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A Tale of Three Markets Revisited

Kathleen C. Engel* and Patricia A. McCoy**

I. Introduction

Susan Wachter's and Elizabeth Renuart's comments highlight two phenomena that are eritical to understanding predatory lending: the paucity of legitimate risk-based pricing in the subprime market and the steering of people of color to predatory loans. We agree completely with Dr. Wachter's assessment that information asymmetries have impeded the evolution of a well-functioning home mortgage market.[1] Without closure of these information gaps or regulations that compensate for the information gaps, predatory lenders will continue to capture excess rents. We likewise endorse Ms. Renuart's timely and astute observation that predatory lending, among other things, must be understood as a story of race and plaee.[2] White customers tend to secure prime loans with favorable rates. In contrast, lenders often steer black and Hispanic customers in poorer neighborhoods to costly subprime loans, regardless of their credit ratings.[3] Without question, racial targeting is a marker of predatory lending and is deeply troubling. While we agree with these and many other assessments the commentators make, we do part company in certain places. In this brief reply, we address the areas in which we disagree with Ms. Renuart and Dr. Wachter and respond to other issues they raised in their comments.

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1. *See* Susan M. Wachter, *Price Revelation and Efficient Mortgage Markets*, 82 TEXAS L. REV. 413, 415 (2003).

2. *See* Elizabeth A. Renuart, *Toward One Competitive and Fair Market: Suggested Reforms in* A Tale of Three Markets *Point in the Right Direction*, 82 TEXAS L. REV. 421, 425–26 (2003).

3. *See* DEP'TS OF HOUS. & URBAN DEV. & TREASURY TASK FORCE, CURBING PREDATORY MORTGAGE LENDING 22, 93 (2000), *available at* http://www.huduser.org/publications /pdf/treasrpt.pdf [hereinafter HUD-TREASURY REPORT] (citing evidence that people of color are more likely than whites with comparable incomes to receive subprime loans), *available at* http://www.huduser.org/publications/pdf/treasrpt.pdf; ROBERT E. LITAN ET AL, THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT 28–29 (2000) (noting that recent research using testers has revealed ongoing racial discrimination by lenders); Howard Lax et al., Subprime Lending: An Investigation of Economic Efficiency 8 (Dec. 21, 2000) (unpublished manuscript, on file with the Texas Law Review) (finding that subprime borrowers tend to live in low-income neighborhoods with disproportionately high concentrations of people of color).

II. Discussion

A. The Suitability Standard and Rules

In her comments, Dr. Wachter expresses concern that our suitability proposal, in the absence of rulemaking, will create an incentive for lenders to be overly cautious and adopt unnecessarily stringent rules.[4] Alternatively, she posits that without sufficient understanding of markets and the impact of predatory lending sanctions, it may be premature to render explicit suitability rules.[5] We agree that bright-line rules are essential to an effective suitability standard. For that reason, we recommend that any suitability legislation provide that borrowers can only bring claims for violations of rules promulgated by the agency vested with implementing authority. Furthermore, we strongly urge that the agency adopt bright-line rules whenever possible. In other words, we do not suggest that suitability provide a cause of action in the absence of a rule violation. Such a course would inevitably lead to inconsistent judicial interpretation.

Several years ago, we would have cchoed Dr. Wachter's alternative concern: "Do we know enough today to determine optimal national regulation in this area?"[6] We contend that there is sufficient evidence today to begin crafting suitability rules. For starters, there are several practices that policymakers and responsible lenders agree are predatory per se (e.g., lending without regard to ability to pay, the use of yield-spread premiums, and the packaging of single-premium credit life insurance with subprime mortgages). These practices could thus be subject to rulemaking without further investigation.[7]

In evaluating the utility of other potential suitability rules, we can look to a number of sources. The Mortgage Bankers Association of America, for example, has promulgated model guidelines that can provide direction.[8] We can also draw on federal, state, and municipal initiatives to address lending abuses. For instance, there is a growing body of experience under the Home

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4. Wachter, *supra* note 1, at 414–15.

5. *Id.* at 415. Dr. Wachter also worries that a national standard would undermine stricter state and local regulations. *Id.* at 416. Our position is that any national standard should set a floor, giving states the option of enacting more stringent laws.

6. *Id.* at 415.

7. We agree with Ms. Renuart's suggestion that any suitability rules should include limits on the financing of points and fees. *See* Renuart, *supra* note 2, at 434. In the Appendix to our original article, we list loan terms and practices that we contend should be deemed unsuitable per se as well as other terms and practices that, depending on the circumstances, may be unsuitable. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS L. REV. 1255, 1367–81 (2002).

8. Mortgage Bankers Ass'n of Am., Best Practices/Legislative Guidelines: Subprime Lending, *at* http://www.mbaa.org/resident/lib2000/0525b.html (last visited Nov.21, 2003).

Ownership and Equity Protection Act (HOEPA).[9] Similarly, states that have enacted predatory lending laws, like North Carolina, serve as laboratories for testing the impact of predatory lending provisions on the home mortgage market.[10] Although the results are not in from every jurisdiction, the evidence from North Carolina suggests that the North Carolina law has deterred some of the worst lending abuses without unduly hampering the legitimate home mortgage market.[11] This evidence together with empirical and theoretical understandings of the market, is now sufficient to inform an initial set of suitability rules.

Just the same, it is premature to promulgate a fixed and complete set of suitability rules. Rather, the designated agency should begin by crafting rules based on the current state of knowledge, and amend the rules and adopt new rules as additional information becomes available from the state "laboratories." There is an additional benefit to piecemeal rulemaking. Predatory lenders will inevitably develop new practices that fall outside the suitability rules. As Ms. Renuart highlighted, since the publication of our original article, a new abuse has emerged, consisting of predatory servicing by agents—a practice that falls outside the purview of most, if not all, predatory lending laws.[12] Any statutory suitability standard must vest full discretion in the implementing agency to designate new practices as unsuitable as predatory lenders and their agents perpetrate new abuses not covered by existing rules.

B. Self-Regulatory Organization

Ms. Renuart expresses skepticism about our proposed self-regulatory organization (SRO) model.[13] Her words are well taken. Almost two years have passed since we wrote our initial article. During that time, instead of mounting a credible attempt at voluntary self-regulation, the subprime industry has devoted enormous sums of time and money to a vociferous campaign aimed at defeating predatory lending legislation and rules in every

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9. *See* 15 U.S.C. §§ 1602(aa), 1639 (2000); *see, e.g.*, HUD-TREASURY REPORT, *supra* note 3, at 5–10 (detailing recommendations of the Department of Housing and Urban Development and the Department of Treasury for amendments to improve HOEPA).

10. N.C. GEN. STAT. §§ 24-1.1E, 24-10.2 (2000).

11. *See* Keith D. Harvey & Peter J. Nigro, Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law 2, 16–17 (2003) (unpublished manuscript, on file with the Texas Law Review) (noting that evidence of a drop in lending by subprime non-bank lenders in North Carolina may indicate that the law is curbing abusive lending); Roberto G. Quercia, et al., The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment 21–22 (2003) (unpublished manuscript, on file with the Texas Law Review), *available at* http://www.kenan_flagler.unc.edu/assets/documents/cc_nc_anti_ predatory_ law_impact.pdf (finding that the North Carolina Anti-Predatory Lending Law reduced the number of loans with predatory terms without inhibiting borrowers with blemished credit from obtaining loans).

12. *See* Renuart, *supra* note 2, at 426–27.

13. *Id.* at 433–34.

conceivable venue, including legislatures, agencies, and courts.[14] Until the subprime industry lays down its arms and establishes tough, binding self-regulation, an SRO proposal would be premature.

C. *Risk-Based Pricing*

We have a substantive difference with Ms. Renuart's comments regarding risk-based pricing. She suggests that when borrowers have sufficient loan-to-value ratios, they should not pay a risk premium if they have less than prime-rate credit scores.[15] There is no escaping the fact that on average, default and foreclosure rates rise as credit scores go down.[16] Lenders who make loans to borrowers with blemished credit face added servicing costs and foreclosure costs, which they may not be able to recoup if the property has depreciated since origination. Thus, lenders and investors will not lend to credit-impaired borrowers unless they can collect a premium commensurate with their added risk. In one sense, as Ms. Renuart points out, this presents a cruel paradox because risk premiums make it even harder for borrowers with bad credit to repay their loans.[17] Nevertheless, the fact remains that in this market economy, capital suppliers will not come to the table unless they can charge a premium that is proportional to risk.

Risk-based pricing, however, is not a license to charge supranormal rates. Risk-based pricing means pricing that is *commensurate* with risk, not *carte blanche*. Nevertheless, under the battle cry of "risk-based pricing," the

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14. *See* Diana B. Henriques & Jonathan Fuerbringer, *Bankers Opposing New State Curbs on Unfair Loans*, N.Y. TIMES, Feb. 14, 2003, at C1; Richard A. Oppel, Jr. & Patrick McGeehan, *Lenders Try to Fend Off Laws on Subprime Loans*, N.Y. TIMES, Apr. 4, 2001, at C1 (both discussing the lending industry's lobbying efforts to block enactment and enforcement of state predatory lending laws).

15. Renuart, *supra* note 2, at 427. We are concerned that this argument could foster a different danger by inadvertently giving support to asset-based lending, something that both we and Ms. Renuart assiduously oppose in residential mortgage lending. As for defaults that borrowers cure before any danger of foreclosure, Ms. Renuart asserts that monthly late fees on the order of five percent of the payment due are sufficient to compensate servicers for collection expenses and loss of the use of principal. *Id.* at 427–28. However, a $50 late fee on a $1,000 overdue payment may not fully defray the office space and staff overhead costs of collecting that payment, in which case the cost of collection would likely have to be captured elsewhere in the interest, fees, and points.

Finally, in response to Ms. Renuart's comments on prepayment penalties in the subprime market, we thoroughly agree that the industry has not demonstrated the need for prepayment penalties and certainly not for ones of the magnitude commonly charged. Prepayment risk and prepayment penalties are highly complex topics that we plan to address in our future work. In the meantime, we reiterate our support for a moratorium on prepayment penalties until such time as the subprime market becomes competitive. For a detailed explanation of this view, see Engel & McCoy, *supra* note 7, at 1377–79.

16. JOHN C. WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT 76 (1997) (demonstrating that "the lower the credit grade, the higher the delinquency rate"); Anthony Pennington-Cross, Subprime and Prime Mortgages: Loss Distributions 7 (2003) (unpublished manuscript, on file with the Texas Law Review) (noting that borrowers with lower credit scores are more likely to default).

17. *See* Renuart, *supra* note 2, at 427.

subprime industry has distorted and misused that concept to charge interest, points, and fees far in excess of the risks that individual borrowers present.[18] This is undeniably true for the large proportion of subprime borrowers who in fact would qualify for prime mortgages.[19] Indeed, the high prevalence of steering in the subprime market shows an ability to price-discriminate that is indicative of an anticompetitive market structure.[20]

Likewise, subprime borrowers with blemished credit histories are the victims of industry rent-seeking. A Freddie Mac study of A-minus subprime mortgages concluded, for instance, that "roughly one-half of the interest rate premium paid by subprime borrowers—100 basis points—cannot easily be explained by the higher levels of risk associated with these types of loans."[21] Additionally, the subprime mortgage market displays numerous features of an industry lacking competition over price. One striking indicator is the marked discontinuity between the prime rate and the best subprime rates.[22] In a true risk-based pricing system, prices would either be graduated or display far smaller discontinuities between prime and subprime loans. The secrecy of subprime rate sheets and the complex, multipart pricing structure of subprime loans with their bewildering array of nominal interest rates, points, fees, and prepayment penalties are further evidence of price discrimination.[23] Finally, yield-spread premiums artificially boost subprime interest rates above what competitive lenders would be willing to accept.[24]

In a truly competitive market, risk premiums would not exceed the risks presented. The fact that they do—and by a substantial margin—is a

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18. *See* Engel & McCoy, *supra* note 7, at 1265–67.

19. For two discussions of steering studies, see *id.* at 1264 n.20, 1279 n.105, and Alan M. White, Risk-Based Mortgage Pricing—Present and Future Research 17–18 (2003) (unpublished manuscript, on file with the Texas Law Review).

20. *See, e.g.*, JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 135 (1988) (explaining that "the producer may observe some signal that is related to the consumer's preferences (e.g., age, occupation, location) and use this signal to price-discriminate; this is termed *third-degree* price discrimination"). In the subprime context, such signals consist of race, ethnicity, gender, age, location, and credit constraints.

21. Lax et al., *supra* note 3, at 18.

22. *See id.* at 17–19; Terri Cullen, *How to Help Your Credit Before Applying for a Loan*, WALL ST. J. ONLINE, July 3, 2003 (listing pricing discontinuities reported by Myfico.com); White, *supra* note 19, at 10–11.

23. *See* White, *supra* note 19, at 8–9, 11–13.

24. *See, e.g.*, HUD-TREASURY REPORT, *supra* note 3, at 40 (describing yield-spread premiums); *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong., 2d Sess. 3 (2002) (statement of Prof. Howell E. Jackson) (concluding that yield spread premiums "serve only to [benefit] mortgage brokers," not consumers, and levy "implicit interest rates [that] are absolutely outrageous"), *available at* http://banking.senate.gov/02_01hrg/010802/jackson.htm; Howell E. Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (Jan. 8, 2002) (unpublished manuscript), *available at* http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf); Susan E. Woodward, Consumer Confusion in the Mortgage Market 2, 7–8, 33 (July 14, 2003) (unpublished manuscript, on file with the Texas Law Review) (reviewing the role of yield-spread premiums in broker compensation and concluding that subprime borrowers are more likely than prime borrowers to select pricing options that allow brokers to extract rents).

compelling sign of competitive distortions in the subprime market. What the pricing structure of subprime loans exemplifies is rent-seeking, not risk-based pricing.

D. Assignee Liability

Ms. Renuart and Dr. Wachter urge us to expand and refine our approach to assignee liability.[25] In the past two years, assignee liability has moved to the forefront of the debate over predatory lending. In our original article, we focused on the origination market, and any policy conclusions we reached on assignee liability were strictly preliminary. Our current research is specifically devoted to assignee liability.

III. Conclusion

As the comments on our *Tale of Three Markets* article reflect, predatory lending has sparked a robust debate. We believe that this debate will generate an informed and effective policy response, and we are grateful to the editors of the *Texas Law Review* for moving the discussion forward by inviting the very important comments by Ms. Renuart and Dr. Wachter.

25. Renuart, *supra* note 2, at 437–38; Wachter, *supra* note 1, at 416–17. Dr. Wachter suggests that assignee liability for extant causes of action would eliminate the need for a suitability standard. *Id.* at 417. We disagree with this suggestion. As we discussed at length in our original article, the existing claims that borrowers can pursue when alleging predatory lending against originators and brokers involve numerous and often insurmountable hurdles. *See* Engel & McCoy, *supra* note 7, at 1299–1309, 1314–17; Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 557 (2002) (discussing assignees' ability to raise holder-in-due-course status as a defense to predatory lending claims). These hurdles would be even higher in suits alleging extant claims against secondary market purchasers.