidentiary paradox. Where lenders use prohibited factors such as race as cheap proxies for individual determinations of creditworthiness, and those proxies have some predictive value, there may be no evidence at all of disparate treatment because similarly situated applicants will appear to be treated similarly. Hylton & Rougeau, *supra* note 64, at 252.

275. See Dane, *supra* note 268, at 549.

276. See Engel, *supra* note 270, at 1185-90 (discussing the role that low damages awards play in deterring victims of discrimination and attorneys from filing suit).

277. 42 U.S.C. § 3612(g)(3) (1994).

To the extent that fair-lending plaintiffs recover only small damages awards or nonmonetary damages such as rescission, their punitive awards will be correspondingly limited.²⁷⁸ Finally, courts are reluctant to impose punitive damages in the absence of actual damages. Many states and at least two circuit courts have refused to uphold punitive damages awards unless plaintiffs have incurred actual damages.²⁷⁹

In 1992, the Department of Justice (DOJ) took action to fill the breach by bringing its first "pattern or practice" lawsuit under ECOA alleging racial discrimination against Decatur Federal Savings and Loan in the Atlanta metropolitan area. The suit culminated in a consent decree in which Decatur agreed to extend one million dollars in loans to previously rejected black applicants.²⁸⁰ Since then, the Justice Department has prosecuted a series of cases alleging lending discrimination, most of which have been in response to press exposés of lending discrimination and all of which have settled.²⁸¹ The DOJ's ability to mount cases, however, is, "hampered by staff shortages, the costly, time-consuming nature of compiling proof of discrimination and inevitable shifts in political winds."²⁸²

Putting these enforcement problems aside, a more basic problem exists with relying on the antidiscrimination laws to halt predatory lending. The fair-lending laws necessarily are tangential in their focus, because they address differential treatment of customers on prohibited grounds such as race, age, or gender, rather than abusive loan terms per se. Of course, such targeting is a major tactic of predatory lenders, which is why ECOA and FHA will always be useful adjuncts in combating predatory lending. Nevertheless, a direct approach that goes to the heart of predatory lending (*i.e.*, to abusive loan terms and practices themselves) offers the greatest potential for stemming predatory loans.

IV. Suitability

As we have shown, the law does not afford adequate redress for predatory lending. Contract law, disclosure, and consumer counseling fail

278. See Engel, *supra* note 270, at 1196–97.

279. See Johanna M. Lundgren, Case Note, *As Weakened Enforcement Power: The Fifth Circuit Limits Punitive Damages under the Fair Housing Act in Louisiana Acorn Fair Housing v. LeBlanc*, 46 LOY. L. REV. 1325, 1329–32 (2001).

280. See Taibi, *supra* note 268, at 1477 & n.53; see also Robert G. Schwemm, *Introduction to Mortgage Lending Discrimination Law*, 28 J. MARSHALL L. REV. 317, 322 (1995).

281. See, e.g., Willy E. Rice, *Race, Gender, "Redlining," and the Discriminatory Access to Loans, Credit, and Insurance: An Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts, 1950–1995*, 33 SAN DIEGO L. REV. 583, 640–42 (1996); Ali Sartipzadeh, *Problems Persist in Sub-Prime Loan Area, Minority Denials Still High, DOJ's Lee Says*, 71 BNA BANKING REP. 436, 437 (1998); Taibi, *supra* note 268, at 1477 & n.53; Jaret Seiberg, *U.S. Imposes Record Fine of \$9 Million in Bias Case*, AM. BANKER, Aug. 14, 1997, at 1–2.

282. Schwemm, *supra* note 280, at 322–23; see generally Rice, *supra* note 281, at 638–39.

because they place the onus on highly vulnerable victims to refrain from signing loans, rather than on the lenders and brokers who perpetrate these loans. Fraud laws and antidiscrimination laws are more formidable, but their scope is too narrow and enforcement is suboptimal.²⁸³ The other traditional response, price regulation, has extensive adverse effects on the availability of credit.

Given these shortfalls, an effective remedy must accomplish several things. It must force predatory lenders and brokers to internalize the harm that they cause and create effective disincentives to refrain from making predatory loans. It must compensate victims for their losses and grant reformation of predatory loan terms. It must outlaw predatory practices in such a way that the law is understandable, violations can be easily proven, and lenders and brokers cannot evade their obligations. At the same time, it must avoid unnecessary price regulation and excessive constraints on legitimate subprime lending. It must furnish the private bar and victims with adequate incentives to bring predatory lending claims, while avoiding incentives toward spurious claims. And it must promote the adoption of best practices by the mortgage industry.

In devising such a remedy, we take a leaf from federal securities law. In the late 1930s, the National Association of Securities Dealers (NASD) first adopted the concept of "suitability."²⁸⁴ The idea of suitability is this: a salesperson "should recommend only securities that are suitable to the needs of the particular customer."²⁸⁵ Under this duty, salespeople must take clients' preferences and individual risk thresholds into account when recommending securities.²⁸⁶ Beginning in the 1940s, the Securities and Exchange Commission (SEC) fashioned parallel suitability requirements under the antifraud provisions of the securities laws to deal with situations including ones that were closely akin to predatory lending, especially high-pressure telephone sales of securities to vulnerable victims by boiler-room operations. Suitability protections are so well-settled in securities for ordinary investors that recent debate has centered on whether to extend the same protections to institutional investors in derivatives.²⁸⁷

283. This is not due, however, to profitable litigation opportunities that the private bar has somehow overlooked. Rather, the reasons for suboptimal enforcement are structural in nature. In the case of fraud, prevailing plaintiffs are not entitled to attorneys' fees, which makes it difficult for victims of predatory lending to secure attorneys. Likewise, low damage awards in discrimination claims do not provide sufficient incentives for plaintiffs to pursue or for lawyers to take on discrimination claims. Lastly, oppressive mandatory-arbitration clauses often foreclose effective recourse.

284. See *infra* section IV(A)(1).

285. LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 1010 (4th ed. 2001); see generally *id.* at 1010–19.

286. See Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 *DUKE L.J.* 445, 449.

287. See, e.g., Hu, *supra* note 132, at 2326–58; Allen D. Madison, *Derivatives Regulation in the Context of the Shingle Theory*, 1999 *COLUM. BUS. L. REV.* 272; Jerry W. Markham, *Protecting*

Nor is the duty of suitability confined to the securities industry. A somewhat narrower version of suitability is found in the commodities industry and in over-the-counter derivatives transactions.²⁸⁸ A duty of suitability is also emerging in the insurance field, partly in response to legislation enacted by Congress in 1999.²⁸⁹ Furthermore, in insurance as well as in securities, regulators and the courts have been particularly rigorous when allegations of suitability violations relate to lending abuses in the financing of securities and insurance purchases.

If the duty of suitability is appropriate for financial instruments that have been the traditional province of the affluent, certainly it is appropriate for financial instruments that are peddled to the poorest rung of society. Suitability is the best response to the problem of predatory lending because it places an affirmative duty on those in the best position to stop predatory lending—lenders and brokers. In addition, suitability is tailored to the specific problem that needs to be addressed. It prohibits the precise practices that result in harm, without re-imposing usury limits, which, as we have shown, disadvantage LMI borrowers. Furthermore, redressing suitability violations with remedies such as loan reformation, disgorgement, and damages would counteract the incentives that lenders and brokers have to exploit information asymmetries to the detriment of borrowers and the secondary market.

Importing suitability into the law of predatory lending is not a new idea. Several states and the federal government have adopted variations on suitability in provisions governing high-cost loans.²⁹⁰ For example, HOEPA prohibits lenders from making high-cost home loans to consumers based on their collateral without regard to their repayment ability.²⁹¹ North Carolina's

the Institutional Investor—Jungle Predator or Shorn Lamb?, 12 YALE J. ON REG. 345 (1995); Jason M. Rosenthal, Note, *Incorporation May Not Mean Sophistication: Should There Be a Suitability Requirement for Banks Selling Derivatives to Corporations?*, 71 CHI.-KENT L. REV. 1249 (1996).

288. See, e.g., OCC Banking Circular No. 277, at 12 (Oct. 27, 1993) (stating that if "the bank believes a particular transaction may not be appropriate for a particular customer, but the customer wishes to proceed, bank management should document its own analysis and the information provided to the customer"), available at <http://www.occ.treas.gov/ftp/bc/bc-277.doc> (last visited Feb. 7, 2002); see generally Hu, *supra* note 132, at 2339–45; Markham, *supra* note 288, at 364–70; George J. Sotos & Kevin F. Bowen, *The Proposed Suitability Standards for the Commodity Industry: "Right Church, Wrong Pew,"* 53 CHI.-KENT L. REV. 289 (1976).

289. See *infra* section IV(A)(2).

290. See generally Daniel S. Ehrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. LAW 117 (2001); John R. Reed, *The Ethical Standard of Suitability in Real Estate*, available at <http://www.johnreed.com/suitability.html>; cf. James M. Carson & Mark D. Forster, *Suitability and Life Insurance Policy Replacement*, 18 J. INS. REG. 427 (2000) (discussing new standards promulgated by NAIC and state regulations addressing unsuitable life-insurance-policy requirements).

291. HOEPA requires that lenders take consumers' current and expected income, current obligations, and employment status into account when assessing their ability to make scheduled loan payments. 12 C.F.R. § 226.34(a)(4) (2001). HOEPA also prohibits certain loan terms and

predatory-lending law contains a comparable provision.²⁹² In a similar vein, the New York Banking Board authorizes license revocation of mortgage lenders and brokers for “unfair, deceptive or unconscionable practices in the course of advertising, brokering or making high cost home loans.”²⁹³ The FTC has ruled that when subprime lenders make loans to borrowers who cannot afford the monthly payments, they violate the unfair and deceptive acts and practices provisions of Section 5 of the Federal Trade Commission Act.²⁹⁴

Although the concept of suitability has the potential to form the basis of an effective remedy to redress predatory lending, existing suitability provisions fall short because they are either too narrow or too broad. Some suitability statutes sanction only a subset of predatory practices. For example, neither HOEPA nor North Carolina’s law addresses the problem of steering. At the same time, all of the current suitability provisions are too broad because they do not give lenders adequate guidance about how to comply. As a result, there is a risk that lenders will decline to engage in legitimate subprime lending for fear that they will unintentionally run afoul of the suitability standard.

Accordingly, in this section, we examine the idea of suitability more closely and propose a suitability standard that is better tailored to the realities of the subprime mortgage market. We start by discussing how suitability works in the securities industry and the theoretical bases for the doctrine. We then propose how suitability can be adapted to the subprime mortgage industry to afford adequate relief and guidance without impinging unduly on

bans direct payments of loan proceeds to home-improvement contractors for such loans. *Id.* § 226.32(d).

In December 2001, the Federal Reserve Board adopted a rule that incorporates a version of suitability. Under the rule, if lenders make HOEPA loans without documenting and verifying borrowers’ repayment ability, there is a presumption that the lenders engaged in a pattern or practice of making HOEPA loans without regard to the borrowers’ ability to repay the loans, thereby violating HOEPA. *See* Federal Reserve, *Truth in Lending*, *supra* note 14, at 65,613–14. The Office of Thrift Supervision is also considering whether to impose a duty of suitability that would ban asset-based lending by thrift institutions. *See* Office of Thrift Supervision, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17,811, 17,817 (proposed Apr. 5, 2000) (to be codified at 12 C.F.R. pt. 560).

292. N.C. GEN. STAT. § 24-1.1E(c)(2) (1999). This standard is presumed to be met where the borrowers’ total monthly debts, including the high-cost home loan, do not exceed 50% of the borrowers’ verified monthly gross income. *Id.* North Carolina also restricts (1) refinancing charges that are designed to strip equity, (2) direct payments of loan proceeds to home-improvement contractors, and (3) a variety of predatory-loan terms. *Id.* §§ 24-1.1E(b)–(c).

293. N.Y. COMP. CODES R. & REGS. tit. 3, § 41.5 (2000). The Board also prohibits a broad panoply of predatory-loan terms and practices. *See id.* §§ 41.2–.3.

294. *See* Ronald G. Isaac, Prepared Statement of the Federal Trade Commission before the California State Assembly Committee on Banking and Finance on Predatory Lending Practices in the Home-Equity Lending Market 5–7 (Feb. 21, 2001) (discussing enforcement actions), *available at* <http://www.ftc.gov/os/2001/02/predlendstate.htm>.

legitimate credit. Finally, we survey and respond to potential criticisms of our proposal.

A. A Brief Overview of Suitability in Securities and Insurance

1. Suitability in the Securities Industry.—

a. The Duty and its Source.—The suitability doctrine originated in the securities industry and dates back to the late 1930s. Far from being monolithic in nature, suitability has numerous strands, consisting of different rules adopted by different bodies for different purposes. In the securities industry, where the doctrine is best developed, suitability requirements appear in the disciplinary rules of industry self-regulatory organizations (SROs) (*i.e.*, the stock exchanges and the NASD). They also appear in the regulations and holdings of the SEC, as well as in court decisions in private securities-fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act)²⁹⁵ and Rule 10b-5.²⁹⁶

b. The NASD and the Stock Exchanges.—The first suitability rules appeared in the disciplinary rules of the NASD and the securities exchanges, which are subject by law to review, revision, and approval by the SEC.²⁹⁷ The best-known suitability rule, the NASD's suitability requirement, was adopted in response to the Maloney Act of 1938.²⁹⁸ In the Maloney Act, Congress authorized the SEC to register national securities associations, subject to the condition that such associations adopt rules designed, among other things, "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade."²⁹⁹

NASD, the only national securities association that registered with the SEC, adopted a suitability requirement as part of its original 1939 Rules of Fair Practice.³⁰⁰ Today's version appears in Rule 2310 of the NASD's Rules of Fair Practice and provides:

295. 15 U.S.C. § 78j(b) (2000).

296. 17 C.F.R. § 240.10b-5 (2001). Suitability is not restricted to corporate securities. Suitability duties in one form or another also exist in the area of municipal securities. Mun. Sec. Rulemaking Bd. (MSRB) Rule G-19, available at <http://www.msrb.org/msrb1/rules/ruleg19.htm> (last visited Feb. 7, 2002).

297. See, e.g., Manuel F. Cohen & Joel J. Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROBS. 691, 707 n.120 (1964) (recounting the expansion of the suitability standard to all broker-dealer firms); Securities Exchange Act of 1934 §§ 15A(k)(1), (k)(2), 19(b) (formerly at 15 U.S.C. §§ 78o-3(k)(1), (k)(2), and currently at 15 U.S.C. § 78s(b) (2000)).

298. Security Exchange Act of 1934, Amendments, Pub. L. No. 38-719, 48 Stat. 895 (codified as amendment at 15 U.S.C. § 78o (2000)).

299. 15 U.S.C. § 78o-3(b)(6) (2000).

300. NASD, CERTIFICATE OF INCORPORATION AND BY-LAWS, RULES OF FAIR PRACTICE, AND CODE OF PROCEDURE FOR HANDLING TRADE PRACTICE COMPLAINTS 39 (1939) (cited in Arvid E. Roach II, *The Suitability Obligations of Brokers: Present Law and the Proposed Federal Securities*

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situations and needs.³⁰¹

Rule 2310 further states that prior to executing a recommended transaction for a noninstitutional customer, all NASD member broker-dealers must make "reasonable efforts to obtain information concerning":

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such [broker-dealer] in making recommendations to the customer.³⁰²

The New York Stock Exchange has a know-your-customer rule, Rule 405,³⁰³ that courts routinely have interpreted³⁰⁴ to impose a suitability requirement.³⁰⁵ The American Stock Exchange and the regional stock exchanges have similar know-your-customer rules.³⁰⁶

c. The Securities and Exchange Commission.—The SEC has not adopted an across-the-board suitability regulation. Rather, beginning in the 1940s, the SEC has interpreted the antifraud provisions of the federal securities laws to impose a suitability requirement and has applied this duty of suitability principally through decisions by the agency and courts in

Code, 29 HASTINGS L.J. 1069, 1074 n.22 (1978)); *see also* SEC, THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION 8 (1974) (stating that the only national securities association that registered is the NASD); Mundheim, *supra* note 286, at 450–51.

301. NASD Rules of Fair Practice, NASD MANUAL (CCH) ¶ 2310(a), IM 2310-2; *see also id.* ¶ 3110 (books and records rule); *see generally* Roach, *supra* note 300, at 1073–78. The NASD and the New York Stock Exchange have special suitability rules for options. *See* NASD MANUAL, *supra* at ¶ 2860(b)(16)(B); N.Y. STOCK EXCHANGE GUIDE (CCH) ¶ 2723.

302. NASD Rules of Fair Practice, NASD MANUAL (CCH) ¶ 2310(b), IM 2310-2.

303. Rule 405 provides:

Every member organization is required . . . to . . . [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

N.Y. STOCK EXCHANGE GUIDE (CCH) ¶ 2405.

304. Rule 405 does not mention suitability per se, but courts derive a suitability requirement from the conjunction of Rules 405 and 401. Rule 401 states that "[e]very member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs." N.Y. STOCK EXCHANGE GUIDE (CCH) ¶ 2401.

305. *See, e.g.,* Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805, 810–11 (1985).

306. *See* Roach, *supra* note 300, at 1086–87.

enforcement and private remedy actions.³⁰⁷ Then-SEC Commissioner Manuel Cohen explained that “[b]ecause of the unlimited variety of opportunities for unethical practices presented in sales transactions, the Commission has relied heavily upon adjudication in the development of standards for selling practices,” including suitability rules.³⁰⁸

d. Adjudicatory Decisions.—In its adjudicated suitability cases, the SEC’s initial task has been to articulate how the duty of suitability arises from the antifraud provisions of the federal securities laws. Under established SEC precedents, securities fraud extends beyond common-law fraud to include “acts that violate the obligation of fair dealing” by “professional broker-dealers and their salesmen.”³⁰⁹ Based on that principle, the SEC has held that recommending unsuitable securities to customers “violates the obligation of fair dealing.”³¹⁰

The Commission variously has relied on two different theories, the “shingle theory” and the “trust and confidence” theory to find that breaches of the duty of suitability constitute securities fraud. Under the shingle theory, the SEC has argued that by hanging out shingles and making their services available to the public, broker-dealers implicitly represent that they “will deal fairly with . . . customers in accordance with the standards of the profession,”³¹¹ and that violations of the implied representation of fair dealing constitute fraud.³¹² Under the SEC’s alternative theory, the “trust and confidence” theory, broker-dealers who cultivate the trust and confidence of their customers thereby become fiduciaries and owe a duty to act in the customers’ best interests.³¹³ Under both theories, securities fraud is

307. Despite the SEC’s preference for developing suitability through adjudicated decisions, in certain narrow areas the Commission has promulgated formal suitability regulations. *See infra* notes 332–41 and accompanying text.

308. Cohen & Rabin, *supra* note 297, at 714.

309. *Id.* at 702; *see also* Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 517 (1948) (noting that courts addressing fraud in the securities context often apply agency-law concepts to securities broker-dealers).

310. Mundheim, *supra* note 286, at 460–61.

311. Cohen & Rabin, *supra* note 297, at 702–03.

312. *Id.*; *see* Mac Robbins & Co., Exchange Act Release No. 6846, [1961–1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,853, at 81,174 (July 11, 1962); Carl J. Bliedung, 38 S.E.C. 518, 521–22 (1958); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 362 (1945); *see also* Roach, *supra* note 300, at 1091–95.

313. *See, e.g.*, Cohen & Rabin, *supra* note 297, at 703; Looper & Co., 38 S.E.C. 294, 300 (1958); Arleen W. Hughes, 27 S.E.C. 629, 638 (1948). As Louis Loss recognized:

Even more typically, of course, the customer does not come in off the street but is actively solicited by a salesman, who will almost inevitably render some advice as an incident to his selling activities, and who may go further to the point where he instills in the customer such a degree of confidence in himself and reliance upon his advice that the customer clearly feels—and the salesman knows the customer feels—that the salesman is acting in the customer’s interest. When you have gotten to that point, you

actionable both for affirmative misrepresentations and where broker-dealers who enlist trust violate that trust by not revealing that securities they recommend are unsuitable.³¹⁴

Under both of these theories, the SEC has condemned securities sales as unsuitable in a variety of circumstances.³¹⁵ Above all, a broker-dealer cannot "recommend a security unless there is an adequate and reasonable basis for such recommendation."³¹⁶ In order for a reasonable basis to exist, broker-dealers must do a reasonable investigation and base their recommendations on the results of the investigations.³¹⁷ They must also take the risk thresholds of their customers into account when recommending securities.³¹⁸ That said, suitability is not a guarantee of future performance. Thus, broker-dealers are not liable for securities that were suitable when purchased but that later suffered disappointing results for reasons beyond the salesperson's control.³¹⁹

One issue that has arisen in securities suitability cases is the role of customer consent to unsuitable stock purchases. The SEC has found brokers liable under the suitability doctrine for buying speculative securities for customers who the broker knew could not afford the risks presented or that were counter to the customer's stated needs,³²⁰ even when the customer consented to the purchase.³²¹ In the controversial case of *Philips & Co.*,³²²

have nothing resembling an arm's-length principal transaction regardless of the form of the confirmation. You have what is in effect and in law a fiduciary relationship.

Loss, *supra* note 309, at 529.

314. See Mundheim, *supra* note 286, at 470-71.

315. For a comprehensive overview, see Roach, *supra* note 300, at 1123-58, or Mundheim, *supra* note 286, at 453.

316. Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969).

317. *Id.*

318. See Mundheim, *supra* note 286, at 449.

319. See, e.g., Arnold S. Jacobs, 5C LITIGATION AND PRACTICE UNDER RULE 10B-5 § 211.01[b], at 9-63, 9-64 (1994).

320. See, e.g., Century Sec. Co., 43 S.E.C. 371, 377 (1967), *aff'd on other grounds sub nom.* Nees v. SEC, 414 F.2d 211 (9th Cir. 1969) (holding liable brokers who recommended nondividend paying stocks to clients that wanted income and dividends from their investments); Irving Friedman, 43 S.E.C. 314, 315-17 (1967) (holding liable a salesman who used high-pressure tactics to induce investors to buy speculative stock); J. Logan & Co., 41 S.E.C. 88, 98-99 (1962), *aff'd sub nom.* Hersli v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964) (holding liable a registrant and its salesman when they induced customers to exchange high-grade securities for speculative ones and to engage in unnecessary transactions); Ramey Kelly Corp., 39 S.E.C. 756, 759 (1960) (holding liable a broker who made material misrepresentations in encouraging an income-seeking customer to liquidate her portfolio); Hammill & Co., 28 S.E.C. 634, 637 (1948) (holding liable a broker who promised a client that he would reinvest proceeds, but instead deposited proceeds into his own account as a loan); Herbert R. May, 27 S.E.C. 814, 824 (1948) (holding liable a salesman who convinced customers desiring non-speculative investments to purchase stock in a financially troubled company). *But see* Gleit, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,799, at 90,887-92 (S.D.N.Y. 1976) (holding that risk is inherent in the stock market and that the investments were reasonable when made).

321. See *Philips & Co.*, 37 S.E.C. 66, 70 (1956) (upholding a disciplinary action against a firm for making unsuitable recommendations).

322. *Id.*

for example, the SEC held that a “broker is obliged to observe [the suitability requirement] regardless of a customer’s wishes.”³²³ In *Philips*, the agency affirmed a NASD finding that a broker violated the NASD’s suitability rule by advising people of limited means to buy oil stock that he knew was too speculative for their financial circumstances, even though the customers voluntarily consented to the purchases.³²⁴

Similarly, over time, the SEC rejected the view that disclosure can cure suitability violations. For example, in *Powell & McGowan, Inc.*,³²⁵ the SEC found violations of suitability where a salesperson sold speculative securities to a senile customer through a “persistent and aggressive sales campaign.”³²⁶ The Commission went further to hold that disclosures would not have exempted the broker from liability because no amount of disclosure would have enabled the customer to evaluate the merits of the securities on a reasoned basis.³²⁷ Subsequently, the Commission suggested that even when customers are fully competent, disclosures might not be sufficient to cure suitability violations.³²⁸ Thus, the Commission’s stance has evolved to embrace a suitability requirement that cannot be waived by disclosures or customer consent.

In a further extension of the doctrine with particular relevance to predatory lending, the SEC has applied the suitability requirement to boiler-room sales of penny stocks when brokers recommend stocks without obtaining information on their customer’s financial circumstances or risk preferences. Boiler-room operations refer to high-pressure sales of low-cost, speculative securities through cold calls over the telephone to unfamiliar and naïve customers. In boiler-room cases such as *Mac Robbins & Co.*,³²⁹ the Commission has repeatedly held that it is fraud for a broker-dealer “to induce a hasty decision by the customer” where “no effort [was] made by the

323. Roach, *supra* note 300, at 1126.

324. *Philips & Co.*, 37 S.E.C. at 67–70; accord Stephen Thorlief Rangen, Exchange Release No. 38,486, 52 S.E.C. 1304, 1311 (Apr. 8, 1997) (upholding New York Stock Exchange’s liability findings and sanctions for advising customers of limited means to invest in highly speculative margin purchases and excessively trading the accounts); Eugene J. Erdos, 47 S.E.C. 985, 989 (1983), *aff’d*, 742 F.2d 507 (9th Cir. 1984) (holding that whether the customer considered the transactions suitable is not the test for a broker’s conduct). *But see Phillips v. Reynolds & Co.*, 294 F. Supp. 1249 (E.D. Pa. 1969) (rejecting claims by affluent and experienced investors, even though they alleged that the broker had actual knowledge of unsuitability).

325. 41 S.E.C. 933 (1964).

326. *Id.* at 934–35.

327. *Id.*; see also Roach, *supra* note 300, at 1127–29.

328. *Whitman & Stirling Co.*, 43 S.E.C. 181, 182–83 (1966); see also Harold R. Fenocchio, Exchange Release No. 12,194, 46 S.E.C. 279, 284 (1976) (noting that even disclosure to a customer with more than 50 years’ investment experience would be insufficient to justify excessively high turnover in mutual-fund accounts).

329. *Mac Robbins & Co.*, Exchange Act Release No. 6846, [1961–1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,853, at 81,174 (July 11, 1962); see also *Best Securities Inc.*, 39 S.E.C. 931 (1960); Gerald M. Greenberg, 40 S.E.C. 133 (1960).

salesman . . . to determine whether the security recommended [was] suitable for the customer."³³⁰

As one commentator has noted, "Boiler rooms are special precisely because, unless the high-pressure salesperson assumes an affirmative duty to inquire and assure suitability, unsuitable transactions are inevitable, and this truth should be obvious to the salesperson."³³¹ The same can be said of subprime mortgage lending. By definition, subprime mortgages impose higher financial burdens and are targeted at individuals of modest means who are least able to afford them and least able to understand their terms. As with boiler-room sales of securities, it should be incumbent on subprime lenders and brokers to determine that borrowers who assume those obligations have the capacity to repay them.

e. SEC Suitability Regulations.—In addition to fashioning the suitability doctrine through adjudication, the SEC has promulgated formal suitability regulations with respect to the sales of certain highly speculative securities. The most important SEC rule in that regard, Rule 15g-9, requires brokers to restrict their sales of speculative low-priced securities to individuals who have (or whose investment advisers have) "sufficient knowledge and experience in financial matters" to be "reasonably . . . capable of evaluating the transactions in penny stocks."³³² For all other investors, penny stocks are per se unsuitable.

Similarly, in Exchange Act Rule 15c2-5, adopted in 1962, the SEC adopted a suitability requirement for "equity-funding programs" involving lending abuses. In the equity-funding programs at issue, broker-dealers convinced "persons of modest means and little financial experience" to purchase mutual fund shares and to pledge those shares to secure personal loans, the proceeds of which were used to pay for insurance-policy premiums.³³³ In essence, equity-funding programs were schemes to sell insurance policies on financing terms that many customers could not afford. The SEC "discovered that in many cases [the programs] were being offered to persons for whom they were wholly inappropriate."³³⁴ In response, in Rule 15c2-5, the Commission announced that henceforth it would be a

330. Cohen & Rabin, *supra* note 297, at 707. Outside of the boiler-room context, some courts have disagreed with the SEC's position that suitability imposes an affirmative duty to investigate the customer's finances. Compare *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021 (S.D.N.Y. 1977) (holding that a sophisticated investor with speculative investment goals could recover for breach of suitability), *aff'd*, 570 F.2d 38 (2d Cir. 1978), with *Parsons v. Hornblower & Weeks-Heimphill Noyes*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,885 (M.D.N.C. 1977) (denying recovery).

331. Roach, *supra* note 300, at 1140.

332. 17 C.F.R. § 240.15g-9(b)(2) (1997). The NASD's parallel penny-stock suitability rule appears at NASD Rules of Fair Practice, NASD MANUAL (CCH) ¶ 2310-1, IM 2310-1.

333. Mundheim, *supra* note 286, at 454.

334. *Id.*

“fraudulent, deceptive, or manipulative act or practice” under Section 15(c)(2) of the Exchange Act³³⁵ for a broker or a dealer to assist in arranging credit to a purchaser of securities (other than routine margin borrowing) without first ascertaining suitability.³³⁶ Specifically, the Rule requires broker-dealers who wish to arrange such loans to:

[Obtain] from such person such information concerning his financial situation and needs, reasonably determine that the entire transaction, including the loan arrangement is suitable for such person, and [retain] in his files a written statement setting forth the basis upon which the broker . . . made such determination.³³⁷

It is worth noting that Rule 15c2-5 has special relevance to predatory lending, insofar as it was the first SEC rule that imposed a duty of suitability in response to loan abuses.

A third SEC rule was Exchange Act Rule 15b10-3, promulgated in 1967, which imposed a suitability duty on brokers who fell outside of NASD regulation. In that rule, the SEC required every broker who was not a member of the NASD and who recommended “the purchase, sale or exchange of any security” to have:

[R]easonable grounds to believe that the recommendation [was] not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer’s investment objectives, financial situation and needs, and any other information known by such broker.³³⁸

The SEC adopted this rule, known as the SECO (SEC-registered Only) suitability rule, pursuant to the Securities Acts Amendments of 1964,³³⁹ which authorized direct SEC regulation of registered brokers who were not members of the NASD.

335. 15 U.S.C. § 78o(c)(2) (2000).

336. Rule 15c2-5 applies to all securities purchases that are financed through means other than routine margin borrowing, not just equity funding programs.

337. 17 C.F.R. § 240.15c2-5 (2002); *see also* *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961) (affirming an award against an insurance agent for selling an equity-funded insurance package not suitable to the plaintiff’s financial situation after making representations to the plaintiff that the program was suitable); *Cohen & Rabin*, *supra* note 297, at 700; *Mundheim*, *supra* note 286, at 454–55; *Roach*, *supra* note 300, at 1087–91, 1152–53.

338. Former 17 C.F.R. § 240.15b10-3 (1967), *reprinted in* *Roach*, *supra* note 300, at 1079; *see also* SEC Securities Exchange Act Release No. 34-8135, [1966–1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,459, at 82,890 (July 27, 1967) (interpreting Rule 15b10-3); *Kerr*, *supra* note 305, at 809–11; *Roach*, *supra* note 300, at 1078–81.

339. Pub. L. No. 88-467, § 1, 78 Stat. 565 (1964). In 1983, Congress amended the Exchange Act to require that all registered brokers in the over-the-counter securities business join the NASD, thereby subjecting them to the NASD’s suitability requirements. Pub. L. No. 98-38, § 3(a)(8), 97 Stat. 205 (1983). As a consequence, the SEC rescinded the SECO suitability rule. 48 Fed. Reg. 53,688 (Nov. 29, 1983); *see also* *Kerr*, *supra* note 305, at 809 n.22.

Finally, the SEC's "accredited-investor" rules are a variation on the suitability doctrine. Under Regulation D, limited offerings and other securities offerings that qualify for an exemption from Securities Act registration are exempt from full disclosure so long as broker-dealers only market exempt offerings to sophisticated investors (or, in SEC jargon, "accredited investors").³⁴⁰ Under Rule 501(a), accredited investors are limited to institutional investors and individuals with net worths in excess of \$1 million or annual incomes for the past two years in excess of \$200,000 individually or \$300,000 when combined with the income of a spouse.³⁴¹ These net worth and income screens serve as filters that prohibit the marketing of more speculative securities to unsophisticated investors.

f. Enforcement.—In the securities industry, there are several avenues for enforcing suitability. SROs can initiate disciplinary proceedings against their members or associates for violating SRO suitability rules or those of the SEC. In SRO proceedings, the SROs can either expel respondents who are found in violation or impose lesser sanctions, such as suspensions or fines. In addition, the SEC can adjudicate suitability through two separate avenues. The first is through appeals of SRO disciplinary proceedings to the SEC. The second is through direct SEC disciplinary proceedings against broker-dealers³⁴² for alleged Exchange Act antifraud violations.³⁴³ Similarly, injured investors can bring suit for suitability violations. Violations involving fraud are actionable under the implied private right of action for securities fraud in Section 10(b) (either in court or in arbitration proceedings).³⁴⁴ Securities-arbitration proceedings initiated by

340. See 17 C.F.R. §§ 230.501(e), 230.505(b)(2)(ii), 230.506(b)(2)(i) (2001); see also *id.* §§ 230.144, 230.144A (2001) (limiting the sale of restricted securities to qualified institutional investors).

341. See *id.* § 230.501(a).

342. The SEC has jurisdiction to charge broker-dealers either in their capacities as NASD members or SEC registrants. See generally Cohen & Rabin, *supra* note 297, at 707–08; Roach, *supra* note 300, at 1119, 1121.

343. See generally Cohen & Rabin, *supra* note 297, at 702, 707–08 (noting that the Commission has established "a high standard of conduct for broker-dealers in their relations with customers"); Roach, *supra* note 300, at 1135, 1140–44 ("The Commission usually initiates actions only against flagrant violators, when an antifraud violation may be in question, leaving other matters to the NASD.").

344. See, e.g., Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1036–37 (S.D.N.Y. 1977), *aff'd*, 570 F.2d 38 (2d Cir. 1978); see also Roach, *supra* note 300, at 1143–55 (reviewing federal-court cases relevant to suitability principles).

Plaintiffs also have urged the courts to recognize an implied cause of action under the NASD's suitability rule and the New York Stock Exchange Rule 405. They have met with limited success because of judicial reluctance to recognize new implied private rights of action under the securities laws. See, e.g., F. Harris Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435, 438–45 (1977) (arguing that "private enforcement of the NASD suitability and stock exchange 'Know Your Customer' rules has not fared well in some circuits"); Roach, *supra* note 300, at 1122–23, 1145–46, 1149, 1185–95.

disappointed investors sometimes result in relief for violations of SRO suitability rules even in the absence of fraud.

g. Industry Implementation.—Suitability determinations are now routine in the securities industry. Legitimate broker-dealers ensure compliance with industry and SEC suitability requirements by surveying their customers to obtain an accurate assessment of customers' risk thresholds and by implementing internal controls. Typically, customers opening new accounts fill out a new-account form. As part of these forms, customers must complete a "suitability" questionnaire that requires them to disclose their: (1) financial status, (2) investment objectives, (3) risk tolerance, and (4) prior investment experience.³⁴⁵ Upper-level management then reviews the customers' answers before any trades are executed. In addition, many firms use computers to compare customers' answers to the suitability questions with the securities that they are considering. The computer can generate "red flags" if comparisons raise suitability concerns. If a client is warned that an investment is unsuitable and nevertheless insists on going forward with the transaction, the transaction will require upper-level management review, explicit warnings, and special client releases at a minimum.³⁴⁶ In many cases, due to liability concerns, legitimate firms will refuse to execute unsuitable transactions because of unsettled case law on the role of consent.³⁴⁷ In other circumstances, SEC rules flatly prohibit waiver of suitability claims, particularly with respect to sales of penny stocks.

2. *Suitability in the Insurance Industry.*—A duty of suitability has taken root in insurance sales as well. As insurance products began incorporating investment features, particularly variable annuity policies and variable life insurance, the suitability standard that applied to securities was extended to apply to these new insurance products.³⁴⁸

Before the 1970s, investments in securities were largely the preserve of the wealthy. For middle- and lower-income people, simpler and safer financial products such as life insurance and bank accounts, certificates of deposit, and government bonds were the savings vehicles of choice. Due to

345. See, e.g., Quick & Reilly, IPO Suitability, at http://www.quick-reilly.com/ipo/ipo_suit.html (last visited Jan. 20, 2002) (requiring IPO customers to complete a questionnaire as to their suitability); Reed, *supra* note 290; Fact Master, Suitability, at <http://www.factmaster.com/About/suit.html> (last visited Jan. 20, 2002) (describing method software used to determine suitability).

346. See, e.g., SBO Net Investor Suitability (last visited Jan. 20, 2002) (describing one firm's review process), available at <http://www.sbonet.com/glossary/definitions.htm#Suitability>.

347. See *supra* notes 320–24 and accompanying text.

348. For descriptions of variable policies, see ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW §§ 13A[b][1], [b][3] (2d ed. 1996), and *NationsBank of N.C. v. VALIC*, 513 U.S. 251, 254 (1995).

the resulting market segmentation, insurance companies enjoyed a captive market and did not face serious competition from the securities industry.

With the popularization of mutual funds, however, the insurance industry faced new competition from securities firms. Individuals of modest means began shifting their savings out of life-insurance policies and bank accounts into mutual funds that offered the risks and rewards of equities. In order to stave off competition from securities, insurers developed variable annuities that featured investment risks, including possible loss of principal. In a development that paralleled the emergence of complex subprime loans for LMI borrowers, these new and "more complex" insurance products were "marketed to consumers that include[d] the same segment of customers that previously limited their purchases to the traditional, uncomplicated life insurance products."³⁴⁹ Due to concerns that "[c]omplex hybrid products [were being] offered to customers in all walks of life and of all financial means," the "expansion of the market . . . created suitability issues that did not exist in the past."³⁵⁰

The seminal decision that expanded the securities suitability doctrine to insurance products was *SEC v. VALIC*,³⁵¹ where the Supreme Court ruled that variable annuities were subject to federal securities regulation. In *VALIC*, the Court noted that while variable annuities are "issued by insurance companies [that] are subject to state insurance regulation," they "also contain investment risks."³⁵² Since *VALIC*, the SEC has regulated variable insurance products as securities³⁵³ and the NASD has imposed a duty of suitability in the sale of these products.³⁵⁴ In a series of recent enforcement actions and Notices to Members, the NASD has specifically emphasized that NASD Rule 2310 on suitability applies to the sale of variable life insurance and annuities.³⁵⁵

In a parallel development, the doctrine of good faith and fair dealing that applies to insurance settlements and insurance sales has been an important force in the evolution of a suitability requirement in insurance. In

349. NAIC, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 17* (Pub. No. SOS-LI 2000); *see also id.* at 23.

350. *Id.* at 17; *see also id.* at 23.

351. 359 U.S. 65 (1959).

352. NAIC, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 2* (Pub. No. SOS-LI 2000).

353. *Id.*

354. *See id.* at 22.

355. *See* NASD Notices to Members 00-44 (July 2000), 99-35 (May 1999), and 96-86 (Dec. 1996) (advising that NASD members have been fined and disciplined by NASD for selling unsuitable variable life-insurance products to customers); Pruco Sec. Corp. Letter of Acceptance Waiver and Consent, NASD No. CAF990010 (July 8, 1999) (finding that an NASD member violated the duty of suitability in the sale of variable life insurance); In the Matter of District Business Conduct Committee for District No. 8 v. Miguel Angel Cruz, NASD No. C8A930048 (Oct. 31, 1997) (same); *see generally* Jeffrey S. Poretz, *Insurance Products as Securities*, in *PRACTICING LAW INSTITUTE, UNDERSTANDING SECURITIES PRODUCTS OF INSURANCE COMPANIES* 71, 124-25 (2001).

almost every state, insurers must act in good faith and deal fairly when they respond to settlement offers.³⁵⁶ Beginning in the early 1970s, this duty of good faith and fair dealing was expanded from third-party claims³⁵⁷ to first-party claims as well,³⁵⁸ including claims by owners of variable annuities and life insurance policies with investment features.

One of the earliest cases in which the courts imposed suitability in insurance was *Anderson v. Knox*.³⁵⁹ In *Anderson*, the Ninth Circuit imposed a duty of suitability in the financing of life insurance that saddled the insured with a \$125,000 loan.³⁶⁰ The insured, Roger Knox, bought the insurance after an insurance salesman advised him that bank-financed insurance “was a suitable program for plaintiff and his family and fitted their needs.” Affirming judgment for Knox, the Ninth Circuit held that he had justifiably relied on the salesman’s assurances that financed insurance was suitable because the salesman held himself out as an expert and knew that Knox did not understand the program.³⁶¹ Furthermore, the appeals court agreed that the insurance program was unsuitable for Knox, because it eliminated insurance protections Knox already had and because Knox could not afford it. The program was similarly unsuitable because it was inappropriate for individuals in plaintiff’s tax bracket, did not provide the investment savings or retirement benefits that Knox needed, and was not worth what it cost.³⁶²

In *Knox*, the court noted expert testimony to the effect that “the usually accepted practice among good life insurance underwriters was not to permit a policy holder to contract for more insurance than he could comfortably afford.”³⁶³ Nevertheless, with three dependents to support on a salary of

356. In most states, the duty arises from contract law, while many states recognize the duty in tort. See, e.g., JERRY, *supra* note 348, §§ 25G, 112[b][1][c] and cases cited therein; see also *Crisci v. Security Ins. Co. of New Haven, Conn.*, 426 P.2d 173 (Cal. 1967) (characterizing the refusal to settle as a tort and awarding damages for mental anguish).

357. See JERRY, *supra* note 348, § 25G[b]; *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 200 (Cal. 1958) (stating that the requirement of good faith and fair dealing in some situation may obligate an insurer to settle); *Brown v. Guar. Ins. Co.*, 319 P.2d 69, 77 (Cal. Ct. App. 1957) (explaining that insurers owe a duty of good faith to insureds regarding compromise offers). Third-party claims involve liability insurance that protects the interests of third parties injured by the insured’s conduct. See JERRY, *supra* note 348, § 13A[e].

358. See JERRY, *supra* note 348, § 25G[c] (reporting that “today courts in about half the states adhere to the rule that the insurer who breaches the duty of good faith and fair dealing, either in the third-party setting or in the first-party setting, is liable to the insured in tort for the damages sustained as a result of the breach”); *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1037 (Cal. 1973) (applying the obligation of good faith and fair dealing to insurers in settling claims). First-party insurance policies “indemnify[] the insured for a loss suffered directly by the insured.” JERRY, *supra* note 348, § 13A[e]. Property insurance and variable annuities are examples of first-party insurance.

359. 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962).

360. See generally *id.* at 703–05, 713.

361. *Id.* at 707–11.

362. *Id.* at 711–20.

363. *Id.* at 714.

\$8,100 per year and no more than \$1,600 in investment income annually, Knox's net interest payments on the insurance policy for 1960 "would have been . . . \$4106.40, 40% of his gross annual income."³⁶⁴ Under the circumstances, the Ninth Circuit held, the lower court "could properly hold that [the program] was not suitable for a man of [Knox's] earning capacity."³⁶⁵

In more recent years, about one-fifth of the states have adopted express suitability requirements in insurance by statute or rule. Currently, six states have statutes or regulations that prohibit the sales of specified insurance products (normally including life insurance and annuities) absent reasonable grounds to believe that the sales would be suitable for the customers.³⁶⁶ These provisions differ in how much guidance they afford insurers as they evaluate the suitability of a particular product for an individual customer. Some provisions provide no guidance whatsoever³⁶⁷ or require only a general duty of inquiry.³⁶⁸ Others mandate that insurers consider customers' insurance objectives, financial situations, needs, and age when recommending products.³⁶⁹ At least three other states have statutes, rules, or

364. *Id.* at 715.

365. *Id.*

366. See IOWA ADMIN. CODE r. 191-15.8(4), 191-15.11(3) (2001) (applying a suitability requirement to producers of life-insurance policies and annuities); KAN. ADMIN. REGS. 40-2-14(c)(5) (applying suitability to the purchase or replacement of life insurance and annuities); MINN. STAT. ANN. §§ 60K.14 (West 1996), 72A.20 (West 1999) (applying suitability to sales by agents of life, endowment, individual accident and sickness, long-term care, annuity, life-endowment insurance, and Medicare supplement insurance); S.D. ADMIN. R. 20:06:14:03(7) (applying suitability to agent sales of individual life-insurance and all health-insurance policies), 20:06:13:43 *et seq.* (applying suitability to all health insurance sales to senior citizens); S.D. CODIFIED LAWS §§ 58-17-87 (Michie 2000) (applying suitability to individual health benefit plans), 58-18B-35 (Michie 2000) (imposing suitability on stop-loss and multiple-employer trusts); VT. STAT. ANN. tit. 8, § 4724 (2001) (applying suitability to all insurance products and expanding the Vermont UDAP statute to make unsuitable sales an unfair or deceptive trade practice); WIS. ADMIN. CODE § 2.16(6) (1999) (applying suitability to insurers or intermediaries who market the purchase or replacement of individual life insurance or annuities). Incorporation of a suitability standard into state UDAP provisions that apply to insurance, as in Vermont, tracks expansion in the definition of unfair and deceptive acts and practices in insurance over the past few decades.

367. See VT. STAT. ANN. tit. 8, § 4724 (2001); see generally James A. McGuire & Kristin Dodge McMahon, *Bad Faith, Excess Liability and Extracontractual Damages: Counsel for the Excess Carrier Looks at the Issues*, 72 U. DET. MERCY L. REV. 49, 60 (1994); Willy E. Rice, *Judicial Bias, the Insurance Industry and Consumer Protection: An Empirical Analysis of State Supreme Courts' Bad Faith, Breach-of-Contract, Breach of Covenant-of-Good-Faith and Excess-Judgment Decisions, 1900-1991*, 41 CATH. U. L. REV. 325, 379-82 (1992).

368. See WIS. ADMIN. CODE § 2.16(6) (requiring that insurers and their intermediaries "make all necessary inquiries under the circumstances to determine that the purchase of the insurance is not unsuitable for the prospective buyer").

369. See IOWA ADMIN. CODE r. 191-15.8(4) (2001) (directing producers to consider "other relevant information" known to them); see also KAN. ADMIN. REGS. 40-2-14(c)(5) (requiring regulated entities to make suitability recommendations "on the basis of information furnished by [the customer], or otherwise obtained"); MINN. STAT. ANN. § 60K.14 (West 1996 & Supp. 2002) (requiring agents to consider "the totality of the particular customer's circumstances, including, but not limited to, the customer's income, the customer's need for insurance, and the values, benefits

rulings that impose suitability obligations of a more limited nature on some segment of insurance sales.³⁷⁰ Other state insurance commissioners have called for suitability standards in insurance, especially with respect to seniors.³⁷¹ In the meantime, one industry trade association, the Insurance Marketplace Standards Association (IMSA), has imposed a suitability requirement on its members for life insurance and annuity sales.³⁷²

The passage of the Gramm-Leach-Bliley Act in November 1999 provided added federal impetus for an industry-wide suitability rule in insurance. Congress there specified that unless twenty-nine states agree on reciprocity in insurance-agent licensing or adopt uniform licensing laws and regulations by November 11, 2002, insurance sales by banks will face a national registration system for insurance agents and brokers under the auspices of the National Association of Registered Agents and Brokers (NARAB).³⁷³ If states opt for uniform licensing laws in lieu of reciprocity, Gramm-Leach-Bliley requires states to adopt suitability standards for insurance sales in order to “ensure that an insurance product, including any annuity contract, sold to a consumer is suitable and appropriate for the consumer based on financial information disclosed by the consumer.”³⁷⁴ With this provision, Congress expressly required any uniform national licensing scheme in insurance to include a suitability standard.

In the most significant development to date, in 2000, the National Association of Insurance Commissioners (NAIC) formally recommended that all states adopt a suitability requirement for the sale of life insurance and annuity products.³⁷⁵ That recommendation grew out of a white paper earlier that year by the Suitability Working Group of the Life Insurance and Annuities Committee of the NAIC that explored standards for the suitability of sales of life insurance and annuities. In its white paper, the Working

and costs of the customer’s existing insurance program, if any, when compared to the values, benefits and costs of the recommended policy or policies”); S.D. ADMIN. R. 20:06:14:03(7) (stating that “agents must examine the totality of the consumer’s circumstances including their financial condition and need for insurance at the time”).

370. See N.M. ADMIN. CODE tit. 13, § 10.8.54.1 (2001) (requiring agents to “make reasonable efforts to determine the appropriateness of a recommended purchase or replacement” of a Medicare supplement policy or certificate); Ohio Dep’t Ins. Bull. 92-1, Agent Marketing of Not Fully Insured Mewas Prohibited (Mar. 1, 1992) (construing the Ohio UDAP statute, OHIO REV. CODE ANN. § 3901.20, to require insurance agents to “determine the status and suitability of any and all products he or she markets”); UTAH CODE ANN. § 31A-23-303 (2001) (authorizing the state insurance commissioner to find certain products “inherently unsuitable”).

371. See NAIC, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 1* (Pub. No. SOS-LI 2000) (reporting that in a 1997 survey by the NAIC, 22 states recommended development of a model act creating suitability requirements for annuity sales).

372. See IMSA, *Principles and Code of Ethical Market Conduct with Commentary*, at http://www.imsaethics.org/i_pc.html.

373. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 321(a), 113 Stat. 1338, 1422 (1999).

374. *Id.* §§ 321(a), (b)(4).

375. See NAIC, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23-24* (Pub. No. SOS-LI 2000).

Group recommended adoption of a duty of suitability, after concluding that the current complexity of life insurance and annuities made disclosure and industry self-regulation inadequate:

Disclosure requirements are no longer sufficient consumer protection in such an environment. . . . [Similarly, w]hile the working group applauds the initiatives embodied in . . . voluntary measures many companies and firms have taken, the working group does not feel that these initiatives are an adequate or sufficient substitute for suitability rules. The IMSA program, certainly a step in the right direction, is voluntary and not enforceable by regulators. Likewise, other voluntary measures cannot substitute for requirements.³⁷⁶

The NAIC formally adopted the white paper in June 2000 and NAIC is now drafting model legislation.³⁷⁷

B. Theoretical Bases for Suitability in the Subprime Market

The duty of suitability, by shifting responsibility for safeguarding customers' interests from customers to insurers and securities broker-dealers, rejects the prevailing paradigm of caveat emptor and forces these providers to internalize the harm that they cause when they exploit information asymmetries to the detriment of customers. The theoretical justifications for the adoption of suitability in the insurance and securities markets apply equally to the home-mortgage market where disclosure and industry self-regulation do not provide sufficient protection for consumers, and financial-services providers use marketing strategies that deliberately inculcate consumer confidence and trust.³⁷⁸ In this section, we discuss these justifications and their applicability to the home-mortgage market.

One rationale for the suitability doctrine is that disclosure does not provide adequate protection to investors. In the seminal case of *Phillips & Co.*,³⁷⁹ the SEC imposed a suitability requirement because "disclosure

^{376.} *Id.*

^{377.} See Summary: Life Insurance and Annuities Suitability Model Regulation (Mar. 6, 2001), at <http://www.naic.org/1papers/models/0301docs/lifeins-annsuitabilsummary.htm>; see also NAIC, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES (Pub. No. SOS-LI 2000). The current draft model language would provide:

Prior to making a recommendation for the purchase, sale or exchange of a fixed life insurance or annuity product, an insurer or an insurance producer shall obtain relevant information from a consumer and shall make reasonable efforts to determine the insurable needs or financial objectives of the consumer and recommend insurance transactions which are suitable in assisting the consumer to meet those needs or objectives.

NAIC, LIFE INSURANCE AND ANNUITIES SUITABILITY MODEL ACT § 2(A) (July 17, 2001), available at <http://www.naic.org/1papers/models/0601docs/suitact2.doc>.

^{378.} See, e.g., Langevoort, *supra* note 122, at 627 (describing why brokers may mischaracterize the risk level of investments); Mundheim, *supra* note 286, at 450; NAIC, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23 (Pub. No. SOS-LI 2000).

^{379.} 37 S.E.C. 66 (1956).

requirements and practices alone [had] not been wholly effective in protecting the investor.”³⁸⁰ Virtually all commentators now agree that current securities disclosures—most notably offering prospectuses under the Securities Act of 1933 and annual and quarterly reports under the Exchange Act—are too arcane, complex, and laden with disclaimers to provide meaningful guidance to individual investors.³⁸¹ As Professor Henry Hu has pointed out with respect to mutual funds, mandatory disclosures do not necessarily provide the precise information that is most essential to investment decisions, especially information necessary for evaluating probabilistic future outcomes.³⁸² In insurance, the NAIC has reached the same conclusion, namely, that disclosure is inadequate.³⁸³

A second justification for suitability in securities rests on findings that “the public has been encouraged to and has relied on the superior skill of the broker-dealer community in its securities transactions.”³⁸⁴ As is true in the insurance industry, broker-dealers and their firms consciously employ marketing strategies that are designed to elicit consumer trust. Not only is reliance encouraged—it is also often necessary because disclosure documents can be virtually incomprehensible. As a result, ordinary consumers are forced to look to their brokers and dealers for advice.³⁸⁵

A third and equally compelling justification for the imposition of securities suitability rests upon the work of Coase, who posited that the party who is in the best position to avoid the harm at the least cost should bear the cost of avoiding the harm.³⁸⁶ In securities, broker-dealers can avoid the harm of unsuitable recommendations more cheaply than their customers. Broker-dealers and their firms specialize in acquiring information about individual issuers, market trends, and portfolio decisions that are appropriate for specific customers. In contrast, requiring every individual investor to acquire that same level of expertise about securities would not be cost-effective. Furthermore, given the aggressive marketing practices by securities firms, it is not clear that requiring consumers to acquire the same level of knowledge that their brokers-dealers possess would lead to a reduction in harm.³⁸⁷ To

380. *Id.* at 68.

381. *See, e.g.,* Kerr, *supra* note 305, at 831 (stating that “the theory that the prospectus can be and is utilized by the lay investor is a myth”).

382. *See* Hu, *supra* note 132, at 2325.

383. *See* NAIC, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23* (Pub. No. SOS-LI 2000).

384. Mundheim, *supra* note 286, at 450.

385. *See* Kerr, *supra* note 305, at 830.

386. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

387. *See* Hu, *supra* note 132, at 2326 (“And even assuming universal literacy is attainable . . . [.] a disproportionate share of societal resources being devoted to investment decisionmaking could occur simultaneously with socially unacceptable levels and distributions of decisionmaking error.”).

the contrary, imposing liability on broker-dealers who sell unsuitable products has a much greater likelihood of avoiding harm.

The same economic rationales for suitability apply to the subprime mortgage market. Disclosure has proven useless, and financial literacy is hopelessly costly and unlikely to succeed. In addition, just as with boiler-room securities operations, the extreme sales tactics of predatory lenders are specifically designed to overcome borrowers' better judgment. Finally, turning to the third rationale for suitability—Coase's theory—lenders often are in a better position than borrowers to predict the amount of debt that borrowers can manage.³⁸⁸ Lenders can draw on extensive proprietary databases with past repayment histories of borrowers to predict borrowers' risk thresholds and ability to repay. For decades, lenders have relied on underwriting guidelines that are based on similar predictions in deciding whether to make loans. Certainly, they can use those same guidelines to determine whether borrowers can afford their repayment obligations.

In addition, lenders are better able to understand the financial consequences of the credit they extend. As discussed before, subprime loans tend to feature the most complex terms, ones that borrowers are ill-equipped to analyze. Lenders are in a superior position to understand the possible financial consequences of complex loan terms such as prepayment penalties and ARMs because they can assemble and analyze aggregate historical data on key issues such as past default rates and interest-rate movements. In contrast, LMI borrowers have neither the access to proprietary borrower data nor the expertise to perform those analyses themselves. The informational advantage that lenders enjoy is compounded by the fact that the lenders design the loan terms and draft the underlying loan agreements and disclosures.

Confronted with these odds, placing the onus on LMI borrowers to protect themselves is not cost-effective. Lenders can avoid the harm from predatory lending in a cost-effective manner by using traditional underwriting processes and guidelines to assess the suitability of customers' loans.

388. Arguably, borrowers are in the best position to know whether they have the subjective intent to repay their loans. But default and foreclosure studies suggest that LMI borrowers who default do so because of unforeseen events, not because they lacked the intent to repay the loans at the time that they consummated the loans. *See, e.g.*, Brent W. Ambrose & Charles A. Capone, *Modeling the Conditional Probability of Foreclosure in the Context of Single-Family Mortgage Default Resolutions*, 26 J. AM. REAL EST. URB. ECON. ASS'N 391 (1998). Furthermore, borrowers with good intentions are often unable to assess their own ability to repay, especially if their loan documents lack transparency or their loans involve probabilistic price terms with uncertain future effects.

C. *Adapting Suitability to Subprime Mortgage Lending*

1. *Structure and Enforcement Channels.*—In the securities industry, private individuals, government, and industry all enforce the duty of suitability.³⁸⁹ This multiple-gatekeeper approach has numerous benefits,³⁹⁰ the most important being vigorous enforcement and establishment of a formal forum for industry input and rules. If a multiple-gatekeeper system is to be achieved in subprime mortgage lending, a cause of action for breach of suitability that is enforceable by private individuals and government is necessary but not sufficient.³⁹¹ A vehicle for mandatory self-regulation by industry is also essential.

To date, voluntary self-regulation has been virtually nonexistent in subprime mortgage lending.³⁹² The subprime industry has little incentive to institute compliance mechanisms because subprime lenders and mortgage brokers are either unregulated or under-regulated.³⁹³ Furthermore, subprime

389. As discussed above, disappointed investors may seek private relief for securities fraud under section 10(b) of the Exchange Act. Sometimes private individuals may obtain relief in arbitration proceedings for violations of SRO disciplinary rules as well. In addition, in SEC enforcement proceedings, broker-dealers face revocation or suspension of their SEC licenses or other SEC sanctions for suitability violations. Finally, industry self-regulation subjects broker-dealers to expulsion or suspension from the NASD or stock exchange, fines, and other sanctions for breach of the suitability rules.

390. See generally Reinier H. Kraakman, *Gatekeepers: An Anatomy of a Third Party Liability Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

391. See *infra* section IV(C)(3) for our proposal recommending such a cause of action.

392. The Mortgage Bankers Association of America is the one industry association that has recommended best-practices guidelines for subprime mortgage lending. See Mortgage Bankers Association of America, *The Non-Conforming Credit Lending Committee Working Group Report/Subprime Lending and High Cost Mortgages: Recommended "Best Practices" & "Legislative Guidelines,"* at <http://www.mbaa.org/resident/lih2000/0525b.html>. Those guidelines are strictly voluntary, however, and are not binding on individual lenders or brokers. Cf. NAIC, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23* (Pub. No. SOS-LI 2000) (recommending suitability laws in insurance because industry measures are "voluntary and not enforceable by regulators").

One subprime lender, Ameriquest Mortgage Company, has gained attention for adopting "best practices" designed to avoid predatory lending. Examples of their guidelines include a requirement that the company assess whether borrowers can afford to repay their loans, prohibitions on mandatory-arbitration clauses, and bans on the financing of single-credit life insurance. Ameriquest Mortgage Co., *Ameriquest's "Best Practices" Policy*, at <http://www.ameriquestmortgage.com/about/press.html> (last visited Apr. 25, 2002); see also Lew Sichelman, *Mortgage Firm Has Good Model for Subprime Lending*, CHI. TRIB., July 29, 2001, at 7F, 2001 WL 4098626 (praising Ameriquest as fair and honest for their "best practices"). Additionally, in letters to potential borrowers, Ameriquest advises the borrowers to "[c]onsult with other lenders, including banks and savings and loans, to confirm the terms we offer are acceptable to you. . . . Do not let anyone pressure you into obtaining a loan." *Id.*; see also Lew Sichelman, *A Lender Advises Clients to Shop Around Before Signing—Imagine That*, L.A. TIMES, July 29, 2001, at K7.

393. While subprime lenders that are affiliates of insured banks are regulated by the Federal Reserve Board, in-depth examinations of those affiliates are quite rare and are motivated primarily by safety and soundness concerns, not consumer protection. Mortgage brokers and lenders are subject to licensing and regulation in some states, but the state regulation that exists has not been enough to counteract the spread of predatory lending.

lenders have reduced incentives to eliminate exploitative practices individually because they stand to lose business or funding sources if they do. For example, subprime lenders who eliminate yield-spread premiums will reduce the income of their brokers and face losing their brokers to other lenders. Subprime lenders who drop prepayment penalties may have difficulty selling their loans on the secondary market, losing crucial financing sources. Their competitors, who retain prepayment penalties, can then capture more of the secondary market. Even if some lenders were inclined to self-regulate, the subprime market has thousands of lenders, making it impossible to mobilize market participants for self-regulation.

Given these obstacles to voluntary self-regulation, the only way for a multiple-gatekeeper system to work in subprime mortgage lending is to advance self-regulation by law. We propose that Congress pass legislation requiring subprime mortgage lenders and brokers to form and join self-regulatory organizations, which must adopt approved rules of fair dealing and practices, including suitability rules, on the pain of direct regulation.

2. *An SRO Requirement.*—In the securities industry, Congress achieved industry self-regulation by enacting federal laws requiring every broker-dealer to join a federally registered exchange or a national self-regulatory organization in order to conduct business. Under those laws, each exchange and SRO has to adopt disciplinary rules for members, which are subject to SEC review, revision, public comment, and approval. Members must comply with the rules under pain of expulsion or other sanctions.³⁹⁴

A similar model in subprime mortgage lending would have several advantages. First, it would eliminate the opportunity for competitors to gain a competitive advantage if only a subset of subprime lenders and brokers adopted best-practices standards. Second, it would generate best-practices standards based on the subprime mortgage industry's insights and experience, rather than by government fiat. Finally, it would compel industry compliance with those standards through the SRO disciplinary process, thereby enlisting industry oversight as a third enforcement arm, in addition to private lawsuits and government enforcement.

We propose a federal law that would require subprime mortgage lenders and brokers to form a self-regulatory organization and to join that organization in order to conduct business under pain of direct federal regulation.³⁹⁵ The government would have to approve the SRO, at which point the SRO would be empowered to supervise the conduct of its members pursuant to government oversight. In order to win government approval, the

394. 15 U.S.C. §§ 78(b)–(c) (2000) (Exchange Act §§ 19(b)–(c)); see generally VI LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2653–57, 2669–70, 2787–830 (3d ed. 1990).

395. Providing an alternative choice of direct regulation would assuage potential constitutional concerns regarding freedom of association.

new SRO would have to satisfy several requirements. It would have to have the purpose and capacity to enforce compliance with its own rules and standards, as well as with laws governing the conduct of the subprime mortgage industry. Membership would have to be open to all subprime lenders and mortgage brokers or, at a minimum, to *licensed* lenders and brokers in states that require licensing.

Additionally, the SRO would be required to adopt rules obligating its members to refrain from deceptive or exploitative lending practices and to promote, in the words of the Exchange Act, “just and equitable principles of trade.”³⁹⁶ As part of that requirement, Congress could specifically mandate that the rules contain a suitability requirement. In order to ensure enforcement, the SRO also would have to adopt disciplinary rules and procedures to enable it to discipline members for violations of the rules or companion laws. All SRO rules would be subject to government review, amendment, public comment, and approval. Finally, federal legislation should prohibit the SRO from imposing any burden on competition that is not necessary or appropriate to accomplish borrower protection.³⁹⁷

Although the SRO proposal could be enacted by individual states, it would have the most powerful effect at the federal level. Enactment of an SRO requirement at the national level would make it impossible for lenders and mortgage brokers to evade regulation by migrating to unregulated states. A national SRO also would be cost-effective in two respects. First, the cost of developing rules and instituting a disciplinary apparatus would be spread across market participants in all fifty states. Second, uniform national SRO standards would significantly reduce compliance costs for lenders and brokers with operations in multiple states.

3. *A New Cause of Action for Breach of the Duty of Suitability.*—While industry self-regulation is essential, it does not force predatory lenders and brokers to internalize the cost of the harm that they cause because it does not necessarily result in recompense to victims.³⁹⁸ Consequently, we recommend legislation creating a new cause of action against subprime mortgage lenders and brokers for breach of a duty of suitability in the making of loans secured by borrowers’ homes. We further propose that Congress empower both injured borrowers and the government to bring suitability claims.

396. Exchange Act § 15A(b)(6).

397. Two additional sets of rules would be advisable: (1) rules ensuring fair disciplinary procedures and fair internal governance by members, and (2) minimum capital, bonding, or insurance requirements for lenders and brokers to help ensure that they internalize the costs of any harm they cause.

398. Typically, SRO disciplinary sanctions are limited to expulsion, suspension, censure, injunctive-style relief, and fines.

a. Dual Federal/State Jurisdiction.—Ideally, a new cause of action for breach of suitability would be federal in nature. A federal cause of action is essential for several reasons. First, a federal suitability rule would promote certainty and efficiency for interstate lenders by adopting a single suitability standard with nationwide applicability. Second, a federal suitability rule would remove the incentives that now exist to transfer predatory lending operations out of strict states such as North Carolina and New York into unregulated states. Finally, a federal right of action would facilitate enforcement against large interstate lenders with operations in many states.

At the federal level, a new private right of action could take one of two routes. First, Congress could enact a new, freestanding cause of action conferring a duty of suitability. Alternatively, Congress could amend an existing statute to provide a new cause of action for breach of suitability. For example, Congress could amend section 5 of the Federal Trade Commission Act to add a private right of action for breach of suitability, or amend HOEPA to add a new suitability claim, keeping in mind that new triggers and remedies would have to be authorized in order to afford appropriate relief.

States also can play a critical role in combating predatory lending. They can pass analogues to the federal suitability legislation that we propose. Similarly, where state UDAP statutes are sufficiently broad, state attorneys general and private individuals can rely on those statutes to bring suitability-type claims. Any federal suitability legislation should not limit the states' ability to enact stronger predatory-lending laws.

For a number of reasons, federal preemption in predatory lending would be highly undesirable.³⁹⁹ First, it would destroy the ability of the states to serve as laboratories for developing regulatory techniques. Regulation of predatory lending has been largely ineffective to date and it is not yet clear where to draw the regulatory line to deter predatory lending without unduly restricting legitimate subprime credit. As the states implement various approaches to redressing predatory lending, their efforts can yield new innovations and valuable insights. Indeed, the North Carolina and New York experiences are expected to yield information on the effect of their particular anti-predatory lending efforts on predatory lenders and the availability of mortgage capital. In a similar vein, state legislation would strengthen the multiple-gatekeeper system by empowering state attorneys general and state agencies to enforce predatory-lending laws. For these reasons, we strongly oppose federal preemption in the area of predatory lending.⁴⁰⁰

399. Federal legislation, however, would need to provide a floor. Lenders and brokers would have to comply with federal standards at a minimum, and federal standards would preempt any weaker state laws.

400. We recognize that stronger state laws might counteract national uniformity to some extent. But we believe that the extent to which that could occur would be minimal. In all likelihood, relatively few states would be able to pass stronger predatory-lending laws, due in part to the formidable lobbying force of the financial-services industry. Indeed, that has been the experience in

b. Agency Enforcement.—We propose a third gatekeeping mechanism: agency enforcement. Consistent with a multiple-gatekeeper approach, agency enforcement would provide a powerful additional deterrent to predatory practices. In addition, the enabling legislation could require the appointed agency to exercise its rulemaking and guideline powers to give content to the general duty of suitability. The agency would thus have the mandate to enumerate specific practices that are regulated as unsuitable. The rulemaking process would provide market actors with opportunities for input into the development of the rules. Agency interpretations of the rules would provide guidance to lenders, which would help them in determining whether practices were unlawful. Lastly, rulemaking would give agencies the flexibility they need to add new practices to the suitability list as needed.

At the federal level, agency oversight authority should be located in one agency.⁴⁰¹ Agency jurisdiction could be vested either in the Board of Governors of the Federal Reserve System or the FTC. Each choice has its advantages and disadvantages. The FTC has specific experience in applying suitability to predatory-lending cases.⁴⁰² In addition, unlike the Federal Reserve, the FTC is not distracted by competing agency goals such as systemic risk and safety and soundness. On the other hand, the Federal Reserve Board has greater independence from political shifts in administrations than the FTC. Similarly, the Federal Reserve brings experience with predatory-lending concerns to the table through its administration of HOEPA, although, in contrast to the FTC, the Federal Reserve has not yet explicitly embraced suitability as a concept.

Vesting rulemaking authority in a government agency can raise enforcement concerns where the agency declines to exercise its authority, whether for political reasons or otherwise. The Federal Reserve engaged in this type of foot-dragging when it hesitated, for several years, to use its authority under HOEPA to strengthen rules against predatory lending. Congress could reduce the risk of potential inaction in a number of ways. In the statute, it could enumerate problematic loan terms and practices and require the agency to promulgate regulations on those subjects by specified

the area of financial privacy under Title V of the Gramm-Leach-Bliley Act of 1999, which imposed federal regulation but allowed states to pass stricter financial privacy laws. *See* 15 U.S.C. §§ 6801–6809 (2000). Notwithstanding Congress's decision not to impose federal preemption, few, if any, states have enacted stricter financial privacy laws to date. *See, e.g.,* LeBoeuf, Lamb, Greene & MacRae, L.L.P., *State Regulations/Legislation on Gramm-Leach-Bliley Privacy Provisions*, available at <http://www.insurelegal.com/20001116PrivacyStateRegChart.html>; Adam Wasch, *Session's Bill Preempts States from Tougher Position Than Current Law*, BNA BANKING REP., Aug. 13, 2001, at 258 (noting that some states have attempted to pass stricter privacy laws, but that none have yet enacted any).

401. This would contrast with the approach taken in many federal consumer-protection statutes in financial services to date, which have divided enforcement authority among multiple agencies. *See, e.g.,* MCCOY, *supra* note 95, §§ 8.02[1][c][iii] (ECOA); 8.02[2][b][ii] (Fair Housing Act).

402. *See supra* notes 203 and 295 and accompanying text.

deadlines. Congress could also require the agency to report back annually or biannually to explain any statutory item that it had declined to regulate. Lastly, Congress could require the implementing agency to issue advance notices of proposed rulemaking by certain dates in order to solicit public comment on the need for additional changes.

c. Defining Suitability.—

i. Rules Versus Standards

In federal securities regulation, suitability is a remarkably vague standard and has best been described as the duty to have “a reasonable basis for recommending a security or investment strategy.”⁴⁰³ While debate has centered on predicating suitability on modern portfolio theory or older views singling out individual securities as unsuitable,⁴⁰⁴ there has been relatively little call to reduce the duty of suitability in securities to a set of more particularized conduct rules.⁴⁰⁵ Using a general reasonableness standard rather than specific rules has had benefits in securities. On the one hand, courts have interpreted the reasonableness standard broadly to give deference to recommendations by brokers-dealers that are controversial, but arguably suitable. On the other hand, the broad and flexible nature of a reasonableness standard has served to deter new suitability abuses.

In contrast, in addressing predatory lending, Congress, state legislatures, and agencies have largely refused to consider a broad reasonableness standard and instead have favored particularized rules.⁴⁰⁶ This raises two critical questions: why have policymakers favored rules over standards in addressing predatory lending, and does it make sense to continue to do so?

The answers turn on differences between the problems that suitability standards in securities and in lending are designed to address. In securities, suitability addresses only the risk characteristics of the investment that an investor has already purchased. Normally, the investor’s ability to pay or the purchase terms are not in question. In subprime mortgage lending, however, suitability addresses an array of loan terms and the borrower’s ability to meet those terms, rather than the reasonableness of assessments about the future performance of an investment. Fundamentally, this is a trickier analysis than suitability analysis in securities because it implicates price terms and practices.

403. Mark J. Astarita, *Brokers Have to Be Their Own Judge*, RES. MAG. (Mar. 1997), available at <http://www.seclaw.com/docs/397.htm>.

404. See, e.g., Kerr, *supra* note 305, at 805 (pointing out that brokers can proceed under traditional guidelines or current ideas of suitability).

405. Cf. Cass R. Sunstein, *Problems With Rules*, 83 CAL. L. REV. 953, 978–96 (1995) (discussing common objections to legal rules, as compared to standards).

406. See, e.g., HOEPA, 15 U.S.C. §§ 1601–1610 (2000); N.C. GEN. STAT. §§ 24-1.1E–24-3 (1999); N.Y. COMP. CODES R. & REGS. tit. 3, § 41.4 (2000).

Without more, a broad reasonableness standard of suitability in subprime lending would pose the danger of deteriorating into general price regulation. Legitimate lenders would err on the side of caution, rather than risk running afoul of an imprecise suitability standard. The effect of that would be a retraction in the availability of legitimate subprime credit.

One way to avoid general price regulation in subprime mortgage lending is to reduce the duty of suitability to specific rules. Avoiding general price regulation does not mean that pricing practices and terms invariably should be free from regulation. To the contrary, it may be appropriate to regulate pricing terms or practices where those terms or practices send inaccurate price signals,⁴⁰⁷ hinder market efficiency, or inflict large, unnecessary negative externalities such as asset-based lending that result in foreclosure. Accordingly, in the following suitability standards, we attempt an initial definition of the boundary line between across-the-board price regulation and inefficient pricing practices:

- (1) As we discuss in the Appendix, subprime mortgage lenders and brokers should be prohibited from selling subprime loans that borrowers cannot repay out of current income, based on reasonable investigation and the consideration of all material facts known to the brokers or lenders at the inception of the loans. Under this standard, lenders would have to lend according to underwriting guidelines and refrain from asset-based lending on owner-occupied properties.
- (2) All loan fees and charges should be transparent and conform to legitimate pricing functions, as defined by the implementing agency. Yield-spread premiums, for example, are contrary to legitimate pricing practices because they impose fees on borrowers for higher interest rates than lenders are willing to accept, thereby sending inaccurate price signals. Similarly, consistent with the function of points, lenders and brokers should be required to document that points assessed represent a tradeoff for interest, as is true in the prime market. Additionally, charges for periodic services, such as insurance premiums, should be assessed per unit of time over the life of the loan, instead of a lump sum at closing.⁴⁰⁸ Fraudulent pricing practices, of course, would be unlawful.
- (3) Refinancings would require an economic rationale for borrowers. This standard would specifically address abuses

407. By "inaccurate price signals," we mean setting the price of loans at what appears to be market rates when, in fact, the prices are the result of harmful rent-seeking.

408. *See infra app.*

such as flipping and refinancing at higher interest rates with no discernable benefit to the borrower.

- (4) Subprime mortgage lenders and brokers would be prohibited from selling loans to borrowers who qualify for prime rates.⁴⁰⁹

The role of these standards would be to assist the appointed regulatory agency in identifying practices that might be predatory per se or, at a minimum, that could be predatory in some situations.

ii. Problematic Lending Practices and Per Se Rules

Many attempts to regulate predatory lending, while well-intended, have banned loan practices that are abusive in some situations but not in all. The list of subprime mortgage practices that are unsuitable per se is relatively short.⁴¹⁰ We believe that subprime mortgage practices are unsuitable per se only when those practices result in fraud or lack of transparency, send inaccurate price signals, lack any economic justification to the borrower, or result in asset-based lending (*i.e.*, mortgages that borrowers cannot afford to repay at the inception of the loan). Final responsibility for determining what is unsuitable per se should rest with the designated federal oversight agency.

Some problematic practices and terms are not unsuitable per se. Lenders may include certain terms because the secondary market demands those terms as a condition of financing loans. For instance, the secondary market may be unwilling to finance subprime loans without prepayment penalties. In other instances, problematic practices and terms may be harmful or helpful to borrowers, depending on the circumstances. Examples may include balloon payments and refinancings at higher interest rates. Nevertheless, in the aggregate, the harm inflicted by such terms may outweigh their benefits, in which case intervention may be justified. In the Appendix, we discuss and evaluate different regulatory methods that have been proposed or adopted to address problematic loan terms and practices that are not unsuitable per se.⁴¹¹

iii. Avoiding Regulatory Arbitrage

While a rule-based system provides needed certainty to lenders, it is substantially more prone to evasion than an open-ended suitability standard. Lenders will have economic incentives to evade specific rules through new, unforeseen practices or loan terms. Indeed, one of HOEPA's major failings is that it does not give the Federal Reserve discretion to address new, abusive practices that fall outside of the practices enumerated in the act.

409. *Id.*

410. *Id.*

411. *Id.*

At the same time, an unadorned clause prohibiting unsuitable loans outright would be inadvisable without additional safeguards. Such a clause would raise the specter of common-law courts' expanding the suitability doctrine to penalize new practices or loan terms, without input from the designated regulatory agency, consumers, or lenders. This would undermine the certainty that lenders need. For that reason, we recommend that Congress provide the oversight agency with authority to regulate additional loan terms or practices without limitation, subject to notice and public comment, where the agency finds those terms or practices unsuitable.

iv. Who Decides? Proceeding by Agency Rulemaking

The question of who decides what suitability means is foundational and is critical to the success of the new duty. In securities, suitability derives from multiple, overlapping definitions by multiple decisionmakers in multiple fora. The SEC defines suitability in agency adjudication and rulemakings, courts do so in Rule 10b-5 cases, and the NASD and exchanges make their own definitions in disciplinary cases. As a result, there has been some degree of uncertainty and inconsistency in the application of suitability to securities sales.⁴¹²

There is reason to believe that in subprime mortgage lending, however, a decentralized definitional framework like the one that has evolved in securities would be cause for concern. Unless the power to define suitability is carefully cabined, there is a danger that courts making suitability determinations would cross over the line into price regulation. Moreover, courts lack the expertise to engage in economic analysis or solicit public input, both of which are needed to craft rules that work.

For these reasons, the power to define which terms or practices are "unsuitable" in subprime mortgage lending should be limited to the federal oversight agency, at least for purposes of private relief and government enforcement. To accomplish this, courts specifically would be prohibited from condemning loan terms or practices as unsuitable unless those terms or practices were already prohibited by statute or by rule.⁴¹³

Within the agency, furthermore, definitions should be issued through formal rulemaking, not through agency adjudication. Formal rulemaking has four advantages over agency adjudication. First, it would make better use of agency expertise. Second, it would enlist invaluable input from the general

412. The extent of such uncertainty and inconsistency has been subject to debate. Compare Kerr, *supra* note 305, at 819 (arguing that NASD and NYSE suitability standards are "replete with broad, vague prohibitions" applied "on an ad hoc basis"), with Madison, *supra* note 287, at 286 ("[I]t would be difficult . . . to argue that a suitability requirement is a burdensome imposition."). Whatever the consequences, they have not proven fatal. Suitability determinations are made all the time in securities and have become routine.

413. For similar reasons, jury findings on suitability should be limited to answers to special interrogatories.

public. Third, it would provide greater consistency than case holdings. Finally, it would afford prior notice to lenders.⁴¹⁴

d. Waiver.—In requiring suitability, a question arises whether borrowers should be allowed to waive suitability protections. In other words, if lenders determine that mortgages are unsuitable for particular loan applicants and advise the applicants to that effect, should the applicants be allowed to waive their right to claim breach of suitability?⁴¹⁵

Waiver is a thorny question because it goes to one of the core rhetorical debates in predatory lending, pitting free choice against paternalism. If waiver were prohibited, lenders would be forced to deny certain loans that they otherwise would make. On the other hand, if waiver were allowed, desperate borrowers might agree to loans that were likely to result in bankruptcy or foreclosure.

The downside of prohibiting waiver bears closer examination. We preface that examination by noting that framing the issue in terms of choice and free will obfuscates the issue because it assumes that free will can be formed. To the contrary, the market for predatory loans relies on deception, naïveté, and information asymmetries—circumstances that are inimical to the formation of free will. The exercise of free will requires adequate information on which to make informed decisions. The very aim of predatory lending is to assure that free choice is *negated* by exploiting information asymmetries and power disparities on the part of vulnerable borrowers. Under the circumstances, framing the issue as one of consumer choice sorely misses the point.

The more fruitful approach is to weigh the costs and benefits of waiver. In analyzing the effect of a no-waiver rule, it is helpful to think about the application of such a rule to different groups of borrowers: (1) borrowers who obtain subprime loans but actually qualify for prime loans, (2) borrowers who cannot repay their loans under any circumstances on the terms proffered, (3) borrowers who obtain loans that they can afford to repay but that contain terms that are otherwise predatory, and (4) borrowers who could repay their loans but who are denied credit nevertheless due to an overly restrictive reading of suitability. With respect to the first group, prime-eligible borrowers, there is little harm if subprime lenders deny them

414. See generally RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE, 368–74 (2002). Although the SRO for the subprime mortgage industry might adopt a different definition of suitability for purposes of disciplining members, that definition would probably not diverge sharply from the agency's own definition because the SRO's definition would be subject to agency review and approval.

415. In securities, commentators have questioned whether suitability determinations should be subjective or objective. See, e.g., Roach, *supra* note 300, at 1174–79, 1181–85. The subjective-objective dichotomy may be more appropriate to suitability in securities, which employs a relatively vague standard, than in subprime mortgage lending, which is better suited to bright-line rules.

credit because of a no-waiver rule. These borrowers could qualify for cheaper credit in the prime market. In fact, a no-waiver rule for prime-eligible borrowers would have the salutary effect of creating an incentive for subprime lenders to refer prime applicants to their prime affiliates, if they have such affiliates. In that setting, the small cost of a no-waiver rule—some inconvenience to the loan applicant—would far outweigh the potential harm to borrowers in the form of needlessly costly credit.

For the second group, borrowers who cannot repay their loans, a no-waiver rule would decrease the likelihood that subprime lenders would make loans to them in the first place. Some loans should not be made and mortgages to borrowers who cannot afford the repayments are among them. These loans injure the borrowers by draining money required for other necessities and often lead to impaired credit, bankruptcy, and foreclosure. They also impose heavy external costs on society because they can result in homelessness, dependence on the state, and neighborhood decline due to abandoned properties. While such a rule may be paternalistic, borrowers and lenders are not the only ones with interests at stake; society has an interest as well. Furthermore, in some cases the borrowers may qualify for credit elsewhere on more affordable terms. If a no-waiver rule denies access to lenders who make loans that borrowers cannot afford, the borrowers may look elsewhere for credit, which ultimately could help create a more efficient market.

For the third group of borrowers—people who can afford to repay their subprime loans but whose loans contain predatory terms—the no-waiver rule may also be beneficial. For these borrowers, a no-waiver rule would discourage subprime lenders from inserting predatory terms into loans. To the extent that this leads to denials of credit, the borrowers can seek credit elsewhere from lenders who engage in legitimate lending practices and, therefore, have less need for waivers.

The hardest case to evaluate involves borrowers who could repay the loans but who are denied credit due to over-regulation that makes lenders reluctant to issue loans without waivers. This could happen if government regulations imposed bright-line rules that were broader than needed to achieve suitability. Alternatively, lenders might give an overly strict reading to a government rule that contains some play, in which case the no-waiver rule could discourage lenders from making legitimate loans to eligible borrowers for fear of running afoul of the suitability standards. For example, under a government rule that prohibits subprime lenders from making loans that borrowers cannot repay out of current income, lenders would have to institute loan-underwriting guidelines. A lender with particularly conservative guidelines might deny borrowers credit because of suitability concerns and the inability to contract for waiver. Of course, if a borrower in this situation did not qualify under one lender's guidelines, the borrower could still apply to other lenders whose guidelines would allow the loan.

Even in the case of bright-line government rules that are overly harsh, the borrower might be able to qualify for a different loan with different loan terms, such as smaller principal. Nevertheless, in some situations, a no-waiver rule would likely mean that creditworthy borrowers could not obtain mortgages at all.

The question, then, is whether waiver should ever be allowed. The problem with waiver is that it opens a back door through which lenders and brokers can engage in the same abuses that militated in favor of regulation in the first place. Waiver would give a green light to lenders to tempt borrowers who were susceptible to abuse into waiving their rights. This would be true even if waiver provisions were accompanied by disclosures because, as we have discussed, disclosures fail to perform their intended purpose.⁴¹⁶ More important, waiver would interfere with the evolution of a truly efficient subprime market. To encourage an efficient market, borrowers need incentives to shop and lenders need incentives to make loan terms more transparent. If no-waiver rules help discourage subprime lenders from making unsuitable loans, borrowers will shop elsewhere for credit on more appropriate terms and from lenders who make loan terms transparent.

The argument against waiver is harder to justify in the presence of over-regulation. But identifying over-regulation is not always easy. Furthermore, if waivers are allowed because of the risk of over-regulation, lenders will insist on waivers for all their customers, regardless of whether they are over-regulated or not. In effect, waivers could undermine the suitability requirement altogether.

The harmful effects of unwise waiver redound to the harm of society, not just borrowers. Given that external harm, lenders and borrowers should not be permitted to exercise waivers in ways that foist external injury on third parties. When balancing the risk of the over-regulated losing credit against the tremendous social and individual costs of predatory lending, the balance tips in favor of a no-waiver rule.

e. Defining "Subprime": Re-examining HOEPA's Triggers.—The suitability proposal that we advance in this Article would be limited to the market for open-end or closed-end subprime loans secured by senior or junior liens on borrowers' homes. Given that we recommend restricting suitability requirements to the subprime market, it is necessary to define the subprime market. There are a number of different ways to describe the market, each of which we discuss and critique below.

To date, HOEPA and most other legislation and administrative rules governing subprime loans (usually called "high-cost loans") rely on "trigger" systems, whereby only loans that exceed certain floors on interest rates or

416. See *supra* text accompanying notes 222–30.

points and fees are regulated. There are two different triggers that have been used to identify high-cost loans subject to regulation: (1) loans with APRs that exceed the yield on Treasury securities of comparable maturity by a set percentage, and (2) loans whose total points and fees exceed some percentage of the total loan amount or some fixed sum, whichever is greater.⁴¹⁷

HOEPA, which uses both interest and points and fees triggers, creates perverse incentives for lenders to restyle interest as noninterest charges in order to fall beneath its triggers. HOEPA is so easily evaded that an estimated ninety-five percent of subprime mortgage loans fall below its triggers.⁴¹⁸ HOEPA's points and fees triggers have another unfortunate, unintended result that has not been appreciated. As already discussed, HOEPA's definition of total points and fees omits certain major price terms. As a result, subprime lenders who want to evade HOEPA write loans that contain price terms that do not fall within HOEPA's total points and fees calculation. These price terms tend to be more complex than the terms contained in traditional prime products. In this respect, the trigger system works against transparency in pricing in the subprime market.

If Congress were to adopt triggers, we propose that they be set at a substantially lower level that approximates the average historical price spread between A and A- mortgages. We further propose that Congress empower the oversight agency with authority to determine and adjust the proper trigger levels following an economic analysis of historic and current spreads. In addition, to avoid the loophole in HOEPA's triggers, we advise that the term "total points and fees" be defined to include all points and fees (including points and fees that are financed) assessed to borrowers without exception.

Even with these measures, triggers may not be the best solution. There is always the risk that lenders will curtail their subprime lending if the number of loans subject to regulation increases.⁴¹⁹ Lenders who stay in the market despite the increased regulation will always have incentives to find new ways to evade the triggers and avoid regulation. For example, they might abandon predatory-loan terms and instead opt for tying high-cost products such as homeowner's insurance to loans with legitimate terms that

417. See, e.g., HOEPA, 15 U.S.C. §§ 1602(aa)(1)–(4) (2000); Truth in Lending (Regulation Z), 12 C.F.R. §§ 226.32(a)(1), (b)(1) (1997); N.C. GEN. STAT. §§ 24-1.1E(a)(4), (a)(6) (1999); N.Y. COMP. CODES R. & REGS. tit. 3, § 41.1(d)–(e) (2000).

418. John Weicher's data suggests, for example, that HOEPA triggers for interest rates might have to be lowered to 3%. See WEICHER, *supra* note 10.

419. See Michael E. Staten & Gregory Elliehausen, *The Impact of the Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* 13–14 (July 24, 2001), at http://www.mbaa.org/industry/reports/01/afsa_0725.pdf (studying the effect of North Carolina's predatory-lending legislation and finding that there was a reduction in the supply of mortgage credit in the state around the same time that the legislation was enacted). *But see* Erick Bergquist, *Data on Predator Law Impact Cause a Stir*, AM. BANKER, Aug. 22, 2001, at 13 (citing criticisms regarding the methodology and conclusions in the Staten and Elliehausen study).

would fall outside any suitability regulations. Or, lenders could attempt to evade the triggers by purchasing individuals' homes and leasing them back at exorbitant rents.

An alternative method for determining whether loans are subject to suitability requirements would be to focus on borrower characteristics. In the home-mortgage market, lenders categorize borrowers as prime or subprime based on their individual credit characteristics and the amount of equity that they have in their property (the loan-to-value ratio). Arguably, a lender's characterization of a borrower under its own guidelines would determine whether the borrower's loan was subprime and, therefore, regulated. The problem with relying on lenders' classifications of borrowers is that there is no dominant, much less uniform, underwriting tool. Some lenders use their own proprietary credit-scoring models. Others rely primarily on FICO scores.⁴²⁰ These various tools do not generate consistent results; for example, borrowers may be classified as subprime using FICO scores, but prime using credit-scoring models.⁴²¹ And, even when lenders use these tools, they do not necessarily adhere to the categorizations that their models or the FICO scores generate.

One yardstick that could be employed to identify borrowers as prime or subprime is Fannie Mae's and Freddie Mac's underwriting criteria for their purchase of home loans. Both Fannie Mae and Freddie Mac use automated underwriting systems, respectively called Desktop Underwriting (DU) and Loan Prospector (LP).⁴²² One clear advantage of using DU or LP is the greater consistency that results from classifying borrowers as prime or subprime.⁴²³ In addition, lenders who sell their loans to Fannie Mae and Freddie Mac already have access to the GSEs' underwriting systems.⁴²⁴

420. FICO scores are statistically generated credit scores that lenders use to evaluate borrowers' creditworthiness. Fair, Isaac & Co. developed the FICO scoring model and makes it available to lenders through credit bureaus. Their website is at <http://www.fair.isaac.com>.

421. See Keith D. Harvey et al., *Disparities in Mortgage Lending, Bank Performance, Economic Influence and Regulatory Oversight*, 23 J. REAL EST. FIN. & ECON. 379 (2001) (documenting that borrowers' risk classifications vary depending on the risk-assessment model employed).

422. See Fannie Mae, *Product Profiles*, at <http://www.newamer.com/profiles.htm#FANNIEMAEPRODUCTS>; Fannie Mae, Announcement 00-03, Attachment 1, at http://www.efanniemae.com/singlefamily/forms_guidelines/guide_announcements/db_guide_announcements.jhtml?role=#00-03; Freddie Mac, *supra* note 20, ch. 4. Fannie Mae and Freddie Mac also do some manual underwriting based on FICO scores. See, e.g., Kim Renay Anderson, *GSEs See Automation as Spurring Low-Mod Housing*, NAT'L MORTGAGE NEWS, June 12, 2000, at 22; Brian Angell, *A Score to Settle; Consumer Demand Is High for Credit Scores. What is the Holdup?*, U.S. BANKER, Aug. 2001, at 34.

423. Determining the application of suitability based on the classification of borrowers as prime or subprime using DU or LP is not free of problems. For example, lenders could make subprime loans to people whom the underwriting systems categorized as prime borrowers, and these lenders would not be subject to the suitability requirements. This is because the reference point for determining the applicability of suitability would be the borrowers' characteristics, not loan terms. One way around this dilemma would be to have a special coverage provision that would extend

Defining the prime market according to borrower characteristics and loan-to-value ratios has at least two benefits. First, because credit-risk models are dynamic in nature, underwriters could adjust their definitions of prime in response to changing economic conditions and new credit-risk data. Second, defining the subprime market based on market classifications of borrowers as subprime or prime would eliminate the incentive for lenders to pile on complex terms and fees to evade HOEPA triggers, which might lead to the development of subprime products with simpler, more transparent terms.

The key question is this: would a market-based definition be less vulnerable to evasion than a system of triggers? Under a market-based approach, lenders would have incentives to manipulate the line between prime and subprime by treating the best subprime borrowers as prime customers in order to escape regulation. To some extent, of course, the market would act as a brake on such evasion, because the marginal cost of making prime loans to subprime borrowers likely would exceed the marginal profit. On the other hand, a market-based definition of subprime might have negative consequences for the prime market that we cannot anticipate.

There are political, philosophical, and regulatory issues that arise in any effort to define the loans to which suitability should apply. Triggers are close cousins to price controls and can be evaded. Relying on the GSEs underwriting systems to classify borrowers has certain advantages over triggers; however, if Congress were to adopt DU and LP as the tools for classifying borrowers, it effectively would be legislatively authorizing the GSEs to define the subprime market. Another potential problem could arise if risk-based pricing becomes the norm, as some commentators predict.⁴²⁵ Currently, borrowers and their loans are classified as prime or subprime. Risk-based pricing would eliminate this classification, making it impossible to use the prime-subprime distinction as a trigger for the application of suitability.⁴²⁶ In sum, both approaches are imperfect, but each is adequate to the regulatory task if properly tailored.

suitability to borrowers whom the underwriting systems categorized as prime, but who could prove that their lenders failed to offer them prime products.

424. Press Release, Fannie Mae, Raines Calls For Open System With Lender Access to Multiple Automated Underwriting Systems; Pledges to Waive DU Fees on Market Expansion Products; Announces Partnership with MBA on Technology, Lender Profitability Issues (Apr. 19, 1999), available at <http://www.fanniemae.com/news/pressreleases/0264.html>; see also Franklin D. Raines, Remarks Prepared for the Mortgage Bankers Association National Secondary Mortgage Conference (Apr. 19, 1999) (citing how 850 lenders were then using desktop underwriting and were processing about 31,000 loan submissions per day), available at http://www.fanniemae.com/news/speeches/speech_38.html.

425. MAKING FAIR LENDING, *supra* note 99, at 23–27.

426. It is also possible that an industry standard would have the effect of limiting LMI borrowers access to capital because they would not fall neatly within the operative parameters. See *supra* note 158 and accompanying text; Tommy Fernandez, *Is Personal Touch Vanishing with Credit Agencies?*, AM. BANKER, July 18, 2001, at 12 (“Some lenders warn that the demise of

f. Relief.—One major justification for a new cause of action for breach of suitability is that it would provide remedies that are tailored to the specific harm that borrowers suffer. Victims of predatory lending can suffer two types of harm: retroactive and prospective. For example, borrowers may have paid illegal charges in the past, or, in the worst case, may have lost their homes to foreclosure. Prospectively, borrowers who are still in their homes may be facing foreclosure or an obligation under their loan agreements to pay future charges that the law deems illegal. Accordingly, remedies for breach of suitability need to address both past and future harm. In addition, the scheme for relief should redress any additional unjust enrichment that accrues to predatory lenders and brokers when the benefits of engaging in predatory lending practices exceed the harm to the plaintiffs.⁴²⁷

For illegal charges already paid, the statute should authorize relief in the form of damages or disgorgement, with interest. For past foreclosures, the statute should create a right of redemption if lenders still own the property. With respect to prospective relief, breach of suitability should be an absolute defense to foreclosure. In addition, Congress should give courts equitable power to reform loans to conform to the law and to strike down illegal terms.⁴²⁸ In some situations, it may be appropriate to permit borrowers to rescind their loans.⁴²⁹ In steering cases, courts should be empowered to order refinancing at then-prevailing prime rates or loan reformation. Injunctions should be available to reschedule loan payments, to enjoin illegal lending practices, to require reporting of timely mortgage payments,⁴³⁰ to reschedule missed payments to the end of the loan, and to correct erroneous credit records.

Finally, the new right of action should include a substantial statutory penalty that would serve to deter predatory lending, to encourage victims to

manual underwriting has bred a growing class of credit-impaired borrowers who are being shunned by small [lending] firms.”)

427. See L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages* (pts. 1–2), 46 *YALE L.J.* 52, 373 (1936–1937). For example, if a lender receives a kickback to make a predatory loan, the kickback should be subject to disgorgement.

428. For example, equitable relief in the form of loan reformation would be justified where a lender convinces a homeowner to refinance a zero-interest mortgage (such as a Habitat for Humanity loan) at higher interest to the substantial detriment of the homeowner. In all but the most unusual circumstances, the interest term should be reformed to a rate of 0%.

429. For instance, in schemes resembling equity-funding programs where lenders convince borrowers to refinance the equity in their homes and invest the loan proceeds in retirement accounts with unfavorable returns, the loans should be forgiven and the borrowers should be made whole for their losses.

430. Some predatory lenders refuse to report timely mortgage payments to credit bureaus because they fear that borrowers will refinance with other companies as their payment histories improve. See *New Assault on Your Credit Rating*, *CONSUMER REP.*, Jan. 2001, at 20; Geoffrey M. Connor, *Banking Law—How to Be a Predatory Lender and How Banks Can Begin to Put an End to the Practice*, *N.J. L.J.*, Sept. 4, 2000, at 29.

vindicate their legal rights, and to attract representation by the private bar.⁴³¹ At this point, we oppose open-ended punitive damages due to the risk of excess deterrence.⁴³² Instead, we propose that all victims of suitability violations receive treble damages or statutory damages, whichever is higher, regardless of the lenders' or brokers' intent or the egregiousness of their conduct. In computing treble damages, actual damages plus any amounts subject to disgorgement should be included. Statutory damages are necessary as a deterrent because, in many cases, the borrowers' relief will be injunctive only, in which case there will not be any actual damages to treble. The amount of the statutory damages should generally depend on the number of times defendants have been found liable for suitability violations; the statutory damages should rise with each violation. In addition, to avoid obsolescence over time, statutory damages should be indexed to inflation. Finally, the statute should authorize reasonable attorneys' fees and costs to prevailing plaintiffs in order to attract able representation. These fees and costs should be available regardless whether cases are resolved through settlement, arbitration, or final judgment.⁴³³

In all likelihood, the most satisfactory resolution of predatory-lending cases will come about through private settlements, particularly where lenders are worried about reputational concerns. Settlements offer the flexibility to forge creative solutions that are tailored to the loans and the borrowers in question. To encourage settlements and avoid undue litigation costs, Congress could require court-ordered mediation as a prerequisite to litigation.

g. Defendants.—The utility of a suitability requirement depends critically on the ability to enforce it against predatory lenders and brokers, some of whom have fly-by-night operations with little capitalization. They can dissolve and reincorporate, sometimes in other states, practically overnight. Their lack of capitalization coupled with the ease with which they can dissolve enables predatory lenders and brokers to evade liability for the harm that they cause borrowers. Accordingly, we propose disregarding the corporate form under highly limited circumstances in order to impose personal liability for predatory lending against shareholders, officers, or directors. Personal liability would only attach where the corporate lender or broker: (1) was judgment-proof due to undercapitalization, or (2) dissolved in

431. In order to be sufficiently substantial to meet the goals of deterring predatory lending and attracting representation, any penalty must be far above the \$11,000 authorized in Fair Housing Act claims. See 24 C.F.R. § 180.671 (2001).

432. Cf. Engel, *supra* note 270, at 1192 (discussing the risk of excess deterrence in discrimination cases).

433. See *id.* at 1189–90 (discussing the effect that limitations on attorneys' ability to recover fees in housing-discrimination cases that settle has had on attorneys' willingness to bring fair-housing claims).

order to evade liability.⁴³⁴ If either one of those threshold requirements were met, then any shareholder, officer, or director of the lender would be personally liable for monetary, injunctive, and equitable relief.⁴³⁵

There has been some debate whether secondary-market purchasers should be held liable for purchasing predatory loans. On the one hand, secondary-market actors, by purchasing predatory loans, create a market for predatory lenders and brokers. On the other hand, suitability violations take place at the time of the loan application and closing, before secondary-market purchasers are involved. On a practical level, it would be difficult, if not impossible, to impose the same suitability requirements on secondary-market purchasers that we propose applying to lenders and brokers. This is because loan purchasers do not have access to original loan documentation and other information that would enable them to determine whether loans meet all the requirements for suitability.

Just the same, there are two circumstances in which injured borrowers should be able to raise suitability violations by lenders or brokers against secondary purchasers. First, breach of suitability should be an absolute defense to foreclosure actions by secondary-market owners of notes. HOEPA already incorporates this notion by abrogating the holder-in-due-course rule for HOEPA loans. The holder-in-due-course rule likewise should be abrogated whenever subprime borrowers raise lack of suitability as a defense to foreclosure. Second, borrowers should be allowed to bring affirmative suitability claims against secondary-market participants who do not have basic internal controls⁴³⁶ and written policies against buying loans with illegal predatory features.

h. Arbitration.—For the reasons that we have already discussed,⁴³⁷ oppressive mandatory-arbitration clauses have been a major obstacle to predatory-lending relief. However, we are reluctant to condemn arbitration outright. Potentially, a cause of action for breach of suitability could create hundreds of thousands of relatively small claims, which would be well-suited to alternative dispute resolution. Arbitration could be valuable to cash-strapped plaintiffs because it normally costs less than litigation and results in swifter outcomes.⁴³⁸ Finally, political realities must be taken into account. Congress is unlikely to ban arbitration clauses altogether in subprime loan

434. Among other things, evidence of later reincorporation or resumption of business through a noncorporate entity could provide evidence of intent.

435. *Cf. Holley v. Crank*, 258 F.3d 1127, 1129 (9th Cir. 2001) (holding owners and officers of a corporation vicariously liable for an employee's violation of the Fair Housing Act).

436. For evaluating such internal controls, see *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

437. See *supra* notes 48–49 and accompanying text.

438. See, e.g., Marc I. Steinberg, *Securities Arbitration: Better for Investors Than The Courts?*, 62 BROOK. L. REV. 1503, 1505–06, 1512–14 (1996).

agreements, in part due to the strong federal policy favoring arbitration in the Federal Arbitration Act.⁴³⁹

Accordingly, our task is not to reject arbitration, but to craft an arbitration scheme that is effective. In our view, the key to making arbitration work in subprime lending is threefold. First, arbitration should be strictly optional and not mandatory. Currently, there is no proof that arbitration in subprime lending is fairer or more efficient than litigation, and victims should not be denied judicial redress, at least until such proof exists.⁴⁴⁰ Second, any arbitration should be conducted under the SRO's auspices or those of the American Arbitration Association (AAA). Finally, the code of arbitration developed by the SRO should be subject to review, revision, and approval by the federal oversight agency.⁴⁴¹ For claims arbitrated through the SRO, arbitrators could award relief based not only on suitability as defined by federal regulations, but also based on the SRO's disciplinary rules governing suitability.⁴⁴²

We again turn to the securities industry to craft safeguards for the arbitration of suitability claims. In cases brought by public customers, mandatory NASD arbitration uses panels of professionally trained arbitrators, a majority of whom must be "public arbitrators" who lack recent ties to the securities industry.⁴⁴³ NASD arbitral awards are now published online⁴⁴⁴ and

439. *See, e.g.,* *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Co.*, 460 U.S. 1, 24–25 (1983) ("[T]he Courts of Appeals have . . . consistently concluded that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. We agree. The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration . . .").

440. *Cf.* Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 *BROOK. L. REV.* 1335, 1360–61 (1996) (arguing the same with respect to securities).

In that regard, it is essential to provide subprime borrowers with a meaningful option to exercise their opt-out rights. Because of the high-pressure nature of closings and the vulnerability of many LMI borrowers, lenders should not be allowed to include form arbitration clauses in loan agreements at closing. Instead, Congress should require lenders to wait for some period after closing—perhaps thirty days—before presenting arbitration agreements to borrowers so that borrowers can focus adequately on the consequences of agreeing to arbitration. In addition, any arbitration agreements signed by borrowers should be reviewed and signed by an attorney or a HUD-certified counselor. *Cf.* G. Richard Shell, *Fair Play, Consent and Securities Arbitration: A Comment on Speidel*, 62 *BROOK. L. REV.* 1365, 1376 (1996) (noting that the Commodities Futures Trading Commission forbids commodities professionals from refusing to serve customers who decline to sign an arbitration agreement and requires standard commodities brokerage agreements to state: "You need not sign this [arbitration] agreement to open an account" with the broker in question).

441. *Cf.* Shell, *supra* note 440, at 1366 ("[T]he only realistic way for the securities arbitration system to reform itself is via governmental regulatory action in cooperation with self-regulatory organizations."). In securities, the SEC oversees SRO arbitration rules and must approve any changes in light of the requirements of the Exchange Act. *See* 15 U.S.C. §§ 78s(b)(2), (c) (2000).

442. *Cf.* Steinberg, *supra* note 438, at 1514–15 (stating that securities arbitrators "may render awards premised on applicable self-regulatory organization ("SRO") standards, industry custom, or even concepts of equity and fairness").

443. *See id.* at 1505 n.10, 1514; Securities Industry Conference on Arbitration, Uniform Code of Arbitration § 8(a)(2); NASD Code of Arbitration Procedures Rules 19(c)–(d).

the NASD will suspend member firms for failing to pay arbitral awards pending appeal in federal courts.⁴⁴⁵ We advocate a similar scheme of supervised arbitration for mortgage lending in the subprime market. In particular, we recommend that the SRO be required to institute the minimum, nonwaivable safeguards listed below:⁴⁴⁶

- Customers should have a right to arbitrate either before the SRO or the AAA.
- All arbitration clauses in subprime mortgage loan agreements should specify that arbitration must be conducted by arbitrators certified by the SRO or the AAA who are operating under the auspices of the certifying body.
- The public should be given an opportunity for notice and comment on the oversight agency's review of SRO arbitration rules and amendments to those rules.
- Aggrieved borrowers should have a meaningful role in selecting the panel's arbitrators under a system such as the AAA's "list method" of selecting arbitrators.
- Every arbitrator on an arbitration panel must be a public arbitrator without significant ties to the mortgage industry.⁴⁴⁷
- Every arbitrator should have a law degree in order to ensure adequate analysis of legal claims.

444. NASD Dispute Resolution, Obtain NASD Arbitration Awards Online, at http://www.nasdadr.com/arb_awards.asp; see also *NASD To Make Arb Results Available Via Web*, FIN. NET NEWS, May 21, 2001, at 2, 2001 WL 9786863; *NASD Set to List Arbitration Cases on the Internet*, L.A. TIMES, May 17, 2001, at C-4, 2001 WL 2487552.

445. See NASD Notice to Members 00-55 (Sept. 18, 2000) ("[I]f arbitration awards are not complied with in a timely manner, NASD Dispute Resolution currently institutes suspension proceedings . . ."); see also Don Bauder, *Investors Score Rare Win in Battle with Brokerage*, SAN DIEGO UNION-TRIB., May 12, 2001, at C-2, 2001 WL 6459794 (reporting an April 26, 2001 ruling by an NASD hearing officer suspending a member firm for refusing to pay an award to investors after it lost an appeal in federal district court); Gretchen Morgenson, *Putting Some Weight Behind Arbitration*, N.Y. TIMES, June 10, 2001, § 3, at 10, LEXIS, Nexis Library, NYT File.

446. The NASD Code of Arbitration Procedure, the NYSE's arbitration rules, the rules of the AAA, and the Statement of Principles of the National Consumer Dispute Advisory Council provide good initial reference works for crafting appropriate guidelines. The Statement of Principles is available at http://www.adr.org/education/education/consumer_protocol.htm. See also Martin H. Malin, *Privatizing Justice, But by How Much? Questions Gilmer Did Not Answer*, 16 OHIO ST. J. ON DISP. RESOL. 589 (2001) (arguing for various protections in employment arbitration proceedings); Smith, *supra* note 48, at 1222-35 (discussing the need for safeguards in arbitration proceedings involving consumer contracts).

447. Under the NASD rules, an arbitrator is considered a "public arbitrator" if he or she has not worked in the securities industry within the past three years. See NASD, CODE OF ARBITRATION PROCEDURE §§ 10308(a)(4)-(a)(5) (2001), available at http://www.nasdadr.com/arb_code/arb_code1.asp#10308. Thus, a lawyer who retired three years ago, but who had spent his or her entire career representing securities firms, would qualify as a public arbitrator. See NASD, SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE 96-97 (1996). We would not recommend adopting this standard for the mortgage-lending industry and would opt instead for requiring "public arbitrators" to have significantly more attenuated relationships with the industry.

- Arbitration panels should be required to apply all statutes and common law applicable to the claims presented.⁴⁴⁸
- Arbitration panels must issue short written opinions, signed by the arbitrators who concur, that summarize the material issues in controversy, how those issues were resolved, the reasons for the decision, and the relief sought and awarded.⁴⁴⁹ In addition, the panel should certify that it resolved all claims presented by the claimant.
- All arbitration awards should be published.⁴⁵⁰
- Arbitration panels must have authority to award all remedies authorized by law, including statutory damages, as well as reasonable attorneys' fees and costs.
- Arbitration agreements may not include any condition that limits the ability of a party to file any claim in arbitration or the ability of arbitrators to make any award.
- Arbitration clauses must not forbid participation in class-action lawsuits.
- Arbitral awards must be promptly paid to plaintiffs pending appeals.
- Federal courts should be authorized to "review arbitral awards for errors in applicable law,"⁴⁵¹ in addition to the more circumscribed scope of review that is authorized in the Federal Arbitration Act.⁴⁵²

D. Critiques of Suitability in Subprime Mortgage Lending and Responses

The principal thrust of this Article is to settle the question whether additional relief is necessary to combat predatory lending. As we have shown, information asymmetries allow predatory lenders to thrive, and the current patchwork of remedies has been wholly ineffective in combating predatory lending.⁴⁵³ In the absence of a new remedy, borrowers and society continue to suffer and this harm will only worsen in a weakening economy.⁴⁵⁴

448. See Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 BROOK. L. REV. 1459, 1490–92 (1996) (arguing that such a policy in securities disputes would protect investor expectations); Therese Maynard, McMahon: *The Next Ten Years*, 62 BROOK. L. REV. 1533, 1555–56 (1996) (suggesting that legal citations would strengthen arbitral decisions).

449. See Brunet, *supra* note 448, at 1488–90.

450. Similarly, we would oppose confidential settlements in suitability cases filed in court.

451. See Speidel, *supra* note 440, at 1362 (recommending addition of the same standard in securities).

452. 9 U.S.C. § 10(a) (2000).

453. See *supra* subpart II(C).

454. See, e.g., *Analysis Say Mortgage Fraud Rises as Economy Slows*, SUNDAY STAR-NEWS (Wilmington, N.C.), Apr. 1, 2001, at 2B ("The reason is, the lenders have to keep feeding the

We do recognize, however, that there are numerous arguments against intervention to curb predatory lending, as well as criticisms of our particular proposal.⁴⁵⁵ In this subpart of the Article, we identify and respond to these criticisms.

1. Normative Objections.—Some oppose a suitability standard in subprime lending on moral grounds, akin to the debate over bankruptcy reform. They contend that borrowers should take personal responsibility for the loans they decide to accept. After all, the argument goes, no one is forcing them to take out loans.

Arguments of this sort are about free choice and the responsibility to accept the consequences of one's decisions. However, predatory lending is not about free choice; it is about the suppression of free choice. When predatory lenders target vulnerable homeowners who do not understand what they are signing, and then deny these borrowers access to vital information about their loans and hurry them into signing, free choice is nowhere to be found.

Compounding matters, the financial straits of LMI borrowers frequently put them in a classic double-bind. The building code inspector, the debt collector, the bondsman, or the IRS may be knocking at the door. The roof may be leaking or the car they need for transportation to work may have broken down. Their child may need costly medical care, but they have no medical insurance. In cases such as these, the choice is between two evils, one of which is certain and the other of which is ill understood. Thus it is not surprising, as behavioral economists have found, that people who are facing crises are more likely to take risks.⁴⁵⁶

Critics counter that many victims of predatory lending refinance their mortgages to buy luxury items such as TVs, stereos, and cars, not to pay for emergencies or home repairs. In their view, the law should not reward profligate conduct by providing borrowers redress for predatory loans, the proceeds of which they use inappropriately to purchase luxury goods.

Concerns about profligate use of loan proceeds are present regardless whether borrowers are low-income, middle-class, or affluent,⁴⁵⁷ however, the

monster to pay the overhead, so they might push a loan through, even though it doesn't fit or they might just phony up some documents.'").

455. See, e.g., David Wessel, *An Inner-City Predator Needs a New Leash*, WALL ST. J., Apr. 19, 2001, at A1, 2001 WL 2860842 (contending that suitability rules are not perfect and that implementing a suitability test in the mortgage business would be difficult).

456. See, e.g., Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251 (1986); see also Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747 (1990); Langevoort, *supra* note 124, at 637.

457. See, e.g., Bankrate, *Understanding Cash Out Refinancing* (Aug. 24, 2001), available at <http://www.bankrate.com/bnm/news/loan/20010824a.asp>; Freddie Mac, *Loan Refinancings that*

social consequences of LMI borrowers entering into predatory loans and engaging in profligate spending⁴⁵⁸ are more severe. The borrowers can go bankrupt and become homeless. When they go bankrupt, their other creditors are hurt. When they become indigent, taxpayers are called on to support them. The severe external effects of default and foreclosure on society justify predatory lending protections, even when home equity is used to finance luxury purchases.

Another, related argument that critics make in response to anti-predatory-lending proposals is that any protections are paternalistic and interfere with borrowers' exercise of free choice. The argument is that predatory-lending legislation will prevent borrowers from obtaining loans that contain terms that are acceptable to both lenders and borrowers, but that the law deems predatory or, under our proposal, unsuitable. We recognize that there is a paternalistic element to the suitability requirement. But we contend that the burden of limited restrictions on free choice is outweighed by the severe negative effects of predatory loans on borrowers and on society. In addition, as we discuss, suitability may make it possible for many of these borrowers to obtain loans from other lenders on better terms.

2. *Market Arguments.*—There are a number of market-based arguments that critics have advanced in support of their position that predatory-lending legislation is unnecessary or counterproductive. One argument is that predatory-lending protections create incentives for borrowers to “game the system,” by taking out loans that they know they cannot repay and then seeking loan forgiveness, claiming that their loans were unsuitable. This argument might have credence for unsecured loans when borrowers are judgment-proof, but is far less likely to apply where borrowers' very homes are at stake. Very few homeowners can afford to engage in that type of brinksmanship, particularly not LMI borrowers, because if they are wrong, they will lose their homes to foreclosure.⁴⁵⁹

The most often-heard criticism is that a suitability rule would result in credit constraints.⁴⁶⁰ To the extent that this criticism refers to loan denials

Took Equity Out of Housing Rose in Second Quarter of 2001 (Aug. 21, 2001), available at <http://www.freddiemac.com/news/archives2001/2qub01.htm>. More affluent borrowers refinance loans or take out second mortgages to finance needed or desired expenditures with their untapped equity, including renovations or home repairs, college education, medical bills, taxes, credit-card debts, or vacations. See, e.g., TERESA A. SULLIVAN ET AL., *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* 225 (2000).

458. There is no sound data on the extent to which borrowers use loan proceeds to engage in profligate spending.

459. Of course, if borrowers materially mislead lenders as to their ability to repay their loans, lenders would have a defense to any suitability claims.

460. See, e.g., Charles W. Calomiris & Robert E. Litan, *Homeownership That's Too Important to Risk*, N.Y. TIMES, Aug. 20, 2001, at A17, LEXIS, Nexis Library, NYT File (“New laws on the

because the borrowers cannot repay their loans out of current and expected income, we endorse this outcome because these loans should not be made in the first place. Furthermore, it is possible that these borrowers will not be shut out of the credit market altogether. Rather, many of these borrowers may qualify for legitimate subprime or even prime loans elsewhere with better, more affordable terms.⁴⁶¹ As for other problematic terms and practices, the operative question is not whether narrowly targeted regulations would have some constraint on credit. Instead, the question is whether the potential harm from carefully crafted, targeted regulations outweighs the harm of maintaining the status quo. Thus, what is called for is a cost-benefit analysis to determine what suitability rules would best address the harm that occurs from predatory lending without inordinately limiting the availability of credit. We believe that our proposal for an SRO that can develop best-practices rules, a federal rulemaking process with full public input, and a feedback loop for revision of rules is best-suited to perform that cost-benefit analysis.

Some critics of suitability and other efforts to combat predatory lending take the position that recent losses in the subprime market⁴⁶² indicate that predatory lending is not profitable and that the market will “correct” itself and predatory lending will cease. We disagree with this conclusion on several grounds. First, no one has established a correlation between reduced profitability in the subprime market and predatory lending. The losses in the subprime market could be attributable to the overall economic slowdown,⁴⁶³ inadequacies in the risk assessment models used by subprime lenders, or a host of other economic or institutional factors.

As we discussed previously, the market, as it is currently structured, will not curb predatory lending. In short, secondary-market actors can protect themselves against the risk of default by inserting recourse provisions when they purchase packages of loans. Predatory lenders insulate themselves from losses when they originate loans by making loans at high interest rates to borrowers with significant equity in their property. In addition, they finance huge fees, often repeatedly. At foreclosure, these lenders, even those who end up holding loans pursuant to recourse provisions, can recoup the unpaid interest and fees.

It is actually possible that, in the absence of interventions to curb predatory lending, legitimate subprime lending will decrease. If predatory

pattern of some already passed at the state and local level could do great harm by discouraging lenders from making any subprime loans at all.”).

461. See *supra* note 20 and accompanying text.

462. See, e.g., Paul Beckett & John Hechinger, ‘Subprime’ Could Be Bad News for Banks, WALL ST. J., Aug. 9, 2001, at C1, 2001 WL 2872200 (“That subprime has been deteriorating is clear. In May [2001], . . . the percentage of subprime mortgages nationwide that were seriously delinquent rose to 6.37% from 5.55% at the end of the last year . . .”).

463. *Id.*

brokers are deceiving legitimate subprime lenders, causing the lenders to suffer losses, predatory lenders will gain a larger market share.⁴⁶⁴ Legitimate subprime lenders, many of which are major institutional lenders who have to answer to shareholders and often regulators, cannot sustain losses for long. The substantial goodwill and long-term reputational interests of these firms, moreover, mean that they cannot simply dissolve and reincorporate under different names. In contrast, fly-by-night predatory lenders do not have these constraints. If they suffer losses that they cannot absorb, they can file for bankruptcy or simply dissolve. The principals can then go underground for a while, form a new corporation, and resume predatory lending anew.

It is also possible that publicity about unchecked predatory lending may make legitimate subprime lenders wary of making high-risk loans and thereby reduce the options for high-risk borrowers who are seeking credit.⁴⁶⁵ If shareholders and regulators put pressure on legitimate subprime lenders to avoid even the appearance of predatory lending, these lenders will adopt more conservative lending practices, which would have the effect of enlarging the market for predatory lenders.⁴⁶⁶

3. *Concerns About Frivolous Litigation.*—Some concede that additional remedies are needed, but oppose the creation of a private cause of action.⁴⁶⁷ We strongly believe that private relief is necessary for three reasons. First and foremost, a private cause of action is economically efficient because it places liability on the parties who are able to avoid the harm of predatory lending with the least cost—predatory lenders and brokers. Second, the compensatory aspect of the private right of action is important because it requires lenders and brokers to internalize the cost of the harm that they cause, thereby undercutting their incentives to engage in predatory lending. Third, we strongly advocate private relief because the government often lacks the resources or the will to pursue civil claims when it has enforcement

464. See, e.g., Laura Mandaro, *Wamu Primed for More Subprime*, AM. BANKER, Aug. 20, 2001, at 1, 2001 WL 26573314 (discussing Bank of America's decision to exit subprime mortgage lending); Riva D. Atlas, *Bank to Drop 2 Businesses to Tighten Up Its Operations*, N.Y. TIMES, Aug. 16, 2001, at C1, LEXIS, Nexis Library, NYT File (same).

465. Cf. Mollenkamp, *supra* note 148, at A1 (citing examples of banks that have dropped their subprime units because of fear of charges of predatory lending).

466. See, e.g., Michele Heller, *FTC Veteran: Keep the Heat on Predators*, AM. BANKER, Aug. 17, 2001, at 1, 4 (quoting former FTC official David Medine to the effect that if "legitimate lenders leav[e] that market, it's going to leave it wide open for predatory lenders to continue to dominate it").

467. See Litan, *supra* note 1, at 2 ("The more prudent course is for policy makers at all levels to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, Congress should provide the federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts.").

authority.⁴⁶⁸ If the government were given the sole power to enforce suitability and the designated agency, for financial, bureaucratic, or political reasons, failed to fully exercise its power, then tens of thousands of predatory-lending victims nationwide would have no or only limited recourse.

One argument in opposition to establishing a private cause of action is that it might spawn frivolous lawsuits. The concern is that dishonest borrowers will enter into legitimate, suitable loans and then challenge the loans because they regret having taken them out in the first place. Our response is that bright-line suitability rules in lieu of fuzzy standards, plus adequate documentation by lenders of compliance, should keep frivolous lawsuits to a minimum.

Some critics focus on class actions and contend that attorneys will bring frivolous strike suits in order to extract settlements or will settle meritorious claims on terms that benefit themselves at plaintiffs' expense. We believe that these concerns about class-action abuses are overstated. To begin with, class actions are not necessarily easy to certify in predatory-lending cases. In damages class actions under *Federal Rule of Civil Procedure* 23(b)(3), plaintiffs must show that the common issues predominate over the individual ones in order to achieve class certification. Loan-underwriting decisions often turn on facts that are unique to the borrowers, making commonality difficult to prove.⁴⁶⁹

To the extent that class actions can be certified in predatory-lending suitability cases, the goal should be to limit the possibilities for abuse, not to deny class-action claims wholesale. With respect to the risk that attorneys will bring frivolous suits, we note that counsel must already certify under

468. Michael Selmi, *Public vs. Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 UCLA L. REV. 1401, 1438 (1998) (finding that the efforts of the EEOC and the HUD to enforce fair-housing and employment-discrimination laws "have largely failed").

469. See *United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192, 210 (D. Mass. 1998) (declining to certify a class in a predatory-lending case because "individual factual questions predominate over those common to the class"); *Peters v. Cars To Go, Inc.*, 184 F.R.D. 270, 277-80 (W.D. Mich. 1998) (certifying one class but denying certification for another due to lack of commonality); cf. *Hoffman v. Grossinger Motor Corp.*, 218 F.3d 680, 683 (7th Cir. 2000) (refusing to construe the TILA in a subprime-auto-loan case in a way that "would make the class action a truly fearsome instrument of consumer-finance litigation").

In part for these reasons, securities class actions rarely assert breach of suitability. For instance, a study of securities class actions filed in 1999 found that the most prevalent claims were for improper revenue recognition and overstated assets. According to the study, "[o]ther prevalent areas included purchase accounting, liabilities and accounting estimates." Suitability was not mentioned. See PRICEWATERHOUSECOOPERS, 1999 SECURITIES LITIGATION STUDY 2-3 (1999), available at <http://securities.stanford.edu/research/reports/19990801pwc103000.pdf>; see also Mukesh Bajaj et al., *Securities Class Action Settlements: An Empirical Analysis* 3-4, 15 (2000), at http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.pdf ("[T]he vast majority of cases involved allegations concerning corporate disclosures."). The prevalence of mandatory-arbitration clauses governing suitability claims in securities also explains the paucity of securities class actions.

Rule 11⁴⁷⁰ that the claims they are pursuing are nonfrivolous, have evidentiary support, and are not being presented for harassment or delay. Making Rule 11 sanctions for frivolous filings mandatory for class counsel in predatory-lending cases would give that provision real force, although we strongly advise against mandatory sanctions for plaintiffs.

With respect to the fear that class counsel will enter into exploitative settlements of meritorious claims, some of the safeguards in the Private Securities Litigation Reform Act of 1995 (PSLRA)⁴⁷¹ should be extended to suitability claims for predatory lending. Named class plaintiffs could be required to swear that they reviewed the complaint and authorized its filing, and that they will not accept added payments for serving as named plaintiffs without court approval.⁴⁷² In addition, total attorneys' fees should be limited by statute to a reasonable percentage of the actual recovery to the class (including statutory damages) and settlements under seal should be barred.⁴⁷³

E. Other Needed Areas of Regulatory Attention

Our proposal relies on governmental, SRO, and private enforcement of suitability. Designing a cause of action and an array of enforcement mechanisms was our top priority because our purpose was to address the core incentive structures that fuel predatory lending. We do not wish to downplay the fact, however, that other aspects of subprime mortgage lending contribute to predatory lending and require attention. We have not discussed those problem areas in detail because they fall outside the scope of this Article. Nevertheless, a comprehensive approach to predatory lending will need to come to grips with these problems.

1. Regulation of Mortgage Brokers.—In the abstract, one might think of mortgage brokers as professionals who help borrowers find loans on the best terms. In practice, mortgage brokers serve a very different function because of the incentive structure in the industry. Brokers work for and are paid by loan originators, not borrowers. Brokers can facilitate predatory lending by scouting out unsophisticated borrowers and convincing them to pay the highest possible prices. While these mortgage brokers have financial

470. FED. R. CIV. P. 11(b).

471. Pub. L. No. 104-67, 109 Stat. 737 (1995).

472. See 15 U.S.C. § 78u-4(a)(2)(A) (2000). We note that formerly it was easy to manufacture securities-fraud class actions by having a staff member in class counsel's firm buy stock in every company in the S&P 500 or another broad index of stocks. The PSLRA contains a number of provisions that are designed to curb those abuses and ensure the independence of named class plaintiffs. See, e.g., *id.* § 78u-4. In contrast, the danger of manufactured suitability claims in the home-mortgage area of this type is quite low. Manufacturing a claim would require class counsel to take the absurd and unethical step of convincing an employee or another unsuspecting individual to go out and obtain a predatory loan secured by his or her home.

473. See *id.* §§ 78u-4(a)(5)–(a)(6).

incentives to deceive lenders as well as borrowers,⁴⁷⁴ in the final analysis they have no incentive to protect borrowers. However, they do care about their relationships with lenders, who provide them with repeat business. Our proposal seeks to realign those incentives by requiring brokers to take suitability into account. In addition, mortgage-broker licensing, capital or bonding requirements, and sanctions could be useful in remedying these problems.⁴⁷⁵

2. *Regulation of Appraisers.*—Inflated appraisals often lie behind predatory loans.⁴⁷⁶ Like mortgage brokers, real-estate appraisers have perverse incentives to inflate property values. Lenders, who sell loans on the secondary market, want appraisals to satisfy secondary-market purchasers. Appraisers who can produce such appraisals will be the most valued and utilized by lenders. In 1989, Congress required federal banking regulators to tighten federal regulation of appraisers used by federally insured banks and thrifts.⁴⁷⁷ At a minimum, those provisions should be extended to appraisers of subprime mortgage properties generally. In addition, borrowers and attorneys general should be able to sue appraisers for inflated appraisals.

3. *Due Diligence by the Secondary Market.*—Due diligence by the secondary market, particularly by the private secondary market, has been lax to date and has failed to deter capital flows to predatory lenders. It is unreasonable to expect secondary-market purchasers to unbundle mortgage-backed securities and examine every mortgage. However, we recommend the adoption of minimum standards for secondary-market purchasers, which could have the effect of filtering out predatory loans, for example, by prohibiting secondary-market purchasers from purchasing loans that include the financing of single-premium credit life insurance.⁴⁷⁸ In addition, it is reasonable to require that secondary-market purchasers conduct periodic audits of loans purchased from originators with high loss ratios in an effort to uncover predatory lending.

4. *CRA Credit for Predatory Loans.*—In a similar vein, banking organizations should be barred from receiving Community Reinvestment Act

474. See *supra* notes 133–38 and accompanying text.

475. See, e.g., N.C. GEN. STAT. §§ 53-243.01–.15 (1999) (North Carolina's Mortgage Lending Act).

476. See *supra* note 38 and accompanying text.

477. See 12 U.S.C. §§ 3331, 3339, 3341 (2000); 12 C.F.R. §§ 34.41–.47, 225.61–.67, 323.1–.7, 564.1–.8 (2001); MCCOY, *supra* note 95, § 6.04[4].

478. Cf. Office of Thrift Supervision, Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17,811, 17,818 (proposed Apr. 5, 2000) (to be codified at 12 C.F.R. pt. 560) (seeking comment on whether OTS should “encourage thrifts to inquire whether securitizers from whom they purchase interests in loan pools have conducted their own due diligence efforts with regard to the underlying loans”).

credit for predatory loans.⁴⁷⁹ Banking entities that originate subprime mortgages should not get CRA credit unless their subprime loans meet the best-practices standards of the SRO and the enforcement agency's suitability guidelines. Banking organizations that purchase subprime mortgages, either individually or in bundles, should not receive CRA credit unless they have instituted due-diligence provisions along the lines suggested above.

5. *Federal Agencies Need to Exercise Preemption Responsibly.*—In the American dual banking system,⁴⁸⁰ federal preemption is a long-held and jealously guarded prerogative. As we discussed earlier, in the area of mortgage lending, federal preemption can have the unfortunate effect of hampering state predatory-lending reforms that are stronger than their federal counterparts. The most prominent examples are challenges to state laws on grounds that AMTPA preempts state prohibitions against subprime terms and practices such as loan flipping, negative amortization, financing of points and fees, and balloon payments.⁴⁸¹ Recently, for instance, the Fourth Circuit held that AMTPA preempted a Virginia statute limiting the size of prepayment penalties in home loans.⁴⁸² Similarly, OCC expansion of national bank powers to issue credit life insurance under expansive readings of section 24(Seventh) of the National Bank Act⁴⁸³ may have inadvertently set the stage for certain credit-life-insurance abuses.

Federal banking regulators that enjoy the privileges of federal preemption need to exercise those privileges responsibly. The Office of Thrift Supervision, for instance, administers AMTPA and has authority to modify its implementing regulations to permit state regulation of nonprice terms. In April 2000, OTS issued an advanced notice of proposed rulemaking seeking comment on whether, due to predatory-lending concerns,

479. See HUD-Treasury Report, *supra* note 8, at 106.

480. For a general description of the dual banking system, see MCCOY, *supra* note 95, § 3.02.

481. See, e.g., Michael Bologna, *Mortgage Brokers' Suit Says U.S. Law Preempts Illinois Predatory Lending Rules*, BNA BANKING REP., July 30, 2001, at 201 (describing *Ill. Ass'n of Mortgage Brokers v. Office of Banks and Real Estate*, 174 F. Supp. 2d 815 (N.D. Ill. 2001)); *Predatory Lending Regulations, Laws Spread Across the Nation*, BNA BANKING REP., Apr. 30, 2001, at 776. For a description of AMTPA, see *supra* notes 82–83 and accompanying text.

482. See *Nat'l Home Equity Mortgage Ass'n v. Face*, 239 F.3d 633, 640 (4th Cir. 2001). Similar preemption challenges might be possible under the DIDMCA. For a description of the DIDMCA, see *supra* notes 79–81 and accompanying text. In addition, special usury provisions in the National Bank Act and the Federal Deposit Insurance Act preempt state usury laws for national and state banks and permit these banks to export high interest rates from states where they are located to other states. See 12 U.S.C. §§ 85, 1831d(a) (2000); *Smiley v. Citibank (South Dakota)*, 517 U.S. 735, 747 (1996) (upholding the Comptroller of the Currency's interpretation of "interest" in § 85 to include credit-card and late-payment fees); *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 301 (1978); cf. Paul Beckett, *Why Patricia Heaton Could Cause Problems for a GE-Owned Bank*, WALL ST. J., Mar. 30, 2001, at A1 (discussing lawsuit contending that a credit-card bank formed by GE was a "state bank" that took deposits and therefore was eligible to export high interest rates to more protective states).

483. 12 U.S.C. § 24(Seventh) (2000); see generally MCCOY, *supra* note 95, § 5.02[5][b][i][A].

AMTPA's regulations should be modified.⁴⁸⁴ OTS should complete that task and modify AMTPA's rules, to the extent possible, to permit regulation of nonprice terms in subprime mortgages by the states. Similarly, the Office of the Comptroller of the Currency should regulate exploitative terms in credit life insurance and similar products and move aggressively against the "rental" of national bank charters by predatory lenders.

6. *Marketing Abuses.*—Predatory lenders locate their prey through aggressive telemarketing and door-to-door solicitation. Aggressive regulation of both types of marketing, within the bounds of the First Amendment, could help shut off this vital pipeline for predatory lenders.

7. *SEC Material Litigation Disclosure.*—If shareholders and people contemplating stock purchases learn that a stock issuer has significant suitability claims pending, they may divest or elect not to purchase stock. This risk creates an incentive for firms to develop mechanisms to detect predatory lending. Under SEC regulations implementing the Securities Act of 1933, issuers of securities must disclose all material pending legal proceedings to which they are party.⁴⁸⁵ Litigation is not "material" unless similar claims, taken together, seek damages exceeding ten percent of the issuer's current assets.⁴⁸⁶ In suitability claims, where injunctions may form the primary relief or the damages sought are small, the ten-percent trigger may not be satisfied. Amending the SEC rule to add a trigger for a large number of small claims would address that problem. In addition, amending the definition of "material pending legal proceedings"⁴⁸⁷ to include arbitrations and agency proceedings, at least for subprime mortgage claims, would be advisable.

V. Conclusion

Predatory lending is more than a fleeting problem. As foreclosures and bankruptcies mount, and neighborhoods decay, predatory lenders and brokers continue their practices virtually free of sanctions. Our study of the forces that have contributed to the emergence of predatory lending and of the extant remedies available to victims of predatory lending has led us to conclude that without government intervention to impose a suitability standard, predatory lending will persist with devastating social consequences.

484. See Office of Thrift Supervision, Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17,811, 17,815–17 (proposed Apr. 5, 2000).

485. 17 C.F.R. § 229.103 (1997) (Regulation S-K Item 103).

486. *Id.* Instr. 2.

487. 17 C.F.R. § 229.103 (1997).

Appendix.

In this Appendix, we evaluate the regulation of a selection of problematic loan terms and practices in subprime mortgages. As part of our evaluation, we analyze the Home Ownership and Equity Protection Act (HOEPA), North Carolina's predatory-lending law, and the High Cost Home Loan Regulation of the New York Banking Department, as well as two model subprime codes promulgated by competing groups: industry guidelines developed by the Mortgage Bankers Association of America (MBA) and model consumer protection legislation developed by the National Consumer Law Center (NCLC).

Our purposes in this section are twofold. First, we identify loan terms and practices that we contend should be treated as unsuitable per se and other practices and terms that should be deemed unsuitable in some, but not all, situations. Second, we critique current methods for regulating these practices and propose approaches that would provide the most efficient protection.

I. Practices That Are Unsuitable Per Se

A limited group of exploitative subprime loan terms and practices do not benefit borrowers under any circumstances. These practices should be prohibited in subprime mortgages as unsuitable per se. In this section, we discuss five major practices that are unsuitable per se.¹

1. We also recommend that the following additional practices be prohibited as unsuitable per se (those already prohibited by HOEPA are noted):

1. *Advance payments.*—Examples include payment schedules that consolidate more than two periodic payments and pay them in advance from the proceeds of the loan. Advance payments for items like life insurance violate the principle of transparent loan pricing. They are prohibited by HOEPA. See 12 C.F.R. § 226.32(d) (2002).

2. *Payments by lenders to home-improvement contractors from mortgage proceeds other than by instruments payable to the borrower or jointly to the borrower and the contractor, or according to a written escrow agreement.*—Checks made solely payable to home-improvement contractors can be major inducements to home-improvement scams. They are prohibited by HOEPA. See 12 C.F.R. § 226.32(e) (2002).

3. *Recommendations or encouragement by lenders to default.*—Recommendations by lenders to default, acceleration of loans at lenders' sole discretion, and modification and deferral fees give lenders excessive incentives to engage in loan flipping or equity stripping.

4. *Clauses that permit lenders, in their sole discretion, to accelerate indebtedness.*—The 2001 amendments to the HOEPA regulations prohibit due-on-demand clauses, except where limited to situations involving misrepresentation by the borrower, missed payments, or collateral impairment by the borrower. See 12 C.F.R. § 226.32(d)(8) (2001); Federal Reserve System, *Truth in Lending*, 66 Fed. Reg. 65,604 (Dec. 20, 2001).

5. *Modification and deferral fees.*

6. *All subprime interest rebates resulting from loan prepayment or acceleration of home loans of any length that are calculated by methods less favorable than the method defined in 15 U.S.C. § 1615(d).*—Interest rebates resulting from loan

A. *Asset-Based Mortgages*

Asset-based home mortgages are loans underwritten solely on the value of homes as collateral, where the homeowners cannot afford the monthly payments under any reasonable set of circumstances and face bankruptcy or default and foreclosure as a result.² Such loans are unsuitable per se because the social value of those loans pales in comparison to the grave harm those loans inflict on homeowners, secondary-market purchasers, neighborhoods, and society at large.

HOEPA, North Carolina, and New York address asset-based subprime lending by prohibiting high-cost home loans without regard to payment ability.³ MBA and NCLC also address asset-based lending in their model legislation. The five provisions differ, however, in how they approach the issue of affordability.

One approach is to require lenders to take specific, enumerated factors into account when determining whether applicants can afford monthly loan payments out of current income, while leaving the application and weighting of those factors to lenders' discretion. For example, the original rules implementing HOEPA required lenders to take "the consumer's current and expected income, current obligations and employment" into account, without providing guidance on how to apply those factors.⁴ The new amendments to the HOEPA regulations add a documentation requirement. Under that requirement, a lender is presumed to violate HOEPA if it engages in "a pattern or practice of making [covered] loans . . . without verifying and

prepayments or acceleration that are calculated according to the Rule of 78 are unfair to consumers because creditors "receive more interest than is actually due, which results in a hidden prepayment penalty." *Testimony Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Banking and Financial Services Regarding the Proposed "Financial Institutions Regulatory Streamlining Act of 1998"* (July 19, 1998) (testimony of Margot Saunders), available at <http://www.consumerlaw.org/testcom/testimony.html>; see also KATHLEEN E. KEEST & ELIZABETH RENUART, *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES* 177-78, 182-83, 192-93 (2d ed. 2000). Currently, TILA prohibits use of the Rule of 78 in precomputed consumer-credit transactions with scheduled terms of 61 months or longer, and HOEPA restricts its use in the small group of high-cost home loans covered by that statute, regardless of their terms. See 15 U.S.C. §§ 1615(d), 1639(c) (2000); KEEST & RENUART, *supra*, at 178-79.

2. See, e.g., Departments of the Treasury and Housing and Urban Development, *Curbing Predatory Home Mortgage Lending*, at 21, 22, 24-25, 27 n.12 (June 20, 2000) [hereinafter HUD-Treasury Report]; Patricia Sturdevant & William J. Brennan, Jr., *A Catalogue of Predatory Lending Practices*, 5 CONSUMER ADVOC. 4, 37 (1999); cf. Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) (stating that "the borrower [must have] a reasonable ability to make the mortgage payments and [must be] likely to do so").

3. See General Regulations of the New York Banking Board §§ 41.3(b), 41.5(b)(3); N.C. GEN. STAT. § 24.1E(c)(2) (1999); 12 C.F.R. § 226.34(a)(4) (2002) (prohibiting high-cost mortgage lenders from engaging in "a pattern or practice" of extending credit without regard to the applicant's repayment ability).

4. 12 C.F.R. § 226.34(a)(4) (2002):

documenting consumers' repayment ability."⁵ The MBA likewise gives lenders discretion in determining affordability, but requires them to act in accordance with "the underwriting standards and procedures normally observed by the lender for the particular loan products."⁶

Another approach is to add a presumption with an objective, substantive test for determining whether borrowers can meet their loan payments. For example, North Carolina provides lenders latitude in determining affordability,⁷ but presumes that borrowers can afford payments when their monthly debt payments, including mortgage payments, do not exceed half of their verified monthly gross incomes.⁸ Similarly, NCLC advocates a presumption, but bases that presumption on the debt-to-income ratios and residual-income guidelines found in the Department of Veterans Affairs' regulations on VA loans.⁹

A third approach permits subprime lenders to make asset-based loans to anyone except applicants of limited means. Thus, under New York's regulations, lenders only need to take repayment ability into account for applicants whose incomes do not exceed 120 percent of the median family income for the metropolitan statistical areas in which their homes are located.¹⁰

5. *Id.*; see also Federal Reserve System, *Truth in Lending*, 66 Fed. Reg. 65,604 (Dec. 20, 2001) (adopting flexible evidentiary standards for proving a "pattern or practice" of extending asset-based loans).

6. The MBA's Legislative Guidelines provide:

A lender should not engage in the practice of making high cost home loans unless the lender reasonably believes that the borrower has the ability to repay the loan based on a consideration of current and expected income, current obligations, employment status, other financial resources or other compensating factors other than the borrower's equity in the dwelling which will secure repayment of the loan as determined through reasonable means in accordance with the underwriting standards and procedures normally observed by the lender for the particular loan products.

Mortgage Bankers Association of America, *Best Practices/Legislative Guidelines: Subprime Lending*, Legislative Guidelines ¶ 6 (2000), available at <http://www.mbaa.org/resident/lib2000/0525b.html>.

7. North Carolina's provision states:

Lender may not make a high-cost home loan unless the lender reasonably believes at the time the loan is consummated that one or more of the obligors, when considered individually or collectively, 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 which secures repayment of the loan).

N.C. GEN. STAT. § 24.1E(c)(2) (1999).

8. *Id.*

9. See NCLC, Model Home Loan Protection Act § 4(g) (2001) (incorporating the debt ratios and residual-income guidelines found in 38 C.F.R. § 36.4337(c)(1), (d)-(e), and VA Form 26-6393), available at http://www.nclc.org/predatory_lending/nclcmmodel_final.html.

10. General Regulations of the New York Banking Board § 41.3(b) (2002); see also *id.* § 41.5(b)(3). For borrowers whose homes are located outside of metropolitan statistical areas, the cutoff is 120% of the nonmetropolitan median family income for New York State. See *id.*

Which of these approaches is preferable? The loose list of factors found in HOEPA's rules and the MBA proposal gives lenders too much discretion. Under the laundry-list approach, presumably, lenders who considered all of the factors, but applied the factors aggressively, could enforce loans based on overly optimistic estimates of borrowers' ability to repay. Accordingly, we prefer the approach taken by North Carolina and NCLC, which combines lists of factors with a presumption that borrowers who satisfy stated debt ratios (and, in the case of NCLC, the VA's residual-income guidelines) can afford the loans. Furthermore, for loans with teaser rates, the eventual, fully indexed interest rate should be used in calculating debt ratios.¹¹

A related issue is whether the debt ratios used by North Carolina and New York are sufficient to ensure that borrowers can afford their loans. Both states establish a presumption of affordability where total debt-to-income ratios do not exceed fifty percent. But for poor individuals with very low incomes or high expenses (such as senior citizens with small Social Security checks or high, unreimbursed medical bills), earmarking fifty percent of their income for ordinary expenses will not suffice for the necessities of life. The VA debt ratios and residual-income guidelines proposed by NCLC address that issue in two ways: first, by lowering the total debt-to-income ratio to forty-one percent, and, second, by providing guidelines for determining whether the monthly income left over for living expenses is adequate after debts have been paid.¹² In any presumption using debt ratios, we therefore strongly recommend adoption of residual-income guidelines such as the VA's.

New York's approach raises a final question: whether to limit prohibitions against asset-based lending based on income.¹³ The premise behind New York's approach—that borrowers with higher incomes are not victims of asset-based lending or are not worthy of protection—is simply wrong. To the contrary, middle-class families who fall above the 120-percent-of-median-income line used in New York could easily get into trouble with asset-based loans—and many have. When subprime lenders make asset-based loans, typically they deceive borrowers about the true cost of the future loan payments.¹⁴ Regardless of income, the injury is the same. For this reason, we oppose New York's means test.

11. Teaser rates are introductory, below-market rates on adjustable-rate mortgages that later expire, often within a short period of time. The new HOEPA guidelines state that in loans with teaser rates, lenders must "consider the consumer's ability to make loan payments based on the nondiscounted or fully indexed rate at the time of consummation." Federal Reserve System, *Truth in Lending*, 66 Fed. Reg. 65,604 (Dec. 20, 2001).

12. See 38 C.F.R. § 36.4337(c)(1), (d)–(e) (2002). Economists would be best equipped to determine where to set maximum debt loads so that borrowers do not fall into foreclosure or bankruptcy.

13. Interestingly, the MBA Guidelines do not advocate such a test. Perhaps this is because of concerns that a means test would be cumbersome for loan officers to apply.

14. For example, adjustable-rate mortgages with teaser rates are often used to lure borrowers into believing that they can afford their monthly payments.

B. *Negative Amortization*

Borrowers gain no discernable benefit from mortgages with negative amortization, except in the limited case of reverse mortgages for senior citizens or the terminally ill, which are heavily regulated.¹⁵ In loans with negative amortization, scheduled payments are not enough to cover the interest due. Unpaid interest is tacked onto the principal, causing the principal to mount. With every payment, the borrower goes deeper into debt and loses more and more equity in his or her home. For this reason, HOEPA,¹⁶ North Carolina,¹⁷ and the New York Banking Department¹⁸ prohibit negative amortization clauses in high-cost home loans. NCLC advocates the same position.¹⁹ MBA's model legislation is silent on the subject.²⁰

Reverse mortgages deplete equity in what is often the borrowers' largest asset, prolonging loan repayment for years at added expense to borrowers and increasing the likelihood of foreclosure. Due to these concerns, we would prohibit negative amortization in all subprime home loans except for reverse mortgages regulated by the Home Equity Conversion Mortgage program of the Department of Housing and Urban Development.

C. *Steering*

Steering occurs when subprime lenders persuade unsuspecting borrowers, who actually qualify for prime loans, to agree to loans at higher subprime rates. Steering is exacerbated by the use of yield-spread premiums, which reward mortgage brokers for convincing borrowers to pay higher interest rates than the lenders are willing to take.

Despite the extent and seriousness of steering, HOEPA, the North Carolina law, and the NCLC model legislation essentially ignore the issue. New York's response is limited to a mandatory disclosure that "[t]he loan which may be offered to you is not necessarily the least expensive loan available to you and you are advised to shop around to determine

15. See, e.g., HUD-Treasury Report, *supra* note 2, at 91–92. Reverse mortgages that allow individuals with a short life span to convert their home equity into a monthly annuity can be beneficial. Reverse mortgages, however, are closely regulated under the Home Equity Conversion Mortgage program administered by the Department of Housing and Urban Development and specifically require mandatory counseling before closing. See *id.* at 92.

16. See 15 U.S.C. § 1639(c)–(i) (2000); 12 C.F.R. § 226.32(d) (2002).

17. See N.C. GEN. STAT. § 24-1.E(b)(3) (1999).

18. See General Regulations of the New York Banking Board § 41.2(c) (2002). Under that provision, New York does permit negative amortization when sought as temporary forbearance by the borrower. *Id.* Unless the terms of such forbearance are carefully policed, however, the borrower's straits could simply become worse.

19. See NCLC, Model Home Loan Protection Act § 4(b) (2001), available at http://www.nclc.org/predatory_lending/nclcmmodel_final.html.

20. See Mortgage Bankers Association of America, *supra* note 6.

comparative interest rates, points and other fees and charges.”²¹ MBA, interestingly, takes a stronger stance, recommending that “[b]orrowers should be offered loan options commensurate with their qualifications, and such options and their costs should be clearly explained.”²²

We strongly recommend that steering of prime customers to subprime loans be prohibited *per se*.²³ To satisfy this standard, a subprime lender would have to demonstrate, under underwriting guidelines in effect at the time of the loan application, that an applicant who received a subprime loan either did not qualify as a prime borrower or fell within a borderline group of applicants whom lenders could either treat as A or A- borrowers. The federal agency charged with implementing suitability would approve the underwriting guidelines that lenders could use, which could include Fannie Mae, Freddie Mac, and private secondary-market standards.

D. *Single-Premium Insurance Payments*

Single-premium policies for credit life insurance and other types of insurance or debt cancellation contracts that are marketed in tandem with subprime mortgages are a common subprime abuse. Under single-premium policies, borrowers pay the same lump sum premium for insurance or debt cancellation coverage, whether they make their loan payments through to maturity or prepay their mortgages. Moreover, single-premium policies are often financed as part of the loan. As the end result, borrowers often pay for needless insurance and assume more onerous debt obligations. If borrowers want credit life insurance or lenders require it, lenders could simply charge monthly insurance premiums. Hence, there is no economic justification for single-premium insurance policies.

The new amendments to the HOEPA rules only require mandatory disclosure of insurance premiums.²⁴ That is MBA’s approach as well.²⁵

21. See General Regulations of the New York Banking Board § 41.4(d) (2002). Another provision of the New York rules, while more oblique, could be used to challenge steering as an unfair and deceptive act or practice. That provision states that unfair and deceptive acts and practices include “[b]rokering or making a high cost home loan which includes points, fees or other finance charges that . . . so significantly exceed the usual and customary charges incurred by mortgage consumers generally in this state for such points, fees or other finance charges as to be unconscionable.” *Id.* § 41.5(b)(1).

22. See Mortgage Bankers Association of America, *supra* note 6, ¶ 3.

23. Steering may also occur within subprime categories (*i.e.*, A- through D). We do not propose making such steering actionable, at least not at this time, because currently there is no standard industry definition for distinguishing among various grades of subprime borrowers.

24. Under those amendments, “where the amount borrowed includes premiums or other charges for optional credit insurance or debt-cancellation coverage, that fact shall be stated, [and] grouped together with the disclosure of the amount borrowed.” 12 C.F.R. § 226.32(c)(5) (2002). In addition, if the consumer finances optional coverage and the monthly payment goes up as a result, “redisclosure is required and a new three-day waiting period applies.” Federal Reserve System, *Truth in Lending*, 66 Fed. Reg. 65,604 (Dec. 20, 2001).

In contrast, North Carolina, New York, and the NCLC model act chart a stricter course, permitting single-premium policies but regulating their financing. North Carolina is the most demanding of the three. It forbids the financing of single-premium credit life, disability, unemployment, life, or health insurance for "consumer home loans" of any size,²⁶ as well as the financing of points, fees, or charges payable to third parties of any type for high-cost home loans.²⁷ NCLC would forbid the financing of all insurance premiums except for premiums that are "calculated and paid on a monthly basis."²⁸ In contrast, New York permits lenders to finance total points, fees and charges (including single-premium payments) in an amount not exceeding five percent of the principal. In addition, New York lenders may finance insurance premiums in excess of the five-percent cap where borrowers' scheduled monthly payments do not exceed fifty percent of their monthly gross incomes.²⁹

In our view, none of these approaches adequately protects consumers. Rather, we urge that single-premium insurance payments in subprime lending be prohibited outright. Even when single-premium payments are not financed, they result in overcharges to borrowers who prepay their loans. Indeed, three major subprime lenders—American General Corporation and the subprime affiliates of Citigroup and Household International—acknowledged this problem in the summer of 2001 by announcing that they were discontinuing their single-premium insurance products.³⁰ Congress should follow their lead and require abolition of single-premium insurance policies and other single-premium products for all subprime mortgage loans.

25. On credit insurance generally, MBA's Legislative Guidelines provide:

A lender or broker should *not* sell credit life, accident and health, disability or unemployment insurance products in connection with a high cost loan *unless* the borrower is provided with a written disclosure containing the following information: (1) the cost of the insurance; (2) the insurance is not a requirement to obtain the loan; and (3) the insurance will be financed as a part of the loan transaction.

See Mortgage Bankers Association of America, *supra* note 6, ¶ 9.

26. See N.C. GEN. STAT. § 24-10.2(b), (e) (1999).

27. See *id.* § 24-1.E(c)(3).

28. See NCLC, Model Home Loan Protection Act § 4(c) (2001), available at http://www.nclc.org/predatory_lending/nclcmmodel_final.html.

29. See General Regulations of the New York Banking Board § 41.3(c). The New York rules do define unfair and deceptive acts and practices to include high-cost mortgage fees that "bear no reasonable relationship to the value of the services actually performed," but are silent as to whether single-premium payments constitute such fees. *Id.* § 41.5(b)(2)(ii).

30. See, e.g., Patrick McGeehan, *Household Announces Changes in Lending Practices*, N.Y. TIMES, July 24, 2001; Patrick McGeehan, *Third Insurer to Stop Selling Single-Premium Credit Life Policies*, N.Y. TIMES, July 21, 2001; Adam Wasch & R. Christian Bruce, *CitiFinancial Announces It Will End Single-Premium Credit Insurance Sales*, BNA BANKING REP., July 2, 2001, at 9-10; Patrick McGeehan, *Citibank Set To End Tactic On Mortgages*, N.Y. TIMES, June 29, 2001, at C1.

II. Other Problematic Practices

In contrast with loan terms or practices that are unsuitable per se, other terms or practices are more ambiguous, either being beneficial to borrowers or exploitative, depending on the circumstances. In this section, we address the treatment of two hotly debated subprime loan terms that fall in this latter category: prepayment penalties and balloon clauses.³¹

A. Prepayment Penalties

In the debate over subprime lending, prepayment penalties have been especially contentious. Prepayment penalty clauses are often sizable and are found in the overwhelming majority of subprime mortgage loans. Prepayment penalties apply whenever borrowers sell their homes, refinance, or terminate their loans involuntarily through default.

In the subprime market, prepayment penalties have a number of pernicious effects. They discourage subprime borrowers from refinancing with other lenders in order to switch to lower rates. They impose high financial penalties for default, thereby promoting equity stripping. Finally, they give lenders incentives to engage in “loan flipping”—in other words, needless repeated refinancings by loan originators or their affiliates. When lenders enforce prepayment penalties, the consequences can include equity stripping, foreclosure, poverty, and neighborhood decline.³²

Predatory lenders have incentives to manufacture defaults in order to trigger prepayment penalties. Lenders can manufacture default in several ways. For instance, they can invoke clauses that permit them to accelerate loans at their sole discretion due to minor, technical breaches of loan agreements. They can include balloon clauses with short due dates that borrowers are unlikely to be able to pay. Alternatively, lenders can make asset-based loans, knowing that the borrowers cannot afford these loans and are virtually certain to default.

Similarly, when borrowers refinance, they trigger prepayment penalties. Some of these refinancings result from defaults and accelerations that lenders manufacture. In other cases, lenders press unsuspecting borrowers whose loans are current to refinance, thereby enabling the lenders to harvest prepayment penalties and a fresh round of fees. Where borrowers can refinance with their original lenders or the lenders’ affiliates, prepayment penalties provide harmful inducements toward equity stripping.

31. Certain other subprime terms fall into the category of practices that are highly problematic under certain circumstances, but not predatory per se. Such practices include the financing of points and fees, the refinancing of low- or zero-interest loans at higher rates (*see, e.g.*, Federal Reserve System, *Truth in Lending*, 66 Fed. Reg. 65,604 (Dec. 20, 2001)), and shifting unsecured debt into mortgages.

32. *See* HUD-Treasury Report, *supra* note 2, at 94.

Nevertheless, prepayment penalties may be justified, at least in theory. Prepayment is a major issue in the subprime market because subprime mortgages prepay on average earlier than prime mortgages.³³ There are two primary reasons why this is the case. First, subprime borrowers have strong incentives to refinance as soon as possible to switch to lower, prime rates. The stated purpose of prepayment penalties in these situations is to compensate lenders and secondary-market purchasers for the loss of expected future revenue.³⁴ Second, subprime borrowers are more likely to default (particularly when predatory practices make loans unaffordable),³⁵ thereby triggering prepayment penalties.

The stated purpose for prepayment penalties—to compensate lenders for lost revenue either due to refinancing or default—only makes sense if subprime loans are priced competitively. But if subprime loans have inflated prices (in other words, if the prices of these loans exceed the risks that borrowers present), then lenders do not need prepayment penalties. Evidence suggests, in fact, that the prices of subprime mortgages *are* inflated. Freddie Mac economists have concluded, for instance, that the price spread between prime and subprime mortgage loans (including rates, points, and fees) is higher than justified by the difference between the credit risks of prime and subprime borrowers.³⁶ Similarly, anywhere from ten to fifty percent of subprime borrowers are prime-eligible individuals who are paying too much for their loans.³⁷ This rent-seeking thus suggests that prepayment penalties are vehicles for extracting supranormal profits from subprime borrowers, rather than compensation to lenders for the costs of prepayment and default.

In the competitive prime market, prepayment penalties serve a second purpose of enhancing consumer choice. In theory, consumers can opt for prepayment penalties in exchange for lower interest rates. In reality,

33. See, e.g., Standard & Poor's, Press Release, *Subprime Prepayment Penalties Spur NIMS, Criteria* (Jan. 4, 2001), available at http://biz.yahoo.com/bw/010104/ny_s_p.html (reporting that subprime mortgages with prepayment penalties prepay 10% less often than subprime mortgages lacking such clauses); Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency* 13 (Dec. 21, 2000) (unpublished manuscript, on file with the Texas Law Review).

34. See HUD-Treasury Report, *supra* note 2, at 93; JOHN C. WEICHER, *THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT* 73–74 (1997). This only becomes an issue when interest rates are falling. When interest rates are rising, lenders can relend the funds at higher rates.

35. See, e.g., John Hechinger, *Home Bound: Nasty Surprise Haunts Some Folks' Mortgage: A Prepayment Penalty*, WALL ST. J., Aug. 1, 2001, at A1, A6.

36. See Lax et al., *supra* note 33, at 18 (adding that “roughly one-half of the interest rate premium paid by subprime borrowers—100 basis points—cannot easily be explained by the higher levels of risk associated with these types of loans”).

37. *Cf. id.* at 16 (“If subprime lending and its higher interest rates and fees are to be justified on the basis of serving higher risk borrowers, [our] finding that some borrowers end up with subprime loans for reasons other than risk is disturbing.”).

however, prepayment penalties in the prime market are rare.³⁸ When prime lenders do offer loans with prepayment penalties, those loans generally appear on a menu of alternatives (along with adjustable-rate mortgages and different levels of points) that permits consumers to trade off time-price differentials in the cost of money.³⁹ If a prime lender insists on prepayment penalties without offering interest rate reductions or other tradeoffs, prime borrowers can use competitive market conditions to vote with their feet and find lenders who offer those tradeoffs.

In contrast, in the subprime market, finding a subprime mortgage without a prepayment penalty is difficult.⁴⁰ This suggests that lenders do not “offer” prepayment penalties to borrowers as tradeoffs for lower interest rates. Rather, it suggests that lenders impose prepayment penalties to inflate the cost of subprime mortgages.

This evidence has generated a variety of regulatory responses. One approach is a full or partial ban on prepayment penalties. NCLC takes the strictest stance, recommending that prepayment penalties be prohibited in all home loans (prime or subprime).⁴¹ North Carolina bans prepayment penalties in all consumer loans of \$150,000 or less, whether or not those loans are high-cost home loans (except where preempted by federal law).⁴²

Other laws or model codes prohibit prepayment penalties unless certain conditions are met. For instance, HOEPA prohibits prepayment penalties in high-cost home loans, except where the penalties satisfy three conditions: (1) the penalty can only be exercised in the first five years following consummation of the loan; (2) the prepayment funds may not come from a refinancing by the original creditor or an affiliate; and (3) the borrower’s total monthly debts at closing (including the HOEPA loan) do not exceed fifty percent of his or her monthly verified gross income.⁴³ In a variation on HOEPA’s approach, MBA would bar prepayment penalties in high-cost home loans, unless those penalties met the following conditions: (1) the penalty could only be exercised in the first five years following execution of the loan; and (2) the amount of the prepayment penalty could not exceed the

38. See Ruth Simon, *Prepayment Clauses Come With Pitfalls*, WALL ST. J., Dec. 12, 2001.

39. See, e.g., HUD-Treasury Report, *supra* note 2, at 97; Pamela Reeves, *Lenders Reconsider Prepayment Penalties*, THE DETROIT NEWS, Dec. 22, 1997, available at <http://detnews.com/STRAT/9712/22/lender/lender.htm>.

In the prime market, a prepayment penalty generally results in an interest discount of 1/8 to 3/8 percent. See Simon, *supra* note 38.

40. See HUD-Treasury Report, *supra* note 2, at 93 (reporting that over 98% of subprime home loans have large prepayment penalties that exceed the liquid resources of most subprime borrowers).

41. See NCLC, Model Home Loan Protection Act § 3(b), available at http://www.nclc.org/predatory_lending/nclcmmodel_final.html.

42. See N.C. GEN. STAT. § 24-1.1E(b) (1999).

43. See 12 C.F.R. § 226.32(d) (2002).

standard industry penalty of six months of advance interest on the amount prepaid in excess of twenty percent of the original principal balance in any twelve-month period measured from the note date or its anniversary.⁴⁴

New York takes the narrowest tack of all. Eschewing a flat prohibition on prepayment penalties, the New York Banking Board instead prohibits the *financing* of prepayment penalties in refinancing transactions by the original lender or one of its affiliates.⁴⁵ Essentially, the Banking Board permits prepayment clauses except where there is a high risk of flipping and equity stripping.

The array of approaches to regulating prepayment penalties reflects the complexity of the issue. On the one hand, prepayment penalties arguably serve two legitimate purposes: increased consumer choice and compensation to subprime lenders or secondary-market purchasers of subprime loans for lost revenue streams. On the other hand, evidence suggests that prepayment penalties do not promote consumer choice in the subprime market and instead are a form of rent-seeking. In view of the severe pricing distortions in the subprime market, it is questionable whether prepayment penalties serve *any* legitimate function in subprime lending. What is clear is that prepayment penalties provide serious perverse incentives for subprime lenders and their affiliates to engage in loan flipping and equity stripping. Similarly, prepayment penalties trap borrowers in high-priced loans and hinder transparent pricing.

For these reasons, we favor a moratorium on prepayment penalty clauses in subprime mortgage loans, until such time as the subprime market becomes competitive. Initially, we recommend a five-year moratorium, coupled with a mandatory report to Congress on the effects of that moratorium in the first three years. Following that report, Congress could either decide whether to continue the moratorium or delegate that decision to the oversight agency.

There are two important reasons why a moratorium should be declared on subprime prepayment penalties in home sales and refinancings. First, prepayment clauses trap borrowers in high-cost loans by discouraging them from selling their homes or refinancing.⁴⁶ Many of those borrowers are victims of steering and should have received prime loans in the first place.⁴⁷ Trapping prime-eligible borrowers in subprime loans that never should have

44. See Mortgage Bankers Association of America, *supra* note 6, ¶ 4.

45. See General Regulations of the New York Banking Board § 41.3.

46. See Hechinger, *supra* note 35, at A1, A6. Even sophisticated, affluent borrowers can suffer from this trap. According to the *Wall Street Journal*, one official of America's Community Bankers (an industry trade group) discovered that his prepayment penalty was so large that he decided not to refinance when interest rates dropped. According to the official, "If I had a crystal ball, I probably wouldn't have done what I did." See Simon, *supra* note 38.

47. See *supra* note 20 and accompanying text.

been made is unconscionable. As for subprime borrowers with blemished credit, society *should* encourage them to refinance at lower rates whenever they improve their credit records. Lowering their debt loads will assist in wealth formation, promote stable home ownership, and decrease the likelihood that these borrowers will become public charges.

Second, a moratorium will promote needed transparency in subprime pricing and increase competition. Because of their deferred and contingent nature, prepayment penalties (like teaser rates and clauses imposing higher interest rates upon default) use the element of surprise to mask the true price of credit. Subprime borrowers are typically naïve individuals who do not understand prepayment penalties or who have undue optimism that the penalties will not go into effect.⁴⁸ A moratorium of the type that we propose would have the salutary effect of encouraging subprime lenders to compete on nominal, upfront interest charges, instead of burying hidden charges in prepayment penalty clauses.

Critics of such an approach argue that a moratorium on prepayment penalties will result in over-regulation, because it will apply in situations where the risks of exploitation are low or nonexistent. For example, when prepayment clauses are triggered because borrowers sell their homes, exploitation is arguably absent. Likewise, when borrowers refinance with wholly unrelated lenders, absent collusion, the risks of equity stripping and flipping are absent or reduced.⁴⁹ Many of these borrowers are paying inflated prices in the first place for their loans, however, and a moratorium will make their costs of financing commensurate with their true credit risks.

Critics may also claim that curtailing prepayment penalties will cause subprime credit to contract. It is not clear, however, that credit contraction will in fact occur. The supranormal price levels found in the subprime mortgage industry suggest that there is room for subprime lenders to earn profits without charging prepayment penalties. Assuming, however, that some degree of credit contraction might occur, we need to ask which loans and which borrowers would be affected. For starters, a moratorium on prepayment penalties would help discourage lenders from engaging in loan flipping or asset-based lending that is designed to result in default. That is precisely our goal. Similarly, lenders might raise nominal interest rates on subprime loans in order to compensate for lost income from prepayment penalties.⁵⁰ Conversely, lenders might respond to a moratorium by keeping

48. See Hechinger, *supra* note 35, at A1, A6; Simon, *supra* note 38.

49. Obviously, loan flipping could occur when an unrelated lender colludes with the original lender to persuade a subprime borrower to refinance and then splits the prepayment penalty with the original lender in the form of a kickback.

50. Under our proposal, lenders would retain that option because we would not impose caps on nominal interest rates. We recognize that a moratorium on prepayment penalties is a form of price control. The market failure in the subprime mortgage market with respect to prepayment penalties

interest rates in check in order to increase market share. This response would promote the competition that we argue is essential to an efficient subprime market.

B. Balloon Payments

Balloon payments are large lump-sum payments that come due at the end of a loan. Balloon payments are used whenever regular monthly loan payments fail to retire the loan balance over the term of the loan. As such, balloon payments are deferred charges and thus raise issues similar to prepayment penalties.

Balloon clauses can have distinct benefits. They allow homeowners who plan to sell or refinance before the balloon payments come due to lower their monthly loan payments. These potential cost savings enable people to obtain credit when they otherwise could not afford it.

Balloon clauses appeared in approximately ten percent of subprime loans originated in 1999, suggesting that the subprime market may in fact offer tradeoffs between interest rates and balloon payment clauses.⁵¹ Nevertheless, balloon payments entail substantial risks for borrowers. These risks are especially great for LMI borrowers. When balloon payments come due, borrowers must either refinance their loans or pay the balloon payments out of pocket. Few, if any, LMI borrowers have the financial resources to pay balloon payments themselves. Refinancing may prove onerous if interest rates have risen. Complicating this task, LMI borrowers with late payment histories and other credit problems may find it impossible or difficult to refinance on terms they can manage.⁵² Furthermore, such credit problems may be the direct result of an original predatory loan that caused delinquencies and marred their credit records. If the borrowers cannot refinance or make their balloon payments, their loans will go into default. Thus, balloon clauses can be disastrous for borrowers with precarious finances, as is true for many subprime borrowers.

In addition to these normal risks, balloon clause abuses are prevalent in the subprime market. For instance, some subprime lenders lure unsuspecting borrowers into mortgages with attractive interest rates, without alerting them that large balloon payments will eventually come due.⁵³ Many subprime borrowers do not realize that they have balloon clauses. Others know that

is currently so severe, however, that anything short of a moratorium would fail to curb these abuses. We would impose an initial five-year time limit on this moratorium to provide an opportunity for empirical study and periodic review by Congress (or an oversight agency) to consider whether market conditions warrant future modification.

51. See HUD-Treasury Report, *supra* note 2, at 96.

52. *Id.* at 97.

53. See *id.*

they have balloon clauses, but do not understand that the clauses necessitate refinancing.⁵⁴

Other unscrupulous subprime lenders use balloon payments as the occasion for loan flipping and equity stripping. In the prime market, balloon payments normally do not go into effect for five to seven years. In the subprime market, some loans contain balloon payments that come due in a much shorter time frame. When these balloon payments come due, the lenders “rescue” the borrowers by refinancing at high rates and rolling the points, fees, and closing costs into the principal, stripping equity in the process.⁵⁵

Most reform legislation either bans balloon payments or prohibits balloon payments that mature within a specified number of years. Texas prohibits balloon payments in home-equity loans.⁵⁶ North Carolina bans balloon payments in high-cost mortgages⁵⁷ and NCLC’s proposal follows suit.⁵⁸

In contrast, HOEPA and the New York Banking Board’s regulations use industry standards as a guide. HOEPA prohibits balloon payments in high-cost home loans (other than bridge loans) with terms of less than five years and requires disclosure of their amounts.⁵⁹ New York has a somewhat stricter rule, prohibiting balloon payments in closed-end high-cost home loans, except where due and payable no earlier than seven years after origination.⁶⁰ The MBA’s Best Practices/Legislative Guidelines are silent on the issue.

As with prepayment penalties, we advocate a moratorium on balloon clauses for an initial period of five years, after which Congress or an oversight agency should reconsider the moratorium following a study of its effects. We do not recommend a moratorium lightly. Unlike prepayment penalties in the subprime market, which offer few, if any, benefits to individual borrowers, balloon clauses do make credit affordable for some subprime loan applicants who otherwise could not afford loans. Accordingly, a moratorium would likely curtail credit for certain individuals who would not otherwise qualify for credit but who would not be hurt by a balloon payment clause, either because they are close to death or they plan to sell their homes before the balloon clauses come due. Given the small fraction of subprime loans with balloon clauses and the even smaller fraction

54. *See id.*

55. *See id.*

56. TEX. CONST. art. XVI, § 50(a).

57. N.C. GEN. STAT. § 24-1.E(b) (1999).

58. *See* NCLC, Model Home Loan Protection Act § 4(a), available at http://www.nclc.org/predatory_lending/nclcmoel_final.html.

59. 15 U.S.C. § 1639(c)-(i) (2000); 12 C.F.R. § 226.32(c)(3), (d) (2002).

60. General Rules of the New York Banking Board § 41.2(b).

of subprime loan applicants who fall in either category, we believe that any impingement on credit would be modest at best.

In contrast, balloon payments can inflict a grave harm on borrowers who cannot refinance or otherwise meet their balloon payments. For these unfortunate borrowers, foreclosure or bankruptcy lies in store. Even for borrowers who can refinance, their desperate need to refinance and the prevalence of subprime abuses make them prey to new, exploitative loans. We contend that in light of the current structure of the subprime market, the magnitude of the harm that balloon payments can cause outweighs the limited restriction that they may have on access to capital.