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Massachusetts' New Predatory Lending Law and the Expanding Rift Between Federal and State Lending Protection

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MASSACHUSETTS' NEW PREDATORY LENDING LAW AND THE EXPANDING RIFT BETWEEN FEDERAL AND STATE LENDING PROTECTION

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Abstract: Predatory lending practices in the mortgage industry cost Americans an estimated $9.1 billion each year. Predatory lending steals hard-earned equity from individuals and disproportionately affects minorities, low-income families, the elderly, and their respective communities. On August 9, 2004, the Massachusetts legislature approved legislation to combat this growing problem. This recent legislation provides strong protection against predatory lending. Despite this positive step, nationally-chartered institutions remain virtually unregulated as a result of weak federal protections and the unwillingness of federal agencies to investigate or prosecute predatory lending practices. This Note concludes that true reform in lending requires a greater delegation of regulatory authority to the states or, in the alternative, stronger federal protections that match the efforts of states such as Massachusetts.

Introduction

Monica Sudler is a 44 year old Boston resident who makes over $50,000 a year.[1] Sudler sought a $10,000 loan to do home repairs, but the lending institution she approached told her that she did not make enough money to take out such a loan.[2] Rather than allowing Ms. Sudler to take out the small loan she requested, the lending institution talked her into refinancing her house with a $113,551 loan at 10.48% interest, three points higher than the mortgage she already had.[3] When Ms. Sudler realized that the refinanced loan was more harmful than helpful, she attempted to get out of the equity-stripping

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[1] Andrew J. Manuse, *Predatory Loans Seen as on Rise in Boston*, Boston Herald, Feb. 12, 2004, at 41.

[2] *Id.*

[3] *Id.*

loan, but in doing so she was forced to pay more than $10,000 in prepayment penalties.[4] "I was bamboozled, hoodwinked, tarred and feathered," she said.[5] She warned those considering a loan, "[l]ook behind every smile, otherwise, you won't have a happy ending."[6]

Unfortunately, Ms. Sudler's experience with lending is not unique.[7] Predatory lending practices in the private consumer home mortgage industry have a devastating impact on the lives of many homeowners in America.[8] Unfair fees and unjustifiably high interest rates have cost American homeowners an estimated $9.1 billion each year.[9] The extreme cost of abusive lending practices drains unsuspecting or misled borrowers of the equity in their homes.[10] The result is often foreclosure.[11] Additionally, unscrupulous lenders target those who are least able to shoulder the immense burden of predatory loans.[12] Predatory lenders target minorities and their communities, homeowners in low-income neighborhoods, and the elderly.[13] The net social cost of predatory lending extends far beyond individual victims, as vulnerable minority and low-income communities become wastelands of boarded-up houses and broken dreams.[14]

Over the past decade, predatory lending abuses have increased dramatically.[15] The greater Boston area has experienced particularly shocking increases in predatory lending.[16] In an attempt to confront the overwhelming problem of predatory lending, the Massachusetts legislature approved the Predatory Home Loan Practices Act (PHLPA or the Act) on August 9, 2004.[17] The Act, which became effective on November 7, 2004, constitutes a substantial step forward in the pro-

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[4] *Id.*

[5] *Id.*

[6] Manuse, *supra* note 1, at 41.

[7] *See* Eric Stein, Coal. for Responsible Lending, Quantifying the Economic Cost of Predatory Lending 2 (2001), *available at* http://www.responsiblelending.org/pdfs/Quant10-01.pdf.

[8] *Id.*

[9] *Id; see infra* Part I.B. (discussing the impact of predatory lending on American homeowners).

[10] Stein, *supra* note 7, at 11.

[11] *Id.*

[12] *See infra* Part I.B.

[13] *See infra* Part I.B.

[14] *See infra* Part I.B.

[15] Ass'n of Cmty. Org. for Reform Now, Separate and Unequal: Predatory Lending in America 13 (2004), *available at* http://www.acorn.org/fileadmin/Community_Reinvestment/Reports/S_and_E_2004/separate_and_unequal_2004.pdf [hereinafter ACORN].

[16] *See infra* notes 85–87 and accompanying text.

[17] Predatory Home Loan Practices Act, 2004 Mass. Acts 268.

tection of Bay State borrowers from predatory lenders.[18] Though mitigated by preemptive federal regulations that restrict the scope of state predatory lending laws,[19] the Act is important because the problem of predatory lending continues to grow in magnitude.[20] In the absence of meaningful federal lending protections, states must continue to pass legislation that protects borrowers from abusive lending practices without inhibiting lenders from providing loans to borrowers with imperfect credit.[21]

This Note examines federal and state legislation to determine the most effective and appropriate means for preventing future borrowers from being similarly harmed by the misleading and often blatantly deceptive practices of predatory lenders. This Note limits its discussion of predatory lending practices to those practices that are most common within the private consumer mortgage industry.[22] Part I of this Note describes common predatory lending practices in more detail and highlights those who are victimized by these practices. Part II considers federal and state anti-predatory lending legislation and the relationship between PHLPA and federal lending protections. Part II also discusses the impact of federal preemption rules that limit the scope of PHLPA and considers a variety of arguments for and against federal preemption. Part III examines the specific terms of PHLPA and the likelihood of the Act's effectiveness in comparison with other state and federal protections. This Note concludes that PHLPA is likely to be effective in combating the most common forms of preda-

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[18] *See id.*

[19] *See infra* Part II.D.

[20] *See infra* Part II.D.

[21] *See, e.g.*, Predatory Home Loan Practices Act, 2004 Mass. Acts 268, § 6; Predatory Lending Act, 1999 N.C. Sess. Laws 332.

[22] In addition to predatory lending that occurs within the private consumer mortgage industry, another damaging form of predatory lending is payday lending. *See* Mass. Div. of Banks, *Internet Payday Loans: Risky Business,* May 30, 2000, http://www.mass.gov/dob/payday.htm (last modified Aug. 3, 2004). This type of predatory lending provides advances on the borrower's paycheck and generally charges outrageous rates of interest. *Id.* (noting that interest rates of online payday lenders typically are between 300% and 500% and also pointing out one lender who charges an astounding 6,205% in interest). The advent of the Internet created a new means for payday lenders to reach potential victims while at the same time decreasing the government's ability to prohibit or regulate this form of lending. *See id.* For example, although no payday lenders are physically located in Massachusetts—due to laws restricting capping interest rates on small loans—this form of predatory lending continues to harm Bay State residents through the aggressive marketing strategies of online payday lenders. *Id.* The efforts of online payday lenders are unchecked because the online payday lenders are not licensed by the state's regulatory agency, the Massachusetts Division of Banks, and are therefore not subject to Massachusetts' laws and regulations. *Id.*

tory lending and that Congress should take steps to expand the scope of protective anti-predatory lending acts as Massachusetts has.

I. Predatory Lending Practices and Their Victims

A. *What Is Predatory Lending?*

Within the private consumer mortgage industry, nearly all predatory loans are subprime loans.[23] Nonetheless, subprime loans serve the important role of allowing individuals with imperfect credit who do not qualify for a prime loan to obtain loans.[24] Subprime loans have higher interest rates than prime loans to account for the higher risk that lending to borrowers with imperfect credit entails.[25] These loans become predatory when the "loan terms or conditions become abusive or when borrowers who should qualify for credit on better terms are targeted instead for higher cost loans."[26]

A large proportion of subprime borrowers are given higher interest rates on mortgage loans than those rates for which they qualify.[27] The predatory practice of charging a higher interest rate than is justified by a borrower's credit history is referred to as a "Rate-Risk Disparity."[28] In 2001, Fannie Mae estimated that up to half of subprime borrowers would have qualified for a lower cost mortgage.[29]

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[23] ACORN, *supra* note 15, at 6. It is important to emphasize that the inverse is not true. *Id.* Not all subprime loans are predatory. *Id.* Nonetheless, since a great deal of subprime loans are predatory and because of the impossibility of researching every individual's subprime loan terms, research in this field examines subprime loans generally to quantify and study the extent of the predatory lending problem. *See, e.g.*, Stein, *supra* note 7. The problem of measuring the extent of predatory lending is increased by the fact that even those borrowers who are aware that they have been victims of predatory lending are often unwilling to report such abuse. *See* Chris Reidy, *New Law Aims to Halt Predatory Home Loans*, Boston Globe, Aug. 11, 2004, at C1. Banking Commissioner Steven Antonakes noted many people who realize that they have an excessively high-cost loan are "too embarrassed" to come forward. *Id.*

[24] ACORN, *supra* note 15, at 6. "Prime loans" are conventional loans that possess standard bank interest rates.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *See* Stein, *supra* note 7, at 2.

[29] ACORN, *supra* note 15, at 6. Fannie Mae was established in 1938 by the federal government "to expand the flow of mortgage money by creating a secondary market." Fannie Mae, Understanding Fannie Mae, http://www.fanniemae.com/aboutfm/understanding/ (last modified Jan. 18, 2005). In 1968, Fannie Mae became a private company and is today a publicly traded corporation. *Id.* Nonetheless, Fannie Mae has not eschewed all connections with the federal government as it continues to operate under a congressional charter that "directs [Fannie Mae] to channel [their] efforts into increasing the availability and

Additionally, Freddie Mac's research indicates that as many as 35% of subprime borrowers had credit ratings that would have qualified for a prime loan.[30] In the case of one major predatory lender, 46% of subprime borrowers had good credit and qualified for prime loans.[31]

The practice of providing borrowers with higher interest rates than are justified by their credit rating is exacerbated by an incentive system that directly rewards this behavior.[32] In as many as 90% of subprime loans, loan brokers are rewarded with kickbacks, known as "Yield Spread Premiums," if the brokers place borrowers in loans with higher interest rates than those for which the borrower qualifies.[33] The greater the "spread" between the interest rate that the borrower qualifies for and the higher interest rate that the borrower agrees to pay, the greater the kickback that the broker receives.[34] Consequently, mortgage brokers are not only provided with strong incentives to "sell" loans to borrowers that have higher interest rates than are warranted, but brokers are encouraged to offer the highest possible interest rate that they can convince a borrower to take.[35] Yield Spread Premiums are "inherently deceptive to the borrower" because no bor-

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affordability of homeownership for low, moderate, and middle-income Americans." *Id.* In keeping with their goal of increasing affordable housing, Fannie Mae conducts research on predatory lending and is often a leader in initiatives to stop predatory lending. *See* Ass'n of Cmty. Org. for Reform Now, Drained Wealth, Withered Dreams II 8 (2004), *available at* http://www.acorn.org/fileadmin/Predatory_Lending/Drained_Wealth_2004.pdf [hereinafter Drained Wealth]. For example, in 2004, Fannie Mae, along with Freddie Mac, announced that they would no longer purchase subprime loans that contain mandatory arbitration clauses, which are thought by some to be abusive. *Id.*; *see infra* Part I.A. (discussing the harms of mandatory arbitration clauses).

[30] *See* ACORN, *supra* note 15, at 6. Freddie Mac, like Fannie Mae, is a corporation that was chartered by Congress in 1970 to stabilize the mortgage market and increase opportunities for affordable rental housing. Freddie Mac, Our Mission and Values, http://www.freddiemac.com/corporate/about/who_we_are/mission.html (last visited Nov. 3, 2005).

[31] ACORN, *supra* note 15, at 6–7. A senior executive of HSBC admitted in 2002 that the major subprime lender that his bank had just acquired, Household International, had given subprime loans to people with "A" credit—the highest credit ranking—46% of the time. *Id.* Household International settled out of court for $485 million for their predatory lending practices. *Id.* at 7.

[32] *See* Ctr. for Responsible Lending, Yield Spread Premiums: A Powerful Incentive for Equity Theft 1 (2004), *available at* http://www.responsiblelending.org/pdfs/ib011-YSP_Equity_Theft-0604.pdf [hereinafter Yield Spread Premiums].

[33] *Id.*

[34] *Id.*

[35] *See id.* The Center for Responsible Lending reported that the average Yield Spread Premium is approximately $1,850 per loan. *Id.* at 2. This constitutes the largest component of a mortgage broker's compensation. *Id.* Consequently, the Yield Spread Premium provides a very strong incentive for brokers to provide excessively high interest rates that have no relationship to a borrower's credit risk. *See id.*

rower who understood that they were being overcharged would accept the higher interest rate.[36] The Center for Responsible Lending estimates that the inflation in interest rates caused bv Yield Spread Premiums costs 600,000 families $2.9 billion each year.[37]

One reason that brokers are able to convince borrowers to accept higher interest rates than are warranted by their credit is that borrowers are not adequately informed about the state of their credit.[38] For example, one study found that half of African-Americans with good credit thought that they had bad credit.[39] These misperceptions may cause borrowers to believe that they have no other choice than to accept the excessively high interest rates that are offered by unscrupulous brokers.[40] Furthermore, the tactics employed by predatory lenders are specifically designed to deceive borrowers into believing that they cannot qualify for a better loan than is being offered.[41]

In addition to convincing borrowers to agree to loan terms that entail excessive interest rates, many lenders use outright deception with so-called "bait and switch" tactics.[42] In "bait and switch" cases, subprime borrowers are advised by predatory lenders that the major terms of a loan are "x," yet, at closing, the terms are much worse than "x."[43] The California Reinvestment Committee's 2001 study of subprime lending practices in the Los Angeles, Oakland, Sacramento, and San Diego areas found that this type of ambush lending occurred in the majority of instances of subprime lending.[44] This study indicated that nearly seven out of ten respondents "reported that they saw key loan terms suddenly change for the worse at closing."[45] A study of

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[36] *See* Stein, *supra* note 7, at 11.

[37] Yield Spread Premiums, *supra* note 32, at 1.

[38] Drained Wealth, *supra* note 29, at 31.

[39] *Id.*

[40] *See id.* Misunderstandings about one's own credit are often generated by a borrower's failure to notice and correct errors in one's credit report that make the borrower's credit rating appear lower than it actually is. *Id.*

[41] *Id.*

[42] Press Release, Cal. Reinvestment Comm., Predatory Lenders Feed on the Poor, Seniors, and People of Color (Nov. 29, 2001), *available at* http://www.calreinvest.org/PredatorvLending/Top10PredatoryPractices7.2.html.

[43] *See id.*

[44] *See id.*

[45] *Id.* The reported prevalence of "bait and switch" tactics is even more shocking for certain groups of people. *See id.* For example, it was found that eight in ten African-American subprime borrowers interviewed reported that key terms in their loans had suddenly changed at closing. *Id.* The prevalence of lenders' use of "bait and switch" tactics was also higher than the general population for borrowers age 55 and older. *Id.* (finding that more than seven out of ten subprime borrowers interviewed who were 55 and older had

subprime lending practices in South Central Pennsylvania similarly found that 71.4% of borrowers surveyed reported that loan terms were different at closing than what they had been led to believe.[46] Though all predatory lending is unjust, this form of blatant fraud is particularly unconscionable and disturbing.[47]

Another frequent abuse in the private consumer mortgage industry is the charging of unjustifiably high fees on subprime loans.[48] Two common types of fees that are tacked onto subprime mortgages are prepayment penalties and single premium insurance plans.[49] Prepayment penalties charge borrowers high fees for paying off a loan before the term of the loan has ended.[50] Consequently, these penalties often force subprime borrowers to retain extremely high interest rates even after the borrowers have established good credit and would otherwise be able to refinance into a prime loan.[51]

The other frequently peddled fee is the single premium insurance plan.[52] This fee purports to insure the amount of the loan in case the borrower dies or becomes disabled.[53] Single premium insurance plans are abusive because—unlike insurance coverage that is paid on a monthly basis—all of the premiums are due up front and are financed into the loan amount.[54] Consequently, for a typical sin-

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reported being the victim of these tactics). The California Reinvestment Committee's findings on the effects of predatory lending on California communities emphasize the disparate impact of predatory lending on the poor, the elderly, and minority groups. *See id.* The disparate impact of predatory lending on certain vulnerable populations is a major concern and a recurrent theme in most studies of the effects of predatory lending. For a fuller discussion of this widely studied phenomenon, *see infra* Part I.B.

[46] Ass'n of Cmty. Org. for Reform Now, Predatory Lending in South Central Pennsylvania: A Review of Rising Foreclosure Filings and the Relationship to Predatory Lending 2 (2003), *available at* http://www.acorn.org/fileadmin/Predatory_Lending/FINAL_REPORT.pdf. Out of the 71.4% of the borrowers who indicated that they had been misled about the terms of the loan, "over half received a higher interest rate than they expected, 10% had a different loan amount and 7% had higher fees than expected." *Id.*

[47] *See id.*

[48] *See* Ctr. for Responsible Lending, Prepayment Penalties in Subprime Loans 1 (2005), *available at* http://www.responsiblelending.org/pdfs/ib008-PPP_in_Subprime_Loans-0604.pdf [hereinafter Prepayment Penalties]. Prepayment penalties are rarely attached to prime, or conventional, home mortgage loans. *Id.*

[49] *Id.*; Stein, *supra* note 7, at 5–6.

[50] *See* Prepayment Penalties, *supra* note 48, at 1.

[51] *Id.*

[52] Stein, *supra* note 7, at 5–6.

[53] *Id.* at 5.

[54] *Id.* Additional indirect evidence of the abusive nature of the single premium insurance plan is the fact that they are generally not offered in the prime mortgage market where borrowers are thought to have more information and bargaining power. *See id.* at 6.

gle premium insurance plan with five years of coverage, it is unlikelv that the premiums will be paid off by the time the coverage expires.[55] Essentially, the borrower cannot receive a benefit from single premium insurance because the coverage typically wears off before it can protect the loan.[56] It is widely believed that lenders use deceptive means to "sell" single premium insurance plans.[57] An industry-funded study in 1994 found that nearly "40% of borrowers either did not know they had received credit insurance or thought that the credit insurance was required or strongly recommended by their creditor."[58]

The harmful nature of individual predatory lending terms is often exacerbated by the combination of several predatory terms into a single subprime loan agreement.[59] For example, prepayment penalties and single premium insurance plans often accompany excessively high interest rates.[60] The combination of high interest rates and excessive fees can be debilitating for struggling and financially stable families alike.[61] The Center for Responsible Lending provides the following hypothetical as an illustration of the manner in which high fees and interest rates typically affect subprime mortgage borrowers:

> An African-American family gets a subprime mortgage loan for $150,000 with a 12% interest rate. After making timely payments for three years, they realize they can qualify for a better loan. However, when the family tries to refinance, they

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[55] *Id.* at 5.

[56] *Id.*

[57] *See* Stein, *supra* note 7, at 6–7.

[58] *Id.* The problems associated with single premium insurance plans have been somewhat alleviated by strong pressure from governmental agencies and consumer advocacy groups. ACORN, *supra* note 15, at 53. Significantly, the Federal Reserve implemented changes in its regulations in October, 2002 to include single premium insurance plan fees in the calculus for determining whether a loan is restricted under the federal Home Ownership Equity Protection Act (HOEPA). *Id.; see infra* Part II.A. for further discussion on HOEPA. By the time these regulations were implemented, many lenders had already "bowed to public pressure and stopped financing [single premium insurance plans]." ACORN, *supra* note 15, at 53. Despite this progress, it is important to continue to be aware of the abusive potential of such fees because, since the passage of the Federal Reserve regulations, lenders have attempted to re-package single premium insurance plans into fees with other names such as "single premium life insurance." *See id.* Additionally, it is likely that media and government pressure will diminish and that the regulations—or the enforcement of them—will become more lax. *See id.* Consequently, continued awareness of these fees and the effectiveness of laws and regulations in sidelining fees of this nature is necessary.

[59] *See* Prepayment Penalties, *supra* note 48, at 1.

[60] *See id.*

[61] *See id.*

> discover their existing loan comes with a hefty prepayment penalty—adding up to 5% of their loan balance, or about $7,500. The family is forced to choose between paying the penalty out of their equity or continuing to pay 12% interest for two more years.[62]

This example demonstrates how the combination of multiple predatory terms in a subprime mortgage agreement can compound the problems for borrowers.[63]

An additional form of predatory lending in the private consumer mortgage industry is the inclusion of a mandatory arbitration clause in subprime mortgage agreements.[64] Mandatory arbitration clauses stipulate that all disputes must be arbitrated and that borrowers must take disputes to arbitration rather than their tribunal of choice.[65] These clauses are harmful to borrowers because they considerably diminish the accountability of lenders.[66] Lenders are much more familiar with the arbitration process than individual borrowers and, as a result, are prepared to take advantage of the nuances of the arbitration system.[67] Borrowers are also placed at a disadvantage because arbitration limits the claims that borrowers may assert as compared with a court of law.[68] Additionally, "fine print" clauses are often

[62] *Id.* (internal citations omitted). Seven thousand, five hundred dollars was the median net worth of African-American households in 2000. *Id.*

[63] *Id.*

[64] Ctr. for Responsible Lending, Mandatory Arbitration Harms Homeowners 1 (2004), *available at* www.responsiblelending.org/pdfs/ib021-Mandatory_Arbitration-1204.pdf [hereinafter Mandatory Arbitration].

[65] *Id.*

[66] *See id.*

[67] *Id.* at 2. It has been suggested that the advantages of lenders flow not only from the greater familiarity that lenders have with the process as compared with borrowers, but also from the inherent incentive system in the arbitration system. Martha Neil, *Litigation over Arbitration: Courts Differ on Enforceability of Mandatory Clauses,* 91 A.B.A. J. 50, 53–54 (2005). Over time, large businesses—such as lending institutions—that employ mandatory arbitration clauses in their contract build relationships with certain arbitrators. *Id.* at 54. It is no surprise that arbitrators who find in favor of the large business will be hired again for future arbitrations. *See id.* Advocates against mandatory arbitration clauses have argued that these circumstances compromise the impartiality of arbitrators in two ways. *See id.* First, the personal relationships that are developed between repeat customers and arbitrators may lead to favoritism towards the repeat customer based purely on friendship or familiarity. *See id.* Second, and perhaps even more troubling, is the incentive of arbitrators to find in favor of repeat arbitrators, such as lending institutions, so that they will be hired in the future. *See id.* at 53–54.

[68] Mandatory Arbitration, *supra* note 64, at 2. Arbitration may also be cost prohibitive for some indigent borrowers who wish to assert claims against lenders. *Id.* at 1. Though arbitration is often celebrated as a low-cost alternative to the traditional court system, the

"agreed" to without the actual knowledge of the borrower.[69] Even if the borrower were aware of the mandatory arbitration clause, subprime borrowers lack the bargaining power to negotiate around this clause.[70] Instead, borrowers are provided with a "take it or leave it choice" with regard to the acceptance of the lender's terms, which, arguably, is not a meaningful choice at all.[71]

The common theme in the above-presented sampling of predatory lending practices is that each of the practices irreversibly strips equity from the homes of individuals by charging unjustifiably high interest rates and fees or by strong-arming individuals into unfair terms.[72] These abusive practices are troubling, especially considering the tremendous negative impact of predatory lending on vulnerable populations in the United States.[73]

B. *Who Are the Victims of Predatory Lending in Subprime Mortgages?*

In 2001, the Coalition for Responsible Lending (Coalition) estimated that predatory lending practices cost American homeowners $9.1 billion each year.[74] In this estimate, the Coalition included calculations for exorbitant and unnecessary fees in the form of prepayment penalties, single premium insurance plans, and other unjustifiably high

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Center for Responsible Lending notes that the administrative and filing costs of arbitration regularly amount to thousands of dollars. *Id.* This amount of money could certainly be prohibitive for individuals disputing their debts to lenders. *See id.*

[69] *Id.*

[70] *Id.*

[71] *See id.*

[72] *See infra* Part I.B.

[73] *See infra* Part I.B.

[74] Stein, *supra* note 7, at 2. The Coalition for Responsible Lending is an alliance of:

> financial institutions, religious organizations, community groups and others dedicated to protecting the home equity of all North Carolinians, estimated at $100 billion. The Coalition currently includes close to 120 organizations whose memberships total over 3 million, as well as others who have joined as individuals, including 120 CEOs of financial institutions. A few of the largest member organizations include AARP-NC, NC NAACP, the NC Credit Union League, and the NC Council of Churches.

Ctr. For Responsible Lending, N.C. Predatory Mortgage Lending Law: Frequently Asked Questions, http://www.responsiblelending.org/predlend_nc/faqs.cfm#three (last visited Aug. 17, 2005). The Coalition for Responsible Lending also cites the N.C. Fair Housing Center and the Community Reinvestment Association of N.C. as important members of their network. *Id.* This Coalition worked very hard to create and lobby for the first significant state anti-predatory lending law in North Carolina. *See id.*

up-front fees.[75] The cost to borrowers who are charged unjustifiably high interest rates, also described as Rate-Risk Disparities, were also accounted for in the Coalition's overall estimate of the cost of predatory lending practices.[76] This $9.1 billion figure provides one with an appreciation of the magnitude of the predatory lending problem.[77]

The harmful effect of predatory lending practices on American homeowners is massive, and all evidence indicates that the problem has been expanding over the past decade.[78] In 1993, lenders originated approximately 100,000 subprime refinance loans and home purchase loans.[79] Just nine years later, in 2002, that number jumped to approximately 1.36 million subprime loans.[80] Some experts in the lending industry suggest that statistics will show additional increases in subprime lending over the course of 2004.[81]

An estimated 65% of subprime mortgage loans in 2002 were refinances of already existing loans.[82] The advocacy group, Association of Community Organizations for Reform Now (ACORN), notes that subprime refinance loans are of particular concern because often homeowners with "significant amounts of equity are convinced to refinance under conditions that leave them considerably worse off than they were before."[83] Between 1993 and 2002, subprime refinance lending skyrocketed, increasing 1,070.8% over the nine year period, compared with a relatively modest increase of 55.6% in prime refinancing.[84]

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[75] Stein, *supra* note 7, at 2. The Coalition for Responsible Lending estimates that prepayment penalties cost approximately 850,000 families $2.3 billion annually, while single premium insurance plans are thought to cost approximately 500,000 families $2.1 billion annually, and other unjustifiably high up-front fees are thought to cost 750,000 families $1.8 billion annually. *Id.* at 3.

[76] *Id.* The Coalition suggests that excessively high interest rates on mortgage loans costs approximately 600,000 families $2.9 billion each year. *Id.*

[77] *See id.* at 13. Eric Stein, the author of this quantitative analysis of the economic impact of certain predatory lending practices, acknowledges in the report that the calculations are "rough, though conservative, estimates." *Id.* Although admitting the difficulty in pinpointing specific dollar amounts with precision, Stein asserts that the numbers "provide an order of magnitude of the amount of equity stripped, each year, from those least able to afford it." *Id.*

[78] ACORN, *supra* note 15, at 6.

[79] *Id.*

[80] *Id.*

[81] *Id.*

[82] *Id.* at 12.

[83] ACORN, *supra* note 15, at 12.

[84] *Id.* at 13–14.

The greater Boston area, in particular, has seen dramatic increases in subprime refinance lending.[85] Subprime refinance lending was almost fifteen times greater in 2002 than it was in 1994 in the greater Boston area, increasing from 140 loans to 2,065 loans.[86] The most recent statistics from the Boston area indicate a continuing upward trend as subprime refinance loans increased from 1,654 loans in 2001 to 2,065 loans in 2002, an astonishing 24.8% increase in this type of lending over the course of one year.[87]

The cost of predatory lending practices is extremely high and continually increasing.[88] Unfortunately, American homeowners do not share this immense burden equally.[89] Predatory lending disproportionately affects some of the most vulnerable members of our society including minorities and their communities, those in low-income neighborhoods, and the elderly.[90]

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[85] Jim Campen, Borrowing Trouble? IV: Subprime Mortgage Refinance Lending in Greater Boston 2000–2002, at 3 (2004), *available at* http://www.mahahome.org/documents/BorrowingTrouble4.pdf. These statistics only apply to subprime refinance loans and not to subprime home purchase loans. *Id.*

[86] *Id.*

[87] *Id.* The ever-increasing amount of subprime lending in the Boston area, may be partially due to the existence of exceptionally high rental rates for Boston apartments. *See* Johnny Diaz, *City Weekly Census Insights: Housing Costs as Percent of Income*, Boston Globe, Jan. 26, 2003, at City Weekly 1. "Fearing being priced out as a renter, [Boston residents] overextend themselves into home ownership, often falling prey to 'predatory lending,' high-pressure sales tactics by lenders who target minority, elderly, and low-income borrowers for loans with high interest rates and fees." *Id.* These borrowers sacrifice a great deal to pay for these largely subprime loans. *See id.* For example, in the Boston neighborhoods of Mission Hill and Grove Hall, homeowners spend an average of 49% of their income on costs related to homeowning. *Id.* Other parts of Boston and neighboring areas withstand average ownership costs between 40% and 62%. *Id.* Boston residents accept these unconscionably high cost loans—that often require nearly half of their income—because they are desperate to avoid skyrocketing rental prices. *See id.* As Christine Jones, a Boston area nurse who spends 58% of her income on her condo, stated, "I didn't want to be at the mercy of rents . . . [l]ooking for an apartment was never even an option." *Id.*

[88] *See* ACORN, *supra* note 15, at 6; Stein, *supra* note 7, at 2.

[89] Drained Wealth, *supra* note 29, at 6.

[90] *Id.* The Center for Responsible Lending has described the elderly (those aged 70 or above) as the "main targets" of predatory lending. Ctr. for Responsible Lending, The Case for Predatory Lending Reform 2 (2002), *available at* http://www.responsiblelending.org/pdfs/pp-Case_for_PL_Reform-1002.pdf. The elderly often own their homes "free and clear of any mortgage debt," thus giving them a great deal of equity. *Id.* (noting that in the United States, "approximately 663,000 elderly homeowners have lived in their homes for over 20 years; own these homes free and clear of debt; have incomes of less than $30,000; and have equity of $100,000 or more"). Despite the fact that many elderly are "asset rich," many elderly are "cash-poor" and live on a fixed-income. *Id.* Unexpected medical or other costs leave this population vulnerable to unscrupulous lenders. *Id.* The problem is compounded by the fact that elderly homeowners are often under-informed

The disproportionate impact of predatory lending on minorities is well documented.[91] In 2002, African-American borrowers were 3.6 times more likely than white borrowers to receive subprime home purchase loans: Latino borrowers were 2.5 times more likely than white borrowers.[92] Additionally, it is estimated that borrowers in predominantly African-American neighborhoods are "five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods."[93]

Similarly, in the greater Boston area, a disproportionate number of subprime refinance loans were made to minorities.[94] In 2002, African-American borrowers in the refinance market were 5.4 times more likely to receive a subprime loan than white borrowers; Latino borrowers were 3.4 times more likely to receive one than white borrowers.[95]

The racial disparity cannot be explained by differences in the average incomes of racial groups, as the disparity also exists among borrowers of the same income level.[96] In 2002, upper-income African-American home purchase borrowers were 2.8 times more likely than upper-income white home purchase borrowers to receive a subprime loan.[97] Similarly, upper-income Latinos were 2.8 times more likely to receive a subprime loan when purchasing a home than were upper-

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about financial options. *Id.* One ex-employee of a subprime lender stated that the "perfect customer" is "an uneducated widow who is on a fixed income—hopefully from her deceased husband's pension and social security—who has her house paid off, is living off of her credit cards, but having a difficult time making payments, and who must make a car payment in addition to her credit card payments." *Id.*

[91] ACORN, *supra* note 15, at 35.

[92] *Id.* The disparities between borrowers of different racial classifications have been increasing with the increase in the number of subprime loans over the past decade. *Id.* The disparities were considerably lower in 1997 when African-Americans were 2.9 times more likely to receive a subprime home purchase loan (compared with 3.6 times in 2002) and Latinos were 2 times more likely than whites to receive such a loan (compared with 2.5 times in 2002). *Id.* The disparities are even more pronounced in certain metropolitan areas. *Id.* at 45. "African-Americans in Milwaukee were nearly nine times more likely than whites to receive a subprime loan when buying a house with a conventional loan and in Chicago were over seven times more likely." *Id.* at 45.

[93] Stein, *supra* note 7, at 8; *see supra* Part I.A. for a discussion of prepayment penalties.

[94] Campen, *supra* note 85, at 3.

[95] *Id.* In 2002, David Swanson, a spokesperson for ACORN, noted that the extreme racial disparities that existed in subprime lending in Boston could be attributable to reasons such as "sub-prime lenders' aggressive marketing efforts in minority neighborhoods and an inadequate commitment from mainstream lenders—namely traditional banks—to offer loans to residents of those places." Jon Chesto, *Minorities Hit with Higher Interest; Report: Predatory Lenders Take Advantage*, Boston Herald, Nov. 27, 2002, at 34.

[96] ACORN, *supra* note 15, at 37–38.

[97] *Id.* at 37.

income white borrowers.[98] Shocking disparities are also present in the middle, moderate, and low-income comparisons of the likelihood of receiving a subprime home purchase loan.[99] Racial disparities among borrowers within the same income level are also found in the subprime refinance market.[100]

The racial disparity in subprime lending may be a result of fundamental racial discrimination in the lending decision process.[101] The Urban Institute prepared a report for the U.S. Department of Housing and Urban Development (HUD) that concluded that minorities "face discrimination from mortgage lenders" in a variety of ways.[102] Through "paired testing" experiments, the Urban Institute found that minorities were "less likely to receive information about loan products, received less time and information from loan officers, and were quoted higher interest rates."[103] The discriminatory treatment of minority borrowers in the loan application process partially explains the racial disparity in subprime lending.[104]

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[98] *Id.*

[99] *Id.*

> Middle-income African-Americans were 3.7 times more likely to receive a subprime [home purchase] loan than middle-income whites while middle-income Latinos were 2.9 times more likely. Moderate-income African-Americans were 3.7 times more likely to receive a subprime [home purchase] loan than moderate-income whites while moderate-income Latinos were 2.1 times more likely than moderate-income whites. Low-income African-Americas [sic] were 3.9 [times] more likely to receive a subprime home purchase loan than low-income whites while low-income Latinos were 1.4 times more likely.

Id.

[100] *Id.* at 21–22. In the home mortgage refinance market, "[u]pper-income African-American homeowners were 2.1 times more likely than upper-income white homeowners to receive a subprime refinance loan in 2002. Upper-income Latinos were 1.3 times more likely to receive a subprime loan than upper-income whites." *Id.* at 22. Middle-income African-American refinance borrowers "were 3.7 times more likely than middle-income whites to receive a subprime refinance loan while middle-income Latinos were 2.6 times more likely than middle-income whites [to receive a subprime loan]." *Id.* "Moderate-income African-Americans were 3.4 times more likely to receive a subprime refinance loan than moderate-income whites while moderate-income Latinos were 2.1 times more likely to receive a subprime refinance loan than moderate-income whites." *Id.* Similarly, "[l]ow-income African-Americans were 3.4 times more likely to receive a subprime refinance loan than low-income whites while low-income Latinos were 1.8 times more likely to receive a subprime loan than low-income whites." *Id.*

[101] Drained Wealth, *supra* note 29, at 30.

[102] *Id.*

[103] *Id.* Paired testing experiments are experiments that use a control group.

[104] *See id.*

In addition to minority groups, low and moderate-income home mortgage borrowers also receive a disproportionately large number of subprime loans.[105] "[R]esidents of low and moderate income neighborhoods were at least two times more likely to be turned down for a [conventional, prime] loan than residents of upper-income neighborhoods."[106] When minority and low-income individuals are rejected by the traditional lending industry that offers prime loans, they are forced to seek subprime loans from "shadow banks" such as check-cashing stores, pawnshops, and payday lenders.[107] In the greater Boston area in 2002, 9.6% of refinance loans made to low-income borrowers were from subprime lenders and 9.0% of the loans made to moderate-income borrowers were from subprime lenders.[108] Comparatively, 7.2% of refinance loans to middle-income borrowers were from subprime lenders.[109] Only 4.1% of loans to upper-income borrowers were from subprime lenders.[110]

The increasing burden of predatory lending on minority and low-income groups is not surprising considering the recent trend of banks exiting minority and low-income neighborhoods.[111] Studies indicate that the proximity of a conventional bank's branches to predominantly low and moderate-income neighborhoods affects the amount of lending that the conventional bank conducts in those areas.[112] Meanwhile, Federal Reserve economists have noted that "the number of banking offices in low and moderate-income areas decreased 21% from 1975 to 1995, while the total number of banks in all areas rose 29% during this same period."[113] Though traditional banks have steadily abandoned these areas, people living in minority and low or moderate-income neighborhoods continue to require financial services.[114] Potential borrowers in these areas are left without the information that accompanies a traditional banking relationship and are, as a result, often easy targets for the aggressive and deceptive

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[105] Campen, *supra* note 85, at 6.

[106] ACORN, *supra* note 15, at 45.

[107] *Id.* at 46. Interestingly, the "shadow banks" are often funded by, otherwise reputable, mainstream lenders. *Id.* For example, Wells Fargo "has arranged more than $700 million in loans since 1998 to three of the largest check cashers: Ace Cash Express, EZ Corp., and Cash America." *Id.*

[108] Campen, *supra* note 85, at 6.

[109] *Id.*

[110] *Id.*

[111] ACORN, *supra* note 15, at 45.

[112] *Id.*

[113] *Id.*

[114] *See id.*

marketing techniques of predatory lenders.[115] This partially explains the concentration of predatory lending in minority and low or moderate-income neighborhoods.[116]

The concentration of subprime loans and predatory lending practices in specific neighborhoods can have a devastating impact on the well being of those neighborhoods as a whole.[117] This is primarily because subprime loans are associated with excessively high foreclosure rates that are thought to be a result of predatory terms.[118] A Joint HUD/Treasury study reported that during a 20-month period, "subprime foreclosure rates averaged 2.6% compared to 0.62% for prime mortgages."[119] The increased likelihood of foreclosure combined with the concentration of subprime lending can lead to boarded-up homes that carry resounding social costs for entire communities.[120] As affordable housing advocate Eric Stein notes:

> The value of surrounding homes, and therefore the equity held by neighboring homeowners, drops as a result of high rates of foreclosure. Crime increases in high-vacancy areas, imposing economic costs. Communities with excessive foreclosure rates face a host of other costs, including lost revenues associated with difficulty [in] attracting investments.[121]

The crippling impact of predatory lending on individual borrowers, their families, and their neighborhoods is what has driven federal and state legislators to the drafting board to consider the best means for preventing, or at least minimizing, harm to future borrowers.

II. The Backdrop: Homeownership Equity Protection Act and the Anti-Predatory Movement

In recognition of the devastation caused by predatory lending in the subprime mortgage market, the federal government undertook the first major legislative reform effort in 1994 through the Home-

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[115] *Id.* at 46.

[116] *See* ACORN, *supra* note 15, at 46.

[117] Stein, *supra* note 7, at 12 (noting the cumulative impact of predatory lending on neighborhoods).

[118] *Id.* at 11. Though one should reasonably expect higher foreclosure risks in this generally higher credit risk category of loans, the foreclosure rate is greater than it should be even accounting for this increased risk, and this difference has been attributed to predatory characteristics of the subprime loans. *Id.*

[119] *Id.*

[120] *Id.* at 12.

[121] *Id.*

ownership Equity Protection Act (HOEPA).[122] This federal effort was followed by supplementary protections through state laws starting with North Carolina's Predatory Lending Law (NCPLL) in 1999.[123] Since 1999, approximately thirty states have followed suit by enacting variations of NCPLL.[124] The extent to which state predatory lending laws are preempted by federal laws and regulations has been hotly debated.[125] The debate revolves around lofty questions of federalism, practical concerns regarding whether federal or state governments are better able to regulate and enforce predatory lending protections, and the inevitable power struggles that stem from conflicts between protecting consumers and protecting cash flow from national bank lobbies.[126] This section seeks to present the basic structure of the federal and state laws and regulations in addition to the conflicts among these authorities.

A. *Homeownership Equity Protection Act*

Congress enacted HOEPA in 1994 as an amendment to the Truth in Lending Act (TILA), 15 U.S.C. § 1691.[127] The primary purpose of HOEPA was to address the problem of 'reverse redlining.'[128] Reverse redlining is the practice of targeting residents "within certain geographic boundaries, often based on income, race, or ethnicity," and giving those targeted borrowers "credit on unfair terms."[129]

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[122] 15 U.S.C. §§ 1602(aa), 1610, 1639, 1640 (2005); Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. Legis. & Pub. Pol'y 177, 193–94 (2003) (describing HOEPA as the first federal legislative response to predatory lending).

[123] Predatory Lending Act, 1999 N.C. Sess. Laws 332; s*ee infra* Part II.B.

[124] *See infra* Part II.C.

[125] *See, e.g.*, Andrew T. Reardon, Note, *An Examination of Recent Preemption Issues in Banking Law*, 90 Iowa L. Rev. 347, 355–71 (2004).

[126] *See id.*. *See generally* Ctr. For Responsible Lending, Federal Preemption Favors Predatory Lending: States have an edge in Protecting Homeowners 1 (2004), *available at* http://www.responsiblelending.org/pdfs/ib010-Fed_Preemption_Favors_PL-0604.pdf [hereinafter Federal Preemption]; The Office of the Comptroller of the Currency's Rules on National Bank Preemption and Visitorial Powers: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs, 108th Cong. 18–19 (2004) (testimony of Martin Eakes, Chief Executive Officer, Center for Responsible Lending) *available at* http://www.responsiblelending.org/pdfs/040704_Senate_Banking.pdf [hereinafter Eakes Testimony].

[127] Barbara J. Van Arsdale, Annotation, *Validity, Construction, and Application of Home Ownership and Equity Protection Act of 1994*, 198 A.L.R. Fed. 631 (2005).

[128] S. Rep. No. 103–169, at 21 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 1881, 1905.

[129] *Id.* "Reverse redlining," or the targeting of individuals in certain communities for credit on unfair terms, is called this because "redlining" is the term used to describe the

Specifically, HOEPA attempted to protect individuals in very low-income areas who had built up substantial equity in their homes.[130] Congress was particularly concerned with protecting these low-income, high-equity borrowers because giving high-cost predatory loans to such borrowers predictably leads to foreclosures with dramatic losses of equity.[131] In an attempt to prevent this form of "reverse redlining," HOEPA mandated new disclosure requirements and other consumer protections for certain types of home mortgage loans.[132]

As compared with later state laws dealing with predatory lending in the home mortgage market, the scope of HOPEA's consumer protections is extremely limited, which is evidenced by two key factors.[133] First, only a narrow category of mortgage loans is regulated by HOEPA.[134] Three major types of mortgages—home purchase mortgages, reverse mortgages, and open-ended credit mortgages—are explicitly excluded from the protections granted by the Act.[135] Second, within the limited category of mortgages within the scope of HOEPA's pro-

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practice of "denying credit within certain geographic boundaries, often based on income, race, or ethnicity." *Id.*

[130] *Id.* at 1906.

[131] *See id.*

[132] *Id.*

[133] *See* 15 U.S.C. § 1602(aa)(1) (2005). In acknowledgement of the exceptionally limited scope of HOEPA's protections, policy analyst Kathleen Keest noted that "[t]he 1994 law helped a lot, but the subprime lending industry has continued to grow tremendously, and so have the problems of predatory mortgage lending." Kathleen Keest, Consequences of the Consumer Lending Revolution, Address Before St. Louis University School of Law & Consumer Federation of America 4 (Dec. 8–9, 2004), *available at* http://www.responsiblelending.org/pdfs/Legislative_Framework-1204.pdf.

[134] 15 U.S.C. § 1602(aa)(1). 15 U.S.C. § 1602(aa)(1) defines the relatively limited types of loans that are regulated under the terms of HOEPA. *See id.*

[135] *Id.* Senate Report No. 103–169 states that purchase loans were excluded from HOEPA's consumer protections because, in their view, "the consumer [in home purchase mortgages] typically lacks substantial equity in the property when such transactions occur [and, therefore,] the consumer is not vulnerable to unscrupulous lenders." S. Rep. No. 103–169, at 21 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 1881, 1907. However, subprime home purchase loans constitute a large portion of the subprime mortgage market and the exclusion of this type of mortgage considerably diminishes the impact that HOEPA can have on the predatory lending problem as a whole. *See supra* Part I.A. Reverse mortgages are mortgages for individuals who already own their homes and use the equity in their homes to take out loans. *See* AARP, Reverse Mortgages, http://www.aarp.org/money/revmort/ (last visited Nov. 3, 2005) (providing a comprehensive description of typical features of reverse mortgages). Open-end credit mortgages are defined by HOEPA as mortgages "under which the creditor reasonably contemplates repeated transactions, which prescribes the terms of such transactions, and which provides for a finance charge which may be computed from time to time on the outstanding unpaid balance." 15 U.S.C. § 1602(i).

tections, only truly egregious terms are regulated.[136] For example, an otherwise qualifying mortgage is regulated only if its interest rate exceeds the Treasury's rate of interest by more than 10%, or if the total points and fees, paid by the consumer at or before closing, exceed 8% of the total loan amount or $400, whichever is greater.[137] Qualifying loans that exceed these guidelines for interest rates or total points and fees are deemed to be a mortgage that is subject to the special regulations of HOEPA.[138]

HOEPA regulates high cost mortgages in three substantial ways.[139] First, these mortgages are subject to disclosure requirements prior to closing.[140] These requirements mandate disclosure to the potential borrower that the borrower is not required to complete the loan transaction and that there is the possibility that they could lose their home through foreclosure on the loan.[141] The lender must also disclose the annual percentage rate, the monthly payment amount, and the maximum amount to which the monthly payment could be increased over the course of the loan.[142] If the lender fails to meet these disclosure requirements, the borrower has the right to cancel the loan.[143]

The second way that HOEPA protects borrowers from high cost mortgages is by providing for a three day waiting period before the loan is consummated.[144] This "cooling-period" is intended to reduce the damaging effects of high pressure sales tactics by giving potential borrowers the opportunity to reflect on whether the loan is accept-

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[136] *See* 15 U.S.C. § 1602(aa)(1)(A)–(B).

[137] *Id.* The borrower's payments that are considered to be the "points and fees" of a particular loan under HOEPA are finance charges with minor exceptions. S. Rep. No. 103–169, at 24. The total finance charge is defined as "the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit." *Id.* All elements of the finance charge are included in the points and fees calculation except for interest and time-price differentials. *Id.* Charges that are not considered part of the finance charge for other purposes of the Truth in Lending Act are also included in HOEPA's points and fees total. *Id.* For example, HOEPA's definition of points and fees also includes "any direct or indirect compensation received by the creditor in connection with credit insurance and any compensation paid to mortgage brokers." *Id.* The definition also includes "charges such as appraisal fees, title examination, document preparation fees, and credit report charges unless the charge is reasonable, paid to an unaffiliated third party, and involves no direct or indirect compensation to the creditor." *Id.* at 24–25.

[138] 15 U.S.C. § 1602(aa).

[139] *See* S. Rep. No. 103–169, at 25.

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.*

[144] S. Rep. No. 103–169, at 25.

able.[145] The Banking, Housing, and Urban Affairs Committee noted that the period "prevents creditors from knocking on a borrower's door and closing a loan on the same day."[146]

The third way in which HOEPA regulates high cost mortgages is through the prohibition of certain inherently misleading terms that disguise the actual cost of a loan.[147] The following terms are prohibited: "prepayment penalties, points on loan amounts refinanced, default interest rates above the rate prior to the default, balloon payments, negative amortization, or prepayment of more than two of the periodic payments."[148] The prohibition on these particularly misleading and damaging terms was intended to protect borrowers from the addition of the most egregious terms to already high cost mortgages.[149]

Though HOEPA's protections are a step in the right direction, the definition of what constitutes a high cost mortgage is extremely under-inclusive.[150] Several organizations that study predatory lending believe that HOEPA's standard of regulating loans with total points and fees over 8% is too permissive and that loans with points and fees well under 8% are also abusive.[151] "Fannie Mae, the [North Carolina] General Assembly, and Washington Mutual have all found that points and fees greater than 5% are abusive."[152] Additionally, the Coalition

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[145] *Id.*

[146] *Id.*

[147] *Id.* The prohibition of these terms is not absolute. *Id.* Congress delegated to the Federal Reserve Board broad discretionary authority to "exempt specific mortgage products or categories of products from the prohibitions." *Id.* The Banking, Housing, and Urban Affairs Committee was particularly concerned with the inadvertent prohibition of mortgage products such as reverse mortgages. *Id.* In addition to exempting beneficial and non-abusive mortgage products from the prohibitions, the discretionary authority granted to the Federal Reserve Board is also intended to allow the Federal Reserve Board to flexibly respond to "new products and practices [that] may emerge that facilitate reverse redlining" and thereby prevent attempts to evade HOEPA regulations. *Id.*

[148] *Id.* Loans with balloon payments require borrowers to make regular payments, often for between five or seven years, and then pay the remainder of the loan balance in one lump sum. ACORN, *supra* note 15, at 54. Balloon payments are harmful because they often force borrowers to refinance their loan in order to pay the balloon payment. *Id.* Additionally, borrowers are often not aware that their loan has a balloon payment and are unable to prepare for the balloon payment. *See id.*

[149] *See* S. Rep. No. 103–169, at 25–27 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 1881, 1909.

[150] *See* Stein, *supra* note 7, at 7.

[151] *See id.*

[152] *Id.*

For Responsible Lending believes that points and fees above 3% are abusive and constitute predatory lending.[153]

Congress' selection of 8%—a relatively high percentage—as the minimum trigger for regulation, may be due to Congress' view of HOEPA's role in the federalist banking system.[154] HOEPA's legislative history suggests that legislators intended HOEPA to serve as a baseline upon which states could build.[155] The House Conference Report states that the purpose of § 152(e) of HOEPA was to clarify that the Act should preempt state mortgage legislation only where such legislation is inconsistent with the federal scheme.[156] Furthermore, the Report states that "[t]he Conferees intend to allow states to enact more protective provisions than those in this legislation."[157] As an example, the Report indicates that state bans on prepayment penalties "would remain in effect following enactment of this legislation."[158] Thus HOEPA's legislative history clearly expresses an intention to allow states to continue to both enforce prior predatory lending laws and to create new statutes that would build upon HOEPA's protections.[159]

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[153] *Id.* Though the Coalition believes that points and fees above 3% are abusive, in making their calculations about the economic costs of predatory lending they define predatory loans as those with points and fees above 5%. *Id.* The Coalition does this because, in their view, the general consensus is that 5% is the proper bar above which points and fees are predatory and require consumer protections. *Id.* To keep these estimations of what constitutes predatory points and fees in perspective, compare them with the average points and fees for prime home mortgage loans, which amount to only 1.1%.

[154] *See* H.R. Rep. No. 103–652, at 162 (1994) (Conf. Rep.), *as reprinted in* 1994 U.S.C.C.A.N. 1977, 1992 (describing the ability of states to enact more protective predatory lending laws that those in this legislation). The United States employs a dual banking system. *See* Reardon, *supra* note 125, at 353. Banks and their subsidiaries have the option of procuring a national or state charter. *See id.*; *supra* Part II.D.

[155] *See* H.R. Rep. No. 103–652, at 162*; see also* Keest, *supra* note 133, at 1–2, 4 (noting that the consumer revolution was historically characterized by federal laws that supplemented, rather than supplanted state laws and that HOEPA was intended to be a minimum standard).

[156] H.R. Rep. No. 103–652, at 162.

[157] *Id.*

[158] *Id.* At the time of the consideration of this legislation, the Senate Report notes that "[p]repayment penalties are presently prohibited in 12 states and limited in at least 10 others." S. Rep. No. 103–169, at 26 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 1881, 1910. Additionally, the Senate Report uses the prevalence of prepayment prohibitions in state legislation as support for inclusion of restrictions on prepayment penalties within HOEPA. *Id.* This acknowledgement of state regulations of home mortgage loans, without more, implies that the Senate also believed that state regulations were in harmony with HOEPA, and that no preemption was necessary. *See id.*

[159] *See* H.R. Rep. No. 103–652, at 162.

B. *State Legislation: The North Carolina Example*

In 1999, five years after HOEPA was enacted, North Carolina became the first state to enact a comprehensive predatory lending law.[160] North Carolina's Predatory Lending Law (NCPLL) is more protective than HOEPA in several respects.[161] First, and perhaps most importantly, NCPLL's definition of a high cost mortgage is more inclusive than HOEPA.[162] Whereas HOEPA prohibits certain especially abusive terms when a mortgage's points and fees exceed 8% of the total amount of the loan, NCPLL prohibits similar terms when the points and fees exceed 5% of the total amount of the loan.[163] NCPLL's determination that home mortgages with points and fees above 5% are abusive is consistent with prevailing views of reputable lenders, government agencies, and consumer watch groups.[164] Second, NCPLL contains a blanket prohibition on the financing of single-premium insurance policies regardless of whether the home mortgage qualifies as a highcost mortgage under the Act.[165] Finally, NCPLL also has a blanket prohibition against prepayment penalties for home mortgage loans of $150,000 or less.[166]

As the first state law of its kind, this law attracted a great deal of scrutiny and its degree of success was analyzed in at least six major studies.[167] Critics of state anti-predatory lending laws reported concerns

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[160] Predatory Lending Act, 1999 N.C. Sess. Laws 332; Robert G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law,* 15 Housing Pol'y Debate 573, 577 (2004) *available at* http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Quercia.pdf [hereinafter Quercia].

[161] *See* Quercia, *supra* note 160, at 597–98.

[162] *See id.*

[163] *See id.* at 597. NCPLL prohibits "the financing of fees, balloon payments, negative amortization, and lending without regard to a homeowner's ability to repay" for high-cost home loans. *Id.* In addition to prohibiting these terms in loans with points and fees exceeding 5% of the total amount of the loan, NCPLL also prohibits these terms for mortgage loans that have annual interest rates that are in violation of HOEPA (currently 8%). *Id.* Therefore, while NCPLL is more protective in terms of regulating loans with high points and fees, NC legislators chose to implement the same level of restrictions with regard to annual interest rates as the existing federal law. *See id.*

[164] *See supra* Part II.A.

[165] Quercia, *supra* note 160, at 597.

[166] *Id.*

[167] *Id.* at 577; Keith Ernst, John Farris & Eric Stein, Ctr. for Responsible Lending, North Carolina's Subprime Home Loan Market after Predatory Lending Reform (2002), *available at* http://www.responsiblelending.org/ (search for "Eric Stein," then follow hyperlink to the article); Morgan Stanley, Channel Check: Surprisingly Strong Subprime Growth, (2002), *available at* http://www.butera-andrews.com/legislative-updates/directory/Media/other/MS-SubPrime.pdf; Keith D. Harvey & Peter J. Nigro, *Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending*

that state efforts to stop abusive practices would scare subprime lenders away.[168] They cautioned that the laws would have the unintended effect of significantlv reducing the number of non-abusive, beneficial subprime loans.[169] This is a significant concern since many non-abusive subprime home mortgages provide those with imperfect credit a second chance.[170] Consequently, the determination of whether state predatory lending laws, such as NCPLL, drive subprime lenders and their beneficial services away is a critical and ongoing debate.[171]

Despite these legitimate concerns, there is evidence that NCPLL achieved its purpose of reducing predatory lending without decreasing the availability of subprime loans.[172] After NCPLL was fully implemented, studies indicated that there was a decline in the total number of subprime loan originations.[173] In a study conducted at the University of North Carolina at Chapel Hill, researchers found that North Carolina experienced a "3 percent decline in overall subprime loan originations in the seven quarters immediately following full implementation of the predatory lending law, versus the preceding seven quarters."[174] This overall decline does not mean that the availability of non-predatory subprime loans decreased.

Although there was an overall decline in subprime lending, this trend was only found in subprime refinance lending and not in home purchase subprime lending.[175] Subprime refinance lending dropped by 20% after the full implementation of NCPLL,[176] while subprime

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Law, 29 J. Real Est. Fin. & Econ. 435 (2004); Gregory Ellihausen & Michael E. Staten, *The Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law* (Nov. 2002) (Georgetown University, McDonough School of Business, Credit Research Center, Working Paper No. 66), *available at* http://www.msb.edu/prog/crc/pdf/RevisedWP66.pdf (last visited Aug. 18, 2005) [hereinafter Ellihausen & Staten].

[168] *See* Quercia, *supra* note 160, at 575; *See* Ellihausen & Staten, *supra* note 167, at 2–3.

[169] *See* Quercia, *supra* note 160, at 575; *See* Ellihausen & Staten, *supra* note 167, at 2–3.

[170] *See* Quercia, *supra* note 160, at 575.

[171] *Id.*

[172] *Id.* at 593.

[173] *Id.* at 586.

[174] *Id.* North Carolina's 3% decline is notable when compared with the increases in subprime lending that occurred in other states and regions. *Id.* During the same time period, there was a 17% increase in subprime loan originations. *Id.* Similarly, there was an 18% increase in subprime lending in the rest of the South. *Id.* States bordering North Carolina also experienced increases in subprime lending that ranged between 3% and 25%. *Id.*

[175] Quercia, *supra* note 160, at 587.

[176] *Id.* In comparison to the 20% decline in refinance lending in North Carolina, "most comparison states experienced more modest losses or small gains." *Id.*

home purchase lending experienced 72% growth.[177] The University of North Carolina researchers concluded that the post-law decline in refinance loans paired with a healthy growth in home purchase loans is indicative of NCPLL's success. The researchers noted that: "[s]ince most abusive subprime lending involves refinancing existing loans, we would expect a good law to result in a decline in home refinancing loans generally and in predatory refinancing loans in particular."[178]

Furthermore, NCPLL does not appear to have diminished access to subprime loans for those who need it the most—high-risk borrowers.[179] The University of North Carolina researchers defined "high-risk borrowers" as borrowers who have a credit score below 580.[180] They determined that NCPLL did not diminish the accessibility of subprime loans to these high-risk borrowers and concluded that "an equal or greater share of subprime lending for both home purchase and refinancing loans went to the most credit-impaired borrowers after NCPLL rather than before."[181]

Other studies have defined "high-risk borrowers" as low-income borrowers and have had mixed results.[182] One study conducted by Elliehausen and Staten found that there was a decrease in subprime loans made to North Carolina borrowers who had annual incomes of $50,000 or less.[183] In contrast, a study by Ernst, Farris, and Stein concluded that NCPLL had not diminished low-income borrower's access to subprime loans.[184] Similarly, a study by Harvey and Nigro determined that NCPLL did not have a disparate adverse impact on North Carolina borrowers with incomes of $25,000 or less, and that prime

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[177] *Id.*

[178] *Id.* at 588*; see supra* Part I.A. (noting that subprime refinance loans are recognized as the form of loan that most frequently has predatory terms).

[179] Quercia, *supra* note 160, at 588–89.

[180] *See id.* at 588.

[181] *Id.* at 589. Home purchase loans made to North Carolina borrowers with a credit score of less than 580 increased 148.8% after the full implementation of NCPLL. *Id.* at 588–589. In comparison, nationally such loans increased by only 62.2%, and in the South there was a 59.2% increase. *Id.* Refinance loans made to North Carolina borrowers with a credit score of less than 580 showed more modest growth of 18.5% and lagged behind both the national increase of 40.7% and the 35.9% increase for the rest of the South. *Id.* at 588–90. Nonetheless, the University of North Carolina study concluded that high-risk borrowers' refinance loan access had not been stifled by NCPLL because the 18.5% increase, though modest, was commensurate with the trends in neighboring Tennessee and South Carolina, which had increases of 17.6% and 24.3% respectively. *Id.*

[182] *Id.* at 588.

[183] *Id.*

[184] Quercia, *supra* note 160, at 588.

and subprime loans to these borrowers had actually increased.[185] With the exception of the Ellihausen and Staten study, all research indicates that access to subprime loans was not diminished by the enactment of NCPLL.

A second major concern with state predatory lending laws was that they would increase the costs of lending for all borrowers.[186] A study conducted in 2002 suggested that NCPLL triggered higher interest rates by diminishing the supply of mortgage credit in North Carolina.[187] However, it is unclear from the available data whether increases in North Carolina's interest rates were causallv related to, or even correlated with, the implementation of NCPLL.[188] Researchers at the University of North Carolina noted that if it were true that NCPLL had caused interest rates to increase by decreasing supply, one should expect to find that North Carolina's interest rates increased at a higher rate than nearby states and the nation as a whole.[189] Yet, an analysis of the relative increases in interest rates demonstrates that North Carolina did not experience unusual increases after the implementation of NCPLL as, in fact, increases in the rest of the United States were greater.[190] Consequently, there is no reliable evidence that interest rates rose as a result of the implementation of the NCPLL.[191]

NCPLL has not had the unintended negative impact that critics feared, and early evidence indicates that NCPLL has succeeded in

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[185] *Id.* at 579, 588. The Harvey and Nigro study also found that the share of prime and subprime loans to minority borrowers in North Carolina had increased. *Id.* at 579.

[186] *Id.* at 590 (citing a study conducted by Elliehausen and Staten that concluded that NCPLL caused overall interest rates to rise by diminishing the supply of mortgage credit).

[187] *Id.*

[188] *See id.* at 590–91.

[189] Quercia, *supra* note 160, at 590–91.

[190] *Id.* at 591. Researchers at the University of North Carolina studied the changes in interest rates relative to other states and regions by comparing the "changes in mean interest rates at origination for owner-occupied homes." *Id.* The mean interest rates from the first quarter of 1998 through the third quarter of 1999 were compared with the mean interest rates between the third quarter of 2000 through the first quarter of 2002. *Id.* North Carolina experienced an increase of 21.7 basis points after NCPLL was implemented. *Id.* The United States experienced an increase of 31.7 basis points and the rest of the South experienced an increase of 28.3 basis points. *Id.*

[191] *See id.* This finding that interest rates did not increase as a result of the implementation of NCPLL is consistent with the findings of a study conducted by a 2001 study by the trade publication *B & C Lending*. *See id.* at 577. This study analyzed the range of products and prices offered by top subprime lenders in North Carolina after NCPLL was implemented. *Id.* "The review found that subprime lenders there were continuing to offer a full array of products and that there was little or no variation in the rates charged." *Id.*

dramatically diminishing predatory lending abuses in North Carolina.[192] After the full implementation of NCPLL, the number of refinancing loans with prepayment penalty terms of three years or more fell by 74.7% in North Carolina while increasing throughout the rest of the United States.[193] Additionally, the number of refinancing loans with balloon payments fell by 54.2% in North Carolina while declining only 12.1% in the rest of the country and 23.3% in the rest of the South.[194] Likewise, refinance loans with a high loan-to-value (LTV) ratio, which are often considered predatory, decreased relative to the rest of the country and region.[195] Furthermore, the number of refinancing loans with one or more predatory terms, declined by 52.7% in North Carolina while increasing by 20.9% in the rest of the United States and 19.4% in the rest of the South.[196] Perhaps most indicative of the success of NCPLL in reducing predatory lending is the fact that out of the total decline in subprime refinancing loans by 3,976 loans, it is estimated that 3,541 of these loans would have had at least one commonly predatory term.[197] Thus, "almost 90% of the de-

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[192] *Id.* at 596.

[193] *Id.* at 593–94. In contrast with the decline in prepayment terms in North Carolina after NCPLL, the frequency of such terms increased by 30.3% in the rest of the United States. *Id.* Similarly, there was an increase of 27.5% in the rest of the South. *Id.* States neighboring North Carolina also saw considerable increases in the presence of these prepayment terms. *Id.* In South Carolina, the presence of these terms saw a 270.7% increase during the relevant period. Quercia, *supra* note 160, at 593–94. Virginia witnessed a similarly alarming increase of 74.8%. *Id.* at 594.

[194] Quercia, *supra* note 160, at 594. It is not certain that the decline in balloon payment terms in North Carolina was due to the implementation of NCPLL because neighboring states experienced decreases similar to North Carolina with the exception of Georgia, which experienced the more moderate decrease of 23.8%. *Id.* In South Carolina, the presence of such terms decreased by an even greater 66.6%; Virginia showed a decline of 48.5%; and Tennessee decreased by 53.7%. *Id.* Consequently, there may be a common regional cause of the decline in balloon payment terms, such as a decrease in demand, and NCPLL may not have caused the decrease. *See id.*

[195] *Id.* at 594–95. Refinancing loans with an LTV of over 100% are loans in which the loan amount is greater than the worth of the house securing the loan. ACORN, *supra* note 15, at 50. This type of loan is predatory because "[e]ven borrowers with excellent credit have no way to escape from a high rate loan if they are 'upside down' and owe more than their home is worth." *Id.* Refinancing loans with a combined LTV of 110% or more decreased by 34.4% in North Carolina after the implementation of NCPLL while increasing by 2.7% in the United States. Quercia, *supra* note 160, at 594–95. This type of loan gained even more ground in the rest of the South, increasing by 21.4%. *Id.* Thus, in the regional context, the decline in North Carolina is even more significant. *See id.*

[196] *Id.* at 595–96. The predatory terms considered in calculating this statistic are: a prepayment penalty of three or more years, a balloon payment, or a combined LTV of 110% or more. *Id.*

[197] *Id.* at 595.

cline in refinancing loans . . . in the postlaw period can be attributed to the decline in predatory loans."[198] NCPLL dramatically decreased predatory lending practices in North Carolina, saving thousands from the damaging effects of predatory loans.[199]

C. *Other States Follow Suit*

Following North Carolina, many states enacted their own versions of predatory lending laws.[200] In 2003 alone, sixteen states enacted some form of predatory lending legislation.[201] Most of the laws recognize, to some degree, the potentially abusive nature of terms such as "excessive points and fees, balloon payments, lengthy prepayment penalties, loan flipping, [and] single-premium life insurance policies."[202] The extent of protections provided, however, vary tremendously among state laws.[203] For example, approximately eleven states have enacted predatory lending laws that, although constructive for their recognition of predatory lending harms, are very similar to existing federal law or industry-promoted bills.[204] Consequently, these laws offer "no meaningful new protections for consumers."[205] In contrast, eleven other states have enacted legislation that is characterized as "moderate to strong:" Arkansas, California, Georgia, Illinois, Massachusetts, New Jersey, New Mexico, New York, North Carolina, South Carolina, and West Virginia.[206] The latter eleven states' capacity to diminish predatory lending harms through strong legislation has been limited, however, by recent preemptive actions of one federal bank regulatory agency, the Officer of Comptroller of the Currency (OCC).[207]

D. *Officer of Comptroller of the Currency Regulations Diminish the Effectiveness of State Anti-Predatory Lending Legislation*

On January 13, 2004, the OCC issued final rules fully preempting states from regulating national banks and their subsidiaries under state

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198 *Id.*
199 *See id.*
200 Quercia, *supra* note 160, at 576, 577 n.4.
201 *Id.* at 576–77.
202 *Id.* at 576; *see infra* Part III. for a discussion of loan "flipping."
203 Quercia, *supra* note 160, at 576–77.
204 *Id.* at 576–577 n.4.
205 *Id.*
206 *Id.*; *see infra* Part III. (describing Massachusetts' predatory lending law as having strong protections relative to other federal and state protections).
207 *See infra* Part II.D.

anti-predatory lending laws.[208] These rules became effective on February 12, 2004.[209] As a result, state anti-predatory lending laws apply only to banks that were created through state bank charters and not to those that were created through a national charter or are subsidiaries of nationally chartered banks.[210] The OCC's recent preemptive actions have been widely criticized, both as an unlawful power-grab by the OCC, and for the harmful effects on borrowers who would otherwise be protected by strong state anti-predatory lending laws.[211]

The power of the OCC to broadly preempt states from regulating nationally chartered banks has been challenged in several recent cases.[212] In this line of cases, courts have consistently held that the OCC does have broad preemption powers.[213] A prominent example of the judiciary's expansive reading of the OCC's preemption power is found in *Wells Fargo Bank, N.A. v. Boutris.*[214] In this case, Wells Fargo Bank sued the Commissioner of the California Department of Corporation for attempting to enforce California laws against the national bank and its subsidiaries.[215] The Commissioner, while conceding that the OCC had exclusive visitorial power over the national bank, argued that the OCC did not reserve the exclusive power to regulate the subsidiaries of national banks.[216] The U.S. District Court for the Eastern

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[208] Reardon, *supra* note 125, at 371. The final rules evolved from two proposed rules. *See id.* at 369. The OCC proposed the first rule on February 7, 2003. *Id.* This rule stated that the OCC, as opposed to states, had the exclusive visitorial power over national banks and their subsidiaries. *Id.* The rule also stated that even if a state provision applied to a national bank, the OCC would maintain oversight over such regulation. *Id.* The second relevant rule was proposed by the OCC on August 5, 2003 and it was in this proposal that the OCC asserted blanket federal preemption over the regulation of national banks and their subsidiary companies. *Id.* at 371.

[209] *Id.* at 372.

[210] *See id.* at 349–50. This preemptive action by the OCC provides banks and other nontraditional lending institutions with a great deal of flexibility. *Id.* at 349. Banks are able to choose the forum from which they receive their charters and are, consequently, able to choose the regulations under which they operate. *Id.* Under this preemptive rule, banks that wish to avoid the stricter state predatory lending laws can simply choose to be a nationally chartered institution. *See id.*

[211] *See, e.g.,* Federal Preemption, *supra* note 126, at 1–2.

[212] Reardon, *supra* note 125, at 349; *see, e.g.,* Jessup v. Pulaski, 327 F.3d 682 (8th Cir. 2003); Bank of Am. v. City & County of San Francisco, 309 F.3d 551 (9th Cir. 2002); Wells Fargo Bank v. Boutris, 265 F. Supp. 2d 1162 (E.D. Cal. 2003).

[213] Reardon, *supra* note 125, at 361–68 (discussing recent decisions which hold that the OCC has expansive preemption powers at length).

[214] *See generally Wells Fargo Bank*, 265 F. Supp. 2d at 1162; Reardon, *supra* note 125, at 367.

[215] *Wells Fargo Bank*, 265 F. Supp. 2d at 1163–64.

[216] *Id.* at 1165.

District of California rejected the Commissioner's argument, holding that states are preempted from regulating, not only national banks, but also their subsidiaries.[217]

Even if the OCC's preemptive actions are legitimate, many critics have argued that the OCC's decision to exercise such power will leave borrowers more vulnerable to the harms associated with predatory lending.[218] The Center for Responsible Lending (CRL) argues that federal preemption is both unnecessary and harmful to borrowers because states regulate predatory lenders more effectively.[219] CRL asserts that federal law is ineffective because "[t]he federal government is far removed from the day-to-day market and slow to respond to changes."[220] Consequently, predatory lenders can find loopholes, or new scams, that go long undetected by the slow-moving federal government.[221] In contrast, CRL argues, states are better equipped to identify and respond to new scams.[222] State legislatures are able to understand the unique characteristics—and abuses—of local real estate markets.[223] A better appreciation of these markets allows states to create flexible protections for communities targeted by predatory lenders.[224] Finally, CRL argues that there is no need for the federal agencies to take the reins through preemption because state protections, such as NCPLL, have been effective in dealing with predatory lending abuses.[225]

Meanwhile, supporters of federal preemption argue that the proliferation of state laws makes it extremely difficult for national banks to be aware of and comply with all of the varying laws and regulatory schemes.[226] Further, they argue that this inefficiency increases costs to

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[217] *Id.* at 1171. This result was affirmed by the ninth circuit. Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949, 954 (6th Cir. 2005).

[218] *See generally* FEDERAL PREEMPTION, *supra* note 126.

[219] *Id.* at 1.

[220] *Id.*

[221] *Id.*

[222] *Id.*

[223] FEDERAL PREEMPTION, *supra* note 126, at 2 (noting that "land values, foreclosure rates and the prevalence of prepayment penalties all vary widely").

[224] *Id.* As an example of a community that requires special attention, beyond what is available from federal protections, the Center for Responsible Lending notes that "in Pennsylvania's rural Monroe County, more than one in five of all mortgaged homes are involved in foreclosure proceedings." *Id.*

[225] *Id.* at 1.

[226] Ass'n of Comty. Organizers for Reform Now, *State Anti-Predatory Lending Laws: More Harm Than Help*, Aug. 22, 2003, http://www.acorn.org/index.php?id=8313&tx_ttnews [pointer] =1&tx_ttnews[tt_news]=9004&tx_ttnews[backPid]=2777&cHash=ba487865bc (last visited Nov. 26, 2005) [hereinafter *State Anti-Predatory Lending Laws*].

borrowers.[227] Specifically, if a multitude of state laws increases the costs of national bank chains, those costs will be passed onto subprime borrowers.[228] Preemption would create a uniform regulatory scheme that supporters contend is more efficient and cost effective, and thus in keeping with the interests of national banks and borrowers.[229]

Despite these claims, the notion that absolute regulatory uniformity is necessary is eroded by the reality of modern federal and state bank regulation.[230] CRL notes that lenders are regularly required to navigate state and local laws, in addition to federal regulations, in many other contexts, and this has not affected their ability to provide borrowers with cost-effective products and services.[231] Additionally, in the context of anti-predatory lending laws, there is evidence that the cost to borrowers is not affected by state regulation.[232] For example, in North Carolina, the cost of lending products and services did not change after the implementation of NCPLL.[233]

Not only is there little support for the notion that state predatory lending laws increase the cost of lending, but there is evidence that states are more willing and capable enforcers of anti-predatory lending laws than are federal agencies.[234] The Director of the Department of Financial Institutions in the State of Washington, Helen P. Howell, noted that "in 2002 alone, the states recovered over $500 million in restitution and fines for predatory lending and other consumer protection violations, compared to only $7 million collected by the OCC."[235] The OCC's lackadaisical approach to enforcement is also evidenced by the fact that the agency has never held a public hearing on predatory lending abuses, despite frequent requests to do so.[236]

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[227] *Id.* The vice president for government affairs at the Mortgage Bankers Association stated his support for federal preemption and noted that "[e]fficiency in the mortgage market relies on uniformity and standardization." *Id.*

[228] *See id.*

[229] *See id.*

[230] Federal Preemption, *supra* note 126, at 2.

[231] *Id.* For example, the Fair Housing Act and the Equal Credit Opportunity Act both have complex federal, state, and local regulatory schemes that those in real estate financing are able to maneuver. *See id.*; 15 U.S.C. §§ 3601–3616 (2005); 15 U.S.C. § 1691 (2005).

[232] *See supra* Part II.B.

[233] *See supra* Part II.B.

[234] Ctr. for Responsible Lending, Analysis of OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices 4 (2005), *available at* http://www.responsiblelending.org/pdfs/pa-OCC_Guidelines-0205.pdf.

[235] *Id.*

[236] *Id.*

One commentator has stated that since asserting preemptive enforcement power in predatory lending, the OCC has "done little more than what's necessary for show."[237] One reason for this may be that the OCC's interests are more closely aligned with those of large bank chains as opposed to subprime borrowers.[238] The OCC's self-defined mission is not to protect borrowers, but is instead to "ensur[e] a stable and competitive national banking system."[239] Additionally, the OCC has reason not to investigate predatory lending abuses by nationally chartered banks because the OCC is funded by national banks through assessments and fees for special services.[240]

In addition to this conflict of interest, the OCC does not have sufficient resources to evaluate suspected predatory lending abuses.[241] For predatory lending investigations, the OCC relies on a staff of national bank examiners who have full-time duties other than protecting borrowers from predatory lending.[242] Additionally, only 50 OCC staff members are available to receive borrower complaints.[243] Meanwhile, the OCC received a staggering 78,000 calls from borrowers in 2003.[244] Even if the OCC were properly motivated, the OCC's resources are insufficient for the enforcement of predatory lending protections.[245]

Despite major concerns with both the legitimacy and the wisdom of OCC's preemptive regulation of nationally chartered lending institutions, the OCC retains the preemptive power they have asserted.[246] States' efforts to protect their subprime borrowers have been seriously hampered by this preemption.[247] Consequently, one must consider these federally imposed limitations when evaluating the effectiveness of state laws, such as Massachusetts' new law, in protecting borrowers from predatory loans.

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[237] Keest, *supra* note 133, at 6.

[238] Eakes Testimony, supra note 126, at 18–19.

[239] *Id.* at 18.

[240] *Id.* (noting that "[t]he OCC's proposed rule is widely viewed as designed to help the largest national banks, which conduct business in many states and also happen to pay the largest assessments to the OCC"). *Id.*

[241] *Id.* at 20–23.

[242] *Id.* at 20–21.

[243] Eakes Testimony, *supra* note 126, at 20–21.

[244] *Id.*

[245] *Id.*

[246] *See supra* text accompanying notes 208–11.

[247] *See supra* text accompanying notes 208–11.

III. The Terms of the Massachusetts Law and Accompanying Regulations

The Predatory Home Loan Practices Act (PHLPA) was approved by the Massachusetts legislature on August 9, 2004 and took effect on November 7, 2004.[248] Similar predatory lending legislation had been introduced in 2001, but failed to pass.[249] Massachusetts Senator Dianne Wilkerson, a supporter of predatory lending reform and sponsor of the PHLPA bill, noted that the legislation that would become PHLPA had languished on Beacon Hill, the location of Massachusetts' capital, for years without sufficient support to pass.[250] Support for the bill's passage gained momentum in March 2004 shortly after ACORN's release of its 2004 comprehensive study of predatory lending.[251] The study documented the dramatically rising levels of predatory lending and its disproportionate effect on minorities.[252] The ultimate passage of PHLPA can thus be viewed as a result of the legislature's recognition of the emergent need to stop the growth of abusive lending practices.[253]

PHLPA is an aggressive response to the abusive lending practices that are most harmful to borrowers.[254] Perhaps most significantly, PHLPA defines a "high cost mortgage" loan very broadly.[255] High cost mortgage loans are defined as loans that either have annual interest rates in excess of 8% the yield on U.S. Treasury securities or have total points and fees in excess of the greater of 5% of the total loan amount or $400.[256] Thus, PHLPA defines high cost mortgage loans similarly to NCPLL, eschewing HOEPA's much more narrow definition.[257]

In addition to broadly defining high cost home mortgage loans, the restrictions on these loans are very protective of Massachusetts'

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[248] Predatory Home Loan Practices Act, 2004 Mass. Acts 268.

[249] Jon Chesto, *Predatory-Lending Bill Nears*, Boston Herald, May 20, 2003, at 29. The 2001 predatory lending legislation may have failed, in part, because the Massachusetts banking regulatory agency had passed predatory lending rules in that year. *Id.* The state's agency regulations were viewed by supporters of PHLPA as neither comprehensive nor permanent enough to protect Massachusetts' borrowers. *Id.*

[250] Thomas Grillo, *Bill to Curb Predatory Lending Backed*, Boston Globe, Mar. 15, 2004, at B2 (describing support for the PHLPA bill).

[251] *Id.*

[252] *Id.*

[253] *See id.*

[254] *See* Predatory Home Loan Practices Act, 2004 Mass. Acts 268.

[255] Mass. Gen. Laws ch. 183C, § 2 (2004).

[256] *Id.* Subordinate-lien loans, as opposed to first-lien loans, are considered high-cost loans if their interest rates exceed the yield on U.S. Treasury securities by more than 9%, rather than 8%. *Id.*

[257] *See supra* Part II.A–B.

subprime borrowers.[258] One of the substantial protections of borrowers who take on high cost loans is the requirement of third-party counseling.[259] Chapter 183C § 3 states that "[a] creditor may not make a high-cost home mortgage loan without first receiving certification from a counselor with a third-party nonprofit organization . . . that the borrower has received counseling on the advisability of the loan transaction."[260] This requirement for counseling is somewhat analogous to the "three day waiting period" that is required by HOEPA prior to closing a loan.[261] The requirement of counseling also forces a borrower to consider the loan agreement over a longer period of time and reduces the effectiveness of high pressure sales techniques.[262] The counseling requirement is more protective than a mere waiting period, however, because it compels a borrower to discuss the benefits and harms of a loan with an expert who may clarifv hidden pitfalls that would not be apparent to the average borrower.[263]

The counseling requirement, though beneficial, is not a panacea. For instance, counseling does not cure harms caused by a lender who uses outright deception by changing terms immediately before closing.[264] Additionally, a recent comprehensive study by Stephen P. Hornburg of the Joint Center for Housing Studies at Harvard University revealed that relatively little is known about the impact and efficacy of counseling.[265] One study conducted in 2001 suggested that one must be skeptical of the ability of mortgage counseling to solve lending problems associated with deeply ingrained racism.[266] Another study, more opti-

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[258] *See* Predatory Home Loan Practices Act, 2004 Mass. Acts 268.

[259] Mass. Gen. Laws ch. 183C, § 3.

[260] *Id.*

[261] *See supra* Part II.A. for a description of HOEPA's three-day waiting requirement.

[262] *See* Mass. Gen. Laws ch. 183C, § 3.

[263] *See id.*

[264] *See supra* Part I.A. for a brief discussion of the use of bait and switch tactics by predatory lenders.

[265] *See generally* Steven P. Hornburg, Strengthening the Case for Homeownership Counseling: Moving Beyond "A Little Bit of Knowledge" 28 (2004), *available at* http://www.jchs.harvard.edu/publications/homeownership/w04-12.pdf.

[266] *Id.* at 13–14. This study notes the historical discrimination against African-Americans in the lending industry in the early part of the 1900's. *Id.* at 13. The study suggests that the discrimination, which forced African-Americans to use unfavorable credit mechanisms, created a self-perception in the African-American community that African-Americans were credit risks. *Id.* at 14. The study concludes that these self-perceptions have to led to overuse of subprime loans by African-Americans. *Id.* Additionally, the overuse of disfavored credit mechanisms, like subprime loans, reinforces the perception that African-Americans are credit risks. *Id.* The researchers thus conclude that counseling cannot com-

mistically indicates that mortgage counseling increases the likelihood that borrowers will shop around for the most beneficial loan terms.[267] Although counseling will not abolish predatory lending, it is an important tool for educating borrowers and is, therefore, a critical piece of PHLPA's reforms.[268]

PHLPA also prohibits lenders from making high cost mortgage loans to borrowers whom lenders know will be unable to make payments on the offered loan.[269] PHLPA accomplishes this by requiring lenders to have a reasonable belief that a borrower "will be able to make the scheduled payments to repay the home loan" based upon a number of financial factors.[270] This prohibition should protect borrowers from unscrupulous lenders who make loans that borrowers will be unable to pay with the intention of foreclosing the equity at stake.[271]

One possible concern with this provision, however, is that it does not provide lenders with clear guidance on how to determine whether a borrower will or will not be able to make loan payments.[272] This lack of a clear guidance could have the unintended consequence of reducing the amount of credit available because a lender may be hesitant to offer high cost loans to borderline borrowers in unclear cases.[273] A lack of clear guidance may also increase the cost of lending by requiring lenders to make time-consuming evaluations of the borrower's ability to pay.[274]

Concerns about the unpredictability of the application of this "reasonable belief" standard are mitigated by the presence of a statutory presumption of lender compliance if certain requirements are satisfied.[275] There is a presumption that a lender reasonably believes that a borrower is able to pay the amount of the loan if the borrower's

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bat these deeply entrenched and community-reinforced beliefs motivating the overuse of subprime loans. *See id.*

[267] *Id.* at 17.

[268] *Id.*

[269] Mass. Gen. Laws ch. 183C, § 4 (2004).

[270] *Id.* The financial factors include "a consideration of the [borrower's] current and expected income, current and expected obligation, employment status, and other financial resources." *Id.* Equity in the house that secures the mortgage may not be considered when determining whether the borrower is able to make the proposed loan payments. *Id.*

[271] *See id.*

[272] *See id.*

[273] *See State Anti-Predatory Lending Laws, supra* note 226 (presenting the argument that state anti-predatory lending laws are difficult for lenders to decipher leading cautious lenders to pull out of the market or increase their costs).

[274] *See id.*

[275] Mass. Gen. Laws ch. 183C, § 4 (2004).

scheduled monthly payments combined with scheduled payments for all other debts do not exceed 50% of the borrower's monthly gross income.[276] Because a responsible lender can quickly determine whether the borrower's debts are greater than 50% of their income, a compliant lender is shielded by the presumption and need not worry about an unpredictable application of the reasonable belief standard in court.[277]

Another significant feature of PHLPA is its prohibition against lenders knowingly refinancing a home loan that was "consummated within the prior 60 months . . . unless the refinancing is in the borrower's interest."[278] This provision prevents lenders from engaging in "flipping," which is the refinancing of a home mortgage loan for the sole purpose of extracting fees from borrowers without providing any benefit to the borrower.[279] Victims of flipping are often left in a worse position after refinancing because of the excessive fees that accompany subprime refinance loans.[280] The anti-flipping provision is an integral part of PHLPA because even fees that seem acceptable can become abusive if they are compounded by multiple, unnecessary refinances.[281]

PHLPA governs not only the terms of home mortgage loans, but also remedies for victims of lender violations of PHLPA.[282] Section 13 of PHLPA states that any provision of a home mortgage loan that requires a borrower to assert a claim or defense in "a forum that is less convenient, more costly, or more dilatory for the resolution of a dispute

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[276] *Id.*

[277] *See id.*

[278] *Id.* § 28C. The Massachusetts Division of Banks promulgated regulations that provide guidance in determining what constitutes the "borrowers interest." 209 Mass. Code Regs. § 53.00 (2005). Refinanced loans meeting certain requirements are automatically deemed to be in compliance with the anti-flipping provision according to the regulations. *Id.* § 53.04. Loans that do not satisfy one of the automatic exemptions must be found to be in the borrower's interest after evaluating a number of factors. *Id.* § 53.07. A suggested, non-exclusive list of the factors to be considered is enumerated in the regulations. *Id.* § 53.04(d)(3).

[279] Stein, *supra* note 7, at 5.

[280] *Id.* Some predatory lenders flip loans by hiding an egregious term in an original home mortgage loan, such as a balloon payment. *Id.* Then, just after closing the original loan, the lender informs the borrower of the unfavorable term and convinces the borrower to immediately refinance into better terms. *Id.* Each time the loan is refinanced, the lender rakes in more unnecessary fees. *See id.* Particularly disturbing is research indicating that "one in ten Habitat for Humanity borrowers [were flipped] from their 0% first mortgages into high interest subprime loans in order to strip equity built up through borrower and volunteer sweat equity." *Id.*

[281] *See id.*

[282] *See, e.g.*, Mass. Gen. Laws ch. 183C, § 13 (2004).

than a judicial forum . . . is unconscionable and void."[283] Section 13 thus prevents lenders from forcing borrowers to pursue their claims through arbitration.[284] This is so even where the loan had a mandatory arbitration clause, provided that arbitration is found to be "less convenient, more costly, or more dilatory."[285] PHLPA's protection of a borrower's right to bring a claim in court is a progressive feature that is not present in many of the other strong predatory lending laws.[286]

The protection that PHLPA provides to Bay State borrowers equals, or exceeds, the protections of comparable acts, such as NCPLL.[287] Due to the similarity of PHLPA's major terms to those of NCPLL, one should expect North Carolina's success in diminishing the impact of predatory lending in their state to translate into similar success in Massachusetts.[288] Some uncertainty remains, however, because success requires not only effective law, but sustained and aggressive enforcement as well.[289]

Conclusion

Predatory lending robs homeowners and their families of hard earned equity. This problem disproportionately affects minorities, low-income families, the elderly, and their respective communities. Undoubtedly, anti-predatory lending laws cannot eliminate the underlying racial and socio-economic discrimination that permeates the subprime lending industry. Nonetheless, strong anti-predatory lending laws can alleviate the effects of that discrimination on already vulnerable populations through strict regulation of subprime lending.

In Massachusetts, PHLPA provides strong protections against predatory lending by following the example of strong and proven state laws such as NCPLL. With vigilant enforcement, PHLPA has the capacity to substantially reduce predatory lending in Massachusetts,

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[283] *Id.*

[284] *See id.*

[285] *See id.; see supra* Part I.A. (discussing the exploitive nature of mandatory arbitration clauses).

[286] *See, e.g.*, Predatory Lending Act, 1999 N.C. Sess. Laws 332. For example, there is no similar provision in NCPLL, which is widely heralded as the frontrunner among strong predatory lending laws. *See id.*

[287] Perhaps the only noteworthy loophole in PHLPA is the one created by the OCC's preemptive actions. *See supra* Part II.A. Unfortunately, PHLPA does not apply to nationally chartered banks or their subsidiaries.

[288] *See supra* Part II.B.

[289] *See supra* Part II.D. (noting the ineffectiveness federal regulation due to a lack of enforcement by OCC).

just as NCPLL did in North Carolina. A reduction in predatory lending will strengthen low-income, minority, and elderly communities in profound ways. By returning equity to individuals in these communities, once dilapidated neighborhoods can become safe and vibrant places to live. PHLPA stands, not only as a strong measure against unjust lending practices, but also a strong measure against the discrimination that unjust lending practices often entail.

Despite strong predatory lending protections, Massachusetts is unable to regulate a large portion of loans—those made by nationally chartered lending institutions and their subsidiaries. Nationally chartered institutions remain virtually unregulated as a result of the weak federal standards of HOEPA and the unwillingness of federal agencies, such as the OCC, to investigate or prosecute predatory lending practices. The United States Congress must take action to bring nationally chartered banks and their subsidiaries into the purview of meaningful regulation. Congress could accomplish this by overruling the preemptive actions of the OCC and returning regulatory oversight to the states or by enacting a stronger federal predatory lending law.